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In This Issue

Mission of the Service and Statement of Principles of Internal Revenue Tax Administration ii

Introduction iii

Definition of Terms and Abbreviations iv

Numerical Finding List v

Finding List of Current Action on Previously Published Items vi

Tax Court 1

Part I.—Rulings and Decisions Under the Internal Revenue Code of 1986 **3**

Part II.—Treaties and Tax Legislation
Table of Contents **201**
Subpart A.—Tax Conventions **202**

Part III.—Administrative, Procedural and Miscellaneous **207**

Notice of Proposed Rulemaking 435
Disbarments and Suspensions List 519
Index 525

Mission of the Service

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

Statement of Principles of Internal Revenue Tax Administration

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

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

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

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

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

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 1996–2 is a consolidation of all items of permanent nature published in the weekly Bulletins 1996–27 through 1996–53 for the period of July 1 through December 31, 1996.

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

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

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

Definition of Terms

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

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

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

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

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

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

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

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

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

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

Abbreviations

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

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

Numerical Finding List

Court Decisions:

2058, 181
2059, 179
2060, 163

Delegation Order:

155 (Rev. 4), 208

Notices:

96–36, 208
96–37, 208
96–38, 209
96–39, 209
96–40, 210
96–41, 211
96–42, 211
96–43, 211
96–44, 212
96–45, 212
96–46, 212
96–47, 213
96–48, 214
96–49, 215
96–50, 216
96–51, 216
96–52, 218
96–53, 219
96–54, 222
96–55, 222
96–56, 223
96–57, 225
96–58, 226
96–59, 226
96–60, 227
96–61, 227
96–62, 228
96–63, 228
96–64, 229
96–65, 232
96–66, 235
96–67, 235
96–68, 236

Proposed Regulations:

CO–9–96, 436
CO–24–96, 437
CO–25–96, 439
CO–26–96, 440
FI–59–94, 442
FI–32–95, 443
FI–48–95, 449
FI–28–96, 458
GL–7–96, 460
IA–292–84, 462
IA–26–94, 479
IA–42–95, 481
IA–29–96, 483
INTL–4–95, 484
PS–39–93, 489
PS–22–96, 491
REG–208215–91, 491
REG–209803–95, 497
REG–209826–96, 498
REG–209827–96, 507
REG–245562–96, 509
REG–251520–96, 511

Railroad Retirement Quarterly Rate:

162

Revenue Procedures:

96–36, 237
96–37, 299
96–38, 300
96–39, 300

Revenue Procedures—Continued

96–40, 301
96–41, 301
96–42, 306
96–43, 330
96–44, 330
96–45, 336
96–46, 338
96–47, 338
96–48, 339
96–49, 369
96–50, 370
96–51, 370
96–52, 372
96–53, 375
96–54, 386
96–55, 387
96–56, 389
96–57, 389
96–58, 390
96–59, 392
96–60, 399
96–61, 401
96–62, 412
96–63, 420
96–64, 427

Revenue Rulings:

96–33, 3
96–34, 75
96–35, 4
96–36, 38
96–37, 77
96–38, 44
96–39, 39
96–40, Void
96–41, 8
96–42, 45
96–43, 78
96–44, 187
96–45, 4
96–46, 40
96–47, 35
96–48, 31
96–49, 79
96–50, 41
96–51, 36
96–52, 81
96–53, 34
96–54, 42
96–55, 57
96–56, 161
96–57, 82
96–58, 6
96–59, 5
96–60, 43
96–61, 189
96–62, 9
96–63, 83
96–64, 199
96–65, 6

Social Security Contributions & Benefit

434

Tax Conventions:

Fiji, 202
Jordan, 202
Luxembourg 203
Russia, 205

Treasury Decisions:

8673, 112
8674, 84
8675, 60

Treasury Decisions—Continued

8676, 9
8677, 119
8678, 134
8679, 25
8680, 194
8681, 192
8682, 12
8683, 169
8684, 70
8685, 174
8686, 152
8687, 47

Finding List of Current Action on Previously Published Items

Notices:

95–45
Superseded by
Rev. Rul. 96–65, 6

Revenue Procedures:

67–396
Modified by
96–56, 389

80–27
Modified by
96–40, 301

84–77
Modified and superseded by
96–60, 399

87–32
Modified by
TD 8680, 194

91–22
Superseded by
96–53, 375

92–20
Modified by
TD 8680, 194

95–16
Superseded by
96–48, 339

95–29
Superseded by
96–36, 237

95–29A
Superseded by
96–36, 237

95–30
Superseded by
96–42, 306

95–46
Superseded by
96–48, 339

95–54
Superseded by
96–63, 420

96–3
Amplified by
96–56, 389
Modified by
Rev. Rul. 96–65, 6

96–25
Modified by
96–58, 390

96–28
Superseded by
96–64, 427

96–41
Modified by
Notice 96–49, 215

96–46
Supplemented by
96–51, 370

Revenue Rulings:

72–341
Obsoleted by
96–65, 6

Revenue Rulings—Continued

93–88
Obsoleted by
96–65, 6

94–92
Obsoleted by
96–65, 6

96–4
Supplemented and superseded by
96–63, 83

96–5
Supplemented and superseded by
96–64, 199

Cumulative List of Actions Relating to Court Decisions Published in the Internal Revenue Bulletin from January 1, 1996 through December 31, 1996

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

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

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

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

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

The Commissioner ACQUIESCES in the following decisions:

William H. and Patricia Adair v. Commissioner,[1]
T.C. Memo. 1995–493
Burlington Northern Railroad Co. v. Commissioner,[2]
82 T.C. 143 (1984)
Eastman Kodak Co. v. United States,[3]
534 F.2d 252 (Ct. Cl. 1976)
Velinsky v. Commissioner,[4]
T.C. Memo 1996–180
Alan K. Lauckner v. United States,[5]
68 F.3d 69 (3d Cir. 1995)
Tele-Communications, Inc. v. Commissioner,[6]
12 F.3d 1005 (10th Cir. 1993)
William H. Murphy v. Commissioner,[7]
103 T.C. 111 (1994)
Clack, Est. of v. Commissioner,[8]
106 T.C. 6 (1996)
Cristofani, Est. of Maria, Deceased, Frank Cristofani, Executor v. Commissioner,[9]
97 T.C. 74 (1991)

The Commissioner does NOT ACQUIESCE in the following decisions:

Estate of Goree v. Commissioner,[10]
T.C. 1994–331

[1]Acquiescence relating to whether petitioner who performed services for the North Atlantic Treaty Organization as a transferee transferred and paid by the U.S. Department of the Army was entitled to the foreign earned income exclusion under section 911 of the Code.

[2]Acquescence and that Rev. Rul. 74–70 be reconsidered relating to whether an accrual basis taxpayer may deduct, pursuant to the all events test of section 1.461–1(a)(2) of the Treasury Regulations, the employer's portion of payroll taxes on year-end salaries where the salaries are properly accruable but unpaid at year-end and the obligation to remit the taxes does not arise until the following year when such wages are paid to employees.

[3]Acquiescence and that Rev. Rul. 74–70 be reconsidered relating to whether an accrual basis taxpayer may deduct, pursuant to the all events test of section 1.461–1(a)(2) of the Treasury Regulations, the employer's portion of payroll taxes on year-end salaries where the salaries are properly accruable but unpaid at year-end and the obligation to remit the taxes does not arise until the following year when such wages are paid to employees.

[4]Acquiescence relating to whether, for purposes of the grossly erroneous requirement of section 6013(e) of the Code, an adjustment to cost of goods sold (COGS) is an omission of gross income or an item of "deduction, credit, or basis."

[5]Acquiescence relating to whether assessments of the trust fund recovery penalty (TFRP) under section 6672 of the Code are subject to the 3-year statute of limitations contained in section 6501(a) of the Code.

[6]Acquiescence relating to whether cable television franchises issued by local governments are franchises within the meaning of section 1253 of the Code.

[7]Acquiescence relating to whether for purposes of the nonrecognition provision of section 1034 of the Code for a divorced or separated taxpayer may compute the gain on a jointly owned residence, by taking into account only his or her allowable share of the basis and net proceeds from the sale of the jointly owned residence when the taxpayer's former spouse has not met the section 1034 requirements for deferral.

[8]Acquiescence in result relating to whether the surviving spouse has a "qualifying income interest for life" in property where (1) the extent of the surviving spouse's income interest is contingent on the executor's qualified terminable interest property (QTIP) election and where (2) any part (or all) of the property for which QTIP treatment is not elected will go to someone other than the surviving spouse.

[9]Acquiescence in result relating to whether transfers of property to a trust, whose contingent remainder beneficiaries have the right to withdraw an amount not exceeding the section 2503(b) exclusion within 15 days following such transfers, constitute gifts of present interests in property within the meaning of section 2503(b) of the Code.

[10]Nonacquiescence relating to whether under *Estate of Bosch v. Commissioner*, 387 U.S. 456 (1967), the Tax Court erred in applying an appellate standard of review to a lower state court factual determination instead of reviewing the question *de novo*.

Robert B. and Eleanor Risman v. Commissioner,[11]
100 T.C. 191 (1993)

Anthony Teong-Chan and Rosanna W. Gaw v. Commissioner,[12]
45 F.3d 461 (D.C. Cir. 1995)

Brown Group, Inc. v. Commissioner,[13]
77 F.3d 217 (8th Cir. 1996)
vacating and remanding 104 T.C. 105 (1995)

Fisher v. Commissioner,[14]
45 F.3d 396 (10th Cir. 1995)

Richard L. and Fiona Simon v. Commissioner,[15]
68 F.3d 41 (2d Cir. 1995)

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[11]Nonacquiescence relating to whether a remittance forwarded to the Service with a Form 4868 constitutes a payment of tax or a deposit in the nature of a cash bond for purposes of the period of limitations for seeking a refund of such remittance.

[12]Nonacquiescence relating to when the period for filing a Tax Court petition begins to run if the notice of deficiency is mailed to the taxpayers' last known address and the Service knows or should know the taxpayers will not receive the notice at their last known address.

[13]Nonacquiescence relating to whether a controlled foreign corporation's ("CFC's") distributive share of partnership income is foreign base company sales income under section 954(d) of the Code, when the partnership income is earned under circumstances in which it would have been foreign base company sales income if earned directly by the CFC partner.

[14]Nonacquiescence relating to whether the United States Court of Appeals for the Tenth Circuit erred in determining that the Commissioner abused her discretion by not waiving the substantial understatement additions to tax under section 6661(c) of the Code.

[15]Nonacquiescence relating to whether professional musicians are entitled, under section 168 of the Code, to depreciate their antique musical instruments used in their trade or business, notwithstanding that the instruments have no determinable useful lives.

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

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

Section 1.—Tax Imposed

26 CFR 1.1–1: Income tax on individuals.

The Service is providing adjusted tax tables for individuals and trusts and estates for taxable years beginning in 1997 to reflect changes in the cost of living. Also provided are certain reductions allowed against the unearned income of minor children in computing the "kiddie tax." The amounts used to determine whether a parent may elect to report the "kiddie tax" on the parent's return are also adjusted. The adjustments concerning the election to report the "kiddie tax" on the parent's return are for taxable years beginning in 1996 and 1997. See Rev. Proc. 96–59, page 392.

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

Section 25.—Interest on Certain Home Mortgages

26 CFR 1.25-4T: Qualified mortgage credit certificate program (temporary).

Guidance is provided for the use of the national and area median gross income figures by issuers of qualified mortgage bonds and mortgage credit certificates in determining the housing cost/income ratio described in section 143(f)(5) of the Code. See Rev. Proc. 96–37, page 299.

Subpart C.—Refundable Credits

Section 32.—Earned Income

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

The Service is providing inflation adjustments for taxable years beginning in 1997 to the limitations on the earned income tax credit. See Rev. Proc. 96–59, page 392.

Subpart D.—Business Related Credits

Section 42.—Low-Income Housing Credit

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1996. See Rev. Rul. 96–34, page 75.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1996. See Rev. Rul. 96–37, page 77.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1996. See Rev. Rul. 96–43, page 78.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1996. See Rev. Rul. 96–49, page 79.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1996. See Rev. Rul. 96–52, page 81.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1996. See Rev. Rul. 96–57, page 82.

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26 CFR 1.42–14: Allocation rules for post-1989 State housing credit ceiling amounts.

This procedure publishes the amounts of unused housing credit carryovers allocated to qualified states under section 42(h)(3)(D) of the Code for calendar year 1996. See Rev. Proc. 96–46, page 40.

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26 CFR 1.42–14: Allocation rules for post-1989 State housing credit ceiling amounts.

This procedure supplements Rev. Proc. 96–46, page 337, by publishing amounts of unused housing credit carryovers allocated to qualified states under § 42(h)(3)(D) of the Internal Revenue Code for calendar year 1996 in addition to those published in Rev. Proc. 96–46. This revenue procedure also publishes the total amounts of unused housing credit carryovers allocated to qualified states under § 42(h)(3)(D) for calendar year 1996.

Low-income housing credit; satisfactory bond; "bond factor" amounts for the period April through June 1996. This ruling announces the monthly bond factor amounts to be used by taxpayers who dispose of qualified low-income buildings or interests therein during the period April through June 1996.

Rev. Rul. 96–33

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

This revenue ruling provides in Table 1 the bond factor amounts for calculating the amount of bond considered satisfactory under § 42(j)(6) for dispositions of qualified low-income buildings or interests therein during the period April through June 1996.

Table 1
Rev. Rul. 96–33

Monthly Bond Factor Amounts for Dispositions Expressed
As a percentage of Total Credits

	Calendar Year Building Placed in Service or, if Section 42(f)(1) Election Was made, the Succeeding Calendar Year									
Month of Disposition	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
Apr '96	76.76	78.26	79.91	81.94	84.43	87.38	90.40	93.16	95.61	97.21
May '96	76.54	78.03	79.68	81.71	84.19	87.12	90.12	92.86	95.32	97.21
Jun '96	76.32	77.81	79.46	81.48	83.95	86.86	89.85	92.58	95.06	97.21

For a list of bond factor amounts applicable to dispositions occurring during other calendar years, see the following revenue rulings: Rev. Rul. 90–60, 1990–2 C.B. 3, for dispositions occurring during calendar years 1987, 1988, and 1989; Rev. Rul. 90–88, 1990–2 C.B. 7, for dispositions occurring during calendar year 1990; Rev. Rul. 91–67, 1991–2 C.B. 13, for dispositions occurring during calendar year 1991; Rev. Rul. 92–101, 1992–2 C.B. 9, for dispositions occurring during calendar year 1992; Rev. Rul. 93–83, 1993–2 C.B. 6, for dispositions occurring during calendar year 1993; Rev. Rul. 94–71, 1994–2 C.B. 4, for dispositions occurring during calendar year 1994; Rev. Rul. 95–83, 1995, 2 C.B. 8, for dispositions occurring during calendar year 1995; and Rev. Rul. 96–16, 1996–1 C.B. 3, for dispositions occurring during the period January through March 1996.

Low-income housing tax credit. Assistance provided by the Federal Emergency Management Agency to the owner of property that is damaged by a disaster will not result in a reduction of the eligible basis of the property under section 42(d)(5), or the recharacterization of the property under section 42(i)(2) as federally subsidized.

Rev. Rul. 96–35

ISSUES

(1) If a qualified low-income building is damaged by a disaster and a below-market loan is provided by the Federal Emergency Management Agency (FEMA) to the owner of the building to repair, reconstruct, or restore the building to its pre-casualty condition, does the loan cause the building to be characterized as federally subsidized under § 42(i)(2) of the Internal Revenue Code?

(2) If a qualified low-income building is damaged by a disaster and a grant is provided by FEMA to the owner of the building to repair, reconstruct, or restore the building to its pre-casualty condition, does the grant require the owner to reduce the building's eligible basis under § 42(d)(5) to the extent of the FEMA grant?

FACTS

Taxpayer, *T*, owns and operates a new qualified low-income building (as defined in § 42(c)(2)) that qualified for the 70-percent present value credit under § 42(b)(2)(B)(i). The building was partially destroyed by a hurricane during the building's 15-year compliance period (as defined in § 42(i)(1)). The President declared the area affected by the hurricane a major disaster area, making available assistance through FEMA. *T* received a FEMA below-market loan and a grant that *T* used to restore the building to its pre-casualty condition.

LAW AND ANALYSIS

Section 42 provides a tax credit for investment in qualified low-income buildings placed in service after December 31, 1986. For any taxable year in a 10-year credit period, the amount of credit is equal to the applicable percentage of the qualified basis of each qualified low-income building.

For a qualified low-income building placed in service after 1987, the term "applicable percentage" means the percentage that will yield over a 10-year period amounts of credit that have a present value equal to: (i) 70 percent of the qualified basis of new buildings that are not federally subsidized for the taxable year (70-percent present value credit), and (ii) 30 percent of the qualified basis of existing buildings, and of new buildings that are federally subsidized for the taxable year (30-percent present value credit).

Under § 42(i)(2)(A), a new building is federally subsidized for any taxable year if, at any time during the taxable year or any prior taxable year, there is or was outstanding any below-market federal loan, the proceeds of which were used (directly or indirectly) for the building or its operation.

Under § 42(c), the qualified basis of any qualified low-income building for any taxable year is an amount equal to the applicable fraction (defined in § 42(c)(1)(B)) of the eligible basis of the building. Section 42(d)(5) provides that if, during any taxable year of the compliance period, a federal grant is used for a building or its operation, the eligible basis of the building for the taxable year and all succeeding taxable years is reduced to the extent of the federal grant.

The rules of § 42(i)(2) and § 42(d)(5) limit the low-income housing credit if federally subsidized loans or federal grants are used to finance a building or meet the operating costs of the building. If a building is damaged in a federally declared disaster, however, FEMA assistance does not substitute for funds that were used to determine the building's basis nor is it used to meet operating costs of the building. Rather, FEMA funds merely help to restore the status of the building to its pre-casualty condition. FEMA funds provide no additional federal benefit to taxpayers that § 42(i)(2) and § 42(d)(5) were intended to limit. Furthermore, reducing the amount of the credit available under § 42 would place the owner of a qualified low-income building at a disadvantage compared with other building owners using FEMA funds. Therefore, the amount of credit available to a building will not be affected under § 42(i)(2) and § 42(d)(5) by the building owner's use of FEMA assistance.

HOLDING

(1) A below-market loan provided by FEMA to the owner of a qualified low-income building damaged by a disaster to repair, reconstruct, or restore the building to its pre-casualty condition does not result in characterizing the building as federally subsidized under § 42(i)(2).

(2) A grant provided by FEMA to the owner of a qualified low-income housing building damaged by a disaster does not cause a reduction of the building's eligible basis under § 42(d)(5) to the extent that the grant funds are used to repair, reconstruct, or restore the building to its pre-casualty condition.

Low-income housing credit; satisfactory bond; "bond factor" amounts for the period July through September 1996. This ruling announces the monthly bond factor amounts to be used by taxpayers who dispose of qualified low-income buildings or interests therein during the period July through September 1996.

Rev. Rul. 96–45

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

This revenue ruling provides in Table 1 the bond factor amounts for calculating the amount of bond considered satisfactory under § 42(j)(6) for dispositions of qualified low-income buildings or interests therein during the period July through September 1996.

Table 1
Rev. Rul. 96–45

Monthly Bond Factor Amounts for Dispositions Expressed As a Percentage of Total Credits

Month of Disposition	Calendar Year Building Placed in Service or, if Section 42(f)(1) Election Was Made, the Succeeding Calendar Year									
	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
Jul '96	81.06	83.47	86.09	89.16	92.78	96.94	101.25	105.33	109.16	112.52
Aug '96	80.84	83.24	85.85	88.92	92.52	96.67	100.96	105.04	108.90	112.52
Sep '96	80.61	83.01	85.62	88.68	92.28	96.41	100.68	104.76	108.66	112.52

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

Low-income housing credit; satisfactory bond; "bond factor" amounts for the period October through December 1996. This ruling announces the monthly bond factor amounts to be used by taxpayers who dispose of qualified low-income buildings or interests therein during the period October through December 1996.

Rev. Rul. 96–59

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

This revenue ruling provides in Table 1 the bond factor amounts for calculating the amount of bond considered satisfactory under § 42(j)(6) for dispositions of qualified low-income buildings or interests therein during the period October through December 1996.

Table 1
Rev. Rul. 96–59

Monthly Bond Factor Amounts for Dispositions Expressed As a Percentage of Total Credits

Month of Disposition	Calendar Year Building Placed in Service or, if Section 42(f)(1) Election Was Made, the Succeeding Calendar Year									
	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
Oct. '96	80.39	82.78	85.39	88.44	92.03	96.15	100.41	104.49	108.44	112.52
Nov. '96	80.17	82.56	85.16	88.21	91.80	95.90	100.16	104.25	108.24	112.52
Dec. '96	79.96	82.35	84.95	87.99	91.57	95.67	99.92	104.02	108.06	112.52

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

Part VI.—Alternative Minimum Tax

Section 59.—Other Definitions and Special Rules

The Service is providing an inflation adjustment for taxable years beginning in 1996 and 1997 to the exemption amount use in computing the alternative minimum tax for a minor child subject to the "kiddie tax." See Rev. Proc. 96–59, page 392.

Subchapter B.—Computation of Taxable Income

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

Section 61.—Gross Income Defined

26 CFR 1.61–1: Gross income.

Are amounts received in satisfaction of a claim for denial of a promotion due to disparate treatment employment discrimination under Title VII of the Civil Rights Act of 1964, as amended in 1991, excludable from gross income under § 104(a)(2)? See Rev. Rul. 96–65, page 6.

26 CFR 1.61–21: Taxation of fringe benefits.

Fringe benefits aircraft valuation formula. For purposes of section 1.61–21(g) of the regulations, relating to the rule for valuing non-commercial flights on employer-provided aircraft, the Standard Industry Fare Level (SIFL), cents-per-mile rates and terminal charges in effect for 1996 are set forth. Rev. Rul. 96–25 modified.

Rev. Rul. 96–58

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

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

Period During Which the Flight Was Taken	*Terminal Charge*	*SIFL Mileage Rates*
7/1/96–12/31/96	$31.61	Up to 500 miles = $.1729 per mile
		501–1500 miles = $.1318 per mile
		Over 1500 miles = $.1267 per mile

Section 62.—Adjusted Gross Income Defined

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

Rules are set forth under which a reimbursement or other expense allowance arrangement for the cost of lodging, meal, and incidental expenses or meal and incidental expenses incurred by an employee while traveling away from home will satisfy the requirements of § 62(c) of the Code as to substantiation of the amount of expenses. See Rev. Proc. 96–64, page 427.

Rules under which a reimbursement or other expense allowance arrangement for the cost of operating an automobile for business purposes will satisfy the requirements of section 62(c) of the Code as to business connection, substantiation, and returning amounts in excess of expenses. See Rev. Proc. 96–63, page 420.

Section 63.—Taxable Income Defined

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

The Service is providing inflation adjustments for taxable years beginning in 1997 to the standard deduction amounts (including the limitation in the case of certain dependents, and the additional standard deduction for the aged or blind). See Rev. Proc. 96–59, page 392.

Section 68.—Overall Limitation on Itemized Deductions

The Service is providing inflation adjustments for taxable years beginning in 1997 to the overall limitation on itemized deductions. See Rev. Proc. 96–59, page 392.

Part III.—Items Specifically Excluded From Gross Income

Section 103.—State and Local Bonds

If an issuer of state or local bonds has used the proceeds of those bonds to pay more than fair market value for nonpurpose investments deposited into an advance refunding escrow, what are the procedures that an issuer may follow to request a closing agreement pursuant to which the purchase of those investments alone will not be sufficient to cause §§ 103(b)(2) and 148 of the Internal Revenue Code to apply to those bonds? See Rev. Proc. 96–41, page 301.

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

Guidance is provided for the use of the national and area median gross income figures by issuers of qualified mortgage bonds and mortgage credit certificates in determining the housing cost/income ratio described in section 143(f)(5) of the Code. See Rev. Proc. 96–37, page 299.

Section 104.—Compensation for Injuries or Sickness

26 CFR 1.104–1(c): Damages received on account of personal injuries or sickness.
(Also §§ 61, 3121, 3231, 3306, 3401, 7805; 1.61–1; 31–3121(a)–1; 31.3231(e)–1; 31.3306(b)–1; 31.3401(a)–1; 301.7805–1.)

Damages received on account of personal injuries or sickness. Under current § 104(a)(2), back pay and damages for emotional distress received to satisfy a claim for denial of a promotion due to disparate treatment employment discrimination under Title VII of the 1964 Civil Rights Act are not excludable from gross income. Under former § 104(a)(2), as in effect before August 21, 1996, back pay received to satisfy such a claim is not excludable from gross income. However, damages received for emotional distress under that statute are excludable. Rev. Rul. 93–88 obsoleted. Notice 95–45 superseded. Rev. Rul. 72–341 and 84–92 obsoleted. Rev. Proc. 96–3 modified.

Rev. Rul. 96–65

ISSUE

Are amounts received in satisfaction of a claim for denial of a promotion due to disparate treatment employment discrimination under Title VII of the Civil

Rights Act of 1964, as amended in 1991 (Title VII), excludable from gross income under § 104(a)(2) of the Internal Revenue Code?

LAW AND ANALYSIS

In general, § 61(a) provides that, except as otherwise provided by law, gross income includes all income from whatever source derived.

Section 104(a)(2), as amended by § 1605 of the Small Business Job Protection Act of 1996 (the 1996 Act) 110 Stat. 1755, 1838, provides generally that gross income does not include the amount of any damages received (whether by suit or agreement) on account of personal *physical* injuries or *physical* sickness. Section 104(a) further provides that, for purposes of paragraph (2), emotional distress is not treated as a physical injury or physical sickness except to the extent of damages paid for medical care (described in § 213(d)(1)(A) or (B)) attributable to emotional distress. The 1996 Act amendments to § 104(a) apply to amounts received after August 20, 1996, but not to amounts received under a written binding agreement, court decree, or mediation award in effect on (or issued on or before) September 13, 1995.

Before its amendment by the 1996 Act, former § 104(a)(2) provided generally that gross income does not include the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness.

Section 1.104–1(c) of the Income Tax Regulations provides that the term "damages received (whether by suit or agreement)" means an amount received (other than workmen's compensation) through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution.

In *United States v. Burke*, 504 U.S. 229 (1992), the Supreme Court held that back pay received for disparate impact gender discrimination under Title VII was not excludable from gross income as damages received on account of personal injuries under former § 104(a)(2) because that part of Title VII did not compensate for a broad range of traditional tort harms.

In light of *Burke*, the Service issued Rev. Rul. 93–88, 1993–2 C.B. 61, which holds that compensatory damages and back pay are excludable from gross income as damages for personal injury under former § 104(a)(2) when received for: (1) disparate treatment gender discrimination under Title VII, as amended in 1991; (2) racial discrimination under § 16 of the Civil Rights Act of 1870, 42 U.S.C. § 1981 and Title VII; and (3) disparate treatment discrimination under the Americans With Disabilities Act, 42 U.S.C. §§ 12101–12213, as amended in 1991. All three of these statutes provide a broad range of compensatory damages of the type the Supreme Court focused upon in *Burke*.

In *Commissioner v. Schleier*, 515 U.S. _____, 115 S. Ct. 2159 (1995), the Supreme Court held that back pay and liquidated damages received to settle a claim under the Age Discrimination in Employment Act of 1967, 29 U.S.C. §§ 621–634 (ADEA), are not excludable from gross income under former § 104(a)(2). The Court concluded that former § 104(a)(2) and its regulations set forth two requirements for a recovery to be excludable from gross income: (1) it must be based on tort or tort type rights, and (2) it must be received "on account of personal injuries or sickness." The Court held that back pay and liquidated damages received under the ADEA meet neither requirement because (1) the ADEA does not compensate for any of the other traditional tort harms associated with personal injury, (2) the back pay is completely independent of the existence or extent of any personal injury, and (3) the ADEA liquidated damages are punitive in nature.

Based on *Schleier*, Notice 95–45, 1995–2 C.B. 330, suspended Rev. Rul. 93–88, and added section 5.05 to Rev. Proc. 95–3, 1995–1 C.B. 385, to provide that pending issuance of published guidance, the Service will not issue rulings or determination letters on whether amounts received are excludable from gross income under § 104(a)(2) in situations affected by Schleier.

In light of *Schleier*, and the amendment of § 104(a)(2) by the 1996 Act, the Internal Revenue Service has reconsidered Rev. Rul. 93–88.

HOLDINGS

(1) *Current § 104(a)(2).* Back pay received in satisfaction of a claim for denial of a promotion due to disparate treatment employment discrimination under Title VII is not excludable from gross income under § 104(a)(2) because it is completely independent of, and thus is not damages received on account of, personal physical injuries or physical sickness under that section. Similarly, amounts received for emotional distress in satisfaction of such a claim are not excludable from gross income under § 104(a)(2), except to the extent they are damages paid for medical care (as described in § 213(d)(1)(A) or (B)) attributable to emotional distress.

(2) *Former § 104(a)(2).* Back pay received in satisfaction of a claim for denial of a promotion due to disparate treatment employment discrimination under Title VII is not excludable from gross income under former § 104(a)(2) because it is completely independent of, and thus is not damages received on account of, personal injuries or sickness under that section. However, damages received for emotional distress in satisfaction of such a claim are excludable from gross income under former § 104(a)(2) because they are received "on account of personal injuries or sickness."

(3) *Wages and compensation.* Back pay includible in gross income under Holding (1) or (2) is "wages" for purposes of § 3121 (Federal Insurance Contributions Act (FICA)), § 3306 (Federal Unemployment Tax Act (FUTA)), and § 3401 (federal income tax withholding), and is "compensation" for purposes of § 3231 (Railroad Retirement Tax Act (RRTA)).

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 93–88 is obsoleted. Notice 95–45 is superseded. Rev. Rul. 72–341, 1972–2 C.B. 32, and Rev. Rul. 84–92, 1984–1 C.B. 204, which hold that amounts received to settle a claim under pre-1991 Title VII are (1) includible in gross income as compensation, (2) "wages" for FICA, FUTA, and federal income tax withholding purposes, and (3) "compensation" for RRTA purposes, are obsoleted. Rev. Proc. 96–3, 1996–1 I.R.B. 82, is modified to delete section 5.05.

PROSPECTIVE APPLICATION

Pursuant to the authority contained in § 7805(b), this revenue ruling will not apply adversely to damages received under any provision of law providing tort or tort type remedies for employment discrimination for race, color, religion, gender, national origin, or other similar classifications, if the damages are received (1) on or before June 14, 1995, the date that *Schleier* was decided

by the Supreme Court, or (2) pursuant to a written binding agreement, court decree, or mediation award in effect on (or issued on or before) June 14, 1995.

Section 127.— Educational Assistance Programs

26 CFR 1.127–2: Educational Assistance Programs.

Educational assistance after termination of employment. Educational assistance plans that provide benefits to participants by reason of their employment with the employer will not fail to qualify as educational assistance programs described in section 127(b) of the Code merely because eligible participants include former employees.

Rev. Rul. 96–41

ISSUE

Does a plan fail to qualify as an educational assistance program described in section 127(b) of the Internal Revenue Code if the plan provides benefits to individuals after their employment has terminated, regardless of the reason for termination?

FACTS

Situation (1). Employer X maintains a plan that is intended to be a qualified educational assistance program. The plan provides educational assistance to participants to help them obtain education and training. Under the plan, X pays expenses incurred by or on behalf of plan participants for instruction and training (including instruction that is part of a degree program as well as vocational and technical training) that constitutes "education" as that term is used in section 127 and the regulations thereunder. Employees who qualify as participants earn educational benefits for hours of service according to a schedule of benefits. The participants are current and former employees of X, and a participant may take courses of instruction either during employment or after termination of employment with X. The former employees who are participants include individuals who terminated their employment voluntarily (including by retirement), were laid off, were terminated involuntarily, or terminated because of disability.

Situation (2). In connection with its corporate "downsizing" efforts, employer Y adopts a plan that is intended to be a qualified educational assistance program. The plan provides educational assistance to participants to help them obtain education and training. The participants are former employees of Y whose employment with Y has terminated in connection with a cutback in operations affecting a broad range of personnel. Under the plan, Y pays expenses incurred by or on behalf of plan participants after termination of employment for instruction and training (including instruction that is part of a degree program as well as vocational and technical training) that constitutes "education" as that term is used in section 127 and the regulations thereunder.

LAW AND ANALYSIS

Section 127(a) provides that gross income of an employee does not include amounts paid or expenses incurred by the employer for educational assistance to the employee if the assistance is furnished pursuant to a program described in § 127(b). Section 127(b)(1) provides that, for purposes of § 127, an educational assistance program is a separate written plan of an employer for the exclusive benefit of his employees to provide such employees with educational assistance, and that the program must meet the other requirements set forth in § 127(b).

A qualified educational assistance program is permitted to provide benefits only to employees, and not to spouses or dependents of employees. Section 1.127–2(d) of the Income Tax Regulations provides that a qualified educational assistance program is only permitted to benefit employees of the employer, including, at the employer's option, individuals who are employees within the meaning of section 1.127–2(h)(1) of the regulations. Under section 1.127–2(h)(1)(i) of the regulations, the term "employee" includes a retired, disabled or laid-off employee.

HOLDING

In both *Situations (1)* and *(2)*, the plans provide benefits to participants by reason of their employment with the employer and, accordingly, will not fail to qualify as educational assistance programs described in section 127(b) merely because eligible participants include former employees, regardless of the reason for termination of employment.

Section 132.—Certain Fringe Benefits

The Service is providing inflation adjustments for taxable years beginning in 1997 to the limitation on the exclusion of a qualified transportation fringe. See Rev. Proc. 96–59, page 392.

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

The Service is providing inflation adjustments for taxable years beginning in 1993 through 1997 to the limitation on the exclusion of income from United States savings bonds for taxpayers who pay qualified higher education expenses for taxable years. See Rev. Proc. 96–59, page 392.

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

Subpart A.—Private Activity Bonds

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

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

Guidance is provided for the use of the national and area median gross income figures by issuers of qualified mortgage bonds and mortgage credit certificates in determining the housing cost/income ratio described in section 143(f)(5) of the Code. See Rev. Proc. 96–37, page 299.

Part V.—Deductions for Personal Exemptions

Section 151.—Allowance of Deductions for Personal Exemptions

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

The Service is providing inflation adjustments for taxable years beginning in 1997 to the personal exemption and to the threshold amounts of adjusted gross income above which the exemption amount phases out. See Rev. Proc. 96–59, page 392.

Part VI.—Itemized Deductions for Individuals and Corporations

Section 162.—Trade or Business Expenses

26 CFR 1.162–1: Business expenses. (Also section 263; 1.263(a)–1.)

Training costs; business expenses. The Supreme Court's decision in *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992), does not affect the treatment of training costs as business expenses which are generally deductible under section 162 of the Code.

Rev. Rul. 96–62

ISSUE

Does the Supreme Court's decision in *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992), affect the treatment of training costs as business expenses, which are generally deductible under § 162 of the Internal Revenue Code?

LAW AND ANALYSIS

Section 162 and § 1.162–1(a) of the Income Tax Regulations allow a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 263(a) and § 1.263(a)–1(a) provide that no deduction is allowed for any amount paid out for permanent improvements or betterments made to increase the value of any property.

Through provisions such as §§ 162(a), 263(a), and related sections, the Internal Revenue Code generally endeavors to match expenses with the revenues of the taxable period to which the expenses are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes. *See INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992); *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 16 (1974).

In *INDOPCO*, the Supreme Court concluded that certain legal and professional fees incurred by a target corporation to facilitate a friendly merger created significant long-term benefits for the taxpayer and, therefore, were capital expenditures. In reaching this decision, the Court specifically rejected the argument that its decision in *Commissioner v. Lincoln Savings and Loan Association*, 403 U.S. 345 (1971), should be read as holding "that *only* expenditures that create or enhance separate and distinct assets are to be capitalized under § 263." *INDOPCO* at 86–87 (emphasis in original).

The *INDOPCO* decision clarifies that the creation or enhancement of a separate and distinct asset is not a prerequisite to capitalization. That clarification does not, however, change the fundamental legal principles for determining whether a particular expenditure can be deducted or must be capitalized. As the Supreme Court has specifically recognized, the "decisive distinctions [between capital and ordinary expenditures] are those of degree and not of kind. . . ." *Welch v. Helvering*, 290 U.S. 111, 114 (1933); *Deputy v. du Pont*, 308 U.S. 488, 496 (1940). Therefore, with respect to expenditures that produce benefits both in the current year and in future years, the determination of whether such expenditures must be capitalized or may be deducted requires a careful examination of all the facts. Although the mere presence of some future benefit may not warrant capitalization, a taxpayer's realization of future benefits is undeniably important in determining whether an expenditure is immediately deductible or must be capitalized. *See INDOPCO* at 87–88.

The *INDOPCO* decision does not affect the treatment of training costs under § 162. Amounts paid or incurred for training, including the costs of trainers and routine updates of training materials, are generally deductible as business expenses under that section even though they may have some future benefit. *INDOPCO* at 87. *See, e.g., Cleveland Electric Illuminating Co. v. United States*, 7 Cl. Ct. 220 (1985) (deduction for costs of training employees to operate new equipment in an existing business); Rev. Rul. 58–238, 1958–1 C.B. 90, 91 (deduction for costs of training employees that relate to the regular conduct of the employer's business); *see also Ithaca Industries, Inc. v. Commissioner*, 97 T.C. 253, 271 (1991) (deduction for costs of training new employees to keep the assembled workforce unchanged), *aff'd*, 17 F.3d 684 (4th Cir.), *cert. denied*, 115 S. Ct. 83 (1994). Training costs must be capitalized only in the unusual circumstance where the training is intended primarily to obtain future benefits significantly beyond those traditionally associated with training provided in the ordinary course of a taxpayer's trade or business. *See, e.g., Cleveland Electric*, 7 Cl. Ct. at 227–29 (capitalization of costs for training employees of an electric utility to operate a new nuclear power plant, which were akin to start-up costs of a new business).

HOLDING

The *INDOPCO* decision does not affect the treatment of training costs as business expenses, which are generally deductible under § 162.

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

The rules for substantiating the amount of a deduction or expense for business use of an automobile that most nearly represents current costs are set forth. See Rev. Proc. 96–63, page 420.

The rules for substantiating the amount of a deduction or expense for lodging, meal, and incidental expenses or meal and incidental expenses incurred while traveling away from home that most nearly represents current costs are set forth. See Rev. Proc. 96–64, page 427.

Section 166.—Bad Debts

26 CFR 1.166–3T: Partial or total worthlessness (temporary).

T.D. 8676

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Modifications of Bad Debts and Dealer Assignments of Notional Principal Contracts

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to the allowance of a deduction for a partially worthless debt when the terms of a debt instrument have been modified. The temporary regulations provide guidance to certain taxpayers that modify the terms of a debt instrument after deducting an amount for partial worthlessness. This document also contains temporary regulations relating to certain assignments of notional principal contracts by dealers in those contracts. The temporary regulations provide guidance to taxpayers relating to consequences of these assignments. The text of these temporary regulations also serves as the text of the proposed regulations set forth in FI–59–94 on page 442.

DATES: These regulations are effective September 23, 1996.

SUPPLEMENTARY INFORMATION:

Background

On December 2, 1992, the IRS published in the **Federal Register** (57 FR 57034 [FI–31–92, 1992–2 C.B. 683]) a notice of proposed rulemaking that set forth proposed income tax regulations (26 CFR part 1) under section 1001 of the Internal Revenue Code (Code). Under § 1.1001–3(a) of the proposed regulations, a significant modification of a debt instrument is deemed to result in an exchange of the original debt instrument for a modified instrument that differs materially either in kind or in

extent. This rule is retained in the final regulations under § 1.1001–3, published in TD 8675, 1996–29 I.R.B. 50. Thus, when a debt is significantly modified, a taxpayer (holder) is required to recognize gain or loss based on the difference between the issue price of the significantly modified debt and the taxpayer's adjusted issue price in the original instrument.

Prior to finalizing the § 1.1001–3 regulations, the IRS and Treasury received comments that gain recognized as the result of a significant modification of a debt instrument often is attributable to the fact that the taxpayer previously claimed a deduction for partial worthlessness with respect to the debt. According to the commentators, the modification does not alter the fact that a portion of the debt remains uncollectible. Thus, the commentators suggested that, in this situation, a taxpayer should be permitted to offset the gain with a corresponding bad debt deduction.

The IRS and Treasury also received comments that the assignment by a dealer in notional principal contracts of its position in a contract to another dealer should not result in a deemed exchange under section 1001. Although the dealer will recognize gain or loss on the disposition of its position, treating the transaction as a deemed exchange would force the counterparty to realize the gain or loss on the contract even though the counterparty is maintaining its position. The commentators argued that dealer-to-dealer assignments are a common business practice and that these assignments have relatively little significance to the dealers' counterparties.

Explanation of Provisions

Section 166(a)(2) and § 1.166–3(a) provide that a deduction for a partially worthless debt is allowed only to the extent the debt is charged off in the taxable year. The charge-off requirement is also contained in § 1.166–2(d)(1) and (3), which provides for a conclusive presumption of worthlessness under certain circumstances.

In general, the amount of a deduction on account of partial worthlessness is the amount by which the adjusted basis of a debt (as determined under section 1011) exceeds the amount recoverable on the debt. The amount of the deduction, however, may not exceed the amount charged off during the taxable year. The charge-off requirement is satisfied for a debt when a portion of the debt is removed from a taxpayer's books and records. This generally is accomplished by reducing the debt's book basis. Thus, when an amount has been deducted for partial worthlessness, there is generally a reduction of both the book basis and tax basis of a debt.

When a taxpayer is required to recognize gain under section 1001 because of a modification of a debt instrument, the taxpayer's tax basis in the debt is increased by the amount of gain recognized. Commentators on the proposed § 1.1001–3 regulations have indicated, however, that regulatory and general accounting principles generally would not permit a corresponding increase in the book basis of the debt. Because the prior charge-off is not restored (that is, the book basis of the debt is not increased), there is no opportunity for the taxpayer to take a new charge-off for pre-existing worthlessness. Thus, the charge-off requirement of section 166(a)(2) can never be satisfied with respect to the amount by which the debt's tax basis exceeds its book basis as a result of the modification, and the excess would not be allowed as a deduction until the debt becomes totally worthless.

The temporary regulations contained in this document set forth limited circumstances under which a taxpayer will be permitted to deduct an amount on account of a partially worthless debt even though no amount has been charged off within the taxable year. The purpose of these temporary regulations is to preserve the portion of a taxpayer's bad debt deduction with respect to a partially worthless debt that corresponds to the amount the taxpayer would have been entitled to deduct for partial worthlessness with respect to the modified debt if the book basis of the modified debt were increased to the same extent as the tax basis of that debt. Thus, these temporary regulations apply only if all of the following conditions are satisfied. First, a significant modification of a debt instrument (within the meaning of § 1.1001–3) must result in a taxpayer's recognition of gain under § 1.1001–1(a). In addition, the debt must have been previously charged off and deducted by the taxpayer, and the prior charge-off and deduction must have satisfied the requirements of § 1.166–3(a)(1) and (2). If these conditions are satisfied, then a modified debt is deemed to have been charged off in the year in which gain is recognized. The amount of the charge-off, however, is limited to the difference between the tax basis of the debt and the greater of the book basis or the fair market value of the debt.

Both the proposed and the final regulations under § 1.1001–3 deal only with modifications of debt instruments. In response to comments on the proposed regulations, however, the temporary regulations contained in this document provide a limited rule dealing with a dealer's assignment of its position in an interest rate or commodity swap, or other notional principal contract to another dealer. If the assignment is permitted by the terms of the contract, the assignment will not be treated as a deemed exchange by the nonassigning party of the original contract for a new contract that differs materially either in kind or in extent. Thus, an assignment to which the rule applies does not trigger gain or loss to the dealer's counterparty. No inference is intended with respect to whether an assignment of rights by one party to other types of bilateral contracts results in an exchange or other disposition under section 1001 by the nonassigning party.

Effective Dates

The temporary regulations apply to significant modifications of debt instruments and assignments of interest rate swaps, commodity swaps, and other notional principal contracts occurring on or after September 23, 1996.

Special Analyses

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

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.166–3T is added to read as follows:

§ 1.166–3T Partial or total worthlessness (temporary).

(a)(1) and (2) [Reserved]. For guidance, see § 1.166– 3(a)(1) and (2).

(3) *Significantly modified debt*—(i) *Deemed charge-off.* If a significant modification of a debt instrument (within the meaning of § 1.1001–3) during a taxable year results in the recognition of gain by a taxpayer under § 1.1001–1(a), and if the requirements of paragraph (a)(3)(ii) of this section are met, there is a deemed charge-off of the debt during that taxable year in the amount specified in paragraph (a)(3)(iii) of this section.

(ii) *Requirements for deemed charge-off.* A debt is deemed to have been charged off only if—

(A) The taxpayer (or, in the case of a debt that constitutes transferred basis property within the meaning of section 7701(a)(43), a transferor taxpayer) has claimed a deduction for partial worthlessness of the debt in any prior taxable year; and

(B) Each prior charge-off and deduction for partial worthlessness satisfied the requirements of paragraphs (a)(1) and (2) of this section.

(iii) *Amount of deemed charge-off.* The amount of the deemed charge-off, if any, is the amount by which the tax basis of the debt exceeds the greater of the fair market value of the debt or the amount of the debt recorded on the taxpayer's books and records reduced as appropriate for a specific allowance for loan losses. The amount of the deemed charge-off, however, may not exceed the amount of recognized gain described in paragraph (a)(3)(i) of this section.

(iv) *Effective date.* This paragraph (a)(3) is effective September 23, 1996.

(b) [Reserved]. For further guidance, see § 1.166–3(b).

Par. 3. Section 1.1001–4T is added to read as follows:

§ 1.1001–4T Modifications of certain notional principal contracts.

(a) *Dealer assignments.* For purposes of § 1.1001–1(a), the substitution of a new party on an interest rate or commodity swap, or other notional principal contract (as defined in § 1.446–3(c)(1)) is not treated as a deemed exchange by the nonassigning party of the original contract for a modified contract that differs materially either in kind or in extent if—

(1) The party assigning its rights and obligations under the contract and the party to which the rights and obligations are assigned are both dealers in notional principal contracts, as defined in § 1.446–3(c)(4)(iii); and

(2) The terms of the contract permit the substitution.

(b) *Effective date.* This section is effective September 23, 1996.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved May 31, 1996.

Leslie Samuels,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on June 24, 1996, 8:45 a.m., and published in the issue of the Federal Register for June 25, 1996, 61 F.R. 32653)

Section 170.—Charitable Contributions

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

The Service is providing inflation adjustments for calendar year 1997 to the "insubstantial benefit" guidelines. Under the guidelines, a charitable contribution is fully deductible even though the contributor receives "insubstantial benefits" from the charity. See Rev. Proc. 96–59, page 392.

26 CFR 1.170A–9: Definition of section 170(b)(1)(A) organization.

Does a fund satisfy the pooled income fund requirements of § 642(c)(5)(E) of the Internal Revenue Code if the fund is maintained by a community trust and in the instrument of transfer either (1) the donor gives the community trust complete discretion to determine how the remainder interest will be used to further charitable purposes, or (2) the donor requests or requires that the community trust place the proceeds from the remainder interest in one of its component funds that is designated to benefit a specific charitable organization? See Rev. Rul. 96–38, on page 44.

Part IX.—Items Not Deductible

Section 263.—Capital Expenditures

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

Does the Supreme Court's decision in *INDOPCO, Inc. v. Commissioner,* 503 U.S. 79 (1992), affect the treatment of training costs as business expenses which are generally deductible under § 162 of the Code? See Rev. Rul. 96–62, page 9.

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

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

When a payor provides a per diem allowance to an employee who is a related party, the rules set forth for the deemed substantiation to the payor of the amount of the employee's ordinary and necessary business expenses for lodging, meal, and/or incidental expenses incurred while traveling away from home do not apply. See Rev. Proc. 96–64, page 427.

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

26 CFR 1.274(d)–1: Substantiation requirements

Simplified optional method for substantiating the amount of a deduction or expense for business use of an automobile. See Rev. Proc. 96–63, page 420.

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

Rules are set forth for substantiating the amount of ordinary and necessary business expense of an employee for lodging, meal, and incidental expenses or meal and incidental expenses incurred while traveling away from home when a payor provides a per diem allowance under a reimbursement or other expense allowance arrangement to pay for such expenses. See Rev. Proc. 96–64, page 427.

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

Simplified optional method for substantiating the amount of a deduction or expense for business use of an automobile. See Rev. Proc. 96–63, page 420.

Rules are set forth for substantiating the amount of ordinary and necessary business expense of an employee for lodging, meal, and incidental expenses or meal and incidental expenses incurred while traveling away from home when a payor provides a per diem allowance under a reimbursement or other expense allowance arrangement to pay for such expenses. Rules are also set forth for an optional method for employees and self-employed individuals to use in computing the deductible costs of business meal and incidental expenses paid or incurred while traveling away from home. See Rev. Proc. 96–64, page 427.

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of July 1996. See Rev. Rul. 96–34, page 75.

Federal short-term, mid-term, and long-term rates are set forth for the month of August 1996. See Rev. Rul. 96–37, page 77.

Federal short-term, mid-term, and long-term rates are set forth for the month of September 1996. See Rev. Rul. 96–43, page 78.

Federal short-term, mid-term, and long-term rates are set forth for the month of October 1996. See Rev. Rul. 96–49, page 79.

Federal short-term, mid-term, and long-term rates are set forth for the month of November 1996. See Rev. Rul. 96–52, page 81.

Federal short-term, mid-term, and long-term rates are set forth for the month of December 1996. See Rev. Rul. 96–57, page 82.

Subchapter C.—Corporate Distributions and Adjustments

Part III.—Corporate Organizations and Reorganizations

Subpart B.—Effects on Shareholders and Security Holders

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

26 CFR 1.355–2: Limitations.

The revenue procedure amplifies the "No Rule" revenue procedure, Rev. Proc. 96–3, 1996–1 C.B. 456, to include certain transactions under § 355 of the Code. See Rev. Proc. 96–39, page 300.

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26 CFR 1.355–3: Active conduct of a trade or business.

The revenue procedure amplifies the "No Rule" revenue procedure, Rev. Proc. 96–3, 1996–1 C.B. 456, to include certain transactions under § 355 of the Code. See Rev. Proc. 96–43, page 330.

Subpart D.—Special Rule; Definitions

Section 367.—Foreign Corporations

26 CFR 1.367(e)–1T: Treatment of section 355 distributions by U.S. corporations to foreign persons.

T.D. 8682

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Treatment of Section 355 Distributions By U.S. Corporations to Foreign Persons

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: These temporary regulations amend the Income Tax Regulations relating to the distribution of stock and securities under section 355 of the Internal Revenue Code of 1986 by a domestic corporation to a person that is not a United States person. These regulations are necessary to implement section 367(e)(1) as added by the Tax Reform Act of 1986. The text of these regulations also serves as the text of * * * REG–209827–96, page 507.

EFFECTIVE DATE: These regulations are effective September 13, 1996.

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 collection of information contained in these regulations has been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget under control number 1545–1487. Responses to this collection of information are required in order for a U.S. corporation that distributes domestic stock or securities to a foreign person to qualify for an exception to the general rule of taxation provided by the regulations under section 367(e)(1).

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

For further information concerning this collection of information, and where to submit comments on the collection of information and the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble to * * * REG–209827–96, page 507.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

On January 16, 1990, temporary regulations under section 367(e)(1) and 367(e)(2) were published in the **Federal Register** (55 FR 1406 [TD 8280, 1990–1 C.B. 80]). A cross-referenced Notice of Proposed Rulemaking was published on that same date (55 FR 1472 [IA–012–90, 1990–1 C.B. 678]). These regulations were proposed to implement section 367(e) of the Internal Revenue Code of 1986 (Code), as revised by sections 631(d)(1) and 1810(g) of the Tax Reform Act of 1986 (100 Stat. 2085, 2272, Public Law 99–514 [1986–3 C.B. (Vol. 1) 1, 189, 745]). On January 15, 1993, final regulations under section 367(e)(1) were published in the **Federal Register.**

Need for Temporary Regulations

Under the current regulations, in certain circumstances the gain recognition exception may be dependent on the form rather than the substance of a taxpayer's transaction. As a result, certain taxpayers may be subject to strict restrictions under this exception, while other taxpayers arguably may avoid the restrictions by structuring their transactions in a different fashion (even though the substance of the transactions is similar). Based on these considerations, it is determined that immediate regulatory guidance will ensure the efficient administration of the tax laws and that it would be impracticable and contrary to the public interest to issue this Treasury decision with prior notice under section 553(b).

Explanation of Provisions

Section 355 provides that, if certain requirements are met, a distributing corporation (Distributing) does not recognize gain or loss on the distribution of the stock or securities of a controlled corporation (Controlled) to Distributing's shareholder or shareholders (Distributee(s)). However, section 367(e)(1) provides that, in the case of any distribution described in section 355 (or so much of section 356 as relates to section 355) by a domestic corporation to a Distributee who is not a United States person (an outbound section 355 distribution), to the extent provided in regulations, gain shall be recognized under principles similar to the principles of section 367.

The existing regulations under section 367(e)(1) provide different tax treatment to Distributing in an outbound section 355 distribution depending upon whether Controlled is a foreign corporation or a domestic corporation. If Controlled is a foreign corporation, an outbound section 355 distribution by Distributing is taxable, with no exceptions. If Controlled is a domestic corporation, however, the existing regulations provide that the distribution is taxable, but permit three exceptions: (i) a FIRPTA exception in cases where both Distributing and Controlled are U.S. real property holding corporations (as defined in section 897(c)(2)) at the time of the distribution, (ii) a publicly traded exception in certain cases where Distributing is publicly traded in the United

States at the time of the distribution, and (iii) a gain recognition agreement (GRA) exception described in detail below.

The new temporary regulations retain the general framework of the existing regulations by permitting no exceptions in the case of an outbound section 355 distribution of foreign stock and the same three exceptions in the case of an outbound section 355 distribution of domestic stock. However, the new temporary regulations substantially modify the GRA exception.

The temporary regulations retain many of the provisions from the existing regulations. However, the IRS and Treasury have decided to reissue all of the regulations under section 367(e)(1) as temporary regulations to obtain a uniform set of regulations.

GRA exception under the existing regulations

The GRA exception in the existing regulations contains a number of specific requirements, all of which must be satisfied for the distributing corporation to defer taxation under the exception.

In general, if Distributee is a resident of a country that has an income tax treaty with the United States and meets certain other requirements, Distributing can defer its gain by entering into a GRA. Under the GRA, if a (foreign) Distributee sells all or a portion of the stock of either Distributing or Controlled within 60 months after the close of the taxable year in which the distribution occurs, Distributing agrees to amend its return and include the deferred gain in income based upon the proportion of the stock that is sold by Distributee. Thus, for example, if Distributee sells 10 percent of its stock of Distributing or Controlled, Distributing is required to amend its return to include 10 percent of the deferred gain. There is no special rule (i.e., no full trigger of the deferred gain) if Distributee sells a substantial amount of its stock of either company. In addition, there is no special rule that triggers gain in the case of a nonrecognition transaction (such as the issuance of additional stock by either Distributing or Controlled to third parties through a public offering) that results in a substantial reduction of the percentage of stock owned by Distributee(s).

The existing regulations generally provide that the GRA will not be triggered if Distributee transfers the stock of either Distributing or Controlled in certain nonrecognition transactions (permitted transactions). The transfer of the stock of either company in a (second) section 355 distribution, however, is not permitted.

In the case of a permitted transaction, the existing regulations provide special successor-in-interest rules under which the deferred gain generally will be taxable unless Distributee maintains a direct or indirect 80 percent interest in the stock of Distributing and Controlled that it owned immediately after the distribution. For example, if Distributing distributed the stock of Controlled in an outbound section 355 distribution that qualified for the GRA exception and, within the term of the GRA, Distributee then contributed the stock of Distributing to a new company (Newco) in a section 351 exchange and received 100 percent of Newco, the successor-in-interest rules apply. Thus, Distributee generally would be required to maintain an 80 percent indirect interest in Distributing. Under these rules, (i) Distributee's sale of up to 20 percent of the stock of Newco, or (ii) Newco's sale of up to 20 percent of the stock of Distributing would result in a corresponding trigger of the deferred gain. The issuance of new stock by Newco or Distributing of up to 20 percent to unrelated persons, however, would not result in any trigger of the GRA. If, however, Newco (or Distributing) issued more than 20 percent of its stock to unrelated persons (or any other nonrecognition transaction reduced Distributee's indirect interest in Distributing to below 80 percent as a result of a nonrecognition transaction), the entire gain would be triggered.

Reasons for change/overview of temporary regulations

The treatment of non pro rata outbound section 355 distributions is not adequately addressed in the existing regulations. For example, assume that a foreign parent (FP) owns all of the stock of Distributing, a domestic corporation, which, in turn, owns all of the stock of Controlled, also a domestic corporation. Assume that the distribution of Controlled by Distributing to FP qualifies for the GRA exception. If FP then contributes all of the stock of Distributing to a newly-formed foreign corporation (Newco), the successor rules would apply, and FP would be required to maintain a direct or indirect 80 percent interest in Distributing.

The outcome under the existing regulations arguably is substantially different, however, if the corporations structured the distribution as a non pro rata distribution. For example, assume that FP first forms Newco and transfers to Newco a percentage of the Distributing stock (the percentage equal to the value of Distributing (without the Controlled stock) divided by the combined value of Distributing and Controlled) in an exchange under section 351. Distributing then distributes the stock of Controlled to FP in exchange for FP's stock of Distributing (a non pro rata section 355 distribution). After the distribution, FP owns all of the stock of Controlled and all of the stock of Newco; Newco owns all of the stock of Distributing. Under the existing regulations, FP is a Distributee. However, because FP has no direct interest in Distributing after the distribution, the regulations effectively treat FP as a Distributee only with respect to Controlled. Moreover, because Newco does not actually receive stock of Controlled in the distribution (even though its percentage ownership interest in Distributing increases as a result of the distribution), it is arguably not a Distributee with respect to the Distributing stock. As a result, because the taxpayer structures the transaction in this manner (rather than a section 355 distribution followed by a section 351 exchange as in the first hypothetical), if the steps of the transaction are respected and in the absence of the application of other sections of the Code, Distributing could take the position that there are no restrictions in the existing regulations with respect to (i) the sale by FP of Newco stock, or (ii) the sale by Newco of Distributing stock.

To remedy this potential disparity in treatment between pro rata and non pro rata distributions, the temporary regulations expand the definition of Distributee in the GRA exception (referred to as Foreign Distributee under such exception) to include all persons that were shareholders of Distributing immediately prior to the distribution. Thus, for example, in the second hypothetical above, Newco and FP would both be Foreign Distributees. Provided that nonrecognition treatment is claimed under the GRA exception with respect to Newco and FP (referred to as Qualified Foreign Distributees in the case of Foreign Distributees for which nonrecognition may be claimed), the GRA would be triggered by either (i) the sale

by FP of Newco stock, or (ii) the sale by Newco of Distributing stock.

Second, even in the case of pro rata distributions, the IRS and Treasury believe that the results obtained under the existing regulations are too dependent upon the form of the transaction. This is principally because taxpayers could be subject to the stricter successor-in-interest rules if their transactions were structured in a particular way, but might be subject to the more liberal distributee rules if the order of the steps of the particular transaction are reversed.

In the preamble to the existing regulations, the IRS and Treasury stated that the successor-in-interest rules were "designed to provide taxpayers with flexibility to restructure their operations, without imposing undue administrative burdens on the Service." The IRS solicited taxpayer comments on the scope of these rules. A number of commentators have stated that the rules are overly restrictive.

The temporary regulations harmonize the treatment of the distributee and successor-in-interest rules in order to minimize the importance of the form of a particular transaction. In addition, as discussed below, the temporary regulations liberalize the strict successor rules by replacing the 80-percent threshold (computed on an individual Distributee basis) with a 50-percent threshold (computed with reference to all Qualified Foreign Distributees as a group).

The temporary regulations follow the existing regulations by providing that a sale by a Qualified Foreign Distributee of the stock of either Controlled or Distributing triggers gain in the same proportion as the percentage of stock that is sold. However, the temporary regulations provide that a sale by Qualified Foreign Distributee(s) of either Distributing or Controlled that results in a substantial transformation results in a trigger of the full amount of the deferred gain. A substantial transformation is defined as a greater than 50-percent (direct or indirect) reduction, on an aggregate basis, in either the total voting power or the total value of the stock of Controlled or Distributing held by Qualified Foreign Distributee(s) immediately after the distribution. The new temporary regulations also provide that a nonrecognition transaction that results in a substantial transformation (such as the issuance of stock by Distributing or Controlled in a public offering) generally causes a trigger of the full amount of the deferred gain. No gain will be triggered if a nonrecognition transaction does not result in a substantial transformation.

The temporary regulations also expand the types of post-distribution nonrecognition transactions that are permitted transactions to include section 355 distributions. A post-distribution section 355 transaction may qualify for nonrecognition treatment if the foreign distributee (referred to as a Substitute Distributee) that receives stock of Distributing and/or Controlled qualifies as a Qualified Foreign Distributee. In such case, the Substitute Distributee will replace the initial Qualified Foreign Distributee as the person whose ownership interest is considered for purposes of determining whether a disposition or substantial transformation has occurred (on a cumulative, aggregate basis) with respect to such stock.

In addition, the temporary regulations provide that foreign persons that owned stock or securities of Distributing within two years prior to the distribution and that own (directly, indirectly, or constructively) 50 percent or more of the stock of Distributing or Controlled immediately after the distribution will also be considered Foreign Distributees. Thus, for example, if F1, a foreign corporation, transfers the stock of US1 to F2 in exchange for all of the stock of F2 in a section 351 exchange and, within two years after the transfer, US1 distributes all of the stock of US2, its wholly owned subsidiary, to F2 in a section 355 exchange, F1 is also treated as a Foreign Distributee under this rule. (F1 would have been treated as a Foreign Distributee without the operation of this rule if the section 355 distribution occurred prior to the section 351 exchange.)

The IRS and the Treasury also believe that certain procedural aspects of the GRA exception need modification. The temporary regulations enhance reporting and security requirements, extend the term of the GRA from 5 to 10 years, and delete other requirements that are believed to be unnecessary in light of the modifications herein.

To address the security concerns of the IRS resulting from the liberalization of the successor-in-interest rules and the expansion of permissible post-distribution nonrecognition transactions to include section 355 distributions, the assets of Distributing are more closely monitored to insure that such corporation has sufficient funds to pay a potential tax on the deferred gain. In addition, Controlled must agree to be secondarily liable (after Distributing) for the tax on the deferred gain.

Moreover, the new temporary regulations extend the term of the GRA from 5 to 10 years in order to conform the GRA term under section 367(e)(1) to the GRA term under section 367(a). Under section 367(a), the GRA term in the case of outbound stock transfers is 10 years when U.S. transferors own at least 50 percent of the stock of a foreign transferee company. See § 1.367(a)–3T(c)(3) and Notice 87–85 (1987–2 C.B. 395). The IRS and Treasury believe that the GRA term under section 367(e)(1) should be no less than the term under section 367(a) when U.S. transferors control the transferee because, once the GRA under section 367(e)(1) expires, the sale of Distributing or Controlled stock by a Qualified Foreign Distributee likely will not be subject to Federal income taxation. In contrast, under section 367(a), even if the GRA lapses, an amount approximating the deferred gain likely will be subject to Federal income taxation if the U.S. transferor later sells the stock of the transferee foreign corporation.

Finally, the IRS and Treasury believe that section 367(e)(1) distributions should be subject to some form of section 6038B reporting, as are transfers described under sections 367(a) and 367(d). Thus, the temporary regulations extend limited section 6038B reporting to section 367(e)(1) transactions. The reporting requirements under section 6038B will be deemed satisfied in the case of a taxpayer that qualifies for one of the three exceptions to taxation under the regulations if the taxpayer complies with the applicable reporting requirements relating to the relevant exception. This change is also intended to extend the statute of limitations under section 6501(c)(8) in cases where distributing corporations do not properly report their outbound section 355 distributions. Separately, the temporary regulations provide new notice and reporting rules in cases where Distributing qualifies for either the FIRPTA or publicly traded exception.

Specific changes to GRA exception in temporary regulations

The specific requirements of the GRA exception, as amended, are as follows:

(A) *Ten or fewer qualified foreign distributees*

The existing regulations provide that Distributing is permitted to claim nonrecognition with respect to 10 or fewer individual or corporate foreign distributees. A ruling is required in the case of a foreign distributee that holds its interest in Distributing through a partnership, trust, or estate (whether foreign or domestic). This requirement is unchanged in the temporary regulations.

(B) *Active trade or business*

The existing regulations provide that, if Distributee is a foreign corporation, it must be engaged in an active trade or business. This requirement is removed in the temporary regulations.

(C) *Value of distributing*

The existing regulations provide that, immediately after the distribution, the value of Distributing must be at least equal to the value of the distributed stock and securities. This requirement is waived by the existing regulations if Distributing and Controlled are members of the same consolidated group at the time of the distribution. This requirement is revised in the temporary regulations to provide that the value of Distributing (the value of its assets less all of its liabilities) must be at least equal to the amount of the deferred gain on all testing dates during the GRA period. (Alternatively, Distributing may satisfy this test using the adjusted basis of its assets instead of fair market value.) A testing date is the last day of each taxable year of Distributing and any day in which Distributing distributes money or property to its shareholders (regardless of whether such distribution is treated as a dividend). The waiver in the existing regulations if Distributing and Controlled are members of the same consolidated group is eliminated in the temporary regulations.

(D) *Treaty residence*

The existing regulations provide that all Distributees are required to be residents of a country that maintains a comprehensive income tax treaty with the United States that contains an exchange of information provision. This requirement is not changed in the temporary regulations.

(E) *Continuity of interest rule*

The existing regulations provide that the Distributee is required to continue to own, for a 60-month period, all of the stock of Distributing and Controlled that it owns at the time of the distribution. This requirement is maintained, but the period is increased to 120 months.

(F) *Distributing must remain in existence*

The existing regulations provide that Distributing cannot go out of existence pursuant to the distribution. This requirement is maintained in the temporary regulations.

(G) *GRA*

The existing regulations provide that Distributing is required to enter into a 5-year GRA and receive annual certifications from Distributees, stating that they continue to own the stock that they held immediately after the distribution. The temporary regulations increase the GRA term to 10 years.

(H) *Annual certifications*

The existing regulations provide that Distributees must provide their certifications directly to Distributing. Under the temporary regulations, Controlled also must provide an annual statement to Distributing, containing information regarding whether any of its Qualified Foreign Distributees have disposed of their stock in Controlled during the relevant taxable year.

Special Analyses

It has been determined that this temporary regulation is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It is hereby certified that this regulation does not have a significant impact on a substantial number of small entities. This certification is based on the fact that the number of corporations that distribute stock or securities to foreign persons in transactions that qualify under section 355, and thus become subject to the collection of information contained in these regulations, is estimated to be only 260 per year. Moreover, because these regulations will primarily affect large multinational corporations with foreign shareholders, it is estimated that out of the 260 annual transactions subject to reporting, very few, if any, will involve small entities. Therefore, the regulations do not significantly alter the reporting or recordkeeping duties of small entities. Thus, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, a copy of these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

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

Part 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entry for section 1.367(e)–1 and adding an entry in numerical order to read as follows:

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

Section 1.367(e)–1T also issued under 26 U.S.C. 367(e)(1) * * *

Par. 2. Sections 1.367(e)–0 and 1.367(e)–1 are removed.

Par. 3. Sections 1.367(e)–0T and 1.367(e)–1T are added to read as follows:

§ 1.367(e)–0T Treatment of section 355 distributions by U.S. corporations to foreign persons; table of contents.

This section lists captioned paragraphs contained in § 1.367(e)–1T.

§ 1.367(e)–1T Treatment of section 355 distributions by U.S. corporations to foreign persons.

(a) Purpose and scope.

(b) Recognition of gain required.

(1) In general.

(2) Computation of gain of the distributing corporation.

(3) Treatment of foreign distributee.

(4) Nonapplication of section 367(a) principles that provide for exceptions to gain recognition.

(5) Partnerships, trusts, and estates.

(i) In general.

(ii) Written statement.

(6) Anti-abuse rule.

(c) Nonrecognition of gain.

(1) Distribution by a U.S. real property holding corporation of stock in a second U.S. real property holding corporation.

(2) Distribution by a publicly traded corporation.

(i) Conditions for nonrecognition.

(ii) Recognition of gain if foreign distributee owns 5 percent of distributing corporation.

(iii) Reporting requirements.

(iv) Timely filed return.

(v) Relation to other nonrecognition provisions.

(3) Distribution of certain domestic stock to 10 or fewer qualified foreign distributees.

(i) In general.

(ii) Conditions for nonrecognition.

(iii) Agreement to recognize gain.

(iv) Waiver of period of limitation.

(v) Annual certifications and other reporting requirements.

(vi) Special rule for nonrecognition transactions.

(vii) Recognition of gain.

(viii) Failure to comply.

(d) Other consequences.

(1) Exchange under section 897(e)(1).

(2) Dividend treatment under section 1248.

(3) Distribution of stock of a passive foreign investment company. [Reserved]

(4) Reporting under section 6038B.

(e) Examples.

(f) Effective date.

§ 1.367(e)–1T Treatment of section 355 distributions by U.S. corporations to foreign persons (temporary).

(a) *Purpose and scope.* This section provides rules concerning the recognition of gain by a domestic corporation on a distribution that qualifies for nonrecognition under section 355 of stock or securities of a domestic or foreign corporation to a person who is not a U.S. person. Paragraph (b) of this section states as a general rule that gain recognition is required on the distribution. Paragraph (c) of this section provides exceptions to the gain recognition rule for certain distributions of stock or securities of a domestic corporation. Paragraph (d) of this section refers to other consequences of distributions described in this section. Paragraph (e) of this section provides examples of these rules. Finally, paragraph (f) of this section specifies the effective date of this section.

(b) *Recognition of gain required*—(1) *In general.* (i) If a domestic corporation (distributing corporation) makes a distribution that qualifies for nonrecognition under section 355 of stock or securities of a domestic or foreign corporation (controlled corporation) to a person who is not a qualified U.S. person, then, except as provided in paragraph (c) of this section, the distributing corporation shall recognize gain (but not loss) on the distribution under section 367(e)(1). No gain is required to be recognized under this section with respect to a distribution to a qualified U.S. person of stock or securities that qualifies for nonrecognition under section 355. For purposes of this section, a qualified U.S. person is—

(A) A citizen or resident of the United States; and

(B) A domestic corporation.

(ii) In the case of stock or securities owned through a partnership, trust, or estate, see paragraph (b)(5) of this section.

(2) *Computation of gain of the distributing corporation.* The gain recognized by the distributing corporation under paragraph (b)(1) of this section shall be equal to the excess of the fair market value of the stock or securities distributed to persons who are not qualified U.S. persons (determined as of the time of the distribution) over the distributing corporation's adjusted basis in the stock or securities distributed to such distributees. For purposes of the preceding sentence, the distributing corporation's adjusted basis in each unit of each class of stock or securities distributed to a distributee shall be equal to the distributing corporation's total adjusted basis in all of the units of the respective class of stock or securities owned immediately before the distribution, divided by the total number of units of the class of stock or securities owned immediately before the distribution.

(3) *Treatment of distributee.* If the distribution otherwise qualifies for nonrecognition under section 355, each distributee shall be considered to have received stock or securities in a distribution qualifying for nonrecognition under section 355, even though the distributing corporation may recognize gain on the distribution under this section. Thus, the distributee shall not be considered to have received a distribution described in section 301 or a distribution in an exchange described in section 302(b) upon the receipt of the stock or securities of the controlled corporation. Except where section 897(e)(1) and the regulations thereunder cause gain to be recognized by the distributee, the basis of the distributed domestic or foreign corporation stock in the hands of the foreign distributee shall be the basis of the distributed stock determined under section 358 without any increase for any gain recognized by the domestic corporation on the distribution.

(4) *Nonapplication of section 367(a) principles that provide for exceptions to gain recognition.* Paragraph (b)(1) of this section requires recognition of gain notwithstanding the application of any principles contained in section 367(a) or the regulations thereunder. The only exceptions to paragraph (b)(1) of this section are contained in paragraph (c) of this section. None of these exceptions applies to distributions of stock or securities of a foreign corporation.

(5) *Partnerships, trusts, and estates*—(i) *In general.* For purposes of this section, stock or securities owned by or for a partnership (whether foreign or domestic) shall be considered to be owned proportionately by its partners. In applying this principle, the proportionate share of the stock or securities of the distributing corporation considered to be owned by a partner of the partnership at the time of the distribution shall equal the partner's distributive share of gain that would be realized by the partnership from a sale of stock of the distributing corporation immediately before the distribution (without regard to whether, under the particular facts, any gain would actually be realized on the sale for U.S. tax purposes), determined under the rules and principles of sections 701 through 761 and the regulations thereunder. For purposes of this section, stock or securities owned by or for a trust or estate (whether foreign or domestic) shall be considered to be owned proportionately by the persons who would be treated as owning such stock or securities under sections 318(a)(2)(A) and (B). In applying section 318(a)(2)(B), if a trust includes interests that are not actuarially ascertainable and a principal purpose of the inclusion of the interests is the avoidance of section 367(e)(1), all such interests shall be considered to be owned by foreign persons. In a case where an interest holder in a partnership, trust, or estate that owns stock of the distributing corporation is itself a partnership, trust, or estate, the rules of this paragraph (b)(5) apply to individuals or corporations that own (direct or indirect) interests in the upper-tier partnership, trust or estate.

(ii) *Written statement.* If, prior to the date on which the distributing corporation must file its income tax return for the year of the distribution, the corporation obtains a written statement, signed under penalties of perjury by an interest holder in a partnership, trust, or estate

that receives a distribution described in paragraph (b)(1) of this section from the corporation, which statement certifies that the interest holder is a qualified U.S. person (as defined in paragraph (b)(1)(i) of this section), no liability shall be imposed under paragraph (b)(1) of this section with respect to the distribution to the partnership, trust, or estate to the extent of the interest holder's interest in the partnership, trust, or estate, unless the distributing corporation knows or has reason to know that the statement is false, or it is subsequently determined that the interest holder, in fact, was not a qualified U.S. person at the time of the distribution. The written statement must set forth the amount of the interest holder's proportionate interest in the partnership, trust, or estate as determined under paragraph (b)(5)(i) of this section and must set forth the amount of such entity's proportionate interest in the distributing and controlled corporation, as well as the interest holder's name, taxpayer identification number, home address (in the case of an individual) or office address and place of incorporation (in the case of a corporation). The written statement must be retained by the distributing corporation with its books and records for a period of three calendar years following the close of the last calendar year in which the corporation relied upon the statement.

(6) *Anti-abuse rule.* If a domestic corporation is directly or indirectly formed or availed of by one or more foreign persons to hold the stock of a second domestic corporation for a principal purpose of avoiding the application of section 367(e)(1) and the requirements of this section, any distribution of stock or securities to which section 355 applies by such second domestic corporation shall be treated for Federal income tax purposes as a distribution to such foreign person or persons, followed by a transfer of the stock or securities to the first domestic corporation. The qualification of the distribution to the foreign person for an exception to the general gain recognition rule of paragraph (b)(1) of this section, and the consequences of the transfer to the first domestic corporation under this section, shall be determined in accordance with all of the facts and circumstances.

(c) *Nonrecognition of gain*—(1) *Distribution by a U.S. real property holding corporation of stock in a second U.S. real property holding corporation.* Gain shall not be recognized under paragraph (b) of this section by a domestic corporation making a distribution that qualifies for nonrecognition under section 355 of stock or securities of a domestic controlled corporation to a person who is not a qualified U.S. person (as defined in paragraph (b)(1)(i) of this section) if the conditions specified in paragraphs (c)(1)(i) and (ii) of this section are both satisfied:

(i) Immediately after the distribution, both the distributing and controlled corporations are U.S. real property holding corporations (as defined in section 897(c)(2)). For the treatment of the distribution under section 897, see section 897(e)(l) and the regulations thereunder.

(ii) The distributing corporation attaches to its timely filed Federal income tax return for the taxable year in which the distribution occurs a statement titled "Section 367(e)(1) – Reporting of Section 355 Distribution by U.S. Real Property Holding Corporation", signed under penalties of perjury by an officer of the corporation, disclosing the following information—

(A) A statement that the distribution is one to which paragraph (c)(1) of this section applies; and

(B) A description of the transaction in which one U.S. real property holding corporation distributes the stock of another U.S. real property holding corporation in a transaction that is described under section 355.

(iii) For purposes of this paragraph (c)(1), an income tax return (including an amended return) will be considered a timely filed Federal income tax return if it is filed prior to the time that the Internal Revenue Service discovers that the reporting requirements of this paragraph have not been satisfied.

(2) *Distribution by a publicly traded corporation*— (i) *Conditions for nonrecognition.* Except as provided by paragraph (c)(2)(ii) of this section, gain shall not be recognized under paragraph (b) of this section by a domestic corporation making a distribution that qualifies for nonrecognition under section 355 of stock or securities of a domestic controlled corporation to a person who is not a qualified U.S. person (as defined in paragraph (b)(1)(i) of this section) if both of the following conditions are satisfied:

(A) Stock of the domestic controlled corporation with a value of more than 80 percent of the outstanding stock of the corporation is distributed with respect to one or more classes of the outstanding stock of the distributing corporation that are regularly traded on an established securities market, as defined in § 1.897–1(m)(1) and (3), located in the United States. Stock is considered to be regularly traded if it is regularly quoted by brokers or dealers making a market in such interests. A broker or dealer is considered to make a market only if the broker or dealer holds himself out to buy or sell interests in the stock at the quoted price.

(B) The distributing corporation satisfies the reporting requirements contained in paragraph (c)(2)(iii) of this section.

(ii) *Recognition of gain if distributee owns 5 percent of distributing corporation.* If, at the time of the distribution, the distributing corporation knows or has reason to know that any distributee who is not a qualified U.S. person (as defined in paragraph (b)(1)(i) of this section) owns, directly, indirectly, or constructively (using the rules of sections 897(c)(3) and (c)(6)(C), but subject to the rules of paragraph (b)(5) of this section), more than 5 percent (by value) of a class of stock or securities of the distributing corporation with respect to which the stock or securities of the controlled corporation is distributed (a 5-percent shareholder), the distributing corporation will qualify for nonrecognition under paragraph (c)(2)(i) of this section if, with respect to such 5-percent shareholder, either—

(A) The distribution qualifies for nonrecognition under paragraph (c)(3) of this section; or

(B) The distributing corporation recognizes gain (but not loss) on the distribution under paragraph (b) of this section.

(iii) *Reporting Requirements.* To qualify for nonrecognition treatment under paragraph (c)(2)(i) of this section, the distributing corporation must attach to its timely filed Federal income tax return, for the taxable year in which the distribution occurs a statement titled "Section 367(e)(1) – Reporting of Section 355 Distribution by U.S. Publicly Traded Corporation to Foreign Persons," signed under penalties of perjury by an officer of the corporation, disclosing the following information:

(A) A statement that the distribution is one to which paragraph (c)(2) of this section applies.

(B) A description of the transaction in which the distributing corporation that is publicly traded on a U.S. securi-

ties market distributed stock or securities of a domestic controlled corporation.

(C) The U.S. securities market on which the stock of the distributing corporation is publicly traded.

(D) A statement that, at the time of the distribution, either—

(*1*) The distributing corporation does not know or have reason to know that any distributee who is not a qualified U.S. shareholder (as defined in paragraph (b)(1)(i) of this section) is a 5-percent shareholder; or

(*2*) The distributing corporation knows or has reason to know that one or more distributees who are not qualified U.S. persons are 5-percent shareholders, and, that with respect to each such 5-percent shareholder, either—

(*i*) Gain will not be recognized because the requirements of paragraph (c)(3) of this section are satisfied; or

(*ii*) Gain (but not loss) will be recognized in accordance with paragraph (b) of this section.

(*iv*) *Timely filed return.* For purposes of this paragraph (c)(2), an income tax return (including an amended return) will be considered a timely filed Federal income tax return if it was received prior to the time that the Internal Revenue Service discovers that the reporting requirements of this paragraph (c)(2) have not been satisfied.

(*v*) *Relation to other nonrecognition provisions.* If the distribution of the stock and securities of the controlled corporation also qualifies for nonrecognition under paragraph (c)(1) of this section, the distributing corporation shall be entitled to nonrecognition under paragraph (c)(1) of this section and not this paragraph (c)(2).

(3) *Distribution of certain domestic stock to 10 or fewer qualified foreign distributees*—(i) *In general.* (A) Gain shall not be recognized under paragraph (b) of this section by a domestic corporation making a distribution that qualifies for nonrecognition under section 355 of stock or securities of a domestic controlled corporation with respect to a foreign distributee (defined in paragraph (c)(3)(i)(B) of this section) that is a qualified foreign distributee (defined in paragraph (c)(3)(i)(C) of this section), provided that each of the conditions contained in paragraph (c)(3)(ii) of this section is satisfied. If one or more foreign distributees are not treated as qualified foreign distributees, the distributing corporation shall recognize a percentage of the gain realized on the distribution, equal to the percentage of its stock owned immediately before the distribution, directly or indirectly, by foreign distributees who are not qualified foreign distributees. See paragraph (b)(5) of this section for rules regarding the ownership of stock held by a partnership, trust, or estate.

(B) For purposes of this paragraph (c)(3), the term *foreign distributee* is any person who is not a qualified U.S. person (as defined in paragraph (b)(1)(i) of this section) if such person—

(*1*) Owned stock or securities of the distributing corporation immediately prior to the distribution;

(*2*) Owned stock or securities of the distributing corporation within two years prior to the distribution and directly, indirectly, or constructively (using the rules of section 318) owns 50 percent or more of either the total voting power or the total value of the stock of the distributing or controlled corporation immediately after the distribution; or

(*3*) Is a transferee or substitute distributee, as defined in paragraph (c)(3)(vi)(C) or (D) of this section.

(C) For purposes of this section, except as provided by paragraph (c)(3)(i)(D) of this section, the term *qualified foreign distributee* is a foreign distributee that, during the entire period for which the agreement to recognize gain (described in paragraph (c)(3)(iii) of this section) is in effect with respect to the distributee, is either an individual or a corporation (as defined in section 7701(a)(3)), resident of a foreign country that maintains a comprehensive income tax treaty with the United States which contains an information exchange provision. However, no more than ten foreign distributees in total may be current or former qualified foreign distributees (including any transferee or substitute distributees as defined in paragraph (c)(3)(vi)(C) or (D) of this section) during the entire term of the gain recognition agreement. See, however, paragraph (c)(3)(vi)(G) of this section for special rules applicable to substitute distributees.

(D) Unless the distributing corporation obtains a ruling from the Internal Revenue Service to the contrary, no foreign distributee shall be treated as a qualified foreign distributee if it holds its interest in the distributing corporation through a partnership, trust or estate, characterized as such under the taxation laws of the United States or any entity that is treated as fiscally transparent under the taxation laws of the foreign country in which it is a resident if such country maintains a comprehensive income tax treaty with the United States which contains an information exchange provision.

(ii) *Conditions for nonrecognition.* A distribution of stock or securities described in paragraph (c)(3)(i) of this section to a qualified foreign distributee shall not result in the recognition of gain if each of the following conditions is satisfied:

(A) If more than ten foreign distributees, at any time during the entire term of the gain recognition agreement, are eligible to be qualified foreign distributees, the distributing corporation shall designate the foreign distributees to be considered qualified foreign distributees for which nonrecognition is claimed under this paragraph (c)(3).

(B) Immediately after the distribution and on each testing date beginning after the distribution and during the period that the agreement to recognize gain (described in paragraph (c)(3)(iii) of this section) is in effect, the value of the distributing corporation (that is, the fair market value of the assets of the distributing corporation, less all liabilities of the distributing corporation) must exceed the amount of gain that the distributing corporation realized, but did not recognize (on or after the distribution) under this paragraph (c)(3), as a consequence of the distribution with respect to qualified foreign distributees. This requirement will be deemed satisfied for any testing date upon which the adjusted basis of the distributing corporation's assets, less all liabilities of the distributing corporation, exceeds the amount of the deferred gain. A testing date is—

(*1*) The last day of any taxable year of the distributing corporation during which the agreement to recognize gain is in effect; and

(*2*) Any date upon which the distributing corporation distributes property to its shareholders under section 301(a).

(C) At all times until the close of the 120-month period following the end of the taxable year of the distributing corporation in which the distribution was made, except under the circumstances and subject to the consequences prescribed in paragraphs (c)(3)(vi) and (vii) of this section, all qualified foreign distributees must continue to own, directly or indirectly, all of the stock and securities of the distributing and controlled corporations that the qualified foreign distributee owned, directly or indirectly, immediately after the distribu-

tion (including any stock and securities of the distributing or controlled corporation later acquired from the distributing or controlled corporation for which the distributee has a holding period determined under section 1223 by reference to the stock or securities).

(D) The distribution of stock or securities described in paragraph (c)(3)(i) of this section must not be a distribution pursuant to which the distributing corporation goes out of existence.

(E) The distributing corporation must file an agreement to recognize gain, and the controlled corporation must agree to be secondarily liable in the event that the distributing corporation does not pay the tax due upon a recognition event described in paragraph (c)(3)(vii) of this section. The agreement is described in paragraph (c)(3)(iii) of this section and filed by the distributing corporation with its Federal income tax return for its taxable year in which the distribution is made.

(F) For each of the taxable years of the distributing corporation, beginning with the taxable year of the distribution and ending with the taxable year that includes the close of the 120-month period following the end of the taxable year of the distributing corporation in which the distribution was made, all qualified foreign distributees and the controlled corporation must provide to the distributing corporation the annual certifications described in paragraph (c)(3)(v) of this section, and the distributing corporation must file the certifications with its tax return.

(iii) *Agreement to recognize gain.* The agreement to recognize gain required by this paragraph (c)(3)(iii) shall be prepared by or on behalf of the distributing corporation and signed under penalties of perjury by an authorized officer of the distributing corporation. An authorized officer of the controlled corporation must also sign the agreement under penalties of perjury, agreeing to extend the statute of limitations and accept liability for the tax in the event that the distributing corporation fails to pay the tax upon a recognition event. The agreement provided by the distributing corporation shall set forth the following items, under the heading "GAIN RECOGNITION AGREEMENT UNDER § 1.367(e)–1T(c)(3)(iii)", with paragraphs labeled to correspond with such items:

(A) A declaration that the distribution is one to which paragraph (c)(3) of this section applies.

(B) A description of each qualified foreign distributee, which shall include the qualified foreign distributee's—

(*1*) Name;

(*2*) Address;

(*3*) Taxpayer identification number (if any); and

(*4*) Residence and citizenship (in the case of an individual) or place of incorporation and country of residence (in the case of a qualified foreign distributee that is a corporation for Federal income tax purposes under section 7701(a)(3)).

(C) A description of the stock and securities of the distributing and controlled corporations owned (directly or indirectly) by each qualified foreign distributee, including—

(*1*) The number or amount of shares;

(*2*) The type of stock or securities;

(*3*) The fair market values of the stock and securities of the controlled corporation owned (directly or indirectly) by the qualified foreign distributee(s), determined immediately before and immediately after the distribution;

(*4*) The distributing corporation's adjusted basis (immediately before the distribution) in the stock and securities of the controlled corporation distributed to the qualified foreign distributees;

(*5*) The fair market value of the distributing corporation (fair market value of its assets, less all liabilities of the distributing corporation) immediately after the distribution. Such amount must exceed the amount of gain that the distributing corporation realized, but did not recognize under this paragraph (c)(3), on the distribution to qualified foreign distributees. Alternatively, the fair market value standard will be deemed satisfied if the adjusted basis of the assets of the distributing corporation, less all liabilities of the distributing corporation, exceeds the amount of the deferred gain.

(*6*) For each applicable valuation, a summary of the method (including appraisals, if any) used for determining the fair market values required by this paragraph (c)(3)(iii).

(D) The distributing corporation's agreement to recognize gain in accordance with paragraph (c)(3)(vii) of this section.

(E) The controlled corporation's agreement to be secondarily liable for the distributing corporation's tax liability, pursuant to the gain recognition agreement described in this paragraph (c)(3)(iii).

(F) A waiver of the period of limitations by both the distributing and controlled corporation as described in paragraph (c)(3)(iv) of this section.

(G) An attached statement from each qualified foreign distributee declaring that the qualified foreign distributee will provide to the distributing corporation the annual certifications described in paragraph (c)(3)(v)(A) of this section for each of the taxable years of the distributing corporation, beginning with the taxable year of the distribution and ending with the taxable year that includes the close of the 120-month period following the taxable year of the distributing corporation in which the distribution was made. The attached statements shall be signed under penalties of perjury by an authorized officer in the case of any qualified foreign distributee that is a corporation for Federal income tax purposes or by the individual in the case of a qualified foreign distributee that is an individual.

(H) An attached statement from the controlled corporation declaring that it will provide to the distributing corporation the annual certifications described in paragraph (c)(3)(v)(B) of this section.

(I) An agreement by the distributing corporation to attach to its tax returns the annual certifications of the qualified foreign distributees and the controlled corporation described in paragraphs (c)(3)(v)(A) and (B) of this section, respectively, and to meet any other reporting requirement in accordance with paragraph (c)(3)(v) of this section.

(iv) *Waiver of period of limitation.* The distributing corporation and the controlled corporation must file, with the gain recognition agreement described in paragraph (c)(3)(iii) of this section, a waiver of the period of limitation on the assessment of tax upon the gain realized on the distribution to the qualified foreign distributee(s). The waiver shall be executed on Form 8838, substitute form, or such other form as may be prescribed by the Commissioner for this purpose and shall extend the period for assessment of such tax to a date not earlier than the close of the thirteenth full year following the taxable year that includes the distribution. A properly executed Form 8838, substitute form, or such other form authorized by this paragraph (c)(3)(iv) shall be deemed to be consented to and signed by a Service Center Director or the Assistant Commissioner (International) for purposes of § 301.6501(c)–1(d) of this chapter.

(v) *Annual certifications and other reporting requirements.* For each of the taxable years of the distributing corporation, beginning with the taxable year of the distribution and ending with the taxable year that includes the close of the 120-month period following the end of the taxable year of the distributing corporation in which the distribution was made, the distributing corporation must file with its Federal income tax return the annual certifications for that year described in this paragraph (c)(3)(v).

(A) Each current qualified foreign distributee must provide to the distributing corporation an annual certification, signed under penalties of perjury by an authorized officer of the qualified foreign distributee that is a corporation or by the qualified foreign distributee that is an individual (as the case may be). Each annual certification must identify the distribution with respect to which it is given by setting forth the date and a summary description of the distribution. In the annual certification, the qualified foreign distributee must declare that—

(*1*) The qualified foreign distributee continues to satisfy paragraph (c)(3)(i)(C) of this section; and

(*2*) The qualified foreign distributee continues to own, directly or indirectly, without interruption, the stock and securities of the distributing and controlled corporations (except to the extent the stock or securities have been disposed of in a transfer described in paragraph (c)(3)(vi) of this section).

(B) The controlled corporation must provide a certification to the distributing corporation, signed under penalties of perjury by an authorized officer of the corporation, that lists each current qualified foreign distributee holding (directly or indirectly) stock of the controlled corporation and its direct or indirect ownership interest in the controlled corporation at both the first day and the last day of the taxable year for which the distributing corporation files its Federal income tax return, and certifies the accuracy of that list.

(C) The distributing corporation must attach to the annual certifications described in paragraphs (c)(3)(v)(A) and (B) of this section, a statement signed under penalties of perjury by an authorized officer of the corporation, in which the corporation declares that, to the best of its knowledge, the annual certifications are true.

(D) The distributing corporation must also attach to the annual certifications a separate statement indicating—

(*1*) The names and addresses of each current and each former qualified foreign distributee;

(*2*) The percentage of direct or indirect ownership that the qualified foreign distributees retain in the distributing corporation at year-end; and

(*3*) A certification that the value of the distributing corporation (or the adjusted basis of its assets), less all of the liabilities of the distributing corporation on all testing dates, exceeded the amount of the gain deferred as of the testing date.

(vi) *Special rule for nonrecognition transactions.* (A) Gain shall not be recognized under paragraph (c)(3)(vii) of this section if the distributing or controlled corporation is acquired by a successor-in-interest (described in paragraph (c)(3)(vi)(B) of this section), or upon a direct or indirect disposition by a qualified foreign distributee of stock or securities of a distributing or controlled corporation (or a successor-in-interest) that is subject to a gain recognition agreement described in paragraph (c)(3)(iii) of this section, if the requirements of this paragraph (c)(3)(vi) are satisfied and the disposition consists of a transfer described in section 332, 337, 351, 354, 355, 356, or 361 that does not result in a substantial transformation (as defined in paragraph (c)(3)(vii)(B) of this section). For special rules regarding transfers described in section 355, see paragraph (c)(3)(vi)(G) of this section.

(B) For purposes of this section, the term *successor-in-interest* refers to any domestic corporation that acquires the assets of the distributing or controlled corporation in a transaction described in section 381(a) to which this paragraph (c)(3)(vi) applies.

(C) For purposes of this section, the term *transferee distributee* refers to:

(*1*) Any corporation whose stock or securities are exchanged for the stock or securities of the distributing or controlled corporation (or a successor-in-interest), or of another transferee distributee, in a transaction described in section 351, 354, or sections 361 and 381(a)(2), to which this paragraph (c)(3)(vi) applies.

(*2*) Any corporation that acquires the assets of any qualified foreign distributee, transferee distributee or substitute distributee in a transaction described in section 381(a).

(D) For purposes of this section, the term *substitute distributee* refers to any person that acquires the stock or securities of the distributing or controlled corporation (or a successor-in-interest), or of a qualified foreign distributee, in a section 355 distribution.

(E) Gain shall not be recognized under paragraph (c)(3)(vii) of this section in a transaction involving a transfer of the assets of the distributing or controlled corporation to a successor-in-interest, only if the following information and agreements are included with the first annual certification thereafter filed under paragraph (c)(3)(v) of this section:

(*1*) A description of the transaction (including a statement of applicable Internal Revenue Code provisions, and a description of stock or securities transferred, exchanged, or received in the transaction).

(*2*) A description of the successor-in-interest (including the name, address, taxpayer identification number, and place of incorporation of the successor in interest).

(*3*) An agreement of the successor-in-interest, signed under penalties of perjury by an authorized officer of the successor-in-interest corporation, to succeed to all of the responsibilities and duties of the distributing corporation or the controlled corporation (as the case may be) under this paragraph (c)(3) as if the successor-in-interest were the distributing or controlled corporation.

(F) Gain shall not be recognized under paragraph (c)(3)(vii) of this section in a transaction described in paragraph (c)(3)(vi)(A) of this section in which a qualified foreign distributee, directly or indirectly, disposes of, and a transferee distributee acquires, stock or securities of the distributing or controlled corporation (or a successor-in-interest), or another transferee distributee, only if the transferee distributee is either a qualified U.S. person or qualifies as a qualified foreign distributee under this paragraph (c)(3) and the following information and agreements are included with the first annual certification thereafter filed under paragraph (c)(3)(v) of this section:

(*1*) A description of the transaction (including a statement of applicable Internal Revenue Code provisions, and a description of the stock or securities of the distributing or controlled corporation (or a successor-in-interest) owned, directly or indirectly, by qualified foreign distributees immediately after the transaction).

(2) An agreement of the distributing corporation and the controlled corporation (amending the agreement described in paragraph (c)(3)(iii) of this section), signed under penalties of perjury by an authorized officer of the corporation, to recognize gain (in the case of the distributing corporation) and to be secondarily liable (in the case of the controlled corporation) in accordance with the provisions of this paragraph (c)(3) upon the occurrence of a disposition, directly or indirectly, by the foreign transferee distributee of any stock or securities of the distributing or controlled corporation (or a successor-in-interest) (other than a disposition that itself satisfies the requirements of this paragraph (c)(3)(vi)).

(3) An agreement of each foreign transferee distributee, signed under penalties of perjury by the individual or an authorized officer of the corporation, to comply with all of the responsibilities, qualifications and duties of a qualified foreign distributee under this paragraph (c)(3), with respect to the stock or securities of the distributing or controlled corporation (or a successor-in-interest) owned, directly or indirectly, by the transferee distributee.

(G) Gain shall not be recognized under paragraph (c)(3)(vii) of this section in the case of a section 355 distribution by a qualified foreign distributee of stock or securities of the distributing or controlled corporation (or a successor-in-interest), or of another qualified foreign distributee. The qualified foreign distributee that distributed the stock or securities is no longer required to comply with the rules of this section applicable to qualified foreign distributees, provided such person no longer has any interest, directly or indirectly, in the distributing and controlled corporation. Thus, for example, such person is not counted as a qualified foreign distributee for purposes of limiting gain recognition to 10 or fewer foreign distributees. In order for this provision to apply, the substitute distributee must either be a qualified U.S. person or satisfy the requirements applicable to qualified foreign distributees contained in this paragraph (c)(3) and must include with the first annual certification thereafter filed under paragraph (c)(3)(v) of this section the following information and agreements:

(1) A description of the transaction (including a statement of applicable Internal Revenue Code sections, and a description of the stock or securities distributed in the transaction).

(2) An agreement of the distributing corporation and the controlled corporation (amending the agreement described in paragraph (c)(3)(iii) of this section), signed under penalties of perjury by an authorized officer of the corporation, to recognize gain (in the case of the distributing corporation) and to be secondarily liable (in the case of the controlled corporation) in accordance with the provisions of this paragraph (c)(3) upon the occurrence of a disposition, directly or indirectly, by a foreign substitute distributee of any stock or securities received by the substitute distributee in the transaction.

(3) An agreement of each foreign substitute distributee, signed under penalties of perjury by the individual or authorized officer of the corporation, to succeed to all of the responsibilities, qualifications and duties of a qualified foreign distributee under this paragraph (c)(3), with respect to the stock or securities of the distributing or controlled corporation (or a successor- in-interest) received by such substitute distributee.

(vii) *Recognition of gain.* (A) (1) The distributing corporation must file, within 90 days of a transaction described in this paragraph (c)(3)(vii)(A), an amended return for the year of the distribution and recognize gain realized but not recognized upon such distribution, if, prior to the close of the 120-month period following the end of the taxable year of the distributing corporation in which the distribution was made, either—

(i) A qualified foreign distributee sells (or otherwise disposes of) the stock or securities of the distributing or controlled corporation that the qualified foreign distributee owned (directly or indirectly) (other than pursuant to a transfer described in paragraph (c)(3)(vi) of this section); or

(ii) Any other transaction (e.g., a public offering or reorganization) results in a substantial transformation (as defined in paragraph (c)(3)(vii)(B) of this section) in either the distributing or controlled corporation (or both).

(2) For purposes of this paragraph (c)(3)(vii)(A), a disposition includes, but is not limited to, any disposition treated as a sale or exchange under this subtitle (e.g., section 301(c)(3)(A), 302(a), 351(b) or 356(a)(1)). For the computation of gain in the case of a sale (or similar disposition), see paragraph (c)(3)(vii)(C) of this section. For the computation of gain in the case of other transactions, see paragraphs (c)(3)(vii)-(D) and (F) of this section. For special rules regarding substitute distributees, see paragraph (c)(3)(vii)(E) of this section.

(B) A transaction is treated as a substantial transformation if, as a result of such transaction, the qualified foreign distributees, transferee distributees and substitute distributees own, in the aggregate, less than 50 percent of either the total voting power or the total value of the stock of the distributing or the controlled corporation, directly or indirectly, that the qualified foreign distributees owned immediately after the distribution.

(C) In the case of a sale (or similar disposition), directly or indirectly, by a qualified foreign distributee of the stock or securities of the distributing or controlled corporation (or a successor-in-interest) that does not result in a substantial transformation, the distributing corporation shall be required to recognize a proportionate amount of the gain realized but not recognized under this paragraph (c)(3), equal to the percentage of stock of the distributing or controlled corporation, as the case may be, sold (or otherwise disposed of), directly or indirectly, by the qualified foreign distributee. However, if the sale (or other disposition) of stock or securities by a qualified foreign distributee results in a substantial transformation, the distributing corporation (or its successor-in-interest) must recognize the entire deferred gain that has not already been recognized under paragraph (c)(3)(vii) of this section.

(D) In the case of a nonrecognition transaction that results in a substantial transformation, the distributing corporation must recognize the entire deferred gain that has not already been recognized under paragraph (c)(3)(vii) of this section. If a nonrecognition transaction does not result in a substantial transformation, the distributing corporation does not recognize any gain provided that the requirements of paragraph (c)(3)(vi) of this section are satisfied.

(E) A sale (or other disposition), directly or indirectly, by a substitute distributee, of all or a portion of the stock or securities of the distributing or controlled corporation (or a successor-in-interest) that the substitute distributee received in the section 355 distribution shall be treated as a disposition of such stock or securities by a qualified foreign distributee (in accordance with paragraph (c)(3)(vii)(C) of this section) for

purposes of computing gain under this paragraph (c)(3)(vii).

(F) Other transactions or events shall trigger gain under this paragraph (c)(3)(vii) as follows:

(1) If a qualified foreign distributee ceases to satisfy the requirements for a qualified foreign distributee contained in paragraph (c)(3)(i)(C) of this section (or any other specified requirements in paragraph (c)(3) of this section), the qualified foreign distributee shall be treated as if it sold all of the stock and securities that it owned, directly or indirectly, in the distributing and controlled corporation (or a successor-in-interest), on the date that such person ceased to meet the requirements.

(2) If a substitute distributee ceases to satisfy the requirements for a qualified foreign distributee contained in paragraph (c)(3)(i)(C) of this section (or any other specified requirements in paragraph (c)(3) of this section), the substitute distributee shall be treated as if it sold all of the stock and securities of the distributing or controlled corporation (or a successor-in-interest) that it received in the distribution, on the date that it ceased to meet the requirements.

(3) If the distributing corporation (or a successor-in-interest) fails to satisfy the requirement contained in paragraph (c)(3)(ii)(B) of this section on any testing date during which the agreement to recognize gain is in effect, such failure will be treated as if a substantial transformation has occurred on such date.

(4) If either the distributing or controlled corporation (or a successor-in-interest) is acquired in a section 381(a) exchange and the acquirer is not a successor-in-interest that satisfies the requirements of paragraph (c)(3)(vi)(E), such acquisition will be treated as if a substantial transformation has occurred on the date of the acquisition.

(G) A qualified foreign distributee that sells (or otherwise disposes of) all of its interest, directly or indirectly, in the distributing and controlled corporation ceases thereafter to be a qualified foreign distributee. In addition, where one qualified foreign distributee owns all of the stock of another qualified foreign distributee, and both persons have identical direct or indirect interests in the distributing or controlled corporation, the direct or indirect sale (or other disposition) by one qualified foreign distributee of all of its interest in the distributing or controlled corporation (under paragraph (c)(3)(vii) of this section) will terminate the qualified foreign distributee status for the second qualified foreign distributee. The principles of this paragraph (c)(3)(vii) shall generally be applied so that any gain relating to the same stock of the distributing or controlled corporation by more than one person is not taxed more than once under this paragraph (c)(3)(vii). In any event, gain recognized pursuant to this paragraph (c)(3)(vii), on a cumulative basis, shall not exceed the amount of gain that the distributing corporation would have recognized under section 367(e)(1) if its initial distribution of the stock or securities of the controlled corporation was fully taxable under paragraph (b) of this section.

(H) If additional tax is required to be paid by the distributing corporation (or a successor-in-interest) for the year of the distribution, interest must be paid by the distributing corporation (or the controlled corporation if the distributing corporation fails to pay the tax due) on that amount at the rates determined under section 6621(a)(2) with respect to the period between the date that was prescribed for filing the distributing corporation's original income tax return for the year of the distribution and the date on which the additional tax for that year is paid.

(I) Net operating losses, capital losses, or credits against tax that were available in the year of the distribution and that are unused (whether or not they have expired since the distribution) at the time of gain recognition described in this paragraph (c)(3)(vii) may be applied (respectively) by the distributing corporation against any gain recognized or tax owed by reason of this provision, but no other adjustments shall be made with respect to any other items of income or deduction in the year of distribution or other years.

(viii) *Failure to comply.* (A) Except as otherwise provided in paragraph (c)(3)(viii)(B) of this section, if the distributing corporation or the controlled corporation fails to comply in any material respect with the requirements of this paragraph (c)(3) or with the terms of an agreement submitted pursuant hereto, or if the distributing corporation knows or has reason to know of any failure of another person to so comply, the distributing corporation shall treat the initial distribution of the stock or securities of the controlled corporation as a taxable exchange in the year of the distribution. In such event, the period for assessment of tax shall be extended until three years after the date on which the Internal Revenue Service receives actual notice of such failure to comply.

(B) If a person fails to comply in any material respect with the requirements of this paragraph or with the terms of an agreement submitted pursuant thereto, the provisions of paragraph (c)(3)(viii)-(A) of this section shall not apply if the person is able to show that such failure was due to reasonable cause and not willful neglect, provided that the person achieves compliance as soon as the person becomes aware of the failure. Whether a failure to materially comply was due to reasonable cause shall be determined by the district director under all the facts and circumstances.

(d) *Other consequences*—(1) *Exchange under section 897(e)(1).* With respect to the treatment under section 897(e)(1) of a foreign distributee on the receipt of stock or securities of a domestic or foreign corporation where the foreign distributee's interest in the distributing domestic corporation is a United States real property interest, see section 897(e)(1) and the regulations thereunder.

(2) *Dividend treatment under section 1248.* With respect to the treatment as a dividend of a portion of the gain recognized by the domestic corporation on the distribution of the stock of certain foreign corporations, see sections 1248(a) and (f) and the regulations thereunder.

(3) *Distribution of stock of a passive foreign investment company.* [Reserved]

(4) *Reporting under section 6038B.* Notice shall be required under section 6038B with respect to a distribution described in this section. See § 1.6038B–1T(e).

(e) *Examples.* The rules of paragraphs (b), (c), and (d) of this section are illustrated by the examples below. In all examples, assume that all foreign companies are treated as corporations for Federal income tax purposes and are not treated as fiscally transparent under the taxation laws of the relevant foreign country.

Example 1. (i) FC, a Country Z company, owns all of the outstanding stock of DC1, a domestic corporation. DC1 owns all of the outstanding stock of DC2, another domestic corporation. The fair market value of the DC1 stock is 300x, and FC has a 100x basis in the DC1 stock. The fair market value of the DC2 stock is 180x, and DC1 has a 80x basis in the DC2 stock. Neither DC1 nor DC2 is a U.S. real property holding corporation. Country Z does not maintain an income tax treaty with the United States.

(ii) In a transaction qualifying for nonrecognition under section 355, DC1 distributes all of the

stock of DC2 to FC. After the distribution, the DC1 stock has a fair market value of 120x.

(iii) Under paragraphs (b)(1) and (2) of this section, DC1 recognizes gain of 100x, which is the difference between the fair market value (180x) and the adjusted basis (80x) of the stock distributed. Under paragraph (d)(1) of this section and section 358, FC takes a basis of 40x in the DC1 stock, and a basis of 60x in the DC2 stock.

Example 2. (i) C, a citizen and resident of Country F, owns all of the stock of DC1, a domestic corporation. DC1, in turn, owns all of the stock of DC2, also a domestic corporation. The fair market value of the DC1 stock is 500x, and C has a 100x basis in the DC1 stock. The DC2 stock has a fair market value of 200x, and DC1 has a 180x basis in the DC2 stock.

(ii) In a transaction qualifying for nonrecognition under section 355, DC1 distributes to C all of the stock of DC2. DC1 and DC2 are U.S. real property holding corporations immediately after the distribution. After the distribution, the DC1 stock has a fair market value of 300x.

(iii) Under paragraph (c)(1) of this section, provided that DC1 complies with the reporting requirements contained in paragraph (c)(1)(ii) of this section, DC1 does not recognize gain on the distribution of the DC2 stock because DC1 and DC2 are U.S. real property holding corporations immediately after the distribution.

(iv) Under section 897(e) and the regulations thereunder, C is considered to have exchanged DC1 stock with a fair market value of 200x and an adjusted basis of 40x for DC2 stock with a fair market value of 200x. Because DC2 is a U.S. real property holding corporation, and its stock is a U.S. real property interest, C does not recognize any gain under section 897(e) on the distribution. C takes a basis of 40x in the DC2 stock, and its basis in the DC1 stock is reduced to 60x pursuant to section 358.

Example 3. (i) All of the outstanding common stock of DC, a domestic corporation that is not a U.S. real property holding corporation, is regularly traded on an established securities market located in the United States. None of the foreign shareholders of DC (directly, indirectly, or constructively) owns more than five percent of the common stock of DC. DC owns all of the stock of DS, a domestic corporation. The stock of DS has appreciated in the hands of DC.

(ii) In a transaction qualifying for nonrecognition under section 355, DC distributes all of the stock of DS to the common shareholders of DC.

(iii) Under paragraph (c)(2) of this section, DC does not recognize gain on the distribution of the DS stock to any foreign distributee, provided that DC complies with the reporting requirements contained in paragraph (c)(2)(iii) of this section. Each shareholder's basis in the DC and DS stock is determined pursuant to section 358.

Example 4. (i) FC, a company resident in Country X, owns all of the stock of DC1, a domestic corporation. DC1, in turn, owns all of the stock of DC2, a domestic corporation. The fair market value of the DC1 stock is 1,000x, and FC has a basis in the DC1 stock of 800x. The DC2 stock has a fair market value of 500x at the time of the distribution, and DC1 has a 100x basis in the DC2 stock. Neither DC1 nor DC2 is a U.S. real property holding corporation. Country X maintains an income tax treaty with the United States that includes an information exchange provision.

(ii) In a transaction qualifying for nonrecognition under section 355, DC1 distributes to FC all of the stock of DC2. Immediately after the distribution, the DC1 stock has a fair market value of 500x. Thus, the value of DC1 exceeds 400x, the amount of the deferred gain on the distribution.

(iii) Under paragraph (c)(3) of this section, DC1 will not recognize gain on the distribution of the DC2 stock to (foreign distributee) FC if FC is a qualified foreign distributee (as described in paragraph (c)(3)(i)(C) of this section) and DC1 enters into a gain recognition agreement (in which DC2 agrees to be secondarily liable), as described in paragraph (c)(3)(iii) of this section, and DC1, DC2 and FC otherwise comply with all of the provisions of paragraph (c)(3) of this section. Pursuant to section 358, FC will take a 400x basis in the DC2 stock and FC's basis in the DC1 stock will be reduced to 400x.

Example 5. (i) Assume the same facts as in *Example 4.* In addition, two years after DC1's distribution of DC2 stock to FC, FC sells 25 percent of the DC2 stock to Y, an unrelated corporation. One year later, FC sells an additional 30 percent of its DC2 stock to Z, another unrelated corporation.

(ii) Under paragraph (c)(3)(vii) of this section, upon FC's sale of 25 percent of its DC2 stock, DC1 is required to file an amended return for the year in which the DC2 stock was distributed to FC, and recognize 100x of gain, which represents 25 percent of the gain realized but not recognized on the distribution.

(iii) Upon FC's second sale of 30 percent of its DC1 stock, DC1 is required to file another amended return for the year of the distribution and recognize the balance of the deferred gain, or 300x, because such sale results in a substantial transformation (within the meaning of paragraph (c)(3)(vii)(B) of this section).

Example 6. (i) Assume the same facts as in *Example 5*, except that FC did not sell an additional 30 percent of its DC2 stock. Instead, DC2 issued additional stock in a public offering that reduced FC's interest in DC2 to less than 50 percent.

(ii) The public offering caused a substantial transformation because, as a result of the public offering, the interest of FC in DC2 was reduced to less than 50 percent of the amount of stock that FC owned in DC2 immediately after the distribution. Thus, the result is the same as in *Example 5.*

Example 7. (i) Assume the same facts as in *Example 4* In addition, one year after DC1's distribution of DC2 stock to FC, FC transfers all of the DC2 stock to FS, a company resident in Country X, in exchange for all of the FS stock, in a transaction described in section 351.

(ii) FS is described as a transferee distributee under paragraph (c)(3)(vi)(C) of this section. The transfer by FC of DC2 stock to FS is a nonrecognition transaction under paragraph (c)(3)(vi) of this section provided all of the requirements in paragraph (c)(3)(vi)(F) of this section are satisfied. (FS is counted, together with FC, for purposes of limiting nonrecognition treatment to up to ten qualified foreign distributees during the time that the gain recognition agreement is in effect.) DC1 will not recognize gain under the gain recognition agreement upon FC's transfer of the stock of DC2 to FS if DC1 enters into a new agreement, agreeing to recognize gain if FS sells DC2 stock, and the provisions of paragraph (c)(3)(vi) of this section are satisfied. A sale by FC of FS stock would be treated as a recognition event under paragraph (c)(3)(vii) because such sale would constitute an indirect disposition by FC of the DC2 stock.

Example 8. (i) PI, an entity treated as a partnership for Federal income tax purposes, owns all of the outstanding stock of DC1, a domestic corporation. DC1 owns all of the outstanding stock of DC2, another domestic corporation. The fair market value of the DC1 stock is 900x and PI has an 900x basis in the DC1 stock. The fair market value of the DC2 stock is 600x and DC1 has a 400x basis in the DC2 stock. Neither DC1 nor DC2 is a U.S. real property holding corporation.

(ii) FC, a company resident in country X, and USP, a U.S. corporation, are the sole partners of PI. Under the rules and principles of sections 701 through 761, FC is entitled to a 60 percent, and USP is entitled to a 40 percent, distributive share of each item of PI income and loss. Country X maintains an income tax treaty with the United States that includes an information exchange provision.

(iii) In a distribution qualifying for nonrecognition under section 355, DC1 distributes all of the stock of DC2 to P1. Paragraph (b)(5)(i) of this section provides that stock owned by a partnership is considered to be owned proportionately by its partners. Under paragraph (b)(5)(ii) of this section, if USP certifies to DC1 that it is a qualified U.S. person (and DC1 does not know or have reason to know that the certification is false), no Federal income tax shall be imposed with respect to the distribution by DC1 of DC2 to P1, to the extent of USP's 40 percent interest in P1.

(iv) Paragraph (c)(3)(i)(D) of this section provides that no foreign distributee may be treated as a qualified foreign distributee with respect to stock of the distributing corporation owned through a partnership, unless the distributing corporation receives a ruling from the Internal Revenue Service to the contrary. Thus, DC1 may not avoid recognition of the remaining 60 percent of the realized gain (relating to the interest of P1 owned by FC) by entering into a gain recognition agreement pursuant to paragraph (c)(3) of this section, unless DC1 obtains a ruling to the contrary.

Example 9. (i) DC1, a domestic corporation, owns all of the stock of DC2, also a domestic corporation. The stock of DC1 is owned equally by three shareholders: A, a domestic corporation, B, a U.S. citizen, and FB, a Country Y company.

(ii) A short time before DC1 adopted a plan to distribute the stock of DC2 to its shareholders, but after the board of directors of DC1 began contemplating the distribution, FB formed Newco, a domestic corporation, and contributed its DC1 stock to Newco in a transaction qualifying for nonrecognition under section 351. A valid business purpose existed for FB's transfer of the DC1 stock to Newco, but this purpose would have been fulfilled irrespective of whether FB transferred the DC1 stock to Newco before the distribution of DC2, or after the distribution of DC2 (in which case FB would have transferred the stock of DC1 and DC2 to Newco).

(iii) Pursuant to paragraph (b)(6) of this section, the District Director may determine that FB formed Newco for a principal purpose of avoiding section 367(e)(1). In such case, for Federal income tax purposes, FB will be treated as having received the stock of DC2 in a section 355 distribution, and then as having transferred the stock to Newco in a section 351 transaction.

(iv) If B was not a shareholder of DC1 so that A and FB were equal (50 percent) shareholders, FB would be treated as a foreign distributee within the meaning of paragraph (c)(3)(i)(B) of this section without the application of paragraph (b)(6) of this section. In such case, DC1 would recognize 50 percent of the gain realized on the distribution of the DC2 stock, unless FB was a qualified foreign distributee within the meaning of para-

graph (c)(3)(i) of this section and the conditions under paragraph (c)(3)(ii) of this section were satisfied.

Example 10. (i) DC1, a domestic corporation, owns all of the stock of DC2, also a domestic corporation. The stock of DC1 is owned by FP, a company resident in Country X. Country X maintains in income tax treaty with the United States that includes an information exchange provision. The DC2 stock has a fair market value of 500x at the time of the distribution, and DC1 has a basis of 100x in the DC2 stock. The stock of DC1 has a value of 500x (excluding DC1's investment in DC2). Neither DC1 nor DC2 is a U.S. real property holding corporation.

(ii) FP forms a holding company resident in Country X, Newco, and transfers 50 percent of its DC1 stock to Newco in an exchange described in section 351. Immediately after those transactions, DC1 distributes all of its DC2 stock to FP in exchange for FP's stock of DC1 in a transaction described in section 355. Thus, after the non pro rata distribution, FP owns all of the stock of DC2, and FP also owns all of the stock of Newco, which, in turn, owns all of the stock of DC1.

(iii) Newco and FP are foreign distributees (under paragraph (c)(3)(i)(B)(1) of this section) because they owned stock of DC1 immediately prior to the distribution. Assuming that all of the requirements of the gain recognition agreement exception under paragraph (c)(3) of this section are satisfied (so that both FP and Newco are qualified foreign distributees under paragraph (c)(3)(i)(C) of this section), DC1 will not be immediately taxable on the 400x gain realized on the distribution of the stock of DC2. Gain will be triggered under the gain recognition agreement under paragraph (c)(3)(vii) of this section if FP sells stock of Newco (because such sale would be an indirect disposition by FP of the stock of DC1), if Newco sells stock of DC1, or if FP sells stock of DC2.

Example 11. (i) Assume the same facts as in *Example 10*, except that Newco is a company resident of Country Z, and Country Z does not maintain an income tax treaty with the United States that includes an information exchange provision.

(ii) DC1 may still enter into a gain recognition agreement under paragraph (c)(3) of this section. Both FP and Newco are foreign distributees, but Newco is not a qualified foreign distributee. Thus, DC1 must recognize 50 percent, or 200x, of the 400x deferred gain on the distribution of DC2 stock. Such (50 percent) portion equals the percentage of the DC1 stock owned by foreign distributees that are not qualified foreign distributees (the 50 percent of the stock owned by Newco). DC1 may defer 50 percent of the gain, with respect to the portion of its stock owned by FP, a qualified foreign distributee, provided that it meets the requirements of paragraph (c)(3) of this section.

Example 12. (i) FC, a company resident in Country X, owns all of the stock of DC1, a domestic corporation (and has owned DC1 for many years). Country X maintains an income tax treaty with the United States that includes an information exchange provision. DC1, in turn, owns all of the stock of DC2, a domestic corporation. DC1 has a basis of 200x in the DC2 stock, and the DC2 stock has a value of 500x. Immediately after the distribution of DC2 described below, DC1 has a value of more than 300x.

(ii) DC1 distributes all of the stock of DC2 to FC (a qualified foreign distributee) in a transaction described under section 355, and satisfies all of the requirements of paragraph (c)(3) of this section to qualify for an exception to the general rule of taxation under section 367(e)(1). Two years after the initial distribution, FC distributes all of the stock of DC2 to its sole shareholder, FP, a resident of Country X, in a transaction described under section 355.

(iii) Under paragraph (c)(3)(vi)(D) of this section, FP is a substitute distributee with respect to the DC2 stock. Provided that the requirements of paragraph (c)(3)(vi)(G) of this section are satisfied, FP replaces FC as a qualified foreign distributee with respect to the DC2 stock (although FC is still a qualified foreign distributee with respect to the DC1 stock). FC is no longer required to maintain an interest in DC2 for purposes of determining whether a substantial transformation occurs. Thus, a sale by FP of the stock of FC would not trigger gain under paragraph (c)(3)(vii) of this section.

Example 13. (i) DC1, a domestic corporation, owns all of the stock of DC2, also a domestic corporation. The stock of DC1 is owned by two shareholders: FP and FX. FP, a company resident in Country Z, owns 25 percent of the stock of DC1. FX, a company resident in Country X, owns 75 percent of the stock of DC1. Country X maintains an income tax treaty with the United States that includes an information exchange provision; Country Z does not. The fair market value of DC2 is 500x and DC1 has a basis of 100x in the DC2 stock. Immediately after the distribution described below, DC1 has a value in excess of 400x.

(ii) FP formed FS, a company resident in Country X, and transferred its 25 percent interest in DC1 to FS in exchange for all of the stock of FS in an exchange described in section 351. Within two years of the exchange, DC1 distributed all of the stock of DC2 to its shareholders.

(iii) Under paragraph (c)(3) of this section, DC1 may defer a portion of its gain realized on the distribution of DC2. DC1 must immediately recognize 25 percent of the realized gain, or 100x, because FP, a 25 percent (indirect) shareholder is a foreign distributee (within the meaning of paragraph (c)(3)(i)(B) of this section), but may not be treated as a qualified foreign distributee (within the meaning of paragraph (c)(3)(i)(C) of this section). DC1 may defer 75 percent of its realized gain if FX is a qualified foreign distributee and DC1 enters into a gain recognition agreement (in which DC2 agrees to be secondarily liable), and the provisions of paragraph (c)(3) of this section are otherwise met. DC1 need not include FS as a qualified foreign distributee because FP and FS had identical 25 percent ownership interests in DC1, and DC1 is taxable with respect to such 25 percent interest. Thus, under paragraph (c)(3)(vii)(G) of this section, a sale by FS of its DC1 or DC2 stock will not result in an additional trigger of the gain recognition agreement under paragraph (c)(3)(vii) of this section.

(iv) If FP was instead a resident of Country X, DC1 could defer its entire realized gain if both FP and FS were qualified foreign distributees. In such case, DC1 would have three qualified foreign distributees. (DC1 is limited to ten qualified foreign distributees, including transferee and substitute distributees during the term of the gain recognition agreement.) If FS sold its entire interest in either DC1 or DC2, DC1 would be required to amend its Federal income tax return for the year of the transfer and include 100x in income. In such case, neither FP nor FS would be considered a qualified foreign distributee immediately after the sale (and, as a result, FP's sale of its FS stock would not trigger additional gain under paragraph (c)(3)(vii)(G) of this section). The result would be the same if FP sold all of the stock of FS (as such sale is an indirect disposition by FP of all its stock of DC1 and DC2). (In such case, the sale by FS of its stock of DC1 or DC2 would not trigger additional gain under paragraph (c)(3)(vii)(G) of this section.)

(f) *Effective date.* This section shall be effective with respect to distributions occurring on or after September 13, 1996. However, taxpayers may elect to apply the rules of this section with respect to distributions occurring on or after December 31, 1995.

Par. 4. Section 1.6038B–1T is amended by revising the second sentence of paragraph (b)(2)(i) and adding the text of paragraph (e) to read as follows:

§ 1.6038B–1T Reporting of transfers described in section 367 (temporary).

* * * * *

(b) * * *

(2) * * * (i) * * * For special reporting rules applicable to transfers described under section 367(e)(1), see paragraph (e) of this section; no reporting is required for transfers described in section 367(e)(2). * * *

* * * * *

(e) * * * (1) *In general.* If a domestic corporation (distributing corporation) makes a distribution described in section 367(e)(1), the distributing corporation must comply with the reporting requirements under this paragraph (e)(1). Form 926 and other requirements described in this section need not be met by the distributing corporation in the case of a distribution described in section 367(e)(1).

(2) *Reporting requirements if transaction is taxable under section 367(e)(1).* If the distribution is taxable to the distributing corporation under section 367(e)(1) and the regulations thereunder, the distributing corporation must attach to its Federal income tax return for the taxable year that includes the date of the transfer a statement titled "Section 367(e)(1) Reporting—Compliance With Section 6038B", signed under penalties of perjury by an officer of the corporation, disclosing the following information:

(i) A description of the transaction in which the U.S. distributing corporation distributed stock or securities of a controlled corporation (whether domestic or foreign) to one or more foreign distributees.

(ii) The basis and fair market value of the stock and securities that were

distributed by the distributing corporation in the transaction.

(3) *Reporting requirements if transaction qualifies for an exception to section 367(e)(1).* If the distributing corporation qualifies for an exception under § 1.367(e)– 1T(c)(1), the requirements of section 6038B are satisfied if the distributing corporation complies with the reporting requirements contained in § 1.367(e)–1T(c)(1)(ii). If the distributing corporation qualifies for an exception under § 1.367(e)–1T(c)(2), the requirements of section 6038B are satisfied if the distributing corporation complies with the reporting requirements contained in § 1.367(e)–1T(c)(2)(iii). If the distributing corporation qualifies for an exception under § 1.367(e)–1T(c)(3), the requirements of section 6038B are satisfied if the distributing corporation complies with the reporting requirements contained in § 1.367(e)–1T(c)(3).

* * * * *

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 5. The authority for citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 6. In § 602.101, paragraph (c) is amended by removing the entry for "1.367(e)–1" and adding an entry in numerical order to read as follows:

§ 602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified and described	*Current OMB control No.*
* * * * *	
1.367(e)–1T	1545–1487
* * * * *	

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved August 7, 1996.

Donald C. Lubick,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on August 9, 1996, 12:19 p.m., and published in the issue of the Federal Register for August 14, 1996, 61 F.R. 42165).

Part V.—Carryovers

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

The adjusted federal long-term rate is set forth for the month of July 1996. See Rev. Rul. 96–34, page 75.

The adjusted federal long-term rate is set forth for the month of August 1996. See Rev. Rul. 96–37, page 77.

The adjusted federal long-term rate is set forth for the month of September 1996. See Rev. Rul. 96–43, page 78.

The adjusted federal long-term rate is set forth for the month of October 1996. See Rev. Rul. 96–49, page 79.

The adjusted federal long-term rate is set forth for the month of November 1996. See Rev. Rul. 96–52, page 81.

The adjusted federal long-term rate is set forth for the month of December 1996. See Rev. Rul. 96–57, page 82.

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26 CFR 1.382–8T: Controlled groups (temporary).

T.D. 8679

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

Regulations Under Section 382 of the Internal Revenue Code of 1986; Application of Section 382 in Short Taxable Years and With Respect to Controlled Groups

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations relating to limitations on net operating loss carryforwards and certain built-in losses following an ownership change and comply with the statutory direction under section 382(m) of the Internal Revenue Code to prescribe regulations concerning short taxable years and controlled groups. This document also contains amendments relating to the end of separate tracking of the stock ownership of loss corporations that cease to exist following a merger or similar transaction. The text of these temporary regulations also serves as the text of the proposed regulations set forth in CO–26–96, page 440.

DATES: These regulations are effective Thursday, June 27, 1996.

For dates of application and special transition rules, see Effective Dates under SUPPLEMENTARY INFORMATION.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these temporary regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under the control number 1545–1434. Section 1.382–8T(h) requires a response from certain corporations that are members of controlled groups. The IRS requires this information to assure compliance with section 382(m)(5) so that the value of a loss corporation that is a member of a controlled group is not taken into account more than once in computing a section 382 limitation. Responses to this collection of information are required to obtain a benefit (relating to the restoration of value for section 382 purposes).

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

For further information concerning this collection of information, and where to submit comments on the collection of information and the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble to CO–26–96, page 440.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background and Explanation of Provisions

On February 4, 1991, the IRS and Treasury issued three notices of proposed rulemaking, CO–132–87 (56 FR 4194 [1991–1 C.B. 728]), CO–077–90 (56 FR 4183 [1991–1 C.B. 749]), and CO–078–90 (56 FR 4228 [1991–1 C.B. 757]), setting forth rules regarding the application of sections 382 and 383 by consolidated groups and by controlled groups, and the carryover and carryback of losses to consolidated and separate return years.

For reasons explained in the preamble to TD 8678 (page 134), the IRS and Treasury are issuing temporary amendments concerning the limitations on net operating loss carryforwards and certain built-in losses and credits following an ownership change of a consolidated group. The temporary regulations contained in this Treasury decision complement those other temporary regulations. They assure that the members of a controlled group cannot duplicate value in computing their respective section 382 limitations, a result not permitted to members of a group filing consolidated returns. See § 1.1502–93T.

These temporary regulations are substantially identical to the rules proposed on January 29, 1991. One provision (relating to the effects of successive ownership changes) was moved from the consolidated return regulations to the section 382 regulations to clarify that it is applicable to all corporations. These temporary amendments do not address the numerous comments on the proposed regulations. Many of these comments are still under consideration.

Effective Dates

The temporary amendments are generally effective as of January 1, 1997. The final rules relating to the value of stock added to § 1.382–2(a)(3)(i) and the temporary rules in § 1.382–2T(f)(1)(ii) (relating to the end of separate tracking of certain loss corporations) are generally effective as of January 29, 1991. The temporary rules in § 1.382–5T (relating generally to short taxable years and successive ownership changes) generally apply to loss corporations that have an ownership change to which section 382(a), as amended by the Tax Reform Act of 1986, applies.

Special Analysis

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

Adoption of Amendments to the Regulations

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

PART 1—INCOME TAXES

Paragraph 1. The authority citation for Part 1 is amended by removing the entries for "1.382–2" and "1.382–2T" and adding entries in numerical order to read as follows:

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

Section 1.382–2 also issued under 26 U.S.C. 382(k)(1), (l)(3), (m), and 26 U.S.C. 383.

Section 1.382–2T also issued under 26 U.S.C. 382(g)(4)(C), (i), (k)(1) and (6), (l)(3), (m), and 26 U.S.C. 383.* * *

Section 1.382–5T also issued under 26 U.S.C. 382(m).* * *

Section 1.382–8T also issued under 26 U.S.C. 382(m).* * *

Par. 2. Section 1.382–1 is amended by:

a. Adding an entry for § 1.382–2, paragraph (a)(1)(iv).

b. Revising the entry for § 1.382–2, paragraph (a)(3)(i).

c. Adding entries for § 1.382–2T, paragraphs (f)(1)(i) through (f)(1)(iii).

d. Adding entries for §§ 1.382–5T and 1.382–8T.

§ 1.382–1 Table of contents.

* * * * *

§ 1.382–2 General rules for ownership change.

(a) * * *

(1) * * *

(iv) End of separate accounting for losses and credits of distributor or transferor loss corporation.

* * * * *

§ 1.382–2T Definition of ownership change under section 382, as amended by the Tax Reform Act of 1986 (temporary).

* * * * *

(f) * * *

(1) * * *

(i) In general.

(ii) End of separate accounting for losses and credits of distributor or transferor loss corporation.

(iii) Application to other successor corporations.

* * * * *

§ 1.382–5T Section 382 limitation (temporary).

(a) Scope.

(b) Computation of value.

(c) Short taxable year.

(d) Successive ownership changes and absorption of a section 382 limitation.

(1) In general.

(2) Recognized built-in gains and losses.

(3) Effective date.

(e) Controlled groups.

(f) Effective date.

* * * * *

§ 1.382–8T Controlled groups (temporary).

(a) Introduction.

(b) Controlled group loss and controlled group with respect to a controlled group loss.

(c) Computation of value.

(1) Reduction in value.

(2) Restoration of value.

(3) Reduction in value by the amount restored.

(4) Appropriate adjustments.

(5) Certain reductions in the value of members of a controlled group.

(d) No double reduction.

(e) Definitions and nomenclature.

(1) Definitions in Section 382 and the regulations thereunder.

(2) Controlled group.

(3) Component member.

(4) Predecessor and successor corporation.

(f) Coordination between consolidated groups and controlled groups.

(g) Examples.

(h) Time and manner of filing election to restore.

(1) Statement required.

(2) Revocation of election.

(3) Filing by component member.

(i) [Reserved]

(j) Effective date.

(1) In general.

(2) Transition rule.

(i) In general.

(ii) Special transition rules for controlled groups that had ownership changes before January 29, 1991.

(3) Amended returns.

Par. 3. Section 1.382–2 is amended as follows:

a The first sentence of paragraph (a)(1)(iii) is amended by removing the

language "Pre-change losses" and adding "Except as provided in § 1.382–2T(f)(1)(ii), pre-change losses" in its place.

b Paragraph (a)(1)(iv) is added.

c The text of § 1.382–2T(f)(18)(i) is redesignated as the text of § 1.382–2(a)(3)(i).

d Newly designated paragraph (a)(3)(i) is amended by adding three sentences at the end.

The additions read as follows:

§ 1.382–2 General rules for ownership change.

(a) * * *

(1) * * *

(iv) *End of separate accounting for losses and credits of distributor or transferor loss corporation.* For further guidance, see § 1.382–2T(f)(1)(ii).

* * * * *

(3) * * * (i) * * * Solely for purposes of determining the percentage of stock owned by a person, each share of all the outstanding shares of stock that have the same material terms is treated as having the same value. Thus, for example, a control premium or blockage discount is disregarded in determining the percentage of stock owned by any person. The previous two sentences of this paragraph (a)(3)(i) apply to any testing date occurring on or after January 29, 1991.

* * * * *

Par. 4. Section 1.382–2T is amended as follows:

(a) Paragraph (e)(2)(iv) *Example (1)* is amended by removing the last sentence.

(b) Paragraph (e)(2)(iv) *Example (2)(ii)* is amended by adding a sentence at the end.

(c) Paragraph (e)(2)(iv) *Example (2)(iii)* is amended by removing the language ", but must be separately accounted for under § 1.382–2(a)(1)(iii) of this section" from the last sentence.

(d) The text following the heading of paragraph (f)(1) is designated as paragraph (f)(1)(i) and a heading for newly designated paragraph (f)(1)(i) is added.

(e) Paragraphs (f)(1)(ii) and (f)(1)(iii) are added.

(f) Paragraph (f)(4) is amended by removing the word "loss" and by adding two sentences at the end.

(g) Paragraph (f)(5) is amended by adding two sentences at the end.

(h) A sentence is added after the heading of paragraph (f)(18)(i).

(i) Paragraph (h)(2)(i)(A) is amended by adding the language "and solely for the purposes of determining whether a loss corporation has an ownership change" immediately after "except as otherwise provided in this section,".

The additions read as follows:

§ 1.382–2T Definitions of ownership change under section 382, as amended by the Tax Reform Act of 1986 (temporary).

* * * * *

(e) * * *

(2) * * *

(iv) * * *

Example (2) * * *

(ii) * * * See paragraph (f)(1)(ii) of this section for rules that end separate accounting for L_1's pre-change losses on any testing date occurring on or after January 29, 1991.

(f) * * *

(1) * * *

(i) *In general.* * * *

(ii) *End of separate accounting for losses and credits of distributor or transferor loss corporation.* The separate tracking of owner shifts of the stock of an acquiring corporation required by § 1.382–2(a)(1)(iii) with respect to the net operating loss carryovers and other attributes described in § 1.382–2(a)(1)(ii) ends when a fold-in event occurs. A fold-in event is either an ownership change of the distributor or transferor corporation in connection with, or after, the transaction to which section 381(a) applies, or a period of 5 consecutive years following the section 381(a) transaction during which the distributor or transferor corporation has not had an ownership change. Starting on the day after the earlier of the change date (but not earlier than the day of the section 381(a) transaction) or the last day of the 5 consecutive year period, the losses and other attributes of the distributor or transferor corporation are treated as losses and attributes of the acquiring corporation for purposes of determining whether an ownership change occurs with respect to such losses. Also, for purposes of determining the beginning of the acquiring corporation's testing period, such losses are considered to arise either in a taxable year that begins not earlier than the later of the day following the change date or the day of the section 381(a) transaction, or in a taxable year that begins 3 years before the end of the 5 consecutive year period. Pre-change losses of a distributor or transferor corporation that are subject to a limitation under section 382 continue to be subject to the limitation notwithstanding the occurrence of a fold-in event. Any ownership change that occurs in connection with, or subsequent to, the section 381 transaction may result in an additional, lesser limitation with respect to such pre-change losses. This paragraph (f)(1)(ii) applies to any testing date occurring on or after January 29, 1991.

(iii) *Application to other successor corporations.* Section 1.382–2(a)(1) (relating to the definition of loss corporation) and this paragraph (f)(1) also apply, as the context may require, to successor corporations other than successors in section 381(a) transactions. For example, if a corporation receives assets from the loss corporation that have basis in excess of value, the recipient corporation's basis for the assets is determined, directly or indirectly, in whole or in part, by reference to the loss corporation's basis, and the amount by which basis exceeds value is material, the recipient corporation is a successor corporation subject to § 1.382–2(a)(1) and this paragraph (f)(1). This paragraph (f)(1)(iii) applies to any testing date occurring on or after January 1, 1997.

* * * * *

(4) *Successor corporation.* * * * A successor corporation also includes, as the context may require, a corporation which receives an asset or assets from another corporation if the corporation's basis for the asset(s) is determined, directly or indirectly, in whole or in part, by reference to the other corporation's basis and the amount by which basis differs from value is, in the aggregate, material. The previous sentence of this paragraph (f)(4) applies to any testing date occurring on or after January 1, 1997.

(5) *Predecessor corporation.* * * * A predecessor corporation also includes, as the context may require, a corporation which transfers an asset or assets to another corporation if the transferee's basis for the asset(s) is determined, directly or indirectly, in whole or in part, by reference to the corporation's basis and the amount by which basis differs from value is, in the aggregate, material. The previous sentence of this paragraph (f)(5) applies to any testing date occurring on or after January 1, 1997.

* * * * *

(18) * * * (i) * * * For further guidance, see § 1.382–2(a)(3)(i).

* * * * *

Par. 5. Sections 1.382–5T and 1.382–8T are added to read as follows:

§ 1.382–5T Section 382 limitation (temporary).

(a) *Scope.* Following an ownership change, the section 382 limitation for any post-change year is an amount equal to the value of the loss corporation multiplied by the long-term tax- exempt rate that applies with respect to the ownership change, and adjusted as required by section 382 and the regulations thereunder. See, for example, section 382(b)(2) (relating to the carryforward of unused section 382 limitation), section 382(b)(3)(B) (relating to the section 382 limitation for the post-change year that includes the change date), section 382(m)(2) (relating to short taxable years), and section 382(h) (relating to recognized built-in gains and section 338 gains).

(b) *Computation of value.* [Reserved]

(c) *Short taxable year.* The section 382 limitation for any post-change year that is less than 365 days is the amount that bears the same ratio to the section 382 limitation determined under section 382(b)(1) as the number of days in the post-change year bears to 365. The section 382 limitation, as so determined, is adjusted as required by section 382 and the regulations thereunder. This paragraph (c) does not apply to a 52–53 week taxable year that is less than 365 days unless a return is required under section 443 (relating to short periods) for such year.

(d) *Successive ownership changes and absorption of a section 382 limitation*—(1) *In general.* If a loss corporation has two (or more) ownership changes, any losses attributable to the period preceding the earlier ownership change are treated as pre-change losses with respect to both ownership changes. Thus, the later ownership change may result in a lesser (but never in a greater) section 382 limitation with respect to such losses. In any case, the amount of taxable income for any post-change year that can be offset by pre-change losses may not exceed the section 382 limitation for such ownership change, reduced by the amount of taxable income offset by pre-change losses subject to any earlier ownership change(s).

(2) *Recognized built-in gains and losses.* [Reserved]

(3) *Effective date.* This paragraph (d) applies to taxable years of a loss corporation beginning on or after January 1, 1997.

(e) *Controlled groups.* See § 1.382–8T for rules for determining the value of a loss corporation that is a member of a controlled group.

(f) *Effective date.* Except as otherwise provided, this section applies to a loss corporation that has an ownership change to which section 382(a), as amended by the Tax Reform Act of 1986, applies.

§ 1.382–8T Controlled groups (temporary).

(a) *Introduction.* This section provides rules to adjust the value of a loss corporation that is a member of a controlled group of corporations on a change date so that the same value is not included more than once in computing the limitations under section 382 for the loss corporations that are members of the controlled group. In general, the adjustment is made under paragraph (c) of this section by reducing the value of the loss corporation by the value of the stock of each component member of the controlled group that the loss corporation owns immediately after the ownership change. The loss corporation's value may, however, be increased under paragraph (c) of this section by any amount of value that the other member elects to restore to the loss corporation.

(b) *Controlled group loss and controlled group with respect to a controlled group loss.* A controlled group loss is a pre-change loss (or a net unrealized built-in loss) of a loss corporation that is attributable to a taxable year of the corporation with respect to which the corporation is a component member of a controlled group (as defined by paragraphs (e)(2) and (3) of this section). The controlled group with respect to each controlled group loss is composed of the loss corporation and each other corporation that is a component member of a controlled group that includes the loss corporation both—

(1) With respect to the taxable year to which the controlled group loss is attributable; and

(2) On the date the loss corporation has an ownership change.

(c) *Computation of value.* For purposes of computing the limitation under section 382 with respect to each controlled group loss, the value of the stock of each component member of the controlled group with respect to that loss is determined immediately before the ownership change, and is adjusted by applying the following rules:

(1) *Reduction in value.* The value of the stock of each component member is reduced by the value (immediately before the ownership change and without regard to any restoration of value or other adjustment under this section) of the stock of any other component member directly owned by the component member immediately after the ownership change.

(2) *Restoration of value.* After the value of the stock of each component member is reduced pursuant to paragraph (c)(1) of this section, the value of the stock of each component member is increased by the amount of value, if any, restored to the component member by another component member (the electing member) pursuant to this paragraph (c)(2). The electing member may elect to restore value to another component member in an amount that does not exceed the lesser of—

(i) The sum of—

(A) The value, determined immediately before the ownership change, of the electing member's stock (after adjustment under paragraph (c)(1) of this section and before any restoration of value under this paragraph (c)(2)); plus

(B) Any amount of value restored to the electing member by another component member under this paragraph (c)(2); or

(ii) The value, determined immediately before the ownership change, of the electing member's stock (without regard to any adjustment under this section) that is directly owned by the other component member immediately after the ownership change.

(3) *Reduction in value by the amount restored.* The value of the stock of the electing member is reduced by any amount of value that the electing member elects to restore under paragraph (c)(2) of this section to another component member.

(4) *Appropriate adjustments.* Appropriate additional adjustments consistent with paragraphs (c)(1), (2), and (3) of this section must be made to prevent any duplication of value. Thus, for example, adjustments must be made to reflect—

(i) Any indirect ownership interest in another component member;

(ii) Any cross ownership of stock by component members of the controlled group with respect to the controlled group loss; and

(iii) Any value used to determine a limitation under section 382 with respect to controlled group losses from the same period.

(5) *Certain reductions in the value of members of a controlled group.* A loss corporation that has an ownership change is required to make adjustments consistent with this paragraph (c) with respect to its stock if the stock of another corporation in which it had a direct or indirect ownership interest was disposed of before the ownership change, and;

(i) Both corporations were component members of a controlled group—

(A) With respect to a taxable year to which a controlled group loss of the loss corporation is attributable; and

(B) At any time during the 2 year period before the ownership change; and

(ii) Both corporations are component members of a controlled group at any time during the 2 year period following the ownership change.

(d) *No double reduction.* To the extent consistent with the purposes of this section, section 382 and this section shall not be applied to duplicate a reduction in the value of a loss corporation. Thus, for example, if the value of a loss corporation is reduced under section 382(l)(1) to reflect a capital contribution of stock of a component member, it is not again reduced by such amount under paragraph (c)(1) of this section. If this paragraph (d) applies to prevent a reduction in value from being duplicated, the application of the other rules of this section, such as those relating to the restoration of value, is correspondingly limited in a manner consistent with the principles of this section.

(e) *Definitions and nomenclature—*(1) *Definitions in section 382 and the regulations thereunder.* Except as otherwise provided, the definitions and nomenclature contained in section 382 and the regulations thereunder apply to this section.

(2) *Controlled group.* Controlled group has the same meaning as in section 1563(a), determined by substituting "50 percent" for "80 percent" each place that it appears, and without regard to section 1563(a)(4).

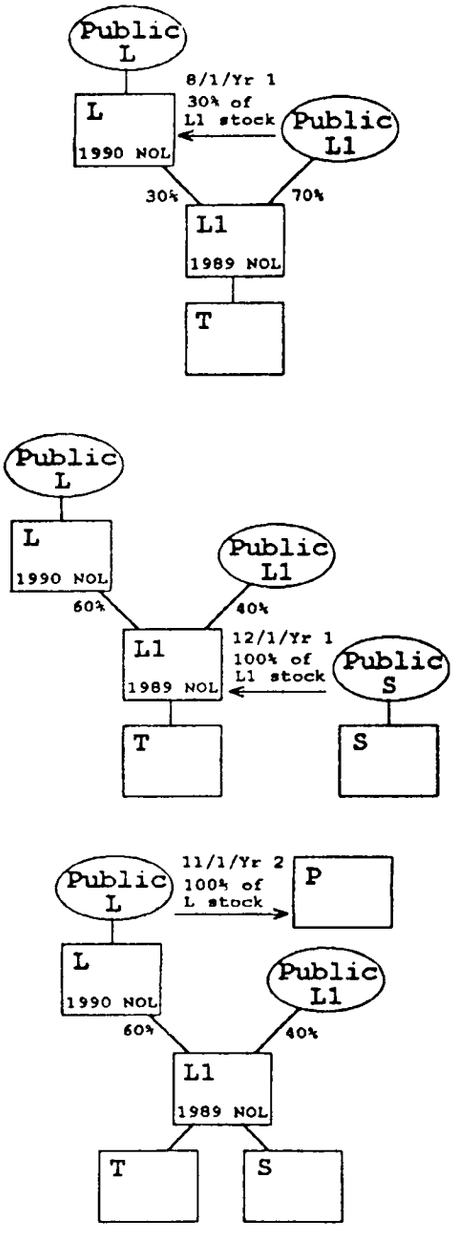
(3) *Component member.* Component member has the same meaning as in section 1563(b), determined by substituting "December 31 (or the change date, if earlier)" for "December 31" each place it appears, and without regard to section 1563(b)(2), (b)(3)(C), and (b)(4).

(4) *Predecessor and successor corporation.* As the context may require, a reference to a corporation, or component member includes a reference to a predecessor or successor corporation.

(f) *Coordination between consolidated groups and controlled groups.* Some or all of the component members of a controlled group may also be members of a consolidated group, and a controlled group loss may be subject to a consolidated section 382 limitation or subgroup section 382 limitation determined under § 1.1502–93T. Except as otherwise provided in this paragraph (f) and §§ 1.1502–91T through 1.1502–99T, § 1.1502–93T applies instead of this section when both sections, by their terms, are otherwise applicable. This section is applicable and may require an adjustment to value if a member of a consolidated group, a loss group, or a loss subgroup (as those terms are defined in §§ 1.1502–1(h) and 1.1502–91T) is also a component member of a controlled group with respect to a controlled group loss. Solely for purposes of applying this section, a consolidated group, loss group, or loss subgroup is treated as a single corporation. Thus to determine the limitation with respect to any portion of the pre-change consolidated attributes or pre-change subgroup attributes of the loss group or loss subgroup that is a controlled group loss, the consolidated section 382 limitation or subgroup section 382 limitation is computed by treating the loss group or the loss subgroup as a single corporation, and adjusting value in accordance with paragraph (c) of this section. See paragraph (g) Example 4 of this section.

(g) *Examples.* For purposes of the examples in this section, unless otherwise stated, the nomenclature and assumptions of the examples in § 1.382–2T(b) apply, all corporations file separate income tax returns on a calendar year basis, the only 5-percent shareholder of a corporation is a public group, and the facts set forth the only owner shifts with respect to the corporations during the testing period.

Example 1. Controlled group with respect to a controlled group loss. (a) Public L owns all of the L stock, L and Public L1 own 30 percent and 70 percent, respectively, of the L1 stock, and L1 owns all of the corporation T stock. L1 has a net operating loss arising in Year 1 that is carried over to Year 4. L has a net operating loss arising in Year 2 that is carried over to Year 4. On August 1, Year 3, L acquires 30 percent of the stock of L1, thereby increasing its percentage ownership interest in L1 to 60 percent. On December 1, Year 3, L1 purchases all of the stock of corporation S from Public S. On November 1, Year 4, P acquires all of the L stock. The acquisition by P of all of the L stock on November 1, Year 4, causes ownership changes of both L and L1 under the rules of § 1.382–2T. The following is a graphic illustration of these facts.



(b)(1) Under paragraph (b) of this section, the Year 1 net operating loss carryover of L1 is a controlled group loss because L1 is a component member of a controlled group with respect to Year 1, the year to which the loss is attributable. L1 and T compose a controlled group with respect to the net operating loss carryover because L1 and T are component members of a controlled group both—

(A) With respect to the taxable year to which L1's net operating loss carryover is attributable (i.e., Year 1); and

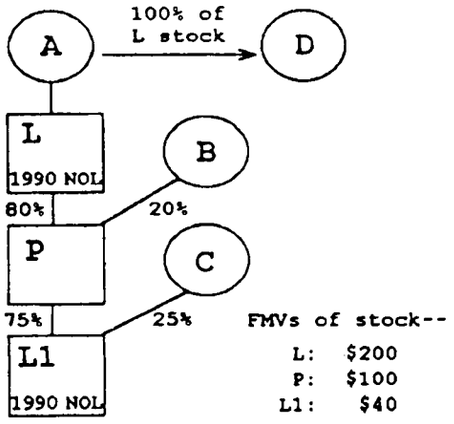
(B) On November 1, Year 4, L1's change date. Although L and S are component members of L1's controlled group on L1's change date, they are not component members of the controlled group with

respect to the Year 1 net operating loss carryover because they were not component members with respect to the year to which the net operating loss carryover is attributable.

(2) The value of L1's stock must therefore be adjusted in accordance with paragraph (c) of this section to take into account an adjustment with respect to the T stock (but not the S stock) in computing L1's limitation under section 382 with respect to its net operating loss carryover.

(c) Although L is a member of a controlled group composed of L, L1, S, and T on November 1, Year 4, L's change date, it is not a component member of a controlled group with respect to Year 2, the taxable year to which its net operating loss carryover is attributable. Therefore, L's Year 2 net operating loss carryover is not a controlled group loss under paragraph (b) of this section and the value of L's stock is not adjusted in accordance with paragraph (c) of this section to compute L's limitation under section 382 with respect to the Year 2 net operating loss carryover.

Example 2. Adjustments to value of the controlled group members. (a) Since Year 1, A has owned all of the stock of L, L and B have owned 80 percent and 20 percent, respectively, of the stock of corporation P, and P and C have owned 75 percent and 25 percent, respectively, of the stock of L1. L and L1 each has a net operating loss for the Year 6 taxable year that is carried over to its respective Year 7 taxable year. On December 1, Year 7, A sells all of the L stock to D. The sale results in ownership changes of both L and L1. Immediately before the ownership changes, the total value of the L1 stock is $40, the total value of the P stock (including the value of its L1 stock) is $100, and the total value of the L stock (including the value of the P stock) is $200. The following is a graphic illustration of these facts.



(b) Under paragraph (b) of this section, the Year 6 net operating loss carryovers of each of L and L1 are controlled group losses because each of L and L1 is a component member of a controlled group with respect to Year 6, the year to which the losses are attributable. L, P, and L1 compose controlled groups with respect to both Year 6 net operating loss carryovers because L, P, and L1 are component members of a controlled group both—

(1) With respect to the taxable years to which the net operating loss carryovers are attributable (i.e., Year 6); and

(2) On December 1, Year 7, the change date.

(c) The value of the stock of L1 for purposes of determining its limitation under section 382 with respect to its net operating loss carryover from Year 6 is $40. L1 does not elect to restore any value to P under paragraph (c)(2) of this section.

(d) The value of the stock of P ($100) is reduced under paragraph (c)(1) of this section by the value of the stock of L1 that it directly owns, $30 (75% x $40). Following the adjustment, the value of the stock of P is $70. P elects to restore this entire $70 of value to L.

(e) The value of the stock of L, $200, is reduced under paragraph (c)(1) of this section by the value of the stock of P it directly owns, i.e., $80 (80% x $100), and increased under paragraph (c)(2) of this section by the amount P elects to restore to L, i.e., $70. Thus, the value of the L stock for purposes of determining L's limitation under section 382 with respect to its net operating loss carryover from Year 6 is $190 ($200 − $80 + $70).

Example 3. Limitation on restoration of value. (a) The facts are the same as in *Example 2*, except that L1 elects to restore $20 to P. For purposes of determining L1's limitation under section 382 with respect to the Year 6 net operating loss carryover, the value of the stock of L1 is $20 ($40 − $20) because the value of its stock is reduced under paragraph (c)(3) of this section by the $20 of value it elects to restore to P.

(b) The value of the stock of P ($100) is reduced under paragraph (c)(1) of this section by the value of the L1 stock it directly owns ($30), and is increased under paragraph (c)(2) of this section by the value that L1 elects to restore to P ($20). Thus, the value of the P stock is $90 ($100 − $30 + $20).

(c)(1) P elects to restore to L the maximum value permitted under this section. The value of the stock of L, $200, is reduced under paragraph (c)(1) of this section by the value of the P stock it directly owns ($80), and is increased by the value that P elects to restore to L. P may elect to restore to L the lesser of—

(A) The sum of the value of its stock immediately after adjustment under paragraph (c)(1) of this section (i.e., $70) plus the value restored to it by L1 (i.e., $20) (a total of $90); or

(B) The value of the P stock (without regard to the adjustment required by paragraphs (c)(1) and (2) of this section) that is directly owned by L immediately before the ownership change (i.e., $80).

(2) Thus, $80 is the maximum amount that P may elect to restore to L. Following the restoration of value by P, the value of the L stock for purposes of determining L's limitation under section 382 is $200 ($200 − $80 + $80).

Example 4. Coordination with consolidated return regulations. (a) P and its wholly owned subsidiary L file a consolidated return. L owns 79 percent of the outstanding stock of L1. P acquired the stock of L in Year 1 and L acquired the stock of L1 in Year 2. The P consolidated group has a consolidated net operating loss arising in the Year 6 consolidated return year that is carried over to Year 8. L1 has a net operating loss arising in its Year 6 taxable year that is also carried over to Year 8. On January 1, Year 8, the P consolidated group has an ownership change under § 1.1502–92T(b)(1)(i) and L1 has an ownership change under § 1.382–2T.

(b)(1) Under paragraph (b) of this section, the Year 6 net operating loss carryover of the P group is a controlled group loss because P, L, and L1 are component members of a controlled group with respect to Year 6, the year to which the loss is attributable. P, L, and L1 compose a controlled group with respect to the Year 6 net operating loss carryover of the P loss group because they are component members of a controlled group both—

(A) With respect to the taxable years to which the net operating loss carryover is attributable (i.e., Year 6); and

(B) On January 1, Year 8, the P group's change date. (2) Because P and L compose a loss group (within the meaning of § 1.1502–91T(c)) with respect to its Year 6 net operating loss carryover, the P loss group must compute a consolidated section 382 limitation with respect to its Year 6 net operating loss carryover as a result of the ownership change.

(c) In computing the consolidated section 382 limitation under § 1.1502–93T with respect to the Year 6 net operating loss carryover, the value of the P stock immediately before the ownership change is reduced under paragraphs (c)(1) and (f) of this section by the value immediately before the ownership change of the L1 stock directly owned by L immediately after the ownership change. L1 may, however, elect to restore such value to the P consolidated group to the extent permitted under paragraph (c)(2) of this section.

Example 5. Appropriate adjustments for indirect ownership interest. (a) Individual A owns all of the stock of L, L owns an 80 percent interest in the capital and profits of partnership PS, and PS owns 75 percent of the stock of L1. Both L and L1 have net operating losses for the Year 1 taxable year that are carried over to their respective Year 2 taxable years. On December 19, Year 2, A sells all of the L stock to an unrelated individual. The sale results in an ownership change of L and L1.

(b) Under paragraph (b) of this section, the Year 1 net operating loss carryovers of each of L and L1 are controlled group losses because each of L and L1 is a component member of a controlled group with respect to Year 1, the year to which the losses are attributable. L and L1 compose controlled groups with respect to each corporation's net operating loss carryovers because L and L1 are component members of a controlled group both—

(1) With respect to the taxable years to which the net operating loss carryovers are attributable (i.e., Year 1); and

(2) On December 19, Year 2, the change date.

(c) L has an indirect ownership interest in L1 which, under paragraph (c)(4) of this section, must be taken into account in applying this section. As a result, the value of the L stock for purposes of determining its limitation under section 382 with respect to the Year 1 net operating loss carryover must be reduced by the value of L's indirect ownership interest in the L1 stock (60 percent) that it owns through PS immediately before the ownership change, and is increased by the amount (if any) that L1 elects to restore to L under paragraph (c)(2) of this section. The value of L1 is reduced under paragraph (c)(3) of this section to the extent that L1 elects to restore value to L.

(h) *Time and manner of filing election to restore*—(1) *Statement required.* The election to restore value described in paragraph (c)(2) of this section must be in the form set forth below. It must be signed on behalf of both the electing member and the corporation to which such value is restored by persons authorized to sign their respective income tax returns. (The common parent of a consolidated group must make the election on behalf of the group.) It must be filed by the loss corporation with its income tax return for the taxable year in which

the ownership change occurs (or with an amended return for such year filed on or before the due date (including extensions) of the income tax return of any component member with respect to the taxable year in which the ownership change occurs). The statement must provide that: "THIS IS AN ELECTION UNDER § 1.382- 8T OF THE INCOME TAX REGULATIONS TO RESTORE ALL OR PART OF THE VALUE OF [insert name and E.I.N. of the electing member] TO [insert name and E.I.N. of the corporation to which value is restored]. The statement must also—

(i) Identify the change date for the loss corporation in connection with which the election is made;

(ii) State the value of the electing member's stock (without regard to any adjustment under paragraph (c) of this section) immediately before the ownership change;

(iii) State the amount of any reduction required under paragraph (c)(1) of this section with respect to stock of the electing member that is owned directly or indirectly by the corporation to which value is restored;

(iv) State the amount of value that the electing member elects to restore to the corporation; and

(v) State whether the value of either component member's stock was adjusted pursuant to paragraph (c)(4) of this section.

(2) *Revocation of election.* An election made under this section is revocable only with the consent of the Commissioner.

(3) *Filing by component member.* An electing member must attach a copy of the statement described in paragraph (h)(1) of this section to its income tax return (or amended return) for the taxable year which includes the change date in connection with which the election is made.

(i) [Reserved]

(j) *Effective date*—(1) *In general.* This section applies to a loss corporation that has an ownership change with respect to a controlled group loss on or after January 1, 1997.

(2) *Transition rule*—(i) *In general.* The members of a controlled group on January 1, 1997, that have had an ownership change with respect to a controlled group loss before January 1, 1997, must determine the limitations under section 382 for any post-change year with respect to controlled group losses by using a reasonable method to preclude the value of stock of a component member that was owned directly or indirectly by another member immediately after an ownership change from being taken into account more than once in determining the limitations under section 382 with respect to controlled group losses. If such a reasonable method was not used for a post-change year, subject to the exception in paragraph (j)(3) of this section, the members of the controlled group described in the preceding sentence must reduce their limitations under section 382 for post-change years for which the income tax return is filed after January 1, 1997, to recapture, as quickly as possible, any limitation that members took into account in excess of the amount that would be allowable under this section.

(ii) *Special transition rule for controlled groups that had ownership changes before January 29, 1991.* For purposes of this section, in the case of an ownership change occurring before January 29, 1991, the controlled group with respect to a controlled group loss does not include a corporation that is not a component member of the controlled group on January 29, 1991. Thus, in the case of an ownership change occurring before January 29, 1991, paragraph (c) of this section does not require that a loss corporation that is a component member of a controlled group to disregard the value of stock of another corporation directly owned immediately after the ownership change in determining the value of its own stock unless the other corporation is a component member of the controlled group on January 29, 1991.

(3) *Amended returns.* A taxpayer that has had an ownership change before January 1, 1997, may file an amended return for any taxable year to modify the amount of a limitation under section 382 with respect to a controlled group loss only if—

(i) The modification complies with the rules contained in this section for computing a limitation under section 382;

(ii) Any other component member of the controlled group with respect to the controlled group loss who elects to restore value and whose taxable income is affected by the election to restore value also files amended returns that comply with such rules; and

(iii) Corresponding adjustments are made in amended returns for all taxable years ending after December 31, 1986.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 6. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 7. In § 602.101, paragraph (c) is amended by adding an entry in numerical order to the table to read as follows:

§ 602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified or described	Current OMB control No.
* * * * *	
1.382.8T	1545-1434
* * * * *	

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved May 31, 1996.

Leslie Samuels,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on June 26, 1996, 8:45 a.m., and published in the issue of the Federal Register for June 27, 1996, 61 F.R. 33313)

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

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

26 CFR 1.401(a)(4)-1: Nondiscrimination requirements of § 401(a)(4)
(Also, §§ 410, 416; 1.410(b)-6, 1.416-1.)

Nondiscrimination and coverage; rollover. The nondiscrimination, actual deferral percentage, and actual contribution percentage tests of a qualified plan are not affected by a qualified rollover to that plan prior to the individual who makes the rollover meeting the plan's age and service requirements. In addition, the rollover will not trigger the minimum nonintegrated benefit or minimum nonintegrated contribution requirements of section 416(c) of the Code.

Rev. Rul. 96-48

ISSUES

(1) If, under a qualified retirement plan, employees who have not satisfied the minimum age and service requirements for participation for a plan year are permitted to make "rollover contri-

butions" to the plan's trust, to what extent are such employees taken into account for purposes of the minimum coverage requirements of § 410(b) of the Internal Revenue Code and the nondiscrimination requirements of §§ 401(a)(4), 401(k)(3), and 401(m)(2)?

(2) Are the employees described in Issue 1 participants for purposes of the minimum contribution and benefit requirements of § 416(c)?

FACTS

Employer X maintains Plan A, a profit-sharing plan qualified under § 401(a) that includes a qualified cash or deferred arrangement, as defined in § 1.401(k)–1(a)(4)(i) of the Income Tax Regulations, and that provides for matching contributions and nonelective contributions. Plan A does not accept after-tax employee contributions. Employer X consists of Division M and Division N. Employees of Division M are eligible to participate in Plan A, i.e., to make salary deferral contributions and receive allocations of matching and nonelective contributions, when they have completed one year of service with Employer X. Employees of Division M who have satisfied Plan A's minimum one year of service requirement are also permitted to make rollover contributions to Plan A's trust. Effective January 1, 1997, Plan A is amended to permit all employees of Division M, including employees who have not completed one year of service, to make rollover contributions to Plan A's trust at any time following commencement of employment. Plan A defines a rollover contribution as a rollover contribution under § 402(c), 403(a)(4), or 408(d)(3)(A)(ii), or a direct rollover under § 401(a)(31).

LAW AND ANALYSIS (ISSUE 1)

MINIMUM COVERAGE REQUIREMENTS OF § 410(b)

Section 410(b) describes minimum coverage requirements that a plan must satisfy in order to be qualified under § 401(a). Under § 1.410(b)–7(c)(1), a plan that consists of (1) elective contributions under a section 401(k) plan (as defined in § 1.410(b)–9), (2) employee and matching contributions under a section 401(m) plan (as defined in § 1.410(b)–9), and (3) nonelective contributions (which are contributions that are neither elective, employee, nor matching contributions) is treated as three separate plans, each of which must separately satisfy the requirements of § 410(b). Under § 1.410(b)–6(b), if a plan applies minimum age and service eligibility conditions permissible under § 410(a)(1) (including any entry date conditions under § 410(b)(4)(C)) and excludes all employees who do not meet those conditions from benefiting under the plan, then all employees who fail to satisfy those conditions are excludable employees for purposes of determining whether the plan satisfies § 410(b).

With respect to the portion of Plan A that is a section 401(k) plan, § 1.410(b)–3(a)(2)(i) provides that an employee is treated as benefiting under the plan for a plan year if and only if the employee is an eligible employee under the plan for the plan year, as defined in § 1.401(k)–1(g)(4). In general, under § 1.401(k)–1(g)(4), an employee is an eligible employee only if the employee is directly or indirectly eligible to make a cash or deferred election under the plan for all or a portion of the plan year.

Section 1.401(k)–1(a)(3)(i) defines a cash or deferred election as any election by an employee to have the employer either provide an amount to the employee in cash or another taxable benefit that is not currently available, or contribute an amount to a trust, or provide an accrual or other benefit, under a plan deferring the receipt of compensation. An election to make a rollover contribution under Plan A is not a cash or deferred election. Consequently, the employees who are not eligible to make salary deferral contributions for a plan year because they have not met Plan A's minimum one year of service requirement are not eligible employees within the meaning of § 1.401(k)–1(g)(4) and are not treated as benefiting under the portion of Plan A that is a section 401(k) plan even though they are eligible to make rollover contributions under Plan A.

With respect to the portion of Plan A that is a section 401(m) plan, § 1.410(b)–3(a)(2)(i) provides that an employee is treated as benefiting under the plan for a plan year if and only if the employee is an eligible employee under the plan for the plan year, as defined in § 1.401(m)–1(f)(4). In general, under § 1.401(m)–1(f)(4), an employee is an eligible employee only if the employee is directly or indirectly eligible to make an employee contribution or to receive an allocation of matching contributions under the plan for the plan year.

Section 1.401(m)–1(f)(6) defines employee contribution to mean any mandatory or voluntary contribution to the plan that is treated at the time of contribution as an after-tax employee contribution. The rollover contributions that are permitted under Plan A are not after-tax contributions and therefore are not employee contributions for purposes of § 401(m). Consequently, the employees who are not eligible to receive allocations of matching contributions for a plan year because they have not met Plan A's minimum one year of service requirement are not eligible employees within the meaning of § 1.401(m)–1(f)(4) and are not treated as benefiting under the portion of Plan A that is a section 401(m) plan even though they are eligible to make rollover contributions under Plan A.

With respect to the portion of Plan A that is treated as a separate plan consisting of nonelective contributions, § 1.410(b)–3(a)(1) provides that an employee is treated as benefiting under the plan for a plan year if and only if the employee receives an allocation for the plan year that is taken into account under § 1.401(a)(4)–2(c)(2)(ii) in determining whether the plan satisfies the nondiscriminatory amount requirement of § 1.401(a)(4)–1(b)(2). As provided in § 1.401(a)(4)–11(b)(1), rollover contributions are not taken into account in determining whether a plan satisfies the nondiscriminatory amount requirement of § 1.401(a)(4)–1(b)(2). Consequently, the employees who do not receive allocations of nonelective contributions for a plan year because they have not satisfied Plan A's minimum one year of service requirement are not treated as benefiting under the portion of Plan A that is treated as a separate plan consisting of nonelective contributions even though they make (or are eligible to make) rollover contributions under Plan A.

Thus, the employees who have not met Plan A's minimum one year of service requirement for participation for a plan year are not treated as benefiting under any of the three portions of Plan A that must separately satisfy the requirements of § 410(b) even though such employees make (or are eligible to make) rollover contributions under Plan A. Therefore, under § 1.410(b)–6(b), these employees are excludable employees for purposes of applying the requirements of § 410(b) to Plan A.

NONDISCRIMINATION REQUIREMENTS OF §§ 401(a)(4), 401(k)(3), AND 401(m)(2)

In order to be qualified under § 401(a), a plan must satisfy the nondiscrimination requirements of § 401(a)(4). Among these requirements are the nondiscriminatory amount of contributions or benefits requirement of § 1.401(a)(4)–1(b)(2) and the nondiscriminatory availability of benefits, rights, and features requirement of § 1.401(a)(4)–1(b)(3).

As provided in § 1.401(a)(4)–1(b)(2)(ii)(B), the nondiscriminatory amount requirement that applies to a section 401(k) plan is the actual deferral percentage (ADP) test in § 401(k)(3). The nondiscriminatory amount requirement that applies to a section 401(m) plan is the actual contribution percentage (ACP) test in § 401(m)(2). Under § 1.401(k)–1(b)(2), only eligible employees are taken into account in the ADP test. Likewise, under § 1.401(m)–1(b)(1), only eligible employees are taken into account in the ACP test. As noted above, the employees who are eligible to make rollover contributions, but not to make salary deferral contributions or to receive matching contributions, under Plan A are not eligible employees with respect to the portion of Plan A that is a section 401(k) plan or the portion of Plan A that is a section 401(m) plan. Thus, these employees are not included in either the ADP test or the ACP test.

In general, only employees within the meaning of § 1.401(a)(4)–12 ("benefiting employees") are tested in applying the nondiscrimination requirements of § 401(a)(4) to a plan. Under § 1.401(a)(4)–12, an employee is a benefiting employee for a given plan year for purposes of the nondiscrimination requirements of § 401(a)(4) if and only if the employee benefits under the plan for the plan year within the meaning of § 1.410(b)–3. As noted above, employees do not benefit under a plan within the meaning of § 1.410(b)–3 merely because they make (or are eligible to make) rollover contributions under the plan, since such contributions are not taken into account in determining whether a plan satisfies the nondiscriminatory amount requirement of § 1.401(a)(4)–1(b)(2). Thus, employees who make (or are eligible to make) rollover contributions under Plan A, but who do not receive allocations of nonelective contributions for a plan year, are not tested in applying the nondiscriminatory amount of contributions or benefits requirement to the portion of Plan A that is treated as a separate plan consisting of nonelective contributions.

The right to make a rollover contribution is an "other right or feature" under § 1.401(a)(4)–4(e)(3)(iii)(I) that must satisfy the nondiscriminatory availability of benefits, rights, and features requirement of § 1.401(a)(4)–1(b)(3). Under § 1.401(a)(4)–4, the tests of whether a benefit, right, or feature is made available in a nondiscriminatory manner are generally applied to benefiting employees. However, § 1.401(a)(4)–4(d)(2) also requires a plan to satisfy a separate test with respect to benefits, rights, and features provided to nonexcludable employees with accrued benefits who are not currently benefiting under the plan (frozen participants). As noted above, employees are not benefiting employees merely because they make (or are eligible to make) rollover contributions under a plan. In addition, the employees who make (or are eligible to make) rollover contributions under Plan A, but who have not met Plan A's minimum one year of service requirement for participation for a plan year, are not frozen participants. Thus, with respect to employees who are not benefiting employees under Plan A for a plan year and who are not frozen participants, the regulations under § 401(a)(4) do not provide guidance for determining whether a benefit, right, or feature available to such employees, such as the right to make rollover contributions, satisfies the nondiscriminatory availability of benefits, rights, and features requirement of § 1.401(a)(4)–1(b)(3).

Section 1.401(a)(4)–1(d) provides that the Commissioner may, in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin, provide any additional guidance that may be necessary or appropriate in applying the nondiscrimination requirements of § 401(a)(4), including additional safe harbors and alternative methods and procedures for satisfying those requirements. Pursuant to this authority, the following rule is provided.

A plan must separately satisfy the nondiscriminatory availability requirement of § 1.401(a)(4)–1(b)(3) with respect to each benefit, right, or feature that is made available under the plan to employees who do not benefit under the plan for a plan year within the meaning of § 1.410(b)–3 and who are not frozen participants within the meaning of § 1.401(a)(4)–4(d)(2). (Such employees are hereinafter referred to as "limited participants".) A plan will separately satisfy this requirement if the benefit, right, or feature is made available to limited participants in a manner that, under all of the relevant facts and circumstances, does not discriminate significantly in favor of nonexcludable employees who are highly compensated employees within the meaning of § 414(q). For purposes of satisfying this requirement, whether an employee is treated as an excludable employee is determined under § 1.410(b)–6 based on any minimum age and service requirements that are applied under the plan as a condition on the availability of the benefit, right, or feature.

If either of the following two safe harbors is satisfied, a benefit, right, or feature will be treated as made available in a manner that does not discriminate significantly in favor of nonexcludable employees who are highly compensated employees. The first safe harbor will automatically be satisfied if the plan, within the meaning of § 1.401(a)(4)–12, meets the following requirements. The limited participants to whom the benefit, right, or feature is currently available, within the meaning of § 1.401(a)(4)–4(b), are all those, and only those, employees who are excluded from participation solely on account of failure to satisfy the plan's minimum age and service requirements, and the benefit, right, or feature also satisfies the effective availability requirement of § 1.401(a)(4)–4(c). Thus, a plan would automatically satisfy this safe harbor if it allowed rollovers by all employees who will participate once they satisfy the plan's minimum age and service rules (and not by any other employees who are excluded from participation in the plan). A plan will not fail to satisfy this design-based safe harbor merely because it limits the availability of the benefit, right, or feature to those employees who have satisfied any lesser uniform minimum age and service requirements. The second safe harbor will be satisfied if the benefit, right, or feature is one that will satisfy § 1.401(a)(4)–4(b) and (c) either (1) when the benefit, right, or feature is treated as available only to employees who are limited participants (i.e., as if it were not available to other employees to whom the benefit, right, or feature is, in fact, available) or (2) when the benefit, right, or feature is treated as available to both limited participants and all other

employees to whom the benefit, right, or feature is, in fact, available under the plan.

Applying this rule to Plan A, the right of employees who have not satisfied Plan A's minimum one year of service requirement for participation for a plan year to make rollover contributions must separately satisfy the nondiscriminatory availability requirement of § 1.401(a)(4)–1(b)(3). The limited participants to whom the right to make rollover contributions under Plan A is currently available, within the meaning of § 1.401(a)(4)–4(b), are all those, and only those, employees who are excluded from participation solely on account of failure to satisfy the plan's minimum one year of service requirement, and, absent other relevant facts and circumstances, the right of such limited participants to make rollover contributions also satisfies the effective availability requirement of § 1.401(a)(4)–4(c). (The right to make rollover contributions does not fail to be currently and effectively available to an employee merely because the employee does not have an amount that is eligible to be rolled over.) Plan A thus satisfies the requirements of the design-based safe harbor described above. Plan A is therefore treated as separately satisfying the nondiscriminatory availability requirement of § 1.401(a)(4)–1(b)(3) with respect to the right of employees who have not satisfied Plan A's minimum one year of service requirement for participation for a plan year to make rollover contributions.

HOLDINGS (ISSUE 1)

1. Plan A is not precluded from treating as excludable, for purposes of § 410(b), all employees who have not completed one year of service (as required by the plan for participation) merely because Plan A permits rollover contributions to be made by such employees.

2. Employees who are eligible to make rollover contributions, but who have not satisfied Plan A's minimum one year of service requirement for participation for a plan year, are not taken into account in applying the ADP test in § 401(k)(3) to the portion of Plan A that is a section 401(k) plan, the ACP test in § 401(m)(2) to the portion of Plan A that is a section 401(m) plan, or the nondiscrimination in amount of contributions or benefits requirement under § 401(a)(4) to the portion of Plan A that consists of nonelective contributions.

3. Plan A must separately satisfy the nondiscriminatory availability requirement of § 1.401(a)(4)–1(b)(3) with respect to the right of employees who have not satisfied the minimum one year of service requirement for participation for a plan year to make rollover contributions to the plan. Plan A is treated as separately satisfying this requirement because it satisfies the requirements of the design-based safe harbor described in this revenue ruling.

LAW AND ANALYSIS (ISSUE 2)

Section 416(c) generally requires each non-key employee who is a participant in a defined benefit or defined contribution plan to accrue a minimum benefit or receive a minimum contribution under the plan in any year the plan is top-heavy. Section 1.416–1, Q&A M–4 and Q&A M–10, describes which employees must receive the top-heavy minimums. In general, each non-key employee who is a participant in a top-heavy plan must receive the minimum if, in the case of a defined contribution plan, the participant has not separated from service by the end of the plan year, or, in the case of a defined benefit plan, the participant has at least 1,000 hours of service for the accrual computation period. Non-key employees may not fail to receive the top-heavy minimum by virtue of being excluded from participation because their compensation is less than a stated amount or because of failure to make mandatory employee contributions or elective contributions.

Employees who have not satisfied the minimum age and service requirements for plan participation for a plan year are not participants for purposes of § 416(c) merely because they make (or are eligible to make) rollover contributions under a plan. Such employees, therefore, are not required to accrue minimum benefits or receive minimum allocations for years in which a plan is top-heavy.

HOLDING (ISSUE 2)

For purposes of the minimum contribution and benefit requirements of § 416(c), employees are not participants for a plan year merely because they make (or are eligible to make) rollover contributions under Plan A.

Covered compensation tables; 1997. The covered compensation tables for the 1997 calendar year for determining contributions to defined benefit plans and permitted disparity are set forth.

Rev. Rul. 96–53

This revenue ruling provides tables of covered compensation under § 401(l)(5)(E) of the Internal Revenue Code (the "Code") and the Income Tax Regulations, thereunder, for the 1997 plan year.

Section 401(l)(5)(E)(i) defines covered compensation with respect to an employee, as the average of the contribution and benefit bases in effect under § 230 of the Social Security Act (the "Act") for each year in the 35-year period ending with the year in which the employee attains social security retirement age.

Section 401(l)(5)(E)(ii) of the Code states that the determination for any year preceding the year in which the employee attains social security retirement age shall be made by assuming that there is no increase in covered compensation after the determination year and before the employee attains social security retirement age.

Section 1.401(l)–1(c)(34) of the regulations defines the taxable wage base as the contribution and benefit base under § 230 of the Act.

Section 1.401(l)–1(c)(7)(i) defines covered compensation for an employee as the average (without indexing) of the taxable wage bases in effect for each calendar year during the 35-year period ending with the last day of the calendar year in which the employee attains (or will attain) social security retirement age. A 35-year period is used for all individuals regardless of the year of birth of the individual. In determining an employee's covered compensation for a plan year, the taxable wage base for all calendar years beginning after the first day of the plan year is assumed to be the same as the taxable wage base in effect as of the beginning of the plan year. An employee's covered compensation for a plan year beginning after the 35-year period applicable under § 1.401(l)–1(c)(7)(i) is the employee's covered compensation for a plan year during which the 35-year period ends. An employee's covered compensation for a plan year beginning before the 35-year period applicable under § 1.401–1(c)(7)(i) is the taxable wage base in effect as of the beginning of the plan year.

Section 1.401(l)–1(c)(7)(ii) provides that, for purposes of determining the amount of an employee's covered compensation under § 1.401(l)–1(c)(7)(i), a plan may use tables, provided by the Commissioner, that are developed by rounding the actual amounts of covered compensation for different years of birth.

For purposes of determining covered compensation for the 1997 year the taxable wage base is $65,400.

The following tables provide covered compensation for 1997:

1997 Covered Compensation Table

Calendar Year of Birth	Calendar Year of Social Security Retirement Age	1997 Covered Compensation
1907	1972	$4,488
1908	1973	4,704
1909	1974	5,004
1910	1975	5,316
1911	1976	5,664
1912	1977	6,060
1913	1978	6,480
1914	1979	7,044
1915	1980	7,692
1916	1981	8,460
1917	1982	9,300
1918	1983	10,236
1919	1984	11,232
1920	1985	12,276
1921	1986	13,368
1922	1987	14,520
1923	1988	15,708
1924	1989	16,968
1925	1990	18,312
1926	1991	19,728
1927	1992	21,192
1928	1993	22,716
1929	1994	24,312
1930	1995	25,920
1931	1996	27,576
1932	1997	29,304
1933	1998	31,032
1934	1999	32,772
1935	2000	34,500
1936	2001	36,180
1937	2002	37,860
1938	2004	41,148
1939	2005	42,792
1940	2006	44,448
1941	2007	46,056
1942	2008	47,616
1943	2009	49,104
1944	2010	50,568
1945	2011	52,008
1946	2012	53,400
1947	2013	54,768
1948	2014	55,980
1949	2015	57,108
1950	2016	58,128
1951	2017	59,064
1952	2018	59,916
1953	2019	60,708
1954	2020	61,440
1955	2022	62,724
1956	2023	63,312
1957	2024	63,804
1958	2025	64,212
1959	2026	64,560
1960	2027	64,836
1961	2028	65,064
1962	2029	65,196
1963	2030	65,316
1964 or later	2031	65,400

1997 Rounded Covered Compensation Table

Year of Birth	Covered Compensation
1932–1933	$30,000
1934	33,000
1935–1936	36,000
1937	39,000
1938–1939	42,000
1940–1941	45,000
1942–1943	48,000
1944–1945	51,000
1946–1947	54,000
1948–1950	57,000
1951–1954	60,000
1955–1957	63,000
1958 or later	65,400

Section 408.—Individual Retirement Accounts

26 CFR 1.408–5: Annual reports by trustees or issuers.

Specifications for paper substitutes for Form 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 96–42, page 306.

26 CFR 1.408–7: Reports on distributions from individual retirement plans.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 96–42, page 306.

Subpart B.—Special Rules

Section 410.—Minimum Coverage Requirements

26 CFR 1.410(b)–6: Excludable employees.

Whether an employee who has not satisfied the minimum age and service requirements for participation in a plan that is qualified under § 401(a) of the Internal Revenue Code, but who has the right to make a rollover contribution to the plan's trust, is an excludable employee for purposes of applying the minimum coverage requirements of § 410(b) to the plan. See Rev. Rul. 96–48, page 31.

Section 411.—Minimum Vesting Standards

26 CFR 1.411(a)–11: Restriction and valuation of distributions.

Participant consent; significant detriment. Based on the facts and circumstances described in the revenue ruling, the loss of the right to choose among a broad range of investment alternatives with materially different risk and return characteristics is a significant detriment that invalidates a participant's consent to an immediate distribution.

Rev. Rul. 96–47

ISSUE

Does a defined contribution plan that allows participants who have not terminated employment to direct the investment of their accounts and that offers a broad range of investment choices satisfy the consent requirements of § 411(a)(11) of the Internal Revenue Code if the accounts of former employees who do not consent to an immediate distribution of their account balances are required to be invested in a money market fund?

FACTS

Plan A, a profit-sharing plan, allows each participant who has not terminated employment to choose the manner in which his or her account is invested among the plan's investment alternatives. The choices include a broad range of investment alternatives, including a money market fund and several other funds with materially different risk and return characteristics.

Plan A provides that a participant who terminates employment prior to normal retirement date will receive his or her vested account balance at normal retirement date unless the participant elects, upon termination of employment or any time thereafter, to receive an immediate distribution of the vested account balance. Plan A also provides that upon termination of employment the participant may no longer choose among investment alternatives and the participant's account will automatically be invested in the money market fund until distributed.

LAW AND ANALYSIS

Section 411(a)(11) sets forth consent requirements that must be satisfied with respect to certain distributions in order for a plan to be qualified under § 401(a). Under § 411(a)(11), if the present value of a participant's nonforfeitable benefit exceeds $3,500, the plan must provide that the benefit is not immediately distributable without the participant's consent.

Section 1.411(a)–11(c)(2)(i) of the Income Tax Regulations provides that consent to a distribution is not valid if, under the plan, a significant detriment is imposed on any participant who does not consent to the distribution. That regulation further provides that whether or not a significant detriment is imposed is determined based on the particular facts and circumstances.

Based on the facts and circumstances applicable to Plan A, the loss of the right to choose among a broad range of investment alternatives with materially different risk and return characteristics is a significant detriment, within the meaning of § 1.411(a)–11(c)(2)(i), that is imposed by Plan A on a participant who does not consent to a distribution. Therefore, Plan A permits an immediate distribution without a valid consent.

HOLDING

Plan A fails to satisfy § 411(a)(11) because a participant's benefit is immediately distributable under the plan without the participant's valid consent.

EFFECT OF PRIOR DETERMINATION LETTER

A plan that has received a determination letter on a provision inconsistent with this revenue ruling, and that satisfies the conditions for reliance set forth in section 22.04(1) through (4) of Rev. Proc. 96–6, 1996–1 I.R.B. 151, may continue to rely on that determination letter for the period described in Rev. Proc. 96–6. Such a plan, however, is not entitled to the extended reliance provisions of Rev. Proc. 89–9, 1989–1 C.B. 780, and Rev. Proc. 89–13, 1989–1 C.B. 801, as modified by Rev. Proc. 93–9, 1993–1 C.B. 474, and Rev. Proc. 93–39, 1993–2 C.B. 513, with respect to the guidance in this revenue ruling. A plan that is amended to comply with this revenue ruling will not lose its otherwise applicable extended reliance period.

Section 412.—Minimum Funding Standards

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1996. See Rev. Rul. 96–34, page 75.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1996. See Rev. Rul. 96–37, page 77.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1996. See Rev. Rul. 96–43, page 78.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1996. See Rev. Rul. 96–49, page 79.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1996. See Rev. Rul. 96–52, page 81.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1996. See Rev. Rul. 96–57, page 82.

Section 416.—Special Rules for Top-Heavy Plans

26 CFR 1.416–1: Questions and answers on top-heavy plans.

Whether an employee who has not satisfied the minimum age and service requirements for participation in a plan that is qualified under § 401(a) of the Internal Revenue Code, but who has the right to make a rollover contribution to the plan's trust, is a participant for purposes of the minimum contribution or benefit requirements of § 416(c). See Rev. Rul. 96–48, page 31.

Subchapter E.—Accounting Periods and Methods of Accounting

Part II.—Methods of Accounting

Subpart C.—Taxable Year for Which Deductions Taken

Section 461.—General Rule for Taxable Year of Deduction

26 CFR 1.461–1: General rule for taxable year of deduction.
(Also § 1.461–5.)

Taxes, accrual of deduction. Under the all events test of section 461 of the Code, an accrual method employer may deduct in Year 1 its otherwise deductible FICA and FUTA taxes imposed with respect to year-end wages properly accrued in Year 1, but paid in Year 2, if the requirements of the recurring item exception are met.

Rev. Rul. 96–51

ISSUE

Under the all events test of § 461 of the Internal Revenue Code, may an accrual method employer deduct in Year 1 its otherwise deductible Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) taxes imposed with respect to year-end wages properly accrued in Year 1, but paid in Year 2?

FACTS

X, a corporation, employs the accrual method of accounting and uses a calendar taxable year. *X* pays otherwise deductible wages to its employees bi-weekly on the Friday immediately following a two-week pay period. Wages for the pay period beginning Saturday, December 23, 1995, and ending Friday, January 5, 1996, were paid to *X*'s employees on Friday, January 12, 1996. Prior to filing its 1995 corporate federal income tax return on March 15, 1996, *X* paid the taxes owed under §§ 3111 (the employer's share of FICA taxes) and 3301 (FUTA taxes) with respect to the December 23–31, 1995 wages that *X* properly accrued in 1995. *X* properly adopted the recurring item exception under § 1.461–5 of the Income Tax Regulations as a method of accounting with respect to *X*'s recurring liability for its share of FICA and FUTA taxes imposed in connection with accrued but unpaid year-end wages. On its 1995 return, *X* deducted the FICA and FUTA taxes it paid on the accrued year-end wages.

LAW AND ANALYSIS

Section 461(a) provides that the amount of any deduction or credit must be taken for the taxable year that is the proper taxable year under the method of accounting used in computing taxable income.

Section 461(h) and § 1.461–1(a)(2)(i) provide that, under the accrual method of accounting, a liability is incurred, and is generally taken into account for federal income tax purposes, in the taxable year in which (1) all the events have occurred that establish the fact of the liability, (2) the amount of the liability can be determined with reasonable accuracy, and (3) economic performance has occurred with respect to the liability. The economic performance requirement applies to liabilities allowable as a deduction or otherwise incurred after July 18, 1984.

Section 1.461–4(g)(6) provides generally that, if a taxpayer is liable to pay a tax, economic performance occurs as the tax is paid to the governmental authority that imposed it.

Section 1.461–5 provides a recurring item exception to the general rule of economic performance. Under the recurring item exception, a liability is treated as incurred for a taxable year if: (1) at the end of the taxable year, all events have occurred that establish the fact of the liability and the amount can be determined with reasonable accuracy; (2) economic performance occurs on or before the earlier of (a) the date that the taxpayer timely files a return (including extensions), or (b) the 15th day of the ninth calendar month after the close of the taxable year; (3) the liability is recurring in nature; and (4) either the amount of the liability is not material or accrual of the liability in the earlier year results in a better matching of the liability against the income to which it relates.

Section 1.461–5(b)(5)(ii) provides that, in the case of a liability for taxes, the matching requirement of the recurring item exception is deemed satisfied.

Rev. Rul. 74–70, 1974–1 C.B. 116, holds that, under the all events test, an accrual basis employer generally may not deduct its share of FICA taxes payable with respect to wages accrued but unpaid at year-end until the taxable year in which those wages are actually or constructively paid.

In *Eastman Kodak Co. v. United States*, 534 F.2d 252 (Ct. Cl. 1976), *acq.*, this Bulletin, page 4, the court held that an accrual basis employer may deduct its share of FICA, FUTA, and state unemployment taxes with respect to year-end wages in the year the wages were accrued, rather than in the following year when the wages were paid. The court held that, under the all events test, the fact of the liability may be established, and the amount thereof reasonably ascertained, even though no legally enforceable obligation to pay the taxes in issue had arisen by year-end. The court found that the fact of the employer's liability for the taxes was established as an automatic consequence of its definite and legal obligation to pay the underlying year-end accrued wages. *See also Burlington Northern R.R. v. Commissioner*, 82 T.C. 143 (1984), *acq.* this Bulletin, page 4 (reaching the same conclusion on the deductibility of the § 3221 employer tax under the Railroad Retirement Tax Act with respect to accrued year-end wages).

Similarly, *X* satisfied the all events test for the federal employment taxes imposed with respect to accrued year-end wages for 1995 because the fact of its liability to pay those taxes was established as an automatic consequence of its accrual of the underlying wages and the amount of those taxes was reasonably ascertainable. Further, *X* satisfied the requirements of the recurring item exception because the all events test was satisfied by the end of 1995, economic performance occurred within the prescribed time because the taxes were paid prior to the filing of *X*'s 1995 return, the liability was recurring in nature, and the accrual of the tax liability in 1995 is deemed (under § 1.461–5(b)(5)(ii)) to result in a better matching of that liability against the income to which it relates. Accordingly, *X* may deduct on its 1995 return the FICA and FUTA taxes it paid on the accrued year-end wages.

HOLDING

Under the all events test of § 461, an accrual method employer may deduct in Year 1 its otherwise deductible FICA and FUTA taxes imposed with respect to year-end wages properly accrued in Year 1, but paid in Year 2, provided the employer satisfies the requirements of the recurring item exception with respect to these taxes.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 74–70 is revoked.

APPLICATION

The tax treatment of an employer's FICA and FUTA taxes with respect to year-end wages within the scope of this revenue ruling constitutes a method of accounting. An employer currently treating those taxes in a manner different from that provided in this revenue ruling must seek the Commissioner's consent to change its method of accounting. A change in method of accounting for those taxes is a change in method of accounting to which §§ 446(e) and 481 apply. This change in method of accounting must be made in accordance with Rev. Proc. 92–20, 1992–1 C.B. 685.

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

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1996. See Rev. Rul. 96–34, page 75.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1996. See Rev. Rul. 96–37, page 77.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1996. See Rev. Rul. 96–43, page 78.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1996. See Rev. Rul. 96–49, page 79.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1996. See Rev. Rul. 96–52, page 81.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1996. See Rev. Rul. 96–57, page 82.

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

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1996. See Rev. Rul. 96–34, page 75.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1996. See Rev. Rul. 96–37, page 77.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1996. See Rev. Rul. 96–43, page 78.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1996. See Rev. Rul. 96–49, page 79.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1996. See Rev. Rul. 96–52, page 81.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1996. See Rev. Rul. 96–57, page 82.

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 May 1996 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, May 31, 1996.

Rev. Rul. 96–36

The following Department Store Inventory Price Indexes for May 1996 were issued by the Bureau of Labor Statistics on June 12, 1996. The indexes are accepted by the Internal Revenue Service, under § 1.472–1(k) of the Income Tax Regulations and Rev. Proc. 86–46, 1986–2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, May 31, 1996.

The Department Store Inventory Price Indexes are prepared on a national basis and include (a) 23 major groups of departments, (b) three special combinations of the major groups - soft goods, durable goods, and miscellaneous goods, and (c) a store total, which covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100, unless otherwise noted)

Groups	May 1995	May 1996	Percent Change from May 1995 to May 1996[1]
1. Piece Goods	507.4	545.1	7.4
2. Domestics and Draperies	643.5	649.3	0.9
3. Women's and Children's Shoes	635.2	659.7	3.9
4. Men's Shoes	920.2	906.5	−1.5
5. Infants' Wear	599.2	631.2	5.3
6. Women's Underwear	529.4	534.1	0.9
7. Women's Hosiery	283.1	286.8	1.3
8. Women's and Girls' Accessories	539.4	550.8	2.1
9. Women's Outerwear and Girls' Wear	437.0	417.9	−4.4
10. Men's Clothing	610.4	626.1	2.6
11. Men's Furnishings	575.7	593.3	3.1
12. Boys' Clothing and Furnishings	483.8	493.3	2.0
13. Jewelry	984.9	1020.1	3.6
14. Notions	750.3	773.8	3.1
15. Toilet Articles and Drugs	857.9	883.8	3.0
16. Furniture and Bedding	655.3	668.0	1.9
17. Floor Coverings	569.4	576.1	1.2
18. Housewares	775.1	803.9	3.7
19. Major Appliances	247.3	245.1	−0.9
20. Radio and Television	84.8	79.2	−6.6
21. Recreation and Education[2]	114.3	112.8	−1.3
22. Home Improvements[2]	122.3	127.2	4.0
23. Auto Accessories[2]	107.2	107.4	0.2
Groups 1–15: Soft Goods	597.1	603.0	1.0
Groups 16–20: Durable Goods	465.4	467.6	0.5
Groups 21–23: Misc. Goods[2]	114.2	113.7	−0.4
Store Total[3]	552.4	556.3	0.7

[1]Absence of a minus sign before percentage change in this column signifies price increase.
[2]Indexes on a January 1986=100 base.
[3]The store total index covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

26 CFR 1.472–1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The June 1996 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, June 30, 1996.

Rev. Rul. 96–39

The following Department Store Inventory Price Indexes for June 1996 were issued by the Bureau of Labor Statistics on July 16, 1996. The indexes are accepted by the Internal Revenue Service, under § 1.472–1(k) of the Income Tax Regulations and Rev. Proc. 86–46, 1986–2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, June 30, 1996.

The Department Store Inventory Price Indexes are prepared on a national basis and include (a) 23 major groups of departments, (b) three special combinations of the major groups—soft goods, durable goods, and miscellaneous goods, and (c) a store total, which covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100, unless otherwise noted)

Groups	June 1995	June 1996	Percent Change from June 1995 to June 1996[1]
1. Piece Goods	522.9	551.1	5.4
2. Domestics and Draperies	646.7	641.0	−0.9
3. Women's and Children's Shoes	624.2	649.3	4.0
4. Men's Shoes	919.3	895.4	−2.6
5. Infants' Wear	587.9	627.1	6.7
6. Women's Underwear	515.1	535.4	3.9
7. Women's Hosiery	283.3	288.0	1.7
8. Women's and Girls' Accessories	549.5	545.5	−0.7
9. Women's Outerwear and Girls' Wear	416.3	401.1	−3.7
10. Men's Clothing	597.5	612.2	2.5
11. Men's Furnishings	562.4	584.5	3.9
12. Boys' Clothing and Furnishings	477.8	485.7	1.7
13. Jewelry	1004.9	1011.5	0.7
14. Notions	758.7	774.1	2.0
15. Toilet Articles and Drugs	859.9	877.8	2.1
16. Furniture and Bedding	663.1	673.6	1.6
17. Floor Coverings	577.0	576.4	−0.1
18. Housewares	771.8	808.7	4.8
19. Major Appliances	247.2	245.5	−0.7
20. Radio and Television	82.1	79.3	−3.4
21. Recreation and Education[2]	114.0	112.8	−1.1
22. Home Improvements[2]	122.6	127.4	3.9
23. Auto Accessories[2]	106.8	107.5	0.7
Groups 1–15: Soft Goods	587.8	592.4	0.8
Groups 16–20: Durable Goods	462.8	469.7	1.5
Groups 21–23: Misc. Goods[2]	113.9	113.7	−0.2
Store Total[3]	545.8	550.3	0.8

[1]Absence of a minus sign before percentage change in this column signifies price increase.
[2]Indexes on a January 1986=100 base.
[3]The store total index covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

26 CFR 1.472–1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The July 1996 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, July 31, 1996.

Rev. Rul. 96–46

The following Department Store Inventory Price Indexes for July 1996 were issued by the Bureau of Labor Statistics on August 13, 1996. The indexes are accepted by the Internal Revenue Service, under § 1.472–1(k) of the Income Tax Regulations and Rev. Proc. 86–46, 1986–2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, July 31, 1996.

The Department Store Inventory Price Indexes are prepared on a national basis and include (a) 23 major groups of departments, (b) three special combinations of the major groups - soft goods, durable goods, and miscellaneous goods, and (c) a store total, which covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100, unless otherwise noted)

Groups	July 1995	July 1996	Percent Change from July 1995 to July 1996[1]
1. Piece Goods	515.5	539.2	4.6
2. Domestics and Draperies	656.6	635.6	−3.2
3. Women's and Children's Shoes	617.5	643.9	4.3
4. Men's Shoes	914.5	888.2	−2.9
5. Infants' Wear	596.5	609.3	2.1
6. Women's Underwear	526.0	536.9	2.1
7. Women's Hosiery	283.3	289.3	2.1
8. Women's and Girls' Accessories	546.7	544.7	−0.4
9. Women's Outerwear and Girls' Wear	398.1	380.6	−4.4
10. Men's Clothing	593.3	610.3	2.9
11. Men's Furnishings	550.5	573.0	4.1
12. Boys' Clothing and Furnishings	474.7	475.9	0.3
13. Jewelry	999.0	1016.0	1.7
14. Notions	838.7	779.4	−7.1
15. Toilet Articles and Drugs	861.1	880.9	2.3
16. Furniture and Bedding	657.8	671.6	2.1
17. Floor Coverings	563.7	577.5	2.4
18. Housewares	777.6	811.9	4.4
19. Major Appliances	245.2	245.8	0.2
20. Radio and Television	82.0	79.2	−3.4
21. Recreation and Education[2]	113.9	112.7	−1.1
22. Home Improvements[2]	122.4	126.8	3.6
23. Auto Accessories[2]	106.7	107.0	0.3
Groups 1–15: Soft Goods	580.5	582.4	0.3
Groups 16–20: Durable Goods	462.4	470.3	1.7
Groups 21–23: Misc. Goods[2]	113.8	113.5	−0.3
Store Total[3]	541.2	544.2	0.6

[1] Absence of a minus sign before percentage change in this column signifies price increase.
[2] Indexes on a January 1986=100 base.
[3] The store total index covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

26 CFR 1.472–1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The August 1996 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, August 31, 1996.

Rev. Rul. 96–50

The following Department Store Inventory Price Indexes for August 1996 were issued by the Bureau of Labor Statistics on September 13, 1996. The indexes are accepted by the Internal Revenue Service, under § 1.472–1(k) of the Income Tax Regulations and Rev. Proc. 86–46, 1986–2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, August 31, 1996.

The Department Store Inventory Price Indexes are prepared on a national basis and include (a) 23 major groups of departments, (b) three special combinations of the major groups - soft goods, durable goods, and miscellaneous goods, and (c) a store total, which covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100, unless otherwise noted)

Groups	Aug. 1995	Aug. 1996	Percent Change from Aug. 1995 to Aug. 1996[1]
1. Piece Goods	534.7	524.3	−1.9
2. Domestics and Draperies	663.1	642.6	−3.1
3. Women's and Children's Shoes	622.3	640.3	2.9
4. Men's Shoes	923.8	895.9	−3.0
5. Infants' Wear	620.6	610.3	−1.7
6. Women's Underwear	519.0	525.8	1.3
7. Women's Hosiery	287.5	287.5	0.0
8. Women's and Girls' Accessories	550.4	546.2	−0.8
9. Women's Outerwear and Girls' Wear	404.5	381.2	−5.8
10. Men's Clothing	604.6	611.7	1.2
11. Men's Furnishings	542.4	567.9	4.7
12. Boys' Clothing and Furnishings	477.3	485.4	1.7
13. Jewelry	1011.2	1023.8	1.2
14. Notions	868.8	770.0	−11.4
15. Toilet Articles and Drugs	861.5	885.1	2.7
16. Furniture and Bedding	659.2	669.2	1.5
17. Floor Coverings	572.4	588.7	2.8
18. Housewares	783.4	810.6	3.5
19. Major Appliances	247.7	244.8	−1.2
20. Radio and Television	82.1	78.8	−4.0
21. Recreation and Education[2]	114.2	112.1	−1.8
22. Home Improvements[2]	122.2	125.9	3.0
23. Auto Accessories[2]	107.1	107.2	0.1
Groups 1 – 15: Soft Goods	585.2	582.9	−0.4
Groups 16 – 20: Durable Goods	465.3	469.2	0.8
Groups 21 – 23: Misc. Goods[2]	114.1	113.1	−0.9
Store Total[3]	544.9	544.0	−0.2

[1] Absence of a minus sign before percentage change in this column signifies price increase.
[2] Indexes on a January 1986=100 base.
[3] The store total index covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

26 CFR 1.472–1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The September 1996 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, 1996.

Rev. Rul. 96–54

The following Department Store Inventory Price Indexes for September 1996 were issued by the Bureau of Labor Statistics on October 16, 1996. The indexes are accepted by the Internal Revenue Service, under § 1.472–1(k) of the Income Tax Regulations and Rev. Proc. 86–46, 1986–2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, September 30, 1996.

The Department Store Inventory Price Indexes are prepared on a national basis and include (a) 23 major groups of departments, (b) three special combinations of the major groups - soft goods, durable goods, and miscellaneous goods, and (c) a store total, which covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100, unless otherwise noted)

Groups	Sep. 1995	Sep. 1996	Percent Change from Sep. 1995 to Sep. 1996[1]
1. Piece Goods	538.3	534.8	−0.7
2. Domestics and Draperies	663.4	644.1	−2.9
3. Women's and Children's Shoes	646.4	647.9	0.2
4. Men's Shoes	926.9	916.1	−1.2
5. Infants' Wear	627.1	631.9	0.8
6. Women's Underwear	517.1	536.0	3.7
7. Women's Hosiery	285.7	289.0	1.2
8. Women's and Girls' Accessories	555.5	557.1	0.3
9. Women's Outerwear and Girls' Wear	418.9	407.2	−2.8
10. Men's Clothing	619.5	612.0	−1.2
11. Men's Furnishings	558.7	573.6	2.7
12. Boys' Clothing and Furnishings	482.8	489.8	1.4
13. Jewelry	1031.4	1040.3	0.9
14. Notions	803.3	795.2	−1.0
15. Toilet Articles and Drugs	863.0	895.9	3.8
16. Furniture and Bedding	665.6	675.6	1.5
17. Floor Coverings	563.1	589.9	4.8
18. Housewares	798.9	810.0	1.4
19. Major Appliances	249.7	247.1	−1.0
20. Radio and Television	81.7	77.2	−5.5
21. Recreation and Education[2]	114.3	111.4	−2.5
22. Home Improvements[2]	121.7	125.9	3.5
23. Auto Accessories[2]	106.9	107.0	0.1
Groups 1–15: Soft Goods	596.7	596.8	0.0
Groups 16–20: Durable Goods	470.1	469.0	−0.2
Groups 21–23: Misc. Goods[2]	114.0	112.6	−1.2
Store Total[3]	553.2	552.2	−0.2

[1] Absence of a minus sign before percentage change in this column signifies price increase.
[2] Indexes on a January 1986=100 base.
[3] The store total index covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

26 CFR 1.472–1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The October 1996 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, 1996.

Rev. Rul. 96–60

The following Department Store Inventory Price Indexes for October 1996 were issued by the Bureau of Labor Statistics on November 14, 1996. The indexes are accepted by the Internal Revenue Service, under § 1.472–1(k) of the Income Tax Regulations and Rev. Proc. 86–46, 1986–2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, October 31, 1996.

The Department Store Inventory Price Indexes are prepared on a national basis and include (a) 23 major groups of departments, (b) three special combinations of the major groups—soft goods, durable goods, and miscellaneous goods, and (c) a store total, which covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100, unless otherwise noted)

Groups	Oct. 1995	Oct. 1996	Percent Change from Oct. 1995 to Oct. 1996[1]
1. Piece Goods	508.6	561.0	10.3
2. Domestics and Draperies	664.7	641.0	−3.6
3. Women's and Children's Shoes	647.5	661.8	2.2
4. Men's Shoes	930.1	920.1	−1.1
5. Infants' Wear	633.8	626.4	−1.2
6. Women's Underwear	522.6	536.8	2.7
7. Women's Hosiery	290.7	285.7	−1.7
8. Women's and Girls' Accessories	558.3	557.5	−0.1
9. Women's Outerwear and Girls' Wear	430.5	417.5	−3.0
10. Men's Clothing	621.1	621.9	0.1
11. Men's Furnishings	572.1	581.7	1.7
12. Boys' Clothing and Furnishings	501.9	490.7	−2.2
13. Jewelry	1014.3	1043.6	2.9
14. Notions	782.3	797.3	1.9
15. Toilet Articles and Drugs	868.7	901.4	3.8
16. Furniture and Bedding	666.4	667.5	0.2
17. Floor Coverings	567.4	585.2	3.1
18. Housewares	801.2	808.1	0.9
19. Major Appliances	248.9	246.2	−1.1
20. Radio and Television	80.6	77.8	−3.5
21. Recreation and Education[2]	114.0	111.8	−1.9
22. Home Improvements[2]	122.1	125.6	2.9
23. Auto Accessories[2]	107.0	107.4	0.4
Groups 1–15: Soft Goods	603.0	603.4	0.1
Groups 16–20: Durable Goods	469.3	467.7	−0.3
Groups 21–23: Misc. Goods[2]	113.9	112.9	−0.9
Store Total[3]	556.9	556.1	−0.1

[1]Absence of a minus sign before percentage change in this column signifies price increase.
[2]Indexes on a January 1986=100 base.
[3]The store total index covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

Part III.—Adjustments

Section 483.—Interest on Certain Deferred Payments

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1996. See Rev. Rul. 96–34, page 75.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1996. See Rev. Rul. 96–37, page 77.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1996. See Rev. Rul. 96–43, page 78.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1996. See Rev. Rul. 96–49, page 79.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1996. See Rev. Rul. 96–52, page 81.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1996. See Rev. Rul. 96–57, page 82.

26 CFR 1.483–1: Computation of interest on certain deferred payments.

As defined by section 1274A, the definitions for both "qualified debt instruments" and "cash method debt instruments" have dollar ceilings on the stated principal amount. The limits to the stated principal amount are adjusted for inflation for sales or exchanges occurring in the 1997 calendar year. See Rev. Rul. 96–63, page 83.

Subchapter F.—Exempt Organizations
Part I.—General Rule

Section 501.—Exemption From Tax on Corporations, Certain Trusts, Etc.

26 CFR 1.501(a)–1: Exemption from taxation.

Procedure provides that exempt organizations that hold group exemption letters should file the group exemption information required annually by Rev. Proc. 80–27, 1980–1 C.B. 677, with the Ogden Service Center, Mail Stop 6271, 1000 South 1200 West, Ogden, UT 84404–4749. Rev. Proc. 80–27 modified. See Rev. Proc. 96–40, page 301.

Part III.—Taxation of Business Income of Certain Exempt Organizations

Section 512.—Unrelated Business Taxable Income

The Service is providing inflation adjustments for taxable years beginning in 1996 and 1997 to the maximum amount of annual dues that can be paid to certain agricultural or horticultural organizations without any portion being treated as unrelated trade or business income by reason of any benefits or privileges available to members. See Rev. Proc. 96–59, page 392.

Section 513.—Unrelated Trade or Business

The Service is providing inflation adjustments for taxable years beginning in 1997 to the maximum amount of a "low cost article." Funds raised through a charity's distribution of "low cost articles" will not be treated as unrelated business income to the charity. See Rev. Proc. 96–59, page 392.

Subchapter G.—Corporations Used to Avoid Income Tax on Shareholders
Part IV.—Deduction for Dividends Paid

Section 561.—Definition of Deduction for Dividends Paid

26 CFR 1.561–1: Deduction for dividends paid.

If a regulated investment company makes distributions to shareholders that vary as a result of the allocation of certain expenses, may the company include those distributions in the amount of its deduction for dividends paid? See Rev. Proc. 96–47, page 338.

Section 562.—Rules Applicable in Determining Dividends Eligible for Dividends Paid Deduction

26 CFR 1.562–2: Preferential dividends.

If a regulated investment company makes distributions to shareholders that vary as a result of the allocation of certain expenses, may the company include those distributions in the amount of its deduction for dividends paid? See Rev. Proc. 96–47, page 338.

Subchapter J.—Estates, Trusts, Beneficiaries, and Decedents
Part I.—Estates, Trusts, and Beneficiaries
Subpart A.—General Rules for Taxation of Estates and Trusts

Section 642.—Special Rules for Credits and Deductions

26 CFR 1.642(c)–5: Definition of pooled income fund.
(Also § 170; 1.170A–9.)

Pooled income fund; community trust; maintenance requirement. This ruling provides guidance on when a fund maintained by a community trust satisfies the maintenance requirement for a pooled income fund under section 642(c)(5)(E) of the Code.

Rev. Rul. 96–38

ISSUE

Does a fund satisfy the pooled income fund requirements of § 642(c)(5)(E) of the Internal Revenue Code if the fund is maintained by a community trust and in the instrument of transfer either (1) the donor gives the community trust complete discretion to determine how the remainder interest will be used to further charitable purposes, or (2) the donor requests or requires that the community trust place the proceeds from the remainder interest in one of its component funds that is designated to benefit a specific charitable organization?

FACTS

Both *A* and *B* are organizations described in § 170(b)(1)(A)(vi) and are community trusts described in § 1.170A–9(e)(10) of the Income Tax Regulations. Each pooled income fund's declaration of trust and instruments of transfer (collectively referred to as the "governing instrument") satisfy the requirements of § 642(c)(5)(A)–(D) and (F); therefore, each proposed fund will qualify as a pooled income fund if the provisions of § 642(c)(5)(E) are satisfied.

Situation 1. A proposes to establish a pooled income fund that *A* will maintain. Under the terms of the governing instrument, a donor contributes to *A* an irrevocable remainder interest in the property that the donor transfers to the pooled income fund, and *A* has full discretion to determine how to use the remainder interest to further *A*'s charitable purposes.

Situation 2. B proposes to establish a pooled income fund that *B* will maintain. Under the terms of the governing instrument, a donor contributes to *B* an irrevocable remainder interest in the property that the donor has transferred to the pooled income fund. In the instrument of transfer, however, the donor may either request or require that after the death of the donor's designated income beneficiaries, *B* place the proceeds of the remainder interest in one of *B*'s component funds that satisfies the requirements of § 1.170A–9(e)(11)(ii) and is designated to benefit a specific charitable organization. Under the terms of *B*'s donor-designated component funds, *B* makes current distributions of the income of the component fund to the designated charitable organization. *B* may also distribute principal to the designated charitable organization to finance special projects or in extraordinary circumstances. As required in § 1.170A–9(e)(11)(v)(B)(1), *B*'s governing body has the power to modify any restriction on the distributions from its component funds if, in the sole judgment of the governing body, the restriction becomes unnecessary, incapable of fulfillment, or inconsistent with the charitable needs of the community or area served.

LAW AND ANALYSIS

A pooled income fund is a trust that satisfies the requirements listed in § 642(c)(5). Section 642(c)(5)(A) and § 1.642(c)–5(b)(1) provide that each donor who transfers property to the trust must contribute an irrevocable remainder interest in the property to or for the use of an organization described in § 170(b)(1)(A), except certain private foundations described in clauses (vii) and (viii) of § 170(b)(1)(A).

Section 642(c)(5)(E) provides that the trust must be maintained by the organization to which the remainder interest is contributed and of which no donor or beneficiary of an income interest is a trustee. Section 1.642(c)–5(b)(5) provides that the maintenance requirement of § 642(c)(5)(E) is satisfied only if the

public charity exercises control directly or indirectly over the fund.

The maintenance requirement is designed to ensure that the fund's assets will not be manipulated for the benefit of noncharitable interests and that the amount received by the charitable organization will reflect the amount of any charitable contribution deduction the donor may have taken for contributing the remainder interest. H.R. Rep. No. 413 (Part 1), 91st Cong., 1st Sess. 58 (1969), 1969–3 C.B. 200, 237; and S. Rep. No. 552, 91st Cong., 1st Sess. 87 (1969), 1969–3 C.B. 423, 479. For an organization to satisfy the maintenance requirement of § 642(c)(5)(E), it may not be serving merely as a conduit for a gift to another beneficiary, but instead must be receiving a contribution itself that it will use to achieve its charitable purposes.

Under § 1.170A–9(e)(11), a group of funds is treated as a single community trust if the funds operate under a common name, have a common governing instrument, prepare common reports, and are under the direction of a common governing board that has the power to modify any restriction on distributions from any of the funds, if in the sole judgment of the governing body, the restriction becomes unnecessary, incapable of fulfillment, or inconsistent with the charitable needs of the community or area served. Under § 1.170A–9(e)(11)(ii), a fund created by gift, bequest, or other transfer that is not subject to any material restriction or condition (within the meaning of § 1.507–2(a)(8)) can be treated as a component part of the single entity. A fund held by a community trust and designated by the donor to pay its income annually to a specific public charity is not subject to a material restriction and therefore may qualify as a component part of the community trust (component fund). § 1.507–2(a)(8)(v), *Example (3).*

In *Situation 1*, the governing instrument provides that the donor contributes an irrevocable remainder interest in the contributed property to *A*, and *A* has discretion over how to use the remainder interest to further charitable purposes. Although *A* may elect to use some or all of the remainder interest for the benefit of other charitable organizations, *A* is given full dominion and control over the remainder interest. Therefore, for § 642(c)(5), a donor in *Situation 1* will be treated as contributing the remainder interest to *A*. Because *A* will maintain the fund, the fund will satisfy the requirements of § 642(c)(5)-(E) and will qualify as a pooled income fund under § 642(c)(5).

In *Situation 2*, the governing instrument allows a donor in the instrument of transfer either to request or to require that *B* place the proceeds from the remainder interest in one of its designated funds that is a component part of *B* under § 1.170A–9(e)(11)(ii). Under § 1.170A–9(e)(11), *B*'s component funds, including its donor-designated funds, are treated as a single entity, rather than separate entities. Thus, even though the donor in *Situation 2* will either request or require that *B* place the proceeds of the remainder interest into one of its donor-designated funds, the donor will be treated under § 642(c)(5) as contributing the remainder interest to *B*. Because *B* will maintain the fund, the fund will satisfy the requirements of § 642(c)(5)(E) and will qualify as a pooled income fund under § 642(c)(5).

HOLDINGS

(1) A fund maintained by a community trust satisfies the maintenance requirement of § 642(c)(5)(E) if, in the instrument of transfer, the donor gives the remainder interest to the community trust with full discretion to choose how the remainder interest will be used to further charitable purposes.

(2) A fund maintained by a community trust satisfies the maintenance requirement of § 642(c)(5)(E) if, in the instrument of transfer, the donor either requests or requires that the community trust place the proceeds of the remainder interest in a fund that has been designated to be used for the benefit of specific charitable organizations provided the fund is a component part that satisfies the requirements of § 1.170A–9(e)(11)(ii).

Subchapter L.—Insurance Companies
Part I.—Life Insurance Companies
Subpart C.—Life Insurance Deductions

Section 807.—Rules for Certain Reserves

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1996. See Rev. Rul. 96–34, page 75.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1996. See Rev. Rul. 96–37, page 77.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1996. See Rev. Rul. 96–43, page 78.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1996. See Rev. Rul. 96–49, page 79.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1996. See Rev. Rul. 96–52, page 81.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1996. See Rev. Rul. 96–57, page 82.

Section 809.—Reduction in Certain Deductions of Mutual Life Insurance Companies

26 CFR 1.809–9: Computation of the differential earnings rate and the recomputed differential earnings rate.

Mutual life insurance companies; differential earnings rate. The differential earnings rate for 1995 and the recomputed differential earnings rate for 1994 are set forth for use by mutual life insurance companies to compute their income tax liabilities for 1995.

Rev. Rul. 96–42

This revenue ruling contains the differential earnings rate for 1995 and the recomputed differential earnings rate for 1994. Under § 809 of the Internal Revenue Code, mutual life insurance companies use these rates in computing their Federal income tax liability for taxable years beginning in 1995. This revenue ruling also contains the figures on which the determinations of these rates are based. Notice 96–15, 1996–13 I.R.B. 19, contained tentative determinations of these rates.

Section 809(a) provides that, in the case of any mutual life insurance company, the amount of the deduction allowable under § 808 for policyholder dividends is reduced (but not below zero) by the "differential earnings amount." Any excess of the differential earnings amount over the amount of the deduction allowable under § 808 is taken into account as a reduction in the closing balance of reserves under subsections (a) and (b) of § 807. The "differential earnings amount" for any taxable year is the amount equal to the product of (a) the life insurance company's average equity base for the taxable year multiplied by (b) the "differential earnings rate" for that taxable year. The

"differential earnings rate" for the taxable year is the excess of (a) the "imputed earnings rate" for the taxable year over (b) the "average mutual earnings rate" for the second calendar year preceding the calendar year in which the taxable year begins. The "imputed earnings rate" for any taxable year is the amount that bears the same ratio to 16.5 percent as the "current stock earnings rate" for the taxable year bears to the "base period stock earnings rate."

Section 809(f) provides that, in the case of any mutual life insurance company, if the "recomputed differential earnings amount" for any taxable year exceeds the differential earnings amount for that taxable year, the excess is included in life insurance gross income for the succeeding taxable year. If the differential earnings amount for any taxable year exceeds the recomputed differential earnings amount for that taxable year, the excess is allowed as a life insurance deduction for the succeeding taxable year. The "recomputed differential earnings amount" for any taxable year is an amount calculated in the same manner as the differential earnings amount for that taxable year, except that the average mutual earnings rate for the calendar year in which the taxable year begins is substituted for the average mutual earnings rate for the second calendar year preceding the calendar year in which the taxable year begins.

The stock earnings rates and mutual earnings rates taken into account under § 809 generally are determined by dividing statement gain from operations by the average equity base. For this purpose, the term "statement gain from operations" means "the net gain or loss from operations required to be set forth in the annual statement, determined without regard to Federal income taxes, and ... properly adjusted for realized capital gains and losses...." See § 809(g)(1). The term "equity base" is defined as an amount determined in the manner prescribed by regulations equal to surplus and capital increased by the amount of nonadmitted financial assets, the excess of statutory reserves over the amount of tax reserves, the sum of certain other reserves, and 50 percent of any policyholder dividends (or other similar liability) payable in the following taxable year. See § 809(b)(2), (3), (4), (5) and (6). Section 1.809–10 of the Income Tax Regulations provides that the equity base includes both the asset valuation reserve and the interest maintenance reserve for taxable years ending after December 31, 1991.

Section 1.809–9(a) of the regulations provides that neither the differential earnings rate under § 809(c) nor the recomputed differential earnings rate that is used in computing the recomputed differential earnings amount under § 809(f)(3) may be less than zero.

For purposes of § 809, the differential earnings rate for 1995 and the rate used to calculate the recomputed differential earnings amount for 1994 (the recomputed differential earnings rate for 1994), and the figures on which these two rates are based are set forth in Table 1.

Rev. Rul. 96–42 TABLE 1

Determination of Rates To Be Used For Taxable Years Beginning in 1995

Differential earnings rate for 1995	0
Recomputed differential earnings rate for 1994	5.887
Imputed earnings rate for 1994	15.109
Imputed earnings rate for 1995	12.625
Base period stock earnings rate	18.221
Current stock earnings rate for 1995	13.942
Stock earnings rate for 1992	7.004
Stock earnings rate for 1993	23.385
Stock earnings rate for 1994	11.437
Average mutual earnings rate for 1993	18.406
Average mutual earnings rate for 1994	9.222

Part II.—Other Insurance Companies

Section 832.—Insurance Company Taxable Income

26 CFR 1.832–4: Gross Income.

The salvage discount factors are set forth for the 1996 accident year. These factors will be used for computing estimated salvage recoverable for purposes of section 832 of the Code. See Rev. Proc. 96–45, page 336.

Part III.—Provisions of General Application

Section 846.—Discounted Unpaid Losses Defined

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1996. See Rev. Rul. 96–34, page 75.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1996. See Rev. Rul. 96–37, page 77.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1996. See Rev. Rul. 96–43, page 78.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1996. See Rev. Rul. 96–49, page 79.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1996. See Rev. Rul. 96–52, page 81.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1996. See Rev. Rul. 96–57, page 82.

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26 CFR 1.846–1: Application of discount factors.

The loss payment patterns and discount factors are set forth for the 1996 accident year. These factors will be used for computing discounted unpaid losses under section 846 of the Code. See Rev. Proc. 96–44, page 330.

The salvage discount factors are set forth for the 1996 accident year. These factors will be used for computing estimated salvage recoverable for purposes of section 832 of the Code. See Rev. Proc. 96–45, page 336.

Subchapter M.—Regulated Investment Companies and Real Estate Investment Trusts

Part I.—Regulated Investment Companies

Section 852.—Taxation of Regulated Investment Companies and Their Shareholders

26 CFR 1.852–1: Taxation of regulated investment companies.

If a regulated investment company makes distributions to shareholders that vary as a result of the allocation of certain expenses, may the company include those distributions in the amount of its deduction for dividends paid? See Rev. Proc. 96–47, page 338.

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26 CFR 1.852–3: Investment company taxable income.

If a regulated investment company makes distributions to shareholders that vary as a result of the allocation of certain expenses, may the company deduct the distributions for purposes of computing the company's investment company taxable income? See Rev. Proc. 96–47, page 338.

Subchapter N.—Tax Based on Income From Sources Within or Without the United States
Part I.—Determination of Sources of Income

Section 863.—Special Rules for Determining Source

26 CFR 1.863–3: Allocation and apportionment of income from certain sales of inventory.

T.D. 8687

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

Source of Income From Sales of Inventory and Natural Resources Produced in One Jurisdiction and Sold in Another Jurisdiction

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains regulations governing the source of income from sales of natural resources or other inventory produced in the United States and sold outside the United States or produced outside the United States and sold in the United States. This document affects persons who produce natural resources or other inventory in the United States and sell outside the United States, or produce natural resources or other inventory outside the United States and sell in the United States.

EFFECTIVE DATE: December 30, 1996.

Applicability: These regulations apply to taxable years beginning after December 30, 1996. However, taxpayers may apply these regulations for taxable years beginning after July 11, 1995, and on or before December 30, 1996.

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. 3507) under control number 1545–1476. Responses to this collection of information are mandatory.

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

The estimated average annual burden per respondent is approximately 2.6 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224, and the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC, 20503.

Books or records relating to this collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains final regulations to be added to the Income Tax Regulations (26 CFR part 1) under section 863 of the Internal Revenue Code (Code). The final regulations provide rules for allocating and apportioning income between U.S. and foreign sources from natural resources and other inventory produced in the United States and sold outside the United States, or produced outside the United States and sold in the United States.

On December 11, 1995, proposed regulations [INTL–0003–95 (1996–1 C.B. 831)] were published in the **Federal Register** (60 FR 63478). The IRS received written comments on the proposed regulations and held a public hearing on April 10, 1996. Having considered the comments and the statements made at the hearing, the IRS and the Treasury Department adopt the proposed regulations as modified by this Treasury decision. The comments and revisions are discussed below.

Explanation of Provisions

I. Allocation of gross income from sales of natural resources under section 863(a)

Section 1.863–1(b) of the proposed regulations relate to the rules governing natural resources. The proposed regulations provide three methods for determining the amount of United States or foreign source income from sales of natural resources. One method (derived from the existing regulations) sources income in its entirety to the location of the natural resources, and applies where the taxpayer does not engage in substantial additional production beyond production of the natural resources. The second method, the export terminal rule, splits sales income at the export terminal, sourcing gross receipts equal to the fair market value at the export terminal to the location of the natural resources, and gross receipts in excess of that amount either to the place of sale or according to the rules in § 1.863–3, depending on the circumstances. The third method requires taxpayers performing additional production in the country where the natural resources are located, to split gross receipts at the point of the additional production, sourcing gross receipts equal to the fair market value prior to that point to the location of the natural resources and gross receipts in excess of that amount according to the rules in § 1.863–3.

1. Implications of the Tenth Circuit's Order in *Phillips*

Section 1.863–1(b)(1)(i) of the proposed regulations sources certain income from natural resources in its entirety to the location of the resources. The preamble to the proposed regulations states that Treasury and the IRS would consider the Tenth Circuit's unpublished opinion in its Order and Judgment in *Phillips Petroleum v. Comm'r*, 97 T.C. 30 (1991), 101 T.C. 78 (1993), *aff'd. without published opinion*, 70 F.3d 1282 (10th Cir., 1995), in finalizing the regulations. In *Phillips*, the Tax Court ruled § 1.863–1(b)'s natural resource regulation, generally sourcing income from U.S. natural resources in its entirety to the United States, invalid to the extent it conflicted with the Court's interpretation of section 863(b)(2). That section provides that gains, profits and income from the sale of inventory property produced within and sold without the United States (or vice versa) shall be treated as derived partly from sources within and partly from sources without the United States. The Tenth Circuit affirmed the Tax Court.

In view of *Phillips*, the final regulations modify the proposed regulations to eliminate the 100 percent allocation rule, making the determination of the source of income subject instead to the export terminal rule. Thus, gross receipts equal to the fair market value of the product at the export terminal are allocated to the location of the farm, mine, well, deposit or uncut timber, with the source of gross receipts from such sales in

excess of the product's fair market value at the export terminal allocated to the country of sale.

Several commentators requested that any change to the natural resource rules made in light of *Phillips* be done in proposed form, providing opportunity to comment on the regulations. However, because the final regulations merely eliminate the rule which required a single source of income for sales of natural resources, and because Treasury and the IRS believe that there has been adequate opportunity to comment on the proposed regulations' export terminal rule, the natural resources rules are issued in final form.

2. Availability of the 50/50 method for natural resources

Several commentators wrote that there is no basis for treating natural resources differently than other inventory. Therefore, producers of natural resources should be permitted to determine the source of their income under the 50/50 method described in § 1.863–3(b)(1). They point to legislation enacted in the Tax Reform Act of 1986, arguing that Congress, in enacting section 865 to govern personal property sales, drew no distinction between sales of natural resources and sales of other inventory. Commentators have also pointed to section 865(b), enacted in 1993, providing that income from sales of U.S. softwood must be U.S. source in its entirety. They conclude that Congress was aware of the Tax Court's decision in *Phillips*, overruling *Phillips* only for softwood, but intending that all other natural resources be sourced under the 50/50 method.

Treasury and the IRS do not believe that Congress in the 1986 Act evidenced an intent to source all income from sales of natural resources under the 50/50 method. Rather, Congress merely referred to the 50/50 method to generally describe the methods for sourcing income from certain types of inventory sales. In addition, the legislative history to the 1993 Act, requiring income from softwood sales to be allocated in its entirety to the United States, does not suggest that Congress intended to overturn the longstanding regime governing sales of other natural resources. Moreover, the Small Business Job Protection Act of 1996, Public Law 104–188 (August 20, 1996) (the 1996 Act), further clarifies that the Service is not required to apply the 50/50 method. Prior to the 1996 Act, section 865(b) provided that income from inventory sales was to be sourced under sections 861(a)(6), 862(a)(6), and 863(b). The 1996 Act, in section 1704(f)(4)(A), amended Code section 865(b)(2) by striking 863(b) and inserting 863. The Act makes this amendment effective as if included in amendments made by section 1211 of the Tax Reform Act of 1986 (Public Law 99–514). This technical correction to the 1986 Act clarifies that Treasury has broad authority to provide rules sourcing income from sales of inventory under section 863, and is not restricted to any particular method.

Treasury and the IRS also believe longstanding distinctions have been made in the tax treatment of natural resources and other property, both in our tax laws and in our tax treaties. Most treaties, for example, grant primary or exclusive taxing jurisdiction to the country where natural resources are located. Thus, income from sales of natural resources is treated differently than income derived from sales of other inventory, which is normally subject to the business profits article of a treaty. See, e.g., Article 6 of the United States Model Income Tax Convention (September 20, 1996), which provides that income from real property, "including income from agriculture and forestry" may be taxed by the country where the resources are located.

The legislative history to section 863's predecessor, section 217(e) of the Revenue Act of 1921, also reflects an intention that natural resources be treated differently from other property. The House version of section 217 (H.R. 8245, 67th Cong., 1st Sess. (Aug.20, 1921)) included a provision sourcing income from natural resources in its entirety to the location of the resources. However, based on testimony raising the possibility of a case where such a single source rule should not apply, the Senate struck the provision that allocated all of the income from natural resources to a single country. (H.R. 8245 (67th Cong., 1st Sess. (November 4, 1921)); Hearings Before The Committee on Finance, United States Senate, H.R. 8245, 67th Cong., 1st Sess. (September 1 to October 1, 1921), at 309–310. A provision similar to that considered by the House, but with flexibility available for unusual cases, was then added to the regulations promulgated in 1922.

Thus, Treasury and the IRS believe that income from natural resources should be sourced differently than income from other sales of inventory.

3. Clarification of language in § 1.863–2

In response to a comment, the final regulations are modified to clarify that the source of income from sales of natural resources must be determined solely under the rules set forth in § 1.863–1(b) of the final regulations. Treasury and the IRS clarified this point in corrections to the proposed regulations, published on August 27, 1996, in the **Federal Register** (61 FR 44023).

4. Additional production activities

The proposed regulations define additional production activities in § 1.863–1(b)(3)(ii) as substantial production activities performed by the taxpayer in addition to activities relating to the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber. The proposed regulations provide that generally the principles of § 1.954–3(a)(4) apply in determining whether an activity qualifies as such additional production. However, in no case will activities that prepare the natural resource itself for export, including those that are designed to facilitate transportation of the natural resource to or from the export terminal, be considered additional production. Thus, the proposed regulations in an example indicate liquefaction of natural gas would not constitute additional production activities.

Liquefaction is the process of liquefying natural gas so that it can be transported by tanker for sales abroad. Several commentators urged us to reconsider our position, arguing that liquefaction is an expensive, complex activity. Treasury and the IRS, however, continue to believe that liquefaction is an activity preparing the natural resource itself for export within the meaning of § 1.863–1(b)(3)(ii) of the final regulations, and that it is appropriate to exclude such activities from the definition of additional production. Even though liquefaction may be an expensive, complex process, liquefied natural gas retains its character as a natural resource, so that liquefaction should be treated no differently than other processes that prepare natural resources for export.

Several commentators requested that the regulations more precisely define the processes that constitute production of natural resources, to better differentiate those activities described in § 1.863–1(b)(1) of the proposed regulations, as

being from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber, from those that qualify as additional production activities within the meaning of § 1.863–1(b)(3)(ii) of the proposed regulations. In particular, a commentator requested that the final regulations specifically address this issue in the case of mining. In response to this comment, the final regulations include an example describing certain mining processes that would not qualify as additional production activities in the case of copper.

5. Treatment of partnerships

The proposed regulations provide that, in applying the rules in § 1.863–3 of the proposed regulations, a partner would be treated as engaged in the production activity of its partnership. However, that provision was not extended to § 1.863–1 of the proposed regulations, which generally provides rules for determining the source of income from sales of natural resources. The final regulations provide rules for transactions involving partners and partnerships, which apply in the same manner to sales of natural resources and to sales of other inventory. See II. 3. of this preamble for a discussion of those rules.

6. Genetically-engineered agricultural products

One commentator requested that final regulations state that natural resources do not include products, such as certain seeds, where the premium value of the product is derived from genetic traits produced by biotechnology or traditional methods, and the seeds themselves are not grown for consumption. The inherent nature of products as agricultural products, however, does not change because they may be subject to research and development. Because they remain natural resources, Treasury and the IRS rejected this comment.

II. Allocation and apportionment of income from sales of inventory other than natural resources

Section 1.863–3 of the proposed regulations provides rules for allocating and apportioning income from inventory sales other than natural resources where the taxpayer produces property in the United States and sells outside the United States, or produces property outside the United States and sells in the United States (Section 863 Sales). The proposed regulations provide three methods: the 50/50 method, the independent factory price method, and the books and records method.

1. Sales in international waters or in space

Consistent with the existing regulations, the proposed regulations limit the methods in § 1.863–3 to sales within a foreign country. The preamble, however, requests comments on whether the regulation should be expanded to cover sales made in international waters or in space. Although the statute refers to sales outside the United States, Treasury and the IRS expressed concern in that preamble that expanding the scope of the regulations to include all such sales could lead to abuses where, for example, a taxpayer produced goods in the United States, passed title to those goods outside the United States, and then sold the goods to U.S. customers. In considering whether to expand the scope of the final regulations to include such sales, Treasury and the IRS requested comments on whether to include an exception to the title passage rule for sales of goods produced in the United States and destined for the U.S. market.

In response to comments and consistent with the preamble to the proposed regulations, the final regulations expand the scope of the existing and proposed regulations to include sales outside the United States. Moreover, to prevent abuse from this expanded rule, the final regulations provide that sales of goods wholly produced in the United States and sold for use, consumption, or disposition in the United States, will be considered to take place in the United States. Income from such sales will be treated as from U.S. sources. The final regulations rely on rules in § 1.864–6(b)(3)(ii) (relating to the determination of whether foreign source income is effectively connected with a U.S. trade or business under section 864(c)(4)(iii)), for determining the country of use, consumption, or disposition. Also, property will be treated as wholly produced in the United States for this purpose if it is subject to no more than packaging, repackaging, labeling, or other minor assembly operations outside the United States. See also § 1.861–7(c) to determine the source of income in any case in which the sales transaction is arranged in a particular manner for the primary purpose of tax avoidance.

Treasury and the IRS are considering whether the rules of the final regulations are appropriate where a product is produced in one country but is destined for use either on the high seas or in space. Until additional guidance is provided, taxpayers may rely upon the general rules of the final regulations for these cases.

2. Segregation and aggregation of sales

Once a taxpayer selects a method under § 1.863–3(b) for dividing gross income derived from Section 863 Sales between production activity and sales activity, § 1.863–3(a) of the proposed regulations provide that a taxpayer must separately apply that method to Section 863 Sales in the United States and to Section 863 Sales outside the United States. The proposed regulations also provide in § 1.863–3(a) that taxpayers must determine the source of gross income under paragraph (c) and taxable income under paragraph (d) by aggregating all Section 863 Sales to which a method described in paragraph (b) applies.

The final regulations clarify that the rules of paragraphs (c) and (d) apply separately to Section 863 Sales in the United States and to Section 863 Sales outside the United States, so that taxpayers are required to aggregate all Section 863 Sales under paragraphs (c) and (d) after the taxpayer has first separately applied the method under paragraph (b) to Section 863 Sales in the United States and to Section 863 Sales outside the United States.

3. Transactions with partnerships

The proposed regulations provide in § 1.863–3(a) that a taxpayer's production activity includes production activities conducted through a partnership of which the taxpayer is a partner either directly or through one or more partnerships. One commentator recommended that final regulations extend the partnership rules to natural resources. However, the commentator suggested that an aggregate approach to partnerships should apply only in cases where the partnership, instead of selling the property and distributing the proceeds to the partner, distributes the property to a partner. In response to the comments, the final regulations modify the proposed regulations. Under the final regulations, the aggregate approach applies to a partnership's production or sales activity only for two purposes. First, the aggregate approach applies for purposes of determining the source of a partner's distributive share of partnership income.

Thus, if a partnership engages in the production of inventory property in the United States and sells such property outside the United States, a partner will be considered to have produced and sold that inventory property in the same manner as the partnership when determining the source of its distributive share of such sales income. Second, the aggregate approach applies for purposes of sourcing income from the sale of inventory property that is transferred in kind from or to a partnership. Thus, for example, where the partnership makes an in kind distribution of inventory property to its partners, the source of the partner's income from the sale of such property is determined based on both its own activity and on the partnership's activity. Similarly, the aggregate approach applies in cases where a partner contributes inventory produced by it to its partnership, if the partnership then sells the inventory (e.g., as a distributor or after further processing).

The entity approach applies for all other purposes. For example, where a partnership manufactures inventory property and sells the property to one of its partners, the source of that partner's income from the resale of the property is determined without regard to the partnership's manufacturing activity. Consistent with this modification, the final regulations also specify that assets owned by a partnership (or a partner) are not deemed owned by the partner (or the partnership) unless the aggregate approach applies to the transaction at issue.

4. Taxable income method

In response to comments, § 1.863–2(b) of the proposed regulations is clarified to provide that taxpayers may elect the principles of § 1.863–3(b)(1) and (c) to determine the source of taxable income (rather than gross income) from sales of inventory property.

5. Independent factory price (IFP) method

One commentator requested clarification that the sale establishing an IFP must be sourced under the IFP method only if a taxpayer elects the IFP method. The proposed and final regulations intend this result. The IFP method applies to either the sale establishing the IFP or to a sale applying the IFP only if the taxpayer elects the IFP method.

The proposed regulations eliminated the provision in existing regulations permitting taxpayers to establish an IFP by methods other than by sales to independent distributors. The preamble, however, requested comments on the continued utility of such a provision. Two commentators recommended that the provision be retained and expanded to permit taxpayers to establish an IFP by any method that is appropriate under section 482. The commentators stated that any evidence acceptable for proving an arm's length price under section 482 should be acceptable as an IFP. The commentators also stated that taxpayers who cannot use the IFP method must use the 50/50 method, and that the 50/50 method may not produce an equitable result for nonresidents importing goods into the United States.

After further consideration, Treasury and the IRS have decided to finalize the regulations on this point as proposed. No convincing evidence has been presented for the need of a broad-based rule permitting taxpayers to establish an IFP by any method that would otherwise be appropriate under section 482 when they can use books and records to demonstrate a more appropriate sourcing result. In view of the absence of a clearly identified benefit for taxpayers and the availability of the books and records method, Treasury and the IRS believe that expansion of the IFP rule is not justified.

6. Books and records

Under both the existing and proposed regulations, taxpayers can request permission from the District Director to use a taxpayer's books and records to allocate or apportion income between U.S. and foreign sources if this method more clearly reflects the taxpayer's income. The preamble to the proposed regulations requests comments on retaining the books and records method. Two commentators asked for retention of this method because instances may arise where a taxpayer does not have third party sales, thereby making the IFP method unavailable. In such cases, a taxpayer may find it advantageous to determine the source of its income on the basis of its books and records. These comments were accepted. The final regulations retain the books and records method, subject to an election and prior approval of the method by the District Director.

7. Determination of source of gross income from production activities

a. Definition of production assets

i. Contract manufacturing

Under the proposed regulations, production assets are limited to those owned directly by the taxpayer that are directly used by the taxpayer to produce the relevant inventory. These rules are intended to insure that taxpayers do not attribute the assets or activities of related or unrelated parties manufacturing under contract with the taxpayer. One commentator asked that the definition of production assets be expanded to include production assets owned by related or unrelated contract manufacturers. The commentator contends that by limiting production assets to those owned by the taxpayer, the regulations source income differently depending upon the form in which the taxpayer conducts business. Treasury and the IRS, however, believe it is appropriate to limit production assets in the apportionment formula to assets owned by the taxpayer and used by the taxpayer to produce the inventory. In addition, taxpayers generally do not know the contract manufacturer's basis in its production assets. Further, it would be very difficult to draw a clear line between contract manufacturers and other suppliers. Thus, Treasury and the IRS do not believe the source of a taxpayer's income should take into account activities of others or assets owned by others with whom the taxpayer has manufacturing arrangements. The final regulations clarify, however, that this rule does not override the single entity rules set forth under § 1.1502–13 (dealing with members of an affiliated group filing on a consolidated basis), or the rules under § 1.863–3(g) dealing with partnerships.

ii. Accounts receivable

One commentator also asserted that accounts receivable should be included as a production asset. This comment was rejected. The production formula is intended to approximate the location of the taxpayer's production activity. Thus, assets not directly involved in production should not be included.

b. Anti-abuse rule

The preamble to the proposed regulations indicated that the purpose of the property fraction is to attribute the source of production income to the location of production activity. Treasury and the IRS, however, were concerned that taxpayers would attempt to artificially affect the location of assets to manipulate the rules, and so solicited comments on whether an anti-abuse rule was needed. No comments were received that objected to such anti-abuse rule. After further considering the issue,

Treasury and the IRS have included an anti-abuse rule in the final regulations to prevent taxpayers from manipulating the property formula to achieve inappropriate results. Therefore, the anti-abuse rule provides that if a taxpayer has entered into or structured one or more transactions with a principal purpose of reducing its U.S. tax liability by affecting the formula in a manner inconsistent with the purpose of the regulation, the District Director may make appropriate adjustments so that the source of the taxpayer's income from production activity more clearly reflects the source of that income. An example in the regulations demonstrates circumstances where the anti-abuse rule may apply. In that example, with a principal purpose of reducing its U.S. tax liability, the taxpayer leases all of its U.S. property so that it owns only property located in a foreign country. The example concludes that the District Director may ignore a sale-leaseback transaction to more clearly reflect the source of the taxpayer's production income.

8. Determination of taxable income

One commentator requested that the calculation of taxable income, when applying the 50/50 method along with the research and experimental (R&E) expense allocation rules in § 1.861–17, be clarified. The commentator suggests that the last sentence of § 1.863–3(d) of the proposed regulations can be read to conflict with the R&E set aside in § 1.861–17. The final regulations clarify that the R&E set aside remains available to taxpayers using the 50/50 method.

9. Reporting requirements

The proposed regulations, in § 1.863–3(e), require a taxpayer to fully explain the methodology used to determine the source of income, the circumstances justifying use of that method, the extent that sales are aggregated, and the amount of income so allocated. One commentator wrote that the reporting requirements in § 1.863–3(e) of the proposed regulations are unnecessary and excessively burdensome. The regulations clarify that the requirement is limited to a statement attached to the tax return, explaining the methodology used, the circumstances justifying that use, the aggregation of sales, and the amount of income allocated. Treasury and the IRS believe the reporting requirements in § 1.863–3(e) of the proposed regulations are reasonable, and serve legitimate administrative purposes.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the rules of this section principally impact large multinationals who pay foreign taxes on substantial foreign operations and therefore the rules will impact very few small entities. Moreover, in those few instances where the rules of this section impact small entities, the economic impact on such entities is not likely to be significant. Accordingly, a regulatory flexibility analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

* * * * *

Adoption of Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Section 1.863–2 also issued under 26 U.S.C. 863.

Section 1.863–3 also issued under 26 U.S.C. 863.

Section 1.863–4 also issued under 26 U.S.C. 863.

Section 1.863–6 also issued under 26 U.S.C. 863. * * *

Par. 2. Sections 1.863–3 and 1.863–3T are redesignated as §§ 1.863–3A and 1.863–3AT, respectively, and an undesignated center heading is added preceding the redesignated sections to read as follows:

Regulations Applicable to Taxable Years Prior to December 30, 1996

Par. 3. Section 1.863–0 is added to read as follows:

§ 1.863–0 Table of contents.

This section lists captions contained in §§ 1.863–1, 1.863–2, and 1.863–3.

§ 1.863–1 Allocation of gross income.

(a) In general.
(b) Natural resources.
(1) In general.
(2) Additional production prior to export terminal.
(3) Definitions.
(i) Production activity.
(ii) Additional production activities.
(iii) Export terminal.
(4) Determination of fair market value.
(5) Determination of gross income.
(6) Tax return disclosure.
(7) Examples.
(c) Determination of taxable income.
(e) Effective dates.

§ 1.863–2 Allocation and apportionment of taxable income.

(a) Determination of taxable income.
(b) Determination of source of taxable income.
(c) Effective dates.

§ 1.863–3 Allocation and apportionment of income from certain sales of inventory.

(a) In general.
(1) Scope
(2) Special rules
(b) Methods to determine income attributable to production activity and sales activity.
(1) 50/50 method.
(i) Determination of gross income.
(ii) Example.
(2) IFP method.
(i) Establishing an IFP.
(ii) Applying the IFP method.
(iii) Determination of gross income.
(iv) Examples.
(3) Books and records method.
(c) Determination of the source of gross income from production activity and sales activity.
(1) Income attributable to production activity.
(i) Production only within the United States or only within foreign countries.
(A) Source of income.
(B) Definition of production assets.
(C) Location of production assets.
(ii) Production both within the United States and within foreign countries.
(A) Source of income.
(B) Adjusted basis of production assets.
(iii) Anti-abuse rule.
(iv) Examples.
(2) Income attributable to sales activity.

(d) Determination of source of taxable income.

(e) Election and reporting rules.

(1) Elections under paragraph (b) of this section.

(2) Disclosure on tax return.

(f) Income partly from sources within a possession of the United States.

(g) Special rules for partnerships.

(h) Effective dates.

Par. 4. In § 1.863–1, paragraphs (a), (b) and (c) are revised and paragraph (e) is added to read as follows:

§ 1.863–1 Allocation of gross income.

(a) *In general.* Items of gross income other than those specified in section 861(a) and section 862(a) will generally be separately allocated to sources within or without the United States. See § 1.863–2 for alternate methods to determine the income from sources within or without the United States in the case of items specified in § 1.863–2(a). See also sections 865(b) and (e)(2). In the case of sales of property involving partners and partnerships, the rules of § 1.863–3(g) apply.

(b) *Natural resources*—(1) *In general.* Notwithstanding any other provision, except to the extent provided in paragraph (b)(2) of this section, gross receipts from the sale outside the United States of products derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber within the United States, must be allocated between sources within and without the United States based on the fair market value of the product at the export terminal (as defined in paragraph (b)(3)(iii) of this section). Notwithstanding any other provision, except to the extent provided in paragraph (b)(2) of this section, gross receipts from the sale within the United States of products derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber outside the United States must be allocated between sources within and without the United States based on the fair market value of the product at the export terminal. For place of sale, see §§ 1.861–7(c) and 1.863–3(c)(2). The source of gross receipts equal to the fair market value of the product at the export terminal will be from sources where the farm, mine, well, deposit, or uncut timber is located. The source of gross receipts from the sale of the product in excess of its fair market value at the export terminal (excess gross receipts) will be determined as follows—

(i) If the taxpayer engages in additional production activities subsequent to shipment from the export terminal and outside the country of sale, the source of excess gross receipts must be determined under § 1.863–3. For purposes of applying § 1.863–3, only production assets used in additional production activity subsequent to the export terminal are taken into account.

(ii) In all other cases, excess gross receipts will be from sources within the country of sale. This paragraph (b)(1)(ii) applies to a taxpayer that engages in additional production activities in the country of sale, as well as to a taxpayer that does not engage in additional production activities at all.

(2) *Additional production prior to export terminal.* Notwithstanding any other provision of this section, gross receipts from the sale of products derived by a taxpayer who performs additional production activities as defined in paragraph (b)(3)(ii) of this section before the relevant product is shipped from the export terminal are allocated between sources within and without the United States based on the fair market value of the product immediately prior to the additional production activities. The source of gross receipts equal to the fair market value of the product immediately prior to the additional production activities will be from sources where the farm, mine, well, deposit, or uncut timber is located. The source of gross receipts from the sale of the product in excess of the fair market value immediately prior to the additional production activities must be determined under § 1.863–3. For purposes of applying § 1.863–3, only production assets used in the additional production activities are taken into account.

(3) *Definitions*—(i) *Production activity.* For purposes of this section, production activity means an activity that creates, fabricates, manufactures, extracts, processes, cures, or ages inventory. See § 1.864–1. Except as otherwise provided in §§ 1.1502–13 or 1.863–(g)(2), only production activities conducted directly by the taxpayer are taken into account.

(ii) *Additional production activities.* For purposes of this section, additional production activities are substantial production activities performed directly by the taxpayer in addition to activities from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber. Whether a taxpayer's activities constitute additional production activities will be determined under the principles of § 1.954–3(a)(4). However, in no case will activities that prepare the natural resource itself for export, including those that are designed to facilitate the transportation of the natural resource to or from the export terminal, be considered additional production activities for purposes of this section.

(iii) *Export terminal.* Where the farm, mine, well, deposit, or uncut timber is located without the United States, the export terminal will be the final point in a foreign country from which goods are shipped to the United States. If there is no such final point in a foreign country (e.g., the property is extracted and produced on the high seas), the export terminal will be the place of production. Where the farm, mine, well, deposit, or uncut timber is located within the United States, the export terminal will be the final point in the United States from which goods are shipped from the United States to a foreign country. The location of the export terminal is determined without regard to any contractual terms agreed to by the taxpayer and without regard to whether there is an actual sale of the products at the export terminal.

(4) *Determination of fair market value.* For purposes of this section, fair market value depends on all of the facts and circumstances as they exist relative to a party in any particular case. Where the products are sold to a related party in a transaction subject to section 482, the determination of fair market value under this section must be consistent with the arm's length price determined under section 482.

(5) *Determination of gross income.* To determine the amount of a taxpayer's gross income from sources within or without the United States, the taxpayer's gross receipts from sources within or without the United States determined under this paragraph (b) must be reduced by the cost of goods sold properly attributable to gross receipts from sources within or without the United States.

(6) *Tax return disclosure.* A taxpayer that determines the source of its income under this paragraph (b) shall attach a statement to its return explaining the methodology used to determine fair market value under paragraph (b)(4) of this section, and explaining any addi-

tional production activities (as defined in paragraph (b)(3)(ii) of this section) performed by the taxpayer. In addition, the taxpayer must provide such other information as is required by § 1.863–3.

(7) *Examples.* The following examples illustrate the rules of this paragraph (b):

Example 1. No additional production. U.S. Mines, a U.S. corporation, operates a copper mine and mill in country X. U.S. Mines extracts copper-bearing rocks from the ground and transports the rocks to the mill where the rocks are ground and processed to produce copper-bearing concentrate. The concentrate is transported to a port where it is dried in preparation for export, stored and then shipped to purchasers in the United States. Because title to the property is passed in the United States and, under the facts and circumstances, none of U.S. Mine's activities constitutes additional production prior to the export terminal within the meaning of § 1.863–1(b)(3)(ii), under § 1.863–1(b)(1) and (b)(1)(ii), gross receipts equal to the fair market value of the concentrate at the export terminal will be from sources without the United States, and excess gross receipts will be from sources within the United States.

Example 2. No additional production. US Gas, a U.S. corporation, extracts natural gas within the United States, and transports the natural gas to a U.S. port where it is liquified in preparation for shipment. The liquified natural gas is then transported via freighter and sold without additional production activities in a foreign country. Liquefaction of natural gas is not an additional production activity because liquefaction prepares the natural gas for transportation from the export terminal. Therefore, under § 1.863–1(b)(1) and (b)(1)(ii), gross receipts equal to the fair market value of the liquefied natural gas at the export terminal will be from sources within the United States, and excess gross receipts will be from sources without the United States.

Example 3. Sale in third country. US Gold, a U.S. corporation, mines gold in country X, produces gold jewelry in the United States, and sells the jewelry in country Y. Assume that the fair market value of the gold at the export terminal in country X is $40, and that US Gold ultimately sells the gold jewelry in country Y for $100. Under § 1.863–1(b), $40 of US Gold's gross receipts will be allocated to sources without the United States. Under § 1.863–1(b)(1)(i), the source of the remaining $60 of gross receipts will be determined under § 1.863–3. If US Gold applies the 50/50 method described in § 1.863–3, $20 of cost of goods sold is properly attributable to activities subsequent to the export terminal, and all of US Gold's production assets subsequent to the export terminal are located in the United States, then $20 of gross income will be allocated to sources within the United States and $20 of gross income will be allocated to sources without the United States.

Example 4. Production in country of sale. US Oil, a U.S. corporation, extracts oil in country X, transports the oil via pipeline to the export terminal in country Y, refines the oil in the United States, and sells the refined product in the United States to unrelated persons. Assume that the fair market value of the oil at the export terminal in country Y is $80, and that US Oil ultimately sells the refined product for $100. Under § 1.863–1(b)(1), $80 of US Oil's gross receipts will be allocated to sources without the United States, and under § 1.863–1(b)(1)(ii) the remaining $20 of gross receipts will be allocated to sources within the United States.

Example 5. Additional production prior to export. The facts are the same as in *Example 1*, except that U.S. Mines also operates a smelter in country X. The concentrate output from the mill is transported to the smelter where it is transformed into smelted copper. The smelted copper is exported to purchasers in the United States. Under the facts and circumstances, all of the processes applied to make copper concentrate are considered mining. Therefore, under § 1.863–1(b)(2), gross receipts equal to the fair market value of the concentrate at the smelter will be from sources without the United States. Under the facts and circumstances, the conversion of the concentrate into smelted copper is an additional production activity in a foreign country within the meaning of § 1.863–1(b)(3)(ii). Therefore, the source of U.S. Mine's excess gross receipts will be determined pursuant to § 1.863–1(b)(2).

(c) *Determination of taxable income.* The taxpayer's taxable income from sources within or without the United States will be determined under the rules of §§ 1.861–8 through 1.861–14T for determining taxable income from sources within the United States.

* * * * *

(e) *Effective dates.* The rules of paragraphs (a), (b) and (c) of this section will apply to taxable years beginning after December 30, 1996. However, taxpayers may apply the rules of this section for taxable years beginning after July 11, 1995, and on or before December 30, 1996. For years beginning before December 30, 1996, see § 1.863–1 (as contained in 26 CFR part 1 revised as of April 1, 1996).

Par. 5. Section 1.863–2 is revised to read as follows:

§ 1.863–2 Allocation and apportionment of taxable income.

(a) *Determination of taxable income.* Section 863(b) provides an alternate method for determining taxable income from sources within the United States in the case of gross income derived from sources partly within and partly without the United States. Under this method, taxable income is determined by deducting from such gross income the expenses, losses, or other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions that cannot definitely be allocated to some item or class of gross income. The income to which this section applies (and that is treated as derived partly from sources within and partly from sources without the United States) will consist of gains, profits, and income

(1) From certain transportation or other services rendered partly within and partly without the United States to the extent not within the scope of section 863(c) or other specific provisions of this title;

(2) From the sale of inventory property (within the meaning of section 865(i)) produced (in whole or in part) by the taxpayer in the United States and sold outside the United States or produced (in whole or in part) by the taxpayer outside the United States and sold in the United States; or

(3) Derived from the purchase of personal property within a possession of the United States and its sale within the United States, to the extent not excluded from the scope of these regulations under § 1.936–6(a)(5), Q&A 7.

(b) *Determination of source of taxable income.* Income treated as derived from sources partly within and partly without the United States under paragraph (a) of this section may be allocated to sources within and without the United States pursuant to § 1.863–1 or apportioned to such sources in accordance with the methods described in other regulations under section 863. To determine the source of certain types of income described in paragraph (a)(1) of this section, see § 1.863–4. To determine the source of gross income described in paragraph (a)(2) of this section, see § 1.863–1 for natural resources and see § 1.863–3 for other inventory. Taxpayers, at their election, may apply the principles of § 1.863–3(b)(1) and (c) to determine the source of taxable income (rather than gross income) from sales of inventory property (other than natural resources). To determine the source of income partly from sources within a possession of the United States, including income described in paragraph (a)(3) of this section, see § 1.863–3(f).

(c) *Effective dates.* This section will apply to taxable years beginning after December 30, 1996. However, taxpayers may apply the rules of this section for taxable years beginning after July 11, 1995, and on or before December 30, 1996. For years beginning before December 30, 1996, see § 1.863–2 (as contained in 26 CFR part 1 revised as of April 1, 1996).

Par. 6. Section 1.863–3 is added to read as follows:

§ 1.863–3 Allocation and apportionment of income from certain sales of inventory.

(a) *In general*—(1) *Scope.* Paragraphs (a) through (e) of this section apply to determine the source of income derived from the sale of inventory property (inventory), which a taxpayer produces (in whole or in part) within the United States and sells outside the United States, or which a taxpayer produces (in whole or in part) outside the United States and sells within the United States (Section 863 Sales). A taxpayer must divide gross income from Section 863 Sales between production activity and sales activity using one of the methods described in paragraph (b) of this section. The source of gross income from production activity and from sales activity must then be determined under paragraph (c) of this section. Taxable income from Section 863 Sales is determined under paragraph (d) of this section. Paragraph (e) of this section describes the rules for electing the methods described in paragraph (b) of this section and the information that a taxpayer must disclose on a tax return. Paragraph (f) of this section applies to determine the source of certain income derived from a possession of the United States. Paragraph (g) of this section provides special rules for partnerships for all sales subject to §§ 1.863–1 through 1.863–3. Paragraph (h) of this section provides effective dates for the rules in this section.

(2) *Rules of application for Section 863 Sales.* Once a taxpayer has elected a method described in paragraph (b) of this section, the taxpayer must separately apply that method to Section 863 Sales in the United States and to Section 863 Sales outside the United States. In addition, the taxpayer must apply the rules of paragraphs (c) and (d) of this section by aggregating all Section 863 Sales to which a method described in paragraph (b) of this section applies, after separately applying that method to Section 863 Sales in the United States and to Section 863 Sales outside the United States. See section 865(i)(1) for the definition of inventory property. See also section 865(e)(2). See § 1.861–7(c) and paragraph (c)(2) of this section for the time and place of sale.

(b) *Methods to determine income attributable to production activity and sales activity*—(1) *50/50 method*—(i) *Determination of gross income.* Generally, gross income from Section 863 Sales will be apportioned between production activity and sales activity under the 50/50 method as described in this paragraph (b)(1). Under the 50/50 method, one-half of the taxpayer's gross income will be considered income attributable to production activity and the source of that income will be determined under the rules of paragraph (c)(1) of this section. The remaining one-half of such gross income will be considered income attributable to sales activity and the source of that income will be determined under the rules of paragraph (c)(2) of this section. In lieu of the 50/50 method, the taxpayer may elect to determine the source of income from Section 863 Sales under the IFP method described in paragraph (b)(2) of this section or, with the consent of the District Director, the books and records method described in paragraph (b)(3) of this section.

(ii) *Example.* The following example illustrates the rules of this paragraph (b)(1):

Example. 50/50 method. (i) P, a U.S. corporation, produces widgets in the United States. P sells the widgets for $100 to D, an unrelated foreign distributor, in another country. P's cost of goods sold is $40. Thus, P's gross income is $60.

(ii) Pursuant to the 50/50 method, one-half of P's gross income, or $30, is considered income attributable to production activity, and one-half of P's gross income, or $30, is considered income attributable to sales activity.

(2) *IFP method*—(i) *Establishing an IFP.* A taxpayer may elect to allocate gross income earned from production activity and sales activity using the independent factory price (IFP) method described in this paragraph (b)(2) if an IFP is fairly established. An IFP is fairly established based on a sale by the taxpayer only if the taxpayer regularly sells part of its output to wholly independent distributors or other selling concerns in such a way as to reasonably reflect the income earned from production activity. A sale will not be considered to fairly establish an IFP if sales activity by the taxpayer with respect to that sale is significant in relation to all of the activities with respect to that product.

(ii) *Applying the IFP method.* If the taxpayer elects to use the IFP method, the amount of the gross sales price equal to the IFP will be treated as attributable to production activity, and the excess of the gross sales price over the IFP will be treated as attributable to sales activity. If a taxpayer elects to use the IFP method, the IFP must be applied to all Section 863 Sales of inventory that are substantially similar in physical characteristics and function, and are sold at a similar level of distribution as the inventory sold in the sale fairly establishing an IFP. The IFP will only be applied to sales that are reasonably contemporaneous with the sale fairly establishing the IFP. An IFP cannot be applied to sales in other geographic markets if the markets are substantially different. If the taxpayer elects the IFP method, the rules of this paragraph will also apply to determine the division of gross receipts between production activity and sales activity in a Section 863 Sale that itself fairly establishes an IFP. If the taxpayer elects to apply the IFP method, the IFP method must be applied to all sales for which an IFP may be fairly established and applied for that taxable year and each subsequent taxable year. The taxpayer will apply either the 50/50 method described in paragraph (b)(1) of this section or the books and records method described in paragraph (b)(3) of this section to any other Section 863 Sale for which an IFP cannot be established or applied for each taxable year.

(iii) *Determination of gross income.* The amount of a taxpayer's gross income from production activity is determined by reducing the amount of gross receipts from production activity by the cost of goods sold properly attributable to production activity. The amount of a taxpayer's gross income from sales activity is determined by reducing the amount of gross receipts from sales activity by the cost of goods sold (if any) properly attributable to sales activity. The source of gross income from production activity is determined under the rules of paragraph (c)(1) of this section, and the source of gross income from sales activity will be determined under the rules of paragraph (c)(2) of this section.

(iv) *Examples.* The following examples illustrate the rules of this paragraph (b)(2):

Example 1. IFP method. (i) P, a U.S. producer, purchases cotton and produces cloth in the United States. P sells cloth in country X to D, an unrelated foreign clothing manufacturer, for $100. Cost of goods sold for cloth is $80, entirely attributable to production activity. P does not engage in significant sales activity in relation to its other activities in the sales to D. Under these facts, the sale to D fairly establishes an IFP of $100. Assume that P elects to use the IFP method. Accordingly, $100 of the gross sales price is treated as attributable to production activity, and no amount of income from this sale is attributable to sales activity. After reducing the gross sales

price by cost of goods sold, $20 of the gross income is treated as attributable to production activity ($100–$80).

(ii) P also sells cloth in country X to A, a unrelated foreign retail outlet, for $110. Because P elected the IFP method and the cloth is substantially similar to the cloth sold to D, the IFP fairly established in the sales to D must be used to determine the amount attributable to production activity in the sale to A. Accordingly, $100 of the gross sales price is treated as attributable to production activity and $10 ($110–$100) is attributable to sales activity. After reducing the gross sales price by cost of goods sold, $20 of the gross income is treated as attributable to production activity ($100–$80) and $10 is attributable to sales activity.

Example 2. Scope of IFP Method. (i) USCo manufactures three dissimilar products. USCo elects to apply the IFP method. In year 1, an IFP can be established for sales of product X, but not for products Y and Z. In year 2, an IFP cannot be established for any of USCo's products. In year 3, an IFP can be established for products X and Y, but not for product Z.

(ii) In year 1, USCo must apply the IFP method to sales of product X. In year 2, although USCo's IFP election remains in effect, USCo is not required to apply the IFP election to any products. In year 3, USCo is required to apply the IFP method to sales of products X and Y.

(3) *Books and records method.* A taxpayer may elect to determine the amount of its gross income from Section 863 Sales that is attributable to production and sales activities for the taxable year based upon its books of account if it has received in advance the permission of the District Director having audit responsibility over its tax return. The taxpayer must establish to the satisfaction of the District Director that the taxpayer, in good faith and unaffected by considerations of tax liability, will regularly employ in its books of account a detailed allocation of receipts and expenditures which clearly reflects the amount of the taxpayer's income from production and sales activities. If a taxpayer receives permission to apply the books and records method, but does not comply with a material condition set forth by the District Director, the District Director may, in its discretion, revoke permission to use the books and records method. The source of gross income treated as attributable to production activity under this method may be determined under the rules of paragraph (c)(1) of this section, and the source of gross income attributable to sales activity will be determined under the rules of paragraph (c)(2) of this section.

(c) *Determination of the source of gross income from production activity and sales activity*—(1) *Income attributable to production activity*—(i) *Production only within the United States or only within foreign countries*—(A) *Source of income.* For purposes of this section, production activity means an activity that creates, fabricates, manufactures, extracts, processes, cures, or ages inventory. See § 1.864–1. Subject to the provisions in § 1.1502–13 or paragraph (g)(2)(ii) of this section, the only production activities that are taken into account for purposes of §§ 1.863–1, 1.863–2, and this section are those conducted directly by the taxpayer. Where the taxpayer's production assets are located only within the United States or only outside the United States, the income attributable to production activity is sourced where the taxpayer's production assets are located. For rules regarding the source of income when production assets are located both within the United States and without the United States, see paragraph (c)(1)(ii) of this section.

(B) *Definition of production assets.* Subject to the provisions of § 1.1502–13 and paragraph (g)(2)(ii) of this section, production assets include only tangible and intangible assets owned directly by the taxpayer that are directly used by the taxpayer to produce inventory described in paragraph (a) of this section. Production assets do not include assets that are not directly used to produce inventory described in paragraph (a) of this section. Thus, production assets do not include such assets as accounts receivables, intangibles not related to production of inventory (e.g., marketing intangibles, including trademarks and customer lists), transportation assets, warehouses, the inventory itself, raw materials, or work-in-process. In addition, production assets do not include cash or other liquid assets (including working capital), investment assets, prepaid expenses, or stock of a subsidiary.

(C) *Location of production assets.* For purposes of this section, a tangible production asset will be considered located where the asset is physically located. An intangible production asset will be considered located where the tangible production assets owned by the taxpayer to which it relates are located.

(ii) *Production both within the United States and within foreign countries*—(A) *Source of income.* Where the taxpayer's production assets are located both within and without the United States, income from sources without the United States will be determined by multiplying the income attributable to the taxpayer's production activity by a fraction, the numerator of which is the average adjusted basis of production assets that are located outside the United States and the denominator of which is the average adjusted basis of all production assets within and without the United States. The remaining income is treated as from sources within the United States.

(B) *Adjusted basis of production assets.* For purposes of paragraph (c)(1)(ii)(A) of this section, the adjusted basis of an asset is determined under section 1011. The average adjusted basis is computed by averaging the adjusted basis of the asset at the beginning and end of the taxable year, unless by reason of material changes during the taxable year such average does not fairly represent the average for such year. In this event, the average adjusted basis will be determined upon a more appropriate basis. If production assets are used to produce inventory sold in Section 863 Sales and are also used to produce other property during the taxable year, the portion of its adjusted basis that is included in the fraction described in paragraph (c)(1)(ii)(A) of this section will be determined under any method that reasonably reflects the portion of the assets that produces inventory sold in Section 863 Sales. For example, the portion of such an asset that is included in the formula may be determined by multiplying the asset's average adjusted basis by a fraction, the numerator of which is the gross receipts from sales of inventory from Section 863 Sales produced by the asset, and the denominator of which is the gross receipts from all property produced by that asset.

(iii) *Anti-abuse rule.* The purpose of this paragraph (c)(1) is to attribute the source of the taxpayer's production income to the location of the taxpayer's production activity. Therefore, if the taxpayer has entered into or structured one or more transactions with a principal purpose of reducing its U.S. tax liability by manipulating the formula described in paragraph (c)(1)(ii)(A) of this section in a manner inconsistent with the purpose of this paragraph (c)(1), the District Director may make appropriate adjustments so that the source of the taxpayer's income from production activity more clearly reflects the source of that income.

(iv) *Examples.* The following examples illustrate the rules of this paragraph (c)(1):

Example 1. Source of production income. (i) A, a U.S. corporation, produces widgets that are sold both within the United States and within a foreign country. The initial manufacture of all widgets

occurs in the United States. The second stage of production of widgets that are sold within a foreign country is completed within the country of sale. A's U.S. plant and machinery which is involved in the initial manufacture of the widgets has an average adjusted basis of $200. A also owns warehouses used to store work-in-process. A owns foreign equipment with an average adjusted basis of $25. A's gross receipts from all sales of widgets is $100, and its gross receipts from export sales of widgets is $25. Assume that apportioning average adjusted basis using gross receipts is reasonable. Assume A's cost of goods sold from the sale of widgets in the foreign countries is $13 and thus, its gross income from widgets sold in foreign countries is $12. A uses the 50/50 method to divide its gross income between production activity and sales activity.

(ii) A determines its production gross income from sources without the United States by multiplying one-half of A's $12 of gross income from sales of widgets in foreign countries, or $6, by a fraction, the numerator of which is all relevant foreign production assets, or $25, and the denominator of which is all relevant production assets, or $75 ($25 foreign assets + ($200 U.S. assets X $25 gross receipts from export sales/$100 gross receipts from all sales)). Therefore, A's gross production income from sources without the United States is $2 ($6 X ($25/$75)).

Example 2. Location of intangible property. Assume the same facts as *Example 1*, except that A employs a patented process that applies only to the initial production of widgets. In computing the formula used to determine the source of income from production activity, A's patent, if it has an average adjusted basis, would be located in the United States.

Example 3. Anti-abuse rule. (i) Assume the same facts as *Example 1*. A sells its U.S. assets to B, an unrelated U.S. corporation, with a principal purpose of reducing its U.S. tax liability by manipulating the property fraction. A then leases these assets from B. After this transaction, under the general rule of paragraph (c)(1)(ii) of this section, all of A's production income would be considered from sources without the United States, because all of A's relevant production assets are located within a foreign country. Since the leased property is not owned by the taxpayer, it is not included in the fraction.

(ii) Because A has entered into a transaction with a principal purpose of reducing its U.S. tax liability by manipulating the formula described in paragraph (c)(1)(ii)(A) of this section, A's income must be adjusted to more clearly reflect the source of that income. In this case, the District Director may redetermine the source of A's production income by ignoring the sale-leaseback transactions.

(2) *Income attributable to sales activity.* The source of the taxpayer's income that is attributable to sales activity will be determined under the provisions of § 1.861–7(c). However, notwithstanding any other provision, for purposes of section 863, the place of sale will be presumed to be the United States if personal property is wholly produced in the United States and the property is sold for use, consumption, or disposition in the United States. See § 1.864–6(b)(3)(ii) to determine the country of use, consumption, or disposition. Also, in applying this paragraph, property will be treated as wholly produced in the United States if it is subject to no more than packaging, repackaging, labeling, or other minor assembly operations outside the United States, within the meaning of § 1.954–3(a)(4)(iii)(property manufactured or produced by a controlled foreign corporation).

(d) *Determination of source of taxable income.* Once the source of gross income has been determined under paragraph (c) of this section, the taxpayer must properly allocate and apportion separately under §§ 1.861–8 through 1.861–14T the amounts of its expenses, losses, and other deductions to its respective amounts of gross income from Section 863 Sales determined separately under each method described in paragraph (b) of this section. In addition, if the taxpayer deducts expenses for research and development under section 174 that may be attributed to its Section 863 Sales under § 1.861–8(e)(3), the taxpayer must separately allocate or apportion expenses, losses, and other deductions to its respective amounts of gross income from each relevant product category that the taxpayer uses in applying the rules of § 1.861–8(e)(3)(i)(A). In the case of gross income from Section 863 Sales determined under the IFP method or the books and records method, the rules of §§ 1.861–8 through 1.861–14T must apply to properly allocate or apportion amounts of expenses, losses and other deductions allocated and apportioned to such gross income between gross income from sources within and without the United States. In the case of gross income from Section 863 Sales determined under the 50/50 method, the amounts of expenses, losses, and other deductions allocated and apportioned to such gross income must be apportioned between sources within and without the United States pro rata based on the relative amounts of gross income from sources within and without the United States determined under the 50/50 method. Research and experimental expenditures qualifying under § 1.861–17 are allocated under that section, and are not allocated and apportioned pro rata under the 50/50 method.

(e) *Election and reporting rules*—(1) *Elections under paragraph (b) of this section.* If a taxpayer does not elect a method specified in paragraph (b)(2) or (3) of this section, the taxpayer must apply the method specified in paragraph (b)(1) of this section. The taxpayer may elect to apply the method specified in paragraph (b)(2) of this section by using the method on a timely filed original return (including extensions). A taxpayer may elect to apply the method specified in paragraph (b)(3) of this section by using the method on a timely filed original return (including extensions), but only if the taxpayer has received permission from the District Director to apply that method. Once a method under paragraph (b) of this section has been used, that method must be used in later taxable years unless the Commissioner consents to a change. However, if a taxpayer elects to change to or from the method specified in paragraph (b)(3) of this section, the taxpayer must obtain permission from the District Director instead of the Commissioner. Permission to change methods from one year to another year will not be withheld unless the change would result in a substantial distortion of the source of the taxpayer's income.

(2) *Disclosure on tax return.* A taxpayer who uses one of the methods described in paragraph (b) of this section must fully explain in a statement attached to the return the methodology used, the circumstances justifying use of that methodology, the extent that sales are aggregated, and the amount of income so allocated.

(f) *Income partly from sources within a possession of the United States.* Taxpayers with income partly from sources within a possession of the United States must apply the rules of § 1.863–3A(c).

(g) *Special rules for partnerships*—(1) *General rule.* For purposes of § 1.863–1 and this section, a taxpayer's production or sales activity does not include production and sales activities conducted by a partnership of which the taxpayer is a partner either directly or through one or more partnerships, except as otherwise provided in paragraph (g)(2) of this section.

(2) *Exceptions*—(i) *In general.* For purposes of determining the source of the partner's distributive share of partnership income or determining the source of the partner's income from the sale of inventory property which the partnership distributes to the partner in kind, the partner's production or sales activity includes an activity conducted by the partnership. In addition, the production activity of a partnership includes the production activity of a taxpayer that is a partner either directly or through one or more partnerships, to the extent that the partner's production activity is related to inventory that the partner

contributes to the partnership in a transaction described under section 721.

(ii) *Attribution of production assets to or from a partnership.* A partner will be treated as owning its proportionate share of the partnership's production assets only to the extent that, under paragraph (g)(2)(i) of this section, the partner's activity includes production activity conducted through a partnership. A partner's share of partnership assets will be determined by reference to the partner's distributive share of partnership income for the year attributable to such production assets. Similarly, to the extent a partnership's activities include the production activities of a partner, the partnership will be treated as owning the partner's production assets related to the inventory that is contributed in kind to the partnership. See paragraph (c)(1)(ii)(B) of this section for rules apportioning the basis of assets to Section 863 Sales.

(iii) *Basis.* For purposes of this section, in those cases where the partner is treated as owning its proportionate share of the partnership's production assets, the partner's basis in production assets held through a partnership shall be determined by reference to the partnership's adjusted basis in its assets (including a partner's special basis adjustment, if any, under section 743). Similarly, a partnership's basis in a partner's production assets is determined with reference to the partner's adjusted basis in its assets.

(iv) *Separate application of methods.* If, under paragraph (g)(2) of this section, a partner is treated as conducting the activity of a partnership, and is treated as owning its proportionate share of a partnership's production assets, a partner must apply the method it has elected under paragraph (b) of this section separately to Section 863 Sales described in this paragraph (g) and all other Section 863 Sales.

(3) *Examples.* The following examples illustrate the rules of this paragraph (g):

Example 1. Distributive share of partnership income. A, a U.S. corporation, forms a partnership in the United States with B, a country X corporation. A and B each have a 50 percent interest in the income, gains, losses, deductions and credits of the partnership. The partnership is engaged in the manufacture and sale of widgets. The widgets are manufactured in the partnership's plant located in the United States and are sold by the partnership outside the United States. The partnership owns the manufacturing facility and all other production assets used to produce the widgets. A's distributive share of partnership income includes 50 percent of the sales income from these sales. In applying the rules of section 863 to determine the source of its distributive share of partnership income from the export sales of widgets, A is treated as carrying on the activity of the partnership related to production of these widgets and as owning a proportionate share of the partnership's assets related to production of the widgets, based upon its distributive share of partnership income.

Example 2. Distribution in kind. Assume the same facts as in *Example 1* except that the partnership, instead of selling the widgets, distributes the widgets to A and B. A then further processes the widgets and then sells them outside the United States. In determining the source of the income earned by A on the sales outside the United States, A is treated as conducting the activities of the partnership related to production of the distributed widgets. Thus, the source of gross income on the sale of the widgets is determined under section 863 and these regulations. A applies the 50/50 method described in paragraph (b)(1) of this section to determine the source of income from the sales. In applying paragraph (c)(1) of this section, A is treated as owning its proportionate share of the partnership's production assets based upon its distributive share of partnership income.

(h) *Effective dates.* The rules of this section apply to taxable years beginning after December 30, 1996. However, taxpayers may apply these regulations for taxable years beginning after July 11, 1995, and on or before December 30, 1996. For years beginning before December 30, 1996, see §§ 1.863–3A and 1.863–3AT.

Par. 7. Section 1.863–4 is amended by revising the section heading and paragraph (a) to read as follows:

§ 1.863–4 Certain transportation services.

(a) *General.* A taxpayer carrying on the business of transportation service (other than an activity giving rise to transportation income described in section 863(c) or to income subject to other specific provisions of this title) between points in the United States and points outside the United States derives income partly from sources within and partly from sources without the United States.

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§ 1.863–5 [Removed]

Par. 8. Section 1.863–5 is removed.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 9. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 10. In § 602.101, paragraph (c) is amended by adding entries for 1.863–1 and 1.863–3A, and revising the entry for 1.863–3 to read as follows:

§ 602.101 OMB Control numbers.

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(c) * * *

CFR part or section where identified and described	Current OMB control No.
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1.863–1	1545–1476
1.863–3	1545–1476
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1.863–3A	1545–0126
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Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved November 25, 1996.

Donald C. Lubick,
Acting Assistant Secretary of Tax Policy.

(Filed by the Office of the Federal Register on November 27, 1996, 8:45 a.m., and published in the issue of the Federal Register for November 29, 1996, 61 F.R. 60540)

Part II.—Nonresident Aliens and Foreign Corporations
Subpart A.—Nonresident Alien Individuals

Section 877.—Expatriation To Avoid Tax

The Service is providing inflation adjustments for calendar year 1997 to amounts used to determine whether a principal purpose of expatriation is to avoid tax. See Rev. Proc. 96–59, page 392.

Part IV.—Domestic International Sale Corporations
Subpart B.—Treatment of Distributions to Shareholders

Section 995.—Taxation of DISC Income to Shareholders

1996 base period T-bill rate. The "base period T-bill rate" for the period ending September 30, 1996, is published, as required by section 995(f)(4) of the Code.

Rev. Rul. 96–55

Section 995(f)(1) of the Internal Revenue Code provides that a shareholder of a DISC shall pay interest each taxable year in an amount equal to the product of the shareholder's DISC-related deferred tax liability for the year and the "base period T-bill rate." Under section 995(f)(4), the base period T-bill rate is the annual rate of interest determined by the Secretary to be equivalent to the average investment yield of

United States Treasury bills with maturities of 52 weeks which were auctioned during the one-year period ending on September 30 of the calendar year ending with (or of the most recent calendar year ending before) the close of the taxable year of the shareholder. The base period T-bill rate for the period ending September 30, 1996, is 5.51 percent.

Pursuant to section 6622 of the Code, interest must be compounded daily. The table below provides factors for compounding the base period T-bill rate daily for any number of days in the shareholder's taxable year (including a 52–53 week accounting period) for the 1996 base period T-bill rate. To compute the amount of the interest charge for the shareholder's taxable year, multiply the amount of the shareholder's DISC-related deferred tax liability (as defined in section 995(f)(2)) for that year by the base period T-bill rate factor corresponding to the number of days in the shareholder's taxable year for which the interest charge is being computed. Generally, one would use the factor for 365 days. One would use a different factor only if the shareholder's taxable year for which the interest charge being determined is a short taxable year, if the shareholder uses the 52–53 week taxable year, or if the shareholder's taxable year is a leap year.

For the base period T-bill rates for the periods ending in prior years, *see*: Rev. Rul. 86–132, 1986–2 C.B. 137; Rev. Rul. 87–129, 1987–2 C.B. 196; Rev. Rul. 88–94, 1988–2 C.B. 301; Rev. Rul. 89–116, 1989–2 C.B. 197; Rev. Rul. 90–96, 1990–2 C.B. 188; Rev. Rul. 91–59, 1991–2 C.B. 347; Rev. Rul. 92–98, 1992–2 C.B. 201; Rev. Rul. 93–77, 1993–2 C.B. 253; Rev. Rul. 94–68, 1994–2 C.B. 177: and Rev. Rul. 95–77, 1995–2 C.B. 122.

1996 ANNUAL RATE, COMPOUNDED DAILY

DAYS	5.51 PERCENT FACTOR
1	.000150546
2	.000301116
3	.000451707
4	.000602322
5	.000752959
6	.000903619
7	.001054301
8	.001205006
9	.001355734
10	.001506485
11	.001657258
12	.001808054
13	.001958873
14	.002109714
15	.002260578
16	.002411465
17	.002562374
18	.002713306
19	.002864261
20	.003015239
21	.003166239
22	.003317263
23	.003468308
24	.003619377
25	.003770468
26	.003921582
27	.004072719
28	.004223879
29	.004375061
30	.004526266
31	.004677494
32	.004828745
33	.004980018
34	.005131314
35	.005282633
36	.005433975
37	.005585340
38	.005736727
39	.005888137
40	.006039570
41	.006191025
42	.006342504
43	.006494005
44	.006645529
45	.006797076
46	.006948646
47	.007100239
48	.007251854
49	.007403492
50	.007555153
51	.007706837
52	.007858544
53	.008010273
54	.008162026
55	.008313801
56	.008465599
57	.008617420
58	.008769263
59	.008921130
60	.009073020
61	.009224932
62	.009376867
63	.009528825
64	.009680806
65	.009832810
66	.009984837
67	.010136886
68	.010288959
69	.010441054
70	.010593173
71	.010745314
72	.010897478
73	.011049665
74	.011201875
75	.011354108
76	.011506364
77	.011658642
78	.011810944
79	.011963268
80	.012115616
81	.012267986
82	.012420380
83	.012572796
84	.012725235
85	.012877697
86	.013030183
87	.013182691
88	.013335222
89	.013487776
90	.013640353
91	.013792953
92	.013945576
93	.014098222
94	.014250890
95	.014403582
96	.014556297
97	.014709035
98	.014861796
99	.015014580
100	.015167387
101	.015320216
102	.015473069
103	.015625945
104	.015778844
105	.015931766
106	.016084711
107	.016237679
108	.016390670
109	.016543684
110	.016696721
111	.016849781
112	.017002864
113	.017155970
114	.017309099
115	.017462252

DAYS	5.51 PERCENT FACTOR	DAYS	5.51 PERCENT FACTOR	DAYS	5.51 PERCENT FACTOR
116	.017615427	171	.026075679	226	.034606268
117	.017768625	172	.026230151	227	.034762024
118	.017921847	173	.026384646	228	.034917804
119	.018075091	174	.026539165	229	.035073607
120	.018228359	175	.026693707	230	.035229433
121	.018381650	176	.026848272	231	.035385284
122	.018534963	177	.027002860	232	.035541157
123	.018688300	178	.027157472	233	.035697054
124	.018841660	179	.027312107	234	.035852975
125	.018995043	180	.027466765	235	.036008919
126	.019148449	181	.027621446	236	.036164886
127	.019301878	182	.027776151	237	.036320877
128	.019455331	183	.027930879	238	.036476891
129	.019608806	184	.028085630	239	.036632929
130	.019762304	185	.028240405	240	.036788991
131	.019915826	186	.028395203	241	.036945076
132	.020069371	187	.028550024	242	.037101184
133	.020222939	188	.028704869	243	.037257316
134	.020376529	189	.028859737	244	.037413471
135	.020530144	190	.029014628	245	.037569650
136	.020683781	191	.029169542	246	.037725853
137	.020837441	192	.029324480	247	.037882079
138	.020991124	193	.029479441	248	.038038328
139	.021144831	194	.029634426	249	.038194601
140	.021298561	195	.029789433	250	.038350898
141	.021452314	196	.029944465	251	.038507218
142	.021606090	197	.030099519	252	.038663561
143	.021759889	198	.030254597	253	.038819928
144	.021913711	199	.030409698	254	.038976319
145	.022067557	200	.030564823	255	.039132733
146	.022221425	201	.030719970	256	.039289171
147	.022375317	202	.030875142	257	.039445632
148	.022529232	203	.031030336	258	.039602117
149	.022683170	204	.031185554	259	.039758625
150	.022837132	205	.031340796	260	.039915157
151	.022991116	206	.031496060	261	.040071713
152	.023145124	207	.031651348	262	.040228292
153	.023299155	208	.031806660	263	.040384895
154	.023453209	209	.031961995	264	.040541521
155	.023607286	210	.032117353	265	.040698171
156	.023761386	211	.032272734	266	.040854844
157	.023915510	212	.032428139	267	.041011541
158	.024069657	213	.032583568	268	.041168262
159	.024223827	214	.032739020	269	.041325006
160	.024378020	215	.032894495	270	.041481774
161	.024532237	216	.033049993	271	.041638565
162	.024686476	217	.033205515	272	.041795380
163	.024840739	218	.033361061	273	.041952219
164	.024995025	219	.033516630	274	.042109081
165	.025149335	220	.033672222	275	.042265967
166	.025303667	221	.033827838	276	.042422876
167	.025458023	222	.033983477	277	.042579809
168	.025612402	223	.034139139	278	.042736766
169	.025766804	224	.034294825	279	.042893746
170	.025921230	225	.034450535	280	.043050750

DAYS	5.51 PERCENT FACTOR
281	.043207778
282	.043364829
283	.043521904
284	.043679002
285	.043836125
286	.043993270
287	.044150440
288	.044307633
289	.044464850
290	.044622090
291	.044779354
292	.044936642
293	.045093954
294	.045251289
295	.045408648
296	.045566030
297	.045723437
298	.045880867
299	.046038320
300	.046195798
301	.046353299
302	.046510823
303	.046668372
304	.046825944
305	.046983540
306	.047141160
307	.047298803
308	.047456470
309	.047614161
310	.047771876
311	.047929614
312	.048087376
313	.048245162
314	.048402971
315	.048560805
316	.048718662
317	.048876543
318	.049034447
319	.049192376
320	.049350328
321	.049508304
322	.049666304
323	.049824327
324	.049982375
325	.050140446
326	.050298541
327	.050456659
328	.050614802
329	.050772968
330	.050931158
331	.051089372
332	.051247610
333	.051405872
334	.051564157
335	.051722466
336	.051880799
337	.052039156
338	.052197537
339	.052355942
340	.052514370
341	.052672822
342	.052831299
343	.052989799
344	.053148322
345	.053306870
346	.053465442
347	.053624037
348	.053782657
349	.053941300
350	.054099967
351	.054258658
352	.054417373
353	.054576112
354	.054734874
355	.054893661
356	.055052471
357	.055211306
358	.055370164
359	.055529046
360	.055687953
361	.055846883
362	.056005837
363	.056164815
364	.056323816
365	.056482842
366	.056641892
367	.056800966
368	.056960063
369	.057119185
370	.057278330
371	.057437500

Subchapter O.—Gain or Loss on Disposition of Property

Part I.—Determination of Amount of and Recognition of Gain or Loss

Section 1001.—Determination of Amount of and Recognition of Gain or Loss

26 CFR 1.1001–3: Modifications of debt instruments.

T.D. 8675

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Modifications of Debt Instruments

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the modification of debt instruments. The regulations govern when a modification is treated as an exchange of the original debt instrument for a modified instrument. The regulations provide needed guidance to issuers and holders of debt instruments.

DATES: These regulations are effective September 24, 1996.

For dates of applicability of these regulations, see § 1.1001–3(h).

SUPPLEMENTARY INFORMATION:

Background

On December 2, 1992, proposed amendments to 26 CFR part 1 were published in the **Federal Register** (57 FR 57034 [FI–31–92, 1992–2 C.B. 683]) to provide guidance under § 1.1001–3. The proposed regulations relate to the modification of debt instruments. On February 17, 1993, the IRS held a public hearing on the proposed regulations. In addition, the IRS received numerous written comments on the proposed regulations. The proposed regulations, with certain changes made in response to comments, are adopted in this Treasury decision as final regulations. The principal changes to the regulations, as well as the major comments and suggestions, are discussed below.

Explanation of Provisions

A. General

The preamble to the proposed regulations states that the proposed regulations are intended to address the uncertainty concerning when the modification of a debt instrument results in a deemed exchange of the old debt instrument for a new instrument. Some of this uncertainty resulted from the possible impact of the decision of the Supreme Court in *Cottage Savings Ass'n v. Commissioner*, 499 U.S. 554 (1991). The preamble invites comments with respect to whether it is desirable to provide rules for the modification of debt instruments as well as comments with respect to what those rules should be.

Although the IRS received many comments on the proposed regulations, relatively few commentators addressed the question of whether regulations on the modification of debt instruments are desirable. A few commentators argued

against the promulgation of regulations on this subject. A number of other commentators were supportive of the attempt to provide certainty through a series of specific rules. Some commentators suggested that the regulations adopt a facts and circumstances approach with safe harbors under which certain modifications would not be treated as exchanges. In contrast, other commentators suggested using additional bright-line rules to provide more certainty with respect to when a modification is, and is not, treated as an exchange of the old debt instrument for a new instrument. Most commentators, however, limited their comments to the specific rules of the proposed regulations.

The IRS and Treasury considered adopting a single, general rule instead of several detailed rules. That approach, while providing less guidance, would have the advantage of reducing complexity and avoiding anomalies that can result from bright- line rules (for example, different results for economically similar transactions). Nevertheless, after considering that approach the IRS and Treasury concluded that both taxpayers and the IRS would benefit from regulations specifically addressing the treatment of certain modifications. A debt modification that results in an exchange may have a variety of consequences, and parties contemplating a change to a debt instrument should be able to determine whether that change will result in an exchange.

Accordingly, the final regulations retain the basic structure of the proposed regulations. Thus, an alteration of the terms of a debt instrument is first tested to determine whether the alteration is a "modification." If there is a modification, the modification is then tested to determine whether it is a "significant modification." A significant modification results in an exchange of the original debt instrument for a modified instrument that differs materially either in kind or in extent within the meaning of § 1.1001–1(a).

Although the final regulations generally follow the approach of the proposed regulations, certain rules have been added or modified to address a number of issues noted by commentators. For example, in one instance the final regulations provide a general rule with respect to a particular type of modification together with a safe harbor for certain changes that will not result in exchanges. In other instances, the final regulations retain the bright-line approach of the proposed regulations. The IRS and Treasury invite comments on the operation of the final regulations and will consider providing additional guidance as appropriate.

B. Other instruments

In the preamble to the proposed regulations, the IRS invites comments with respect to whether the regulations should be expanded to address modifications of financial instruments other than debt instruments. In response, several commentators argued that a dealer's assignment of its position in an interest rate swap contract or other notional principal contract should not result in an exchange under section 1001 for the nonassigning counterparty. In response to these comments, the IRS and Treasury are issuing proposed and temporary regulations that provide a special rule for dealer assignments of notional principal contracts. However, those temporary and proposed regulations and these final regulations do not address whether particular instruments are debt instruments for Federal income tax purposes.

With the exception of those temporary and proposed regulations, the final regulations have not been expanded to cover the modification of financial instruments other than debt instruments. The modification of other instruments is less common than the modification of debt instruments, and the rules for modifications of debt instruments would not necessarily work well or be appropriate in determining whether modifications of other instruments result in exchanges under section 1001. For equity instruments in particular, the IRS and Treasury believe that the application of certain rules in these regulations would be inappropriate. Similarly, for contracts that are not debt instruments, the final regulations do not limit or otherwise affect the application of the "fundamental change" concept articulated in Rev. Rul. 90–109 (1990–2 C.B. 191), in which the IRS concluded that the exercise by a life insurance policyholder of an option to change the insured under the policy changed "the fundamental substance" of the contract, and thus was a disposition under section 1001.

C. Modifications

The final regulations retain the general rule of the proposed regulations that a modification includes any alteration of a legal right or obligation of the issuer or holder. The final regulations, however, do not adopt the rule of the proposed regulations that a unilateral waiver of a right that does not rise to the level of a settlement of terms between the parties is not a modification of the original instrument. Commentators noted that it often is impossible to distinguish between a unilateral waiver of a right and a workout agreed to by the parties in which only the holder of the instrument makes meaningful concessions. Moreover, in the case of a prepayable debt instrument, the holder's waiver of rights may be an inducement to the obligor not to terminate the debt instrument.

In defining when an alteration is a modification, the final regulations also generally retain the rule that a change in a term of a debt instrument that occurs by operation of the terms of a debt instrument is not a modification. A change may occur by operation of the terms of an instrument at a specified time, as a result of a contingency specified in the instrument, or upon the exercise of an option provided for in the instrument to change a term.

The final regulations limit the application of the rule for changes that occur by operation of the terms of a debt instrument in three respects. First, the final regulations retain the rule of the proposed regulations that any alteration that results in an instrument or property right that is not debt for federal income tax purposes is a modification, even if the alteration occurs by operation of the terms of the instrument (unless the alteration occurs pursuant to a holder's option under the terms of the instrument to convert the instrument into equity of the issuer). Second, the final regulations also provide that any alteration that results in a substitution of a new obligor, the addition or deletion of a co-obligor, or a change in the recourse nature of an instrument is a modification. The IRS and Treasury believe that these changes may be so fundamental that they should be considered modifications even if they occur by operation of the terms of an instrument. Thus, these modifications always must be tested for significance to determine whether they result in exchanges.

Third, the final regulations provide that alterations resulting from the exercise of either of two categories of options are modifications. These two categories of options are (i) those that are not unilateral (defined essentially in the same manner as in the proposed regulations) and (ii) holder options the

exercise of which results in a deferral or a reduction in any scheduled payment of interest or principal. Because alterations resulting from the exercise of such options typically involve either negotiations between an issuer and holder or a workout, the IRS and Treasury believe it is appropriate to treat them as modifications and test for significance. In this regard, the rule for holder options resulting in deferrals or reductions of payments addresses more specifically the concerns underlying the proposed regulations' rule discussed above regarding unilateral waivers that rise to the level of a settlement of the terms.

Many commentators argued that the proposed regulations are overly restrictive in recognizing only temporary nonperformance by the issuer and temporary waivers of default rights by holders as not being modifications. In particular, commentators expressed concern about an example in the proposed regulations that illustrates the temporary waiver rule with a situation in which the waiver is only for a 3-month period. The IRS and Treasury recognize that parties may need a period of time to modify the terms of a debt instrument following an issuer's default and that a holder's waiver or nonenforcement of default rights may not itself evidence an agreement with respect to new terms.

The final regulations respond to these comments in two respects. First, the regulations provide that nonperformance by the issuer is not, in and of itself, a modification. Second, the regulations provide a limited exception to the rule that a waiver of rights is a modification. Under this exception, absent an actual written or oral agreement by the issuer and the holder to alter other terms of the instrument, an agreement by the holder to stay collection or temporarily waive an acceleration clause or similar default right is not a modification for a period of two years following the issuer's nonperformance, or for a longer period (after the initial two-year period) during which the parties conduct good faith negotiations or during the pendency of bankruptcy proceedings. Once the parties agree to new terms, however, there is a modification of the instrument.

As under the proposed regulations, a modification is tested when the parties agree to a change even if the change is not immediately effective, but the final regulations add exceptions for a change in a term that is agreed to by the parties but is subject to reasonable closing conditions or that occurs as a result of bankruptcy proceedings. In these cases, a modification occurs on the date the change in the term becomes effective. Thus, if the conditions do not occur (and the change in the term does not become effective), a modification does not occur.

D. Significant modifications

The final regulations retain the structure of the proposed regulations for determining whether a modification is significant, but change a number of the specific rules for particular types of modifications. The final regulations also add a new general rule for types of modifications for which specific rules are not provided. Under this general rule (the general significance rule), a modification is significant if, based on all the facts and circumstances, the legal rights or obligations being changed and the degree to which they are being changed are economically significant. The general significance rule also applies to a type of modification for which specific rules are provided if the modification is effective upon the occurrence of a substantial contingency. Moreover, the general significance rule will apply for certain types of modifications that are effective on a substantially deferred basis. When testing a modification under the general significance rule, all modifications made to the instrument (other than those for which specific bright-line rules are provided) are considered collectively. Thus, a series of related modifications, each of which independently is not significant under the general significance rule, may together constitute a significant modification.

With the addition of the general significance rule, certain specific rules of the proposed regulations have not been included in the final regulations. For example, under the proposed regulations, whether the addition or deletion of a put or call right is a significant modification depends on the value of the put or call. The significance of an alteration of a put or call right depends on whether the alteration significantly affects the value of the right. The proposed regulations provide similar rules for the addition, deletion, or alteration of a conversion or exchange right. Under the proposed regulations, certain changes in the types of payments under a debt instrument (for example, a change from a fixed rate debt instrument to a variable rate or contingent payment debt instrument) are significant modifications. These rules have not been included in the final regulations because the general significance rule provides adequate guidance.

For changes in the yield of a debt instrument, the final regulations provide that a change in yield is significant if the change exceeds the greater of 25 basis points or five percent of the original yield on the instrument. This rule was modified in response to comments that a change of more than 25 basis points should be permitted in the case of debt instruments issued with high interest rates. The final regulations also limit this change-of-yield bright-line rule to fixed rate and variable rate debt instruments. Because of the difficulties in developing appropriate mechanisms for measuring changes in the yield of other debt instruments (for example, contingent payment debt instruments), the final regulations provide that the significance of changes in the yield of those other instruments is determined under the general significance rule. The final regulations also incorporate other technical changes to clarify the application of the change-in-yield rules.

The final regulations do not adopt the suggestion of some commentators that a reduction in the principal amount of a debt instrument should not be considered a modification. As under the proposed regulations, for purposes of determining if there is a significant modification, the yield on the modified instrument is computed by reference to the adjusted issue price immediately before the modification. A reduction in principal reduces the total payments on the modified instrument and often results in a significantly reduced yield on the instrument. Thus, these rules give the same weight to changes in the principal amount as to changes in the interest payments. The IRS and Treasury believe that the tax consequences of a change in the yield that results from a change in the amounts payable should not differ because of the characterization of the payments that are reduced as principal rather than interest.

For changes in the timing of payments (including any resulting change in the amount of payments), the proposed regulations contain a rule that an extension of the final maturity of an instrument for the lesser of five years or 50 percent of the original term of the instrument is not a significant modification. Any other change in the timing of payments is subject to two rules. Under the first rule, any material deferral of

payments is a significant modification. Under the second rule, any change in terms designed to avoid the application of the rules for original issue discount is a significant modification. Commentators objected to both of these rules because they do not provide bright-line rules for determining whether a modification is significant. In addition, the commentators argued that an example in the proposed regulations that concerns the deferral of interim payments is inconsistent with the rule for an extension of final maturity.

The final regulations combine the rules for extensions of final maturity and other changes in the timing and/or amounts of payments. While adopting the material deferral rule generally, the final regulations also allow the deferral of payments within a safe-harbor period (the lesser of five years or 50 percent of the original term of the instrument) if the deferred amounts are unconditionally payable at the end of that period. The final regulations do not contain the rule that the Commissioner may treat any deferral of payments made with a principal purpose of avoiding the time value of money rules, including the rules for original issue discount, as a significant modification. The concerns addressed by this rule in the proposed regulations have been resolved in final regulations recently issued under section 1275. See § 1.1275–2(j).

For a change in the obligor on an instrument, the final regulations retain the general rule in the proposed regulations that changing the obligor on a recourse debt instrument is significant. In addition to the exception for section 381(a) transactions in the proposed regulations, the final regulations include an exception for transactions in which the new obligor acquires substantially all of the assets of the original obligor. Each exception must meet two requirements. First, other than the substitution of a new obligor, the transaction must not result in any alteration that would be a significant modification but for the fact that it occurs by operation of the terms of the instrument. Second, the transaction must not result in a change in payment expectations. The final regulations also provide that the substitution of a new obligor on a tax-exempt bond is not a significant modification if the new obligor is a related entity to the original obligor and the collateral securing the instrument continues to include the original collateral.

A change in payment expectations occurs if there is a substantial enhancement or impairment of the obligor's capacity to meet its payment obligations under the instrument and the enhancement or impairment results in a change to an adequate capacity from a speculative capacity or vice versa. There is no change in payment expectations, however, if the obligor has at least an adequate capacity to meet its payment obligations both before and after the modification.

The final regulations also apply the payment expectations test to determine whether the addition or deletion of a co-obligor is a significant modification. Similarly, the final regulations provide that whether certain other modifications are significant is determined by reference to whether the modifications result in a change in payment expectations. Those modifications include (i) the release, substitution, or addition of collateral as security for a recourse debt, (ii) the addition, deletion, or alteration of a guarantee or other credit enhancement, and (iii) a change in the priority of a debt instrument. As under the proposed regulations, a modification that releases, substitutes, or adds a substantial amount of collateral as security for a nonrecourse debt instrument is a significant modification.

A number of commentators raised questions regarding the circumstances under which the modification of a debt instrument will require a determination of whether the modified instrument is debt or equity. Many expressed concern that a deterioration in the financial condition of the issuer between the date of original issuance and the date of the modification could lead to a determination that the modified instrument is not debt for tax purposes. The final regulations address this concern by providing a rule that for purposes of this regulation, unless there is a substitution of a new obligor, any deterioration in the financial condition of the issuer is not considered in determining whether the modified instrument is properly characterized as debt.

The final regulations also modify the rules pertaining to the significance of changes in the method under which payments are calculated. The proposed regulations provide that a modification is significant if it results in a change between the categories of fixed rate, variable rate, and contingent payment instruments or if it changes the currency in which payment under the debt instrument is made. The Treasury and the IRS determined that such an approach was both too broad and too narrow (i.e., certain changes involving economically insignificant adjustments would be characterized as significant, while other more economically dramatic changes would not be characterized as significant). Accordingly, the final regulations do not provide any bright-line rules so that the significance of any change in the method under which payments are calculated is determined under the general significance rule.

The final regulations adopt the rule of the proposed regulations that a change in the recourse nature of an instrument is a significant modification, but limit this specific rule to changes from substantially all recourse to substantially all nonrecourse, or vice versa. If an instrument is not substantially all recourse or not substantially all nonrecourse either before or after a modification, the significance of the modification is determined under the general significance rule. The final regulations also provide two exceptions. First, a modification that changes a recourse debt instrument to a nonrecourse debt instrument is not a significant modification if the instrument continues to be secured only by the original collateral and the modification does not result in a change in payment expectations. Second, a defeasance of a tax-exempt bond permitted by the terms of the instrument generally is not a significant modification.

E. Rules of application

The rules of application in the final regulations are similar to those in the proposed regulations. In general, the final regulations treat a series of changes of an instrument over time as a single change. To avoid the need to retain information for all modifications that affect yield over the life of the debt instrument, however, the final regulations add a rule that, for changes in the yield, modifications occurring more than five years earlier are disregarded.

The final regulations do not adopt the suggestion of commentators that the rules in § 1.1001–3 should not apply to tax-exempt bonds. These commentators stated that, as a result of an intervening change in the Internal Revenue Code (Code) or regulations, a significant modification could result in bonds that were tax-exempt when issued ceasing to be tax-exempt bonds. Because many changes in the Code and regulations

have been made applicable to refunding bonds, it is appropriate that changes to outstanding tax-exempt bonds that are, in substance, the equivalent of refundings be treated as such. The IRS and Treasury believe that the standards used under § 1.1001–3 generally are appropriate for this purpose.

In response to other comments, a number of changes have been made to better coordinate the final regulations with municipal financing practices. The regulations clarify that state and local bonds (other than those financing conduit loans) are treated as recourse obligations for purposes of determining whether a modification is significant. State and local bonds financing conduit loans are nonrecourse only if there is no recourse to either the actual issuer or the conduit borrower. In the case of bonds financing conduit loans, the final regulations clarify that the obligor of a tax-exempt bond is the entity that issues the bond and not the conduit borrower. The regulations note, however, that a transaction between a holder of a tax-exempt bond and a conduit borrower may result in an indirect modification of the tax-exempt bond.

F. Other matters

The preamble to the proposed regulations indicates that Notice 88–130 (1988–2 C.B. 543), which provides special rules for qualified tender bonds, will continue to apply. The final regulations continue this approach, and thus do not apply for purposes of determining whether tax-exempt bonds that are qualified tender bonds are reissued for purposes of sections 103 and 141 through 150. The IRS and Treasury are reviewing the rules of Notice 88–130 and intend to issue proposed regulations on this subject under section 150. When the final regulations are issued under section 150, the exclusion for qualified tender bonds in § 1.1001–3 will be revised or eliminated as appropriate.

Also, as noted in the preamble to the proposed regulations, a modification of a debt instrument that results in an exchange under section 1001 does not determine if there has been an exchange or other disposition of an installment obligation under section 453B. Whether or not there has been an exchange or other disposition of an installment obligation is determined under the cases and rulings applicable to section 453B. Similarly, the fact that an alteration does not constitute a modification or a significant modification does not preclude other tax consequences.

Simultaneously with the issuance of these final regulations, the IRS and Treasury are issuing temporary and proposed regulations under section 166. Those regulations allow taxpayers, in certain limited situations, to claim a deduction for a partially worthless debt when the terms of a debt instrument are modified. Commentators on the proposed regulations noted that section 166 permits a deduction for a partially worthless debt only in the year that the taxpayer makes a partial charge-off for book accounting purposes. A significant modification of a debt instrument that has been partially charged off may result in the recognition of gain and an increased tax basis in the instrument. Because the book charge-off is not reversed, however, the taxpayer cannot take another charge-off, and thus the taxpayer cannot meet the requirement for a deduction for a partially worthless debt under section 166. In this situation, the temporary and proposed regulations deem the charge-off to have occurred at the time of the significant modification if certain requirements are met.

Effective Dates

The final regulation applies to alterations of the terms of a debt instrument on or after September 24, 1996. Taxpayers, however, may rely on this section for alterations of the terms of a debt instrument after December 2, 1992, and before September 24, 1996.

Special Analyses

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

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.1001–3 is added to read as follows:

§ 1.1001–3 Modifications of debt instruments.

(a) *Scope*—(1) *In general.* This section provides rules for determining whether a modification of the terms of a debt instrument results in an exchange for purposes of § 1.1001–1(a). This section applies to any modification of a debt instrument, regardless of the form of the modification. For example, this section applies to an exchange of a new instrument for an existing debt instrument, or to an amendment of an existing debt instrument. This section also applies to a modification of a debt instrument that the issuer and holder accomplish indirectly through one or more transactions with third parties. This section, however, does not apply to exchanges of debt instruments between holders.

(2) *Qualified tender bonds.* This section does not apply for purposes of determining whether tax-exempt bonds that are qualified tender bonds are reissued for purposes of sections 103 and 141 through 150.

(b) *General rule.* For purposes of § 1.1001–1(a), a significant modification of a debt instrument, within the meaning of this section, results in an exchange of the original debt instrument for a modified instrument that differs materially either in kind or in extent. A modification that is not a significant modification is not an exchange for purposes of § 1.1001–1(a). Paragraphs (c) and (d) of this section define the term *modification* and contain examples illustrating the application of the rule. Paragraphs (e) and (f) of this section provide rules for determining when a modification is a significant modification. Paragraph (g) of this section contains examples illustrating the application of the rules in paragraphs (e) and (f) of this section.

(c) *Modification defined*—(1) *In general*—(i) *Alteration of terms.* A modification means any alteration, including

any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise.

(ii) *Alterations occurring by operation of the terms of a debt instrument.* Except as provided in paragraph (c)(2) of this section, an alteration of a legal right or obligation that occurs by operation of the terms of a debt instrument is not a modification. An alteration that occurs by operation of the terms may occur automatically (for example, an annual resetting of the interest rate based on the value of an index or a specified increase in the interest rate if the value of the collateral declines from a specified level) or may occur as a result of the exercise of an option provided to an issuer or a holder to change a term of a debt instrument.

(2) *Exceptions.* The alterations described in this paragraph (c)(2) are modifications, even if the alterations occur by operation of the terms of a debt instrument.

(i) *Change in obligor or nature of instrument.* An alteration that results in the substitution of a new obligor, the addition or deletion of a co-obligor, or a change (in whole or in part) in the recourse nature of the instrument (from recourse to nonrecourse or from nonrecourse to recourse) is a modification.

(ii) *Property that is not debt.* An alteration that results in an instrument or property right that is not debt for federal income tax purposes is a modification unless the alteration occurs pursuant to a holder's option under the terms of the instrument to convert the instrument into equity of the issuer (notwithstanding paragraph (c)(2)(iii) of this section).

(iii) *Certain alterations resulting from the exercise of an option.* An alteration that results from the exercise of an option provided to an issuer or a holder to change a term of a debt instrument is a modification unless—

(A) The option is unilateral (as defined in paragraph (c)(3) of this section); and

(B) In the case of an option exercisable by a holder, the exercise of the option does not result in (or, in the case of a variable or contingent payment, is not reasonably expected to result in) a deferral of, or a reduction in, any scheduled payment of interest or principal.

(3) *Unilateral option.* For purposes of this section, an option is unilateral only if, under the terms of an instrument or under applicable law—

(i) There does not exist at the time the option is exercised, or as a result of the exercise, a right of the other party to alter or terminate the instrument or put the instrument to a person who is related (within the meaning of section 267(b) or section 707(b)(1)) to the issuer;

(ii) The exercise of the option does not require the consent or approval of—

(A) The other party;

(B) A person who is related to that party (within the meaning of section 267(b) or section 707(b)(1)), whether or not that person is a party to the instrument; or

(C) A court or arbitrator; and

(iii) The exercise of the option does not require consideration (other than incidental costs and expenses relating to the exercise of the option), unless, on the issue date of the instrument, the consideration is a de minimis amount, a specified amount, or an amount that is based on a formula that uses objective financial information (as defined in § 1.446–3(c)(4)(ii))/

(4) *Failure to perform*—(i) *In general.* The failure of an issuer to perform its obligations under a debt instrument is not itself an alteration of a legal right or obligation and is not a modification.

(ii) *Holder's temporary forbearance.* Notwithstanding paragraph (c)(1) of this section, absent a written or oral agreement to alter other terms of the debt instrument, an agreement by the holder to stay collection or temporarily waive an acceleration clause or similar default right (including such a waiver following the exercise of a right to demand payment in full) is not a modification unless and until the forbearance remains in effect for a period that exceeds—

(A) Two years following the issuer's initial failure to perform; and

(B) Any additional period during which the parties conduct good faith negotiations or during which the issuer is in a title 11 or similar case (as defined in section 368(a)(3)(A)).

(5) *Failure to exercise an option.* If a party to a debt instrument has an option to change a term of an instrument, the failure of the party to exercise that option is not a modification.

(6) *Time of modification*—(i) *In general.* Except as provided in this paragraph (c)(6), an agreement to change a term of a debt instrument is a modification at the time the issuer and holder enter into the agreement, even if the change in the term is not immediately effective.

(ii) *Closing conditions.* If the parties condition a change in a term of a debt instrument on reasonable closing conditions (for example, shareholder, regulatory, or senior creditor approval, or additional financing), a modification occurs on the closing date of the agreement. Thus, if the reasonable closing conditions do not occur so that the change in the term does not become effective, a modification does not occur.

(iii) *Bankruptcy proceedings.* If a change in a term of a debt instrument occurs pursuant to a plan of reorganization in a title 11 or similar case (within the meaning of section 368(a)(3)(A)), a modification occurs upon the effective date of the plan. Thus, unless the plan becomes effective, a modification does not occur.

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

Example 1. Reset bond. A bond provides for the interest rate to be reset every 49 days through an auction by a remarketing agent. The reset of the interest rate occurs by operation of the terms of the bond and is not an alteration described in paragraph (c)(2) of this section. Thus, the reset of the interest rate is not a modification.

Example 2. Obligation to maintain collateral. The original terms of a bond provide that the bond must be secured by a certain type of collateral having a specified value. The terms also require the issuer to substitute collateral if the value of the original collateral decreases. Any substitution of collateral that is required to maintain the value of the collateral occurs by operation of the terms of the bond and is not an alteration described in paragraph (c)(2) of this section. Thus, such a substitution of collateral is not a modification.

Example 3. Alteration contingent on an act of a party. The original terms of a bond provide that the interest rate is 9 percent. The terms also provide that, if the issuer files an effective registration statement covering the bonds with the Securities and Exchange Commission, the interest rate will decrease to 8 percent. If the issuer registers the bond, the resulting decrease in the interest rate occurs by operation of the terms of the bond and is not an alteration described in paragraph (c)(2) of this section. Thus, such a decrease in the interest rate is not a modification.

Example 4. Substitution of a new obligor occurring by operation of the terms of the debt instrument. Under the original terms of a bond issued by a corporation, an acquirer of substantially all of the corporation's assets may assume the corporation's obligations under the bond. Substantially all of the corporation's assets are acquired by another corporation and the acquiring corporation becomes the new obligor on the bond. Under paragraph (c)(2)(i) of this section, the substitution of a new obligor, even though it occurs by operation of the terms of the bond, is a modification.

Example 5. Defeasance with release of covenants. (i) A corporation issues a 30-year, recourse bond. Under the terms of the bond, the corporation

may secure a release of the financial and restrictive covenants by placing in trust government securities as collateral that will provide interest and principal payments sufficient to satisfy all scheduled payments on the bond. The corporation remains obligated for all payments, including the contribution of additional securities to the trust if necessary to provide sufficient amounts to satisfy the payment obligations. Under paragraph (c)(3) of this section, the option to defease the bond is a unilateral option.

(ii) The alterations occur by operation of the terms of the debt instrument and are not described in paragraph (c)(2) of this section. Thus, such a release of the covenants is not a modification.

Example 6. Legal defeasance. Under the terms of a recourse bond, the issuer may secure a release of the financial and restrictive covenants by placing in trust government securities that will provide interest and principal payments sufficient to satisfy all scheduled payments on the bond. Upon the creation of the trust, the issuer is released from any recourse liability on the bond and has no obligation to contribute additional securities to the trust if the trust funds are not sufficient to satisfy the scheduled payments on the bond. The release of the issuer is an alteration described in paragraph (c)(2)(i) of this section, and thus is a modification.

Example 7. Exercise of an option by a holder that reduces amounts payable. (i) A financial institution holds a residential mortgage. Under the original terms of the mortgage, the financial institution has an option to decrease the interest rate. The financial institution anticipates that, if market interest rates decline, it may exercise this option in lieu of the mortgagor refinancing with another lender.

(ii) The financial institution exercises the option to reduce the interest rate. The exercise of the option results in a reduction in scheduled payments and is an alteration described in paragraph (c)(2)(iii) of this section. Thus, the change in interest rate is a modification.

Example 8. Conversion of adjustable rate to fixed rate mortgage. (i) The original terms of a mortgage provide for a variable interest rate, reset annually based on the value of an objective index. Under the terms of the mortgage, the mortgagor may, upon the payment of a fee equal to a specified percentage of the outstanding principal amount of the mortgage, convert to a fixed rate of interest as determined based on the value of a second objective index. The exercise of the option does not require the consent or approval of any person or create a right of the holder to alter the terms of, or to put, the instrument.

(ii) Because the required consideration to exercise the option is a specified amount fixed on the issue date, the exercise of the option is unilateral as defined in paragraph (c)(3) of this section. The conversion to a fixed rate of interest is not an alteration described in paragraph (c)(2) of this section. Thus, the change in the type of interest rate occurs by operation of the terms of the instrument and is not a modification.

Example 9. Holder's option to increase interest rate. (i) A corporation issues an 8-year note to a bank in exchange for cash. Under the terms of the note, the bank has the option to increase the rate of interest by a specified amount upon a certain decline in the corporation's credit rating. The bank's right to increase the interest rate is a unilateral option as described in paragraph (c)(3) of this section.

(ii) The credit rating of the corporation declines below the specified level. The bank exercises its option to increase the rate of interest. The increase in the rate of interest occurs by operation of the terms of the note and does not result in a deferral or a reduction in the scheduled payments or any other alteration described in paragraph (c)(2) of this section. Thus, the change in interest rate is not a modification.

Example 10. Issuer's right to defer payment of interest. A corporation issues a 5-year note. Under the terms of the note, interest is payable annually at the rate of 10 percent. The corporation, however, has an option to defer any payment of interest until maturity. For any payments that are deferred, interest will compound at a rate of 12 percent. The exercise of the option, which results in the deferral of payments, does not result from the exercise of an option by the holder. The exercise of the option occurs by operation of the terms of the debt instrument and is not a modification.

Example 11. Holder's option to grant deferral of payment. (i) A corporation issues a 10-year note to a bank in exchange for cash. Interest on the note is payable semi-annually. Under the terms of the note, the bank may grant the corporation the right to defer all or part of the interest payments. For any payments that are deferred, interest will compound at a rate 150 basis points greater than the stated rate of interest.

(ii) The corporation encounters financial difficulty and is unable to satisfy its obligations under the note. The bank exercises its option under the note and grants the corporation the right to defer payments. The exercise of the option results in a right of the corporation to defer scheduled payments and, under paragraph (c)(3)(i) of this section, is not a unilateral option. Thus, the alteration is described in paragraph (c)(2)(iii) of this section and is a modification.

Example 12. Alteration requiring consent. The original terms of a bond include a provision that the issuer may extend the maturity of the bond with the consent of the holder. Because any extension pursuant to this term requires the consent of both parties, such an extension does not occur by the exercise of a unilateral option (as defined in paragraph (c)(3) of this section) and is a modification.

Example 13. Waiver of an acceleration clause. Under the terms of a bond, if the issuer fails to make a scheduled payment, the full principal amount of the bond is due and payable immediately. Following the issuer's failure to make a scheduled payment, the holder temporarily waives its right to receive the full principal for a period ending one year from the date of the issuer's default to allow the issuer to obtain additional financial resources. Under paragraph (c)(4)(ii) of this section, the temporary waiver in this situation is not a modification. The result would be the same if the terms provided the holder with the right to demand the full principal amount upon the failure of the issuer to make a scheduled payment and, upon such a failure, the holder exercised that right and then waived the right to receive the payment for one year.

(e) *Significant modifications.* Whether the modification of a debt instrument is a significant modification is determined under the rules of this paragraph (e). Paragraph (e)(1) of this section provides a general rule for determining the significance of modifications not otherwise addressed in this paragraph (e). Paragraphs (e)(2) through (6) of this section provide specific rules for determining the significance of certain types of modifications. Paragraph (f) of this section provides rules of application, including rules for modifications that are effective on a deferred basis or upon the occurrence of a contingency.

(1) *General rule.* Except as otherwise provided in paragraphs (e)(2) through (e)(6) of this section, a modification is a significant modification only if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant. In making a determination under this paragraph (e)(1), all modifications to the debt instrument (other than modifications subject to paragraphs (e)(2) through (6) of this section) are considered collectively, so that a series of such modifications may be significant when considered together although each modification, if considered alone, would not be significant.

(2) *Change in yield*—(i) *Scope of rule.* This paragraph (e)(2) applies to debt instruments that provide for only fixed payments, debt instruments with alternative payment schedules subject to § 1.1272–1(c), debt instruments that provide for a fixed yield subject to § 1.1272–1(d) (such as certain demand loans), and variable rate debt instruments. Whether a change in the yield of other debt instruments (for example, a contingent payment debt instrument) is a significant modification is determined under paragraph (e)(1) of this section.

(ii) *In general.* A change in the yield of a debt instrument is a significant modification if the yield computed under paragraph (e)(2)(iii) of this section varies from the annual yield on the unmodified instrument (determined as of the date of the modification) by more than the greater of—

(A) ¼ of one percent (25 basis points); or

(B) 5 percent of the annual yield of the unmodified instrument (.05 x annual yield).

(iii) *Yield of the modified instrument*—(A) *In general.* The yield computed under this paragraph (e)(2)(iii) is the annual yield of a debt instrument with—

(*1*) an issue price equal to the adjusted issue price of the unmodified instrument on the date of the modification (increased by any accrued but unpaid interest and decreased by any accrued bond issuance premium not yet taken into account, and increased or decreased, respectively, to reflect pay-

ments made to the issuer or to the holder as consideration for the modification); and

(2) payments equal to the payments on the modified debt instrument from the date of the modification.

(B) *Prepayment penalty.* For purposes of this paragraph (e)(2)(iii), a commercially reasonable prepayment penalty for a pro rata prepayment (as defined in § 1.1275–2(f)) is not consideration for a modification of a debt instrument and is not taken into account in determining the yield of the modified instrument.

(iv) *Variable rate debt instruments.* For purposes of this paragraph (e)(2), the annual yield of a variable rate debt instrument is the annual yield of the equivalent fixed rate debt instrument (as defined in § 1.1275–5(e)) which is constructed based on the terms of the instrument (either modified or unmodified, whichever is applicable) as of the date of the modification.

(3) *Changes in timing of payments*—(i) *In general.* A modification that changes the timing of payments (including any resulting change in the amount of payments) due under a debt instrument is a significant modification if it results in the material deferral of scheduled payments. The deferral may occur either through an extension of the final maturity date of an instrument or through a deferral of payments due prior to maturity. The materiality of the deferral depends on all the facts and circumstances, including the length of the deferral, the original term of the instrument, the amounts of the payments that are deferred, and the time period between the modification and the actual deferral of payments.

(ii) *Safe-harbor period.* The deferral of one or more scheduled payments within the safe-harbor period is not a material deferral if the deferred payments are unconditionally payable no later than at the end of the safe-harbor period. The safe-harbor period begins on the original due date of the first scheduled payment that is deferred and extends for a period equal to the lesser of five years or 50 percent of the original term of the instrument. For purposes of this paragraph (e)(3)(ii), the term of an instrument is determined without regard to any option to extend the original maturity and deferrals of de minimis payments are ignored. If the period during which payments are deferred is less than the full safe-harbor period, the unused portion of the period remains a safe-harbor period for any subsequent deferral of payments on the instrument.

(4) *Change in obligor or security*—(i) *Substitution of a new obligor on recourse debt instruments*—(A) *In general.* Except as provided in paragraph (e)(4)(i)(B), (C), or (D) of this section, the substitution of a new obligor on a recourse debt instrument is a significant modification.

(B) *Section 381(a) transaction.* The substitution of a new obligor is not a significant modification if the acquiring corporation (within the meaning of section 381) becomes the new obligor pursuant to a transaction to which section 381(a) applies, the transaction does not result in a change in payment expectations, and the transaction (other than a reorganization within the meaning of section 368(a)(1)(F)) does not result in a significant alteration.

(C) *Certain asset acquisitions.* The substitution of a new obligor is not a significant modification if the new obligor acquires substantially all of the assets of the original obligor, the transaction does not result in a change in payment expectations, and the transaction does not result in a significant alteration.

(D) *Tax-exempt bonds.* The substitution of a new obligor on a tax-exempt bond is not a significant modification if the new obligor is a related entity to the original obligor as defined in section 168(h)(4)(A) and the collateral securing the instrument continues to include the original collateral.

(E) *Significant alteration.* For purposes of this paragraph (e)(4), a significant alteration is an alteration that would be a significant modification but for the fact that the alteration occurs by operation of the terms of the instrument.

(F) *Section 338 election.* For purposes of this section, an election under section 338 following a qualified stock purchase of an issuer's stock does not result in the substitution of a new obligor.

(G) *Bankruptcy proceedings.* For purposes of this section, the filing of a petition in a title 11 or similar case (as defined in section 368(a)(3)(A)) by itself does not result in the substitution of a new obligor.

(ii) *Substitution of a new obligor on nonrecourse debt instruments.* The substitution of a new obligor on a nonrecourse debt instrument is not a significant modification.

(iii) *Addition or deletion of co-obligor.* The addition or deletion of a co-obligor on a debt instrument is a significant modification if the addition or deletion of the co-obligor results in a change in payment expectations. If the addition or deletion of a co-obligor is part of a transaction or series of related transactions that results in the substitution of a new obligor, however, the transaction is treated as a substitution of a new obligor (and is tested under paragraph (e)(4)(i)) of this section rather than as an addition or deletion of a co-obligor.

(iv) *Change in security or credit enhancement*—(A) *Recourse debt instruments.* A modification that releases, substitutes, adds or otherwise alters the collateral for, a guarantee on, or other form of credit enhancement for a recourse debt instrument is a significant modification if the modification results in a change in payment expectations.

(B) *Nonrecourse debt instruments.* A modification that releases, substitutes, adds or otherwise alters a substantial amount of the collateral for, a guarantee on, or other form of credit enhancement for a nonrecourse debt instrument is a significant modification. A substitution of collateral is not a significant modification, however, if the collateral is fungible or otherwise of a type where the particular units pledged are unimportant (for example, government securities or financial instruments of a particular type and rating). In addition, the substitution of a similar commercially available credit enhancement contract is not a significant modification, and an improvement to the property securing a nonrecourse debt instrument does not result in a significant modification.

(v) *Change in priority of debt.* A change in the priority of a debt instrument relative to other debt of the issuer is a significant modification if it results in a change in payment expectations.

(vi) Change in payment expectations—(A) *In general.* For purposes of this section, a change in payment expectations occurs if, as a result of a transaction—

(*1*) There is a substantial enhancement of the obligor's capacity to meet the payment obligations under a debt instrument and that capacity was primarily speculative prior to the modification and is adequate after the modification; or

(2) There is a substantial impairment of the obligor's capacity to meet the payment obligations under a debt instrument and that capacity was adequate

prior to the modification and is primarily speculative after the modification.

(B) *Obligor's capacity.* The obligor's capacity includes any source for payment, including collateral, guarantees, or other credit enhancement.

(5) *Changes in the nature of a debt instrument*—(i) *Property that is not debt.* A modification of a debt instrument that results in an instrument or property right that is not debt for federal income tax purposes is a significant modification. For purposes of this paragraph (e)(5)(i), any deterioration in the financial condition of the obligor between the issue date of the unmodified instrument and the date of modification (as it relates to the obligor's ability to repay the debt) is not taken into account unless, in connection with the modification, there is a substitution of a new obligor or the addition or deletion of a co-obligor.

(ii) *Change in recourse nature*—(A) *In general.* Except as provided in paragraph (e)(5)(ii)(B) of this section, a change in the nature of a debt instrument from recourse (or substantially all recourse) to nonrecourse (or substantially all nonrecourse) is a significant modification. Thus, for example, a legal defeasance of a debt instrument in which the issuer is released from all liability to make payments on the debt instrument (including an obligation to contribute additional securities to a trust if necessary to provide sufficient funds to meet all scheduled payments on the instrument) is a significant modification. Similarly, a change in the nature of the debt instrument from nonrecourse (or substantially all nonrecourse) to recourse (or substantially all recourse) is a significant modification. If an instrument is not substantially all recourse or not substantially all nonrecourse either before or after a modification, the significance of the modification is determined under paragraph (e)(1) of this section.

(B) *Exceptions*—(*1*) *Defeasance of tax-exempt bonds.* A defeasance of a tax-exempt bond is not a significant modification even if the issuer is released from any liability to make payments under the instrument if the defeasance occurs by operation of the terms of the original bond and the issuer places in trust government securities or tax-exempt government bonds that are reasonably expected to provide interest and principal payments sufficient to satisfy the payment obligations under the bond.

(*2*) *Original collateral.* A modification that changes a recourse debt instrument to a nonrecourse debt instrument is not a significant modification if the instrument continues to be secured only by the original collateral and the modification does not result in a change in payment expectations. For this purpose, if the original collateral is fungible or otherwise of a type where the particular units pledged are unimportant (for example, government securities or financial instruments of a particular type and rating), replacement of some or all units of the original collateral with other units of the same or similar type and aggregate value is not considered a change in the original collateral.

(6) *Accounting or financial covenants.* A modification that adds, deletes, or alters customary accounting or financial covenants is not a significant modification.

(f) *Rules of application*—(1) *Testing for significance*—(A) *In general.* Whether a modification of any term is a significant modification is determined under each applicable rule in paragraphs (e)(2) through (6) of this section and, if not specifically addressed in those rules, under the general rule in paragraph (e)(1) of this section. For example, a deferral of payments that changes the yield of a fixed rate debt instrument must be tested under both paragraphs (e)(2) and (3) of this section.

(B) *Contingent modifications.* If a modification described in paragraphs (e)(2) through (5) of this section is effective only upon the occurrence of a substantial contingency, whether or not the change is a significant modification is determined under paragraph (e)(1) of this section rather than under paragraphs (e)(2) through (5) of this section.

(C) *Deferred modifications.* If a modification described in paragraphs (e)(4) and (5) of this section is effective on a substantially deferred basis, whether or not the change is a significant modification is determined under paragraph (e)(1) of this section rather than under paragraphs (e)(4) and (5) of this section.

(2) *Modifications that are not significant.* If a rule in paragraphs (e)(2) through (4) of this section prescribes a degree of change in a term of a debt instrument that is a significant modification, a change of the same type but of a lesser degree is not a significant modification under that rule. For example, a 20 basis point change in the yield of a fixed rate debt instrument is not a significant modification under paragraph (e)(2) of this section. Likewise, if a rule in paragraph (e)(4) of this section requires a change in payment expectations for a modification to be significant, a modification of the same type that does not result in a change in payment expectations is not a significant modification under that rule.

(3) *Cumulative effect of modifications.* Two or more modifications of a debt instrument over any period of time constitute a significant modification if, had they been done as a single change, the change would have resulted in a significant modification under paragraph (e) of this section. Thus, for example, a series of changes in the maturity of a debt instrument constitutes a significant modification if, combined as a single change, the change would have resulted in a significant modification. The significant modification occurs at the time that the cumulative modification would be significant under paragraph (e) of this section. In testing for a change of yield under paragraph (e)(2) of this section, however, any prior modification occurring more than 5 years before the date of the modification being tested is disregarded.

(4) *Modifications of different terms.* Modifications of different terms of a debt instrument, none of which separately would be a significant modification under paragraphs (e)(2) through (6) of this section, do not collectively constitute a significant modification. For example, a change in yield that is not a significant modification under paragraph (e)(2) of this section and a substitution of collateral that is not a significant modification under paragraph (e)(4)(iv) of this section do not together result in a significant modification. Although the significance of each modification is determined independently, in testing a particular modification it is assumed that all other simultaneous modifications have already occurred.

(5) *Definitions.* For purposes of this section:

(i) *Issuer* and *obligor* are used interchangeably and mean the issuer of a debt instrument or a successor obligor.

(ii) *Variable rate debt instrument* and *contingent payment debt instrument* have the meanings given those terms in section 1275 and the regulations thereunder.

(iii) *Tax-exempt bond* means a state or local bond that satisfies the requirements of section 103(a).

(iv) *Conduit loan* and *conduit borrower* have the same meanings as in § 1.150–1(b).

(6) *Certain rules for tax-exempt bonds*—(i) *Conduit loans.* For purposes of this section, the obligor of a tax-exempt bond is the entity that actually issues the bond and not a conduit borrower of bond proceeds. In determining whether there is a significant modification of a tax-exempt bond, however, transactions between holders of the tax-exempt bond and a borrower of a conduit loan may be an indirect modification under paragraph (a)(1) of this section. For example, a payment by the holder of a tax-exempt bond to a conduit borrower to waive a call right may result in an indirect modification of the tax-exempt bond by changing the yield on that bond.

(ii) *Recourse nature*—(A) *In general.* For purposes of this section, a tax-exempt bond that does not finance a conduit loan is a recourse debt instrument.

(B) *Proceeds used for conduit loans.* For purposes of this section, a tax-exempt bond that finances a conduit loan is a recourse debt instrument unless both the bond and the conduit loan are nonrecourse instruments.

(C) *Government securities as collateral.* Notwithstanding paragraphs (f)(6)(ii)(A) and (B) of this section, for purposes of this section a tax-exempt bond that is secured only by a trust holding government securities or tax-exempt government bonds that are reasonably expected to provide interest and principal payments sufficient to satisfy the payment obligations under the bond is a nonrecourse instrument.

(g) *Examples.* The following examples illustrate the provisions of paragraphs (e) and (f) of this section:

Example 1. Modification of call right. (i) Under the terms of a 30-year, fixed-rate bond, the issuer can call the bond for 102 percent of par at the end of ten years or for 101 percent of par at the end of 20 years. At the end of the eighth year, the holder of the bond pays the issuer to waive the issuer's right to call the bond at the end of the tenth year. On the date of the modification, the issuer's credit rating is approximately the same as when the bond was issued, but market rates of interest have declined from that date.

(ii) The holder's payment to the issuer changes the yield on the bond. Whether the change in yield is a significant modification depends on whether the yield on the modified bond varies from the yield on the original bond by more than the change in yield as described in paragraph (e)(2)(ii) of this section.

(iii) If the change in yield is not a significant modification, the elimination of the issuer's call right must also be tested for significance. Because the specific rules of paragraphs (e)(2) through (e)(6) of this section do not address this modification, the significance of the modification must be determined under the general rule of paragraph (e)(1) of this section.

Example 2. Extension of maturity and change in yield. (i) A zero-coupon bond has an original maturity of ten years. At the end of the fifth year, the parties agree to extend the maturity for a period of two years without increasing the stated redemption price at maturity (i.e., there are no additional payments due between the original and extended maturity dates, and the amount due at the extended maturity date is equal to the amount due at the original maturity date).

(ii) The deferral of the scheduled payment at maturity is tested under paragraph (e)(3) of this section. The safe-harbor period under paragraph (e)(3)(ii) of this section starts with the date the payment that is being deferred is due. For this modification, the safe-harbor period starts on the original maturity date, and ends five years from this date. All payments deferred within this period are unconditionally payable before the end of the safe-harbor period. Thus, the deferral of the payment at maturity for a period of two years is not a material deferral under the safe-harbor rule of paragraph (e)(3)(ii) of this section and thus is not a significant modification.

(iii) Even though the extension of maturity is not a significant modification under paragraph (e)(3)(ii) of this section, the modification also decreases the yield of the bond. The change in yield must be tested under paragraph (e)(2) of this section.

Example 3. Change in yield resulting from reduction of principal. (i) A debt instrument issued at par has an original maturity of ten years and provides for the payment of $100,000 at maturity with interest payments at the rate of 10 percent payable at the end of each year. At the end of the fifth year, and after the annual payment of interest, the issuer and holder agree to reduce the amount payable at maturity to $80,000. The annual interest rate remains at 10 percent but is payable on the reduced principal.

(ii) In applying the change in yield rule of paragraph (e)(2) of this section, the yield of the instrument after the modification (measured from the date that the parties agree to the modification to its final maturity date) is computed using the adjusted issue price of $100,000. With four annual payments of $8,000, and a payment of $88,000 at maturity, the yield on the instrument after the modification for purposes of determining if there has been a significant modification under paragraph (e)(2)(i) of this section is 4.332 percent. Thus, the reduction in principal is a significant modification.

Example 4. Deferral of scheduled interest payments. (i) A 20-year debt instrument issued at par provides for the payment of $100,000 at maturity with annual interest payments at the rate of 10 percent. At the beginning of the eleventh year, the issuer and holder agree to defer all remaining interest payments until maturity with compounding. The yield of the modified instrument remains at 10 percent.

(ii) The safe-harbor period of paragraph (e)(3)(ii) of this section begins at the end of the eleventh year, when the interest payment for that year is deferred, and ends at the end of the sixteenth year. However, the payments deferred during this period are not unconditionally payable by the end of that 5-year period. Thus, the deferral of the interest payments is not within the safe-harbor period.

(iii) This modification materially defers the payments due under the instrument and is a significant modification under paragraph (e)(3)(i) of this section.

Example 5. Assumption of mortgage with increase in interest rate. (i) A recourse debt instrument with a 9 percent annual yield is secured by an office building. Under the terms of the instrument, a purchaser of the building may assume the debt and be substituted for the original obligor if the purchaser has a specified credit rating and if the interest rate on the instrument is increased by one-half percent (50 basis points). The building is sold, the purchaser assumes the debt, and the interest rate increases by 50 basis points.

(ii) If the purchaser's acquisition of the building does not satisfy the requirements of paragraphs (e)(4)(i)(B) or (C) of this section, the substitution of the purchaser as the obligor is a significant modification under paragraph (e)(4)(i)(A) of this section.

(iii) If the purchaser acquires substantially all of the assets of the original obligor, the assumption of the debt instrument will not result in a significant modification if there is not a change in payment expectations and the assumption does not result in a significant alteration.

(iv) The change in the interest rate, if tested under the rules of paragraph (e)(2) of this section, would result in a significant modification. The change in interest rate that results from the transaction is a significant alteration. Thus, the transaction does not meet the requirements of paragraph (e)(4)(i)(C) of this section and is a significant modification under paragraph (e)(4)(i)(A) of this section.

Example 6. Assumption of mortgage. (i) A recourse debt instrument is secured by a building. In connection with the sale of the building, the purchaser of the building assumes the debt and is substituted as the new obligor on the debt instrument. The purchaser does not acquire substantially all of the assets of the original obligor.

(ii) The transaction does not satisfy any of the exceptions set forth in paragraph (e)(4)(i)(B) or (C) of this section. Thus, the substitution of the purchaser as the obligor is a significant modification under paragraph (e)(4)(i)(A) of this section.

(iii) Section 1274(c)(4), however, provides that if a debt instrument is assumed in connection with the sale or exchange of property, the assumption is not taken into account in determining if section 1274 applies to the debt instrument unless the terms and conditions of the debt instrument are modified in connection with the sale or exchange. Because the purchaser assumed the debt instrument in connection with the sale of property and the debt instrument was not otherwise modified, the debt instrument is not retested to determine whether it provides for adequate stated interest.

Example 7. Substitution of a new obligor in section 381(a) transaction. (i) The interest rate on a 30-year debt instrument issued by a corporation provides for a variable rate of interest that is reset annually on June 1st based on an objective index.

(ii) In the tenth year, the issuer merges (in a transaction to which section 381(a) applies) into another corporation that becomes the new obligor on the debt instrument. The merger occurs on June 1st, at which time the interest rate is also reset by operation of the terms of the instrument. The new interest rate varies from the previous interest rate by more than the greater of 25 basis points and 5 percent of the annual yield of the unmodified

instrument. The substitution of a new obligor does not result in a change in payment expectations.

(iii) The substitution of the new obligor occurs in a section 381(a) transaction and does not result in a change in payment expectations. Although the interest rate changed by more than the greater of 25 basis points and 5 percent of the annual yield of the unmodified instrument, this alteration did not occur as a result of the transaction and is not a significant alteration under paragraph (e)(4)(i)(E) of this section. Thus, the substitution meets the requirements of paragraph (e)(4)(i)(B) of this section and is not a significant modification.

Example 8. Substitution of credit enhancement contract. (i) Under the terms of a recourse debt instrument, the issuer's obligations are secured by a letter of credit from a specified bank. The debt instrument does not contain any provision allowing a substitution of a letter of credit from a different bank. The specified bank, however, encounters financial difficulty and rating agencies lower its credit rating. The issuer and holder agree that the issuer will substitute a letter of credit from another bank with a higher credit rating.

(ii) Under paragraph (e)(4)(iv)(A) of this section, the substitution of a different credit enhancement contract is not a significant modification of a recourse debt instrument unless the substitution results in a change in payment expectations. While the substitution of a new letter of credit by a bank with a higher credit rating does not itself result in a change in payment expectations, such a substitution may result in a change in payment expectations under certain circumstances (for example, if the obligor's capacity to meet payment obligations is dependent on the letter of credit and the substitution substantially enhances that capacity from primarily speculative to adequate).

Example 9. Improvement to collateral securing nonrecourse debt. A parcel of land and its improvements, a shopping center, secure a nonrecourse debt instrument. The obligor expands the shopping center with the construction of an additional building on the same parcel of land. After the construction, the improvements that secure the nonrecourse debt include the new building. The building is an improvement to the property securing the nonrecourse debt instrument and its inclusion in the collateral securing the debt is not a significant modification under paragraph (e)(4)(iv)(B) of this section.

(h) *Effective date.* This section applies to alterations of the terms of a debt instrument on or after September 24, 1996. Taxpayers, however, may rely on this section for alterations of the terms of a debt instrument after December 2, 1992, and before September 24, 1996.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved:

Leslie Samuels,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on June 25, 1996, 8:45 a.m., and published in the issue of the Federal Register for June 26, 1996, 61 F.R. 32926)

Part II.—Basis Rules of General Application

Section 1016.—Adjustments to Basis

26 CFR 1.1016–3: Exhaustion, wear and tear, obsolescence, amortization, and depletion for periods since February 28, 1913.

Reduction of basis for business use of an automobile under either the optional standard mileage rate method or a mileage allowance under a reimbursement or other expense allowance arrangement. See Rev. Proc. 96–63, page 420.

Subchapter P.—Capital Gains and Losses
Part IV.—Special Rules for Determining Capital Gains and Losses

Section 1254.—Gain From Disposition of Interest in Oil, Gas, Geothermal, or Other Mineral Properties

26 CFR 1.1254–4: Special rules for S corporations and their shareholders.

T.D. 8684

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

Treatment of Gain From the Disposition of Interest in Certain Natural Resource Recapture Property by S Corporations and Their Shareholders

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the tax treatment by S corporations and their shareholders of gain from the disposition by an S corporation (and a corporation that was formerly an S corporation) of certain natural resource recapture property (section 1254 property after enactment of the Tax Reform Act of 1986 and oil, gas, or geothermal property before enactment of the Tax Reform Act of 1986), and also rules relating to the disposition of stock in an S corporation that holds certain natural resource recapture property. Changes to the applicable tax law were made by the Tax Reform Act of 1986, and the Subchapter S Revision Act of 1982. The regulations provide the public with guidance in complying with the changed tax laws.

EFFECTIVE DATE: October 10, 1996.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1493. This information is required by the IRS to establish that a portion of the gain recognized upon a sale or exchange of S corporation stock is not attributable to a shareholder's section 1254 costs so as to qualify for the exception contained in § 1.1254–4(c)(2)(i)(A).

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

The estimated annual burden per respondent varies from .5 hours to 1.5 hours, depending on individual circumstances, with an estimated average of 1 hour.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224, and to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to this collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

On December 21, 1995, the IRS published in the **Federal Register** a notice of proposed rulemaking (60 FR 66238 [PS–7–89, 1996–1 C.B. 847]) providing rules for applying the provisions of section 1254 to the disposition of natural resource recapture property by an S corporation (and a corporation that was formerly an S corporation) and the disposition of S corporation stock. No written comments responding to this notice were received. No public hearing was held because no hearing was requested. The proposed regulations are adopted without any substantive change

by this Treasury decision. However, in the course of preparing the final regulations for publication, the IRS and Treasury Department have determined that §§ 1.1254–2 and 1.1254–3 are in need of minor technical clarifications. Accordingly, §§ 1.1254–2 and 1.1254–3 are clarified as discussed below.

Clarification of §§ 1.1254–2 and 1.1254–3

Section 1.1254–2(d)(1) is amended to state that § 1.1254– 2(d)(1) is applied without regard to § 1.1254–1(b)(2)(vii). This amendment clarifies that section 1254 costs must be recaptured in a like-kind exchange or involuntary conversion that involves the acquisition of property that is not natural resource recapture property. The amendment makes clear that the treatment of like-kind exchanges and involuntary conversions involving natural resource recapture property is similar to the treatment of these transactions involving section 1245 property. See §§ 1.1245–3(a)(3), 1.1245–4(d)(1), 1.1245–4(d)(2), *Example 2*, and 1.1245–5(a)(2), *Example.*

Section 1.1254–3(b)(1) provides that if natural resource recapture property is transferred in certain transactions the amount of section 1254 costs with respect to the property in the hands of the transferee equals the amount of section 1254 costs with respect to the property in the hands of the transferor minus the amount of any gain taken into account as ordinary income under section 1254(a)(1) by the transferor upon the disposition. The intent of this rule is that in these transactions the section 1254 costs with respect to the property are to be transferred to the transferee but reduced by any gain taken into account as ordinary income. However, in the case of an S corporation or partnership transferor, the section 1254 costs have generally been allocated among the shareholders or partners. Consequently, § 1.1254–3(b)(1) is clarified to provide that in the case of an S corporation transferor the section 1254 costs include the section 1254 costs of the shareholders minus any gain taken into account by the shareholders as ordinary income. A similar clarification is added for partnership transferors.

Similarly, § 1.1254–3(d) is clarified for like-kind exchanges and involuntary conversions to provide that in the case of an S corporation the section 1254 costs include the section 1254 costs of the shareholders minus any gain taken into account by the shareholders as ordinary income. A similar clarification is added for a partnership.

Effective Date

Section 1.1254–4 applies to dispositions of natural resource recapture property by an S corporation (and a corporation that was formerly an S corporation) and dispositions of S corporation stock occurring on or after October 10, 1996. The clarifications to §§ 1.1254–2 and 1.1254–3 are effective for dispositions of property occurring on or after October 10, 1996.

Special Analyses

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

* * * * *

Amendments to the Regulations

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

PART 1—INCOME TAXES

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

Authority: 26 U.S.C. 7805 * * *
Section 1.1254–4 also issued under 26 U.S.C. 1254(b). * * *

Par. 2. Section 1.1254–0 is amended by revising the entry for § 1.1254–4 to read as follows:

§ 1.1254–0 Table of contents for section 1254 recapture rules.

* * * * *

§ 1.1254–4 Special rules for S corporations and their shareholders.

(a) In general.

(b) Determination of gain treated as ordinary income under section 1254 upon a disposition of natural resource recapture property by an S corporation.

(1) General rule.

(2) Examples.

(c) Character of gain recognized by a shareholder upon a sale or exchange of S corporation stock.

(1) General rule.

(2) Exceptions.

(3) Examples.

(d) Section 1254 costs of a shareholder.

(e) Section 1254 costs of an acquiring shareholder after certain acquisitions.

(1) Basis determined under section 1012.

(2) Basis determined under section 1014(a).

(3) Basis determined under section 1014(b)(9).

(4) Gifts and section 1041 transfers.

(f) Special rules for a corporation that was formerly an S corporation or formerly a C corporation.

(1) Section 1254 costs of an S corporation that was formerly a C corporation.

(2) Examples.

(3) Section 1254 costs of a C corporation that was formerly an S corporation.

(g) Determination of a shareholder's section 1254 costs upon certain stock transactions

(1) Issuance of stock.

(2) Natural resource recapture property acquired in exchange for stock.

(3) Treatment of nonvested stock.

(4) Exception.

(5) Aggregate of S corporation shareholders' section 1254 costs with respect to natural resource recapture property held by the S corporation

(6) Examples.

* * * * *

Par. 3. Section 1.1254–2 is amended by revising paragraph (d)(1)(ii) to read as follows:

§ 1.1254–2 Exceptions and limitations.

* * * * *

(d) * * * (1) * * *

(ii) The fair market value of property acquired that is not natural resource recapture property (determined without regard to § 1.1254–1(b)(2)(vii)) and is not taken into account under paragraph

(d)(1)(i) of this section (that is, qualifying property under section 1031 or 1033 that is not natural resource recapture property).

* * * * *

Par. 4. Section 1.1254–3 is amended by revising paragraphs (b)(1)(i), (b)(1)(ii), (d)(1)(i) and (d)(1)(ii) to read as follows:

§ 1.1254–3 Section 1254 costs immediately after certain acquisitions.

* * * * *

(b) * * * (1) * * *

(i) The amount of section 1254 costs with respect to the natural resource recapture property in the hands of the transferor immediately before the disposition (and in the case of an S corporation or partnership transferor, the section 1254 costs of the shareholders or partners with respect to the natural resource recapture property); minus

(ii) The amount of any gain taken into account as ordinary income under section 1254(a)(1) by the transferor upon the disposition (and in the case of an S corporation or partnership transferor, any such gain taken into account as ordinary income by the shareholders or partners).

* * * * *

(d) * * * (1) * * *

(i) The amount of section 1254 costs with respect to the natural resource recapture property disposed of (including the section 1254 costs of the shareholders of an S corporation or of the partners of a partnership with respect to the natural resource recapture property); minus

(ii) The amount of any gain taken into account as ordinary income under section 1254(a)(1) by the transferor upon the disposition (and in the case of an S corporation or partnership transferor, any such gain taken into account as ordinary income by the shareholders or partners).

* * * * *

Par. 5. Section 1.1254–4 is amended by adding text to read as follows:

§ 1.1254–4 Special rules for S corporations and their shareholders.

(a) *In general.* This section provides rules for applying the provisions of section 1254 to S corporations and their shareholders upon the disposition by an S corporation (and a corporation that was formerly an S corporation) of natural resource recapture property and upon the disposition by a shareholder of stock of an S corporation that holds natural resource recapture property.

(b) *Determination of gain treated as ordinary income under section 1254 upon a disposition of natural resource recapture property by an S corporation*—(1) *General rule.* Upon a disposition of natural resource recapture property by an S corporation, the amount of gain treated as ordinary income under section 1254 is determined at the shareholder level. Each shareholder must recognize as ordinary income under section 1254 the lesser of—

(i) The shareholder's section 1254 costs with respect to the property disposed of; or

(ii) The shareholder's share of the amount, if any, by which the amount realized on the sale, exchange, or involuntary conversion, or the fair market value of the property upon any other disposition (including a distribution), exceeds the adjusted basis of the property.

(2) *Examples.* The following examples illustrate the provisions of paragraph (b)(1) of this section:

Example 1. Disposition of natural resource recapture property other than oil and gas property. A and B are equal shareholders in X, an S corporation. On January 1, 1997, X acquires for $90,000 an undeveloped mineral property, its sole property. During 1997, X expends and deducts $100,000 in developing the property. On January 15, 1998, X sells the property for $250,000 when X's basis in the property is $90,000. Thus, X recognizes gain of $160,000 on the sale. A and B's share of the $160,000 gain recognized is $80,000 each. Each shareholder has $50,000 of section 1254 costs with respect to the property. Under these circumstances, A and B each are required to recognize $50,000 of the $80,000 of gain on the sale of the property as ordinary income under section 1254.

Example 2. Disposition of oil and gas property the adjusted basis of which is allocated to the shareholders under section 613A(c)(11). C and D are equal shareholders in Y, an S corporation. On January 1, 1997, Y acquires for $150,000 an undeveloped oil and gas property, its sole property. During 1997, Y expends in developing the property $40,000 in intangible drilling costs which it elects to expense under section 263(c). On January 15, 1998, Y sells the property for $200,000. C and D's share of the $200,000 amount realized on the sale is $100,000 each. C and D each have a basis of $75,000 in the property and $20,000 of section 1254 costs with respect to the property. Under these circumstances, C and D each are required to recognize $20,000 of the $25,000 gain on the sale of the property as ordinary income under section 1254.

(c) *Character of gain recognized by a shareholder upon a sale or exchange of S corporation stock*—(1) *General rule.* Except as provided in paragraph (c)(2) of this section, if an S corporation shareholder recognizes gain upon a sale or exchange of stock in the S corporation (determined without regard to section 1254), the gain is treated as ordinary income under section 1254 to the extent of the shareholder's section 1254 costs (with respect to the shares sold or exchanged).

(2) *Exceptions*—(i) *Gain not attributable to section 1254 costs*—(A) *General rule.* Paragraph (c)(1) of this section does not apply to any portion of the gain recognized on the sale or exchange of the stock that the taxpayer establishes is not attributable to section 1254 costs. The portion of the gain recognized that is not attributable to section 1254 costs is that portion of the gain recognized that exceeds the amount of ordinary income that the shareholder would have recognized under section 1254 (with respect to the shares sold or exchanged) if, immediately prior to the sale or exchange of the stock, the corporation had sold at fair market value all of the corporation's property the disposition of which would result in the recognition by the shareholder of ordinary income under section 1254.

(B) *Substantiation.* To establish that a portion of the gain recognized is not attributable to a shareholder's section 1254 costs so as to qualify for the exception contained in paragraph (c)(2)(i)(A) of this section, the shareholder must attach to the shareholder's tax return a statement detailing the shareholder's share of the fair market value and basis, and the shareholder's section 1254 costs, for each of the S corporation's natural resource recapture properties held immediately before the sale or exchange of stock.

(ii) *Transactions entered into as part of a plan to avoid recognition of ordinary income under section 1254.* In the case of a contribution of property prior to a sale or exchange of stock pursuant to a plan a principal purpose of which is to avoid recognition of ordinary income under section 1254, paragraph (c)(1) of this section does not apply. Instead, the amount recognized as ordinary income under section 1254 is the amount of ordinary income the selling or exchanging shareholder would have recognized under section 1254 (with respect to the shares sold or exchanged) had the S corporation sold its natural resource recapture property the disposition of which would have resulted in the recognition of ordinary income under section

1254. The amount recognized as ordinary income under the preceding sentence reduces the amount realized on the sale or exchange of the stock. This reduced amount realized is used in determining any gain or loss on the sale or exchange.

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

Example 1. Application of general rule upon a sale of S corporation stock. C and D are equal shareholders in Y, an S corporation. As of January 1, 1997, Y holds two mining properties: Blackacre, with an adjusted basis of $5,000 and a fair market value of $35,000, and Whiteacre, with an adjusted basis of $20,000 and a fair market value of $15,000. Y also holds securities with a basis of $5,000 and a fair market value of $10,000. On January 1, 1997, D sells 50 percent of D's Y stock to E for $15,000. As of the date of the sale, D's adjusted basis in the Y stock sold is $7,500, and D has $18,000 of section 1254 costs with respect to Blackacre and $12,000 of section 1254 costs with respect to Whiteacre. Under this paragraph (c), the gain recognized by D upon the sale of Y stock is treated as ordinary income to the extent of D's section 1254 costs with respect to the stock sold, unless D establishes that a portion of such excess is not attributable to D's section 1254 costs. However, because D would recognize $7,500 in ordinary income under section 1254 with respect to the stock sold if Y sold Blackacre (the only asset the disposition of which would result in ordinary income to D under section 1254), the $7,500 of gain recognized by D upon the sale of D's Y stock is attributable to D's section 1254 costs. Therefore, upon the sale of stock to E, D recognizes $7,500 of ordinary income under this paragraph (c).

Example 2. Sale of S corporation stock where gain is not entirely attributable to section 1254 costs. Assume the same facts as in *Example 1*, except that Blackacre has a fair market value of $25,000, and the securities have a fair market value of $20,000. Immediately prior to the sale of stock to E, if Y had sold Blackacre (its only asset the disposition of which would result in the recognition of ordinary income to D under section 1254), D would recognize $5,000 in ordinary income with respect to the stock sold under section 1254. D attaches a statement to D's tax return for 1997 detailing D's share of the fair market values and bases, and D's section 1254 costs with respect to Blackacre and Whiteacre. Therefore, upon the sale of stock to E, of the $7,500 gain recognized by D, $5,000 is ordinary income under this paragraph (c).

Example 3. Contribution of property prior to sale of S corporation stock as part of a plan to avoid recognition of ordinary income under section 1254. H owns all of the stock of Z, an S corporation. As of January 1, 1997, H has $3,000 of section 1254 costs with respect to property P, which is natural resource recapture property and Z's only asset. Property P has an adjusted basis of $5,000 and a fair market value of $8,000. H has a basis of $5,000 in Z stock, which has a fair market value of $8,000. On January 1, 1997, H contributes securities to Z which have a basis of $7,000 and a fair market value of $4,000. On April 15, 1997, H sells all of the Z stock to J for $12,000. On that date, H's adjusted basis in the Z stock is also $12,000. Based on all the facts and circumstances, the sale of stock is part of a plan (along with the contribution by H of the securities to Z) that has a principal purpose to avoid recognition of ordinary income under section 1254. Consequently, under paragraph (c)(2)(ii) of this section, H must recognize $3,000 as ordinary income under section 1254, the amount of ordinary income that H would recognize as ordinary income under section 1254 if property P were sold at fair market value. In addition, H reduces the amount realized on the sale of the stock ($12,000) by $3,000. As a result, H also recognizes a $3,000 capital loss on the sale of the stock ($9,000 amount realized less $12,000 adjusted basis).

(d) *Section 1254 costs of a shareholder.* An S corporation shareholder's section 1254 costs with respect to any natural resource recapture property held by the corporation include all of the shareholder's section 1254 costs with respect to the property in the hands of the S corporation. See § 1.1254–1(b)(1) for the definition of section 1254 costs.

(e) *Section 1254 costs of an acquiring shareholder after certain acquisitions*—(1) *Basis determined under section 1012.* If stock in an S corporation that holds natural resource recapture property is acquired and the acquiring shareholder's basis for the stock is determined solely by reference to its cost (within the meaning of section 1012), the amount of section 1254 costs with respect to the property held by the corporation in the acquiring shareholder's hands is zero on the acquisition date.

(2) *Basis determined under section 1014(a).* If stock in an S corporation that holds natural resource recapture property is acquired from a decedent and the acquiring shareholder's basis is determined, by reason of the application of section 1014(a), solely by reference to the fair market value of the stock on the date of the decedent's death or on the applicable date provided in section 2032 (relating to alternate valuation date), the amount of section 1254 costs with respect to the property held by the corporation in the acquiring shareholder's hands is zero on the acquisition date.

(3) *Basis determined under section 1014(b)(9).* If stock in an S corporation that holds natural resource recapture property is acquired before the death of the decedent, the amount of section 1254 costs with respect to the property held by the corporation in the acquiring shareholder's hands includes the amount, if any, of the section 1254 costs deducted by the acquiring shareholder before the decedent's death, to the extent that the basis of the stock (determined under section 1014(a)) is required to be reduced under section 1014(b)(9) (relating to adjustments to basis when the property is acquired before the death of the decedent).

(4) *Gifts and section 1041 transfers.* If stock is acquired in a transfer that is a gift, in a transfer that is a part sale or exchange and part gift, or in a transfer that is described in section 1041(a), the amount of section 1254 costs with respect to the property held by the corporation in the acquiring shareholder's hands immediately after the transfer is an amount equal to—

(i) The amount of section 1254 costs with respect to the property held by the corporation in the hands of the transferor immediately before the transfer; minus

(ii) The amount of any gain recognized as ordinary income under section 1254 by the transferor upon the transfer.

(f) *Special rules for a corporation that was formerly an S corporation or formerly a C corporation*—(1) *Section 1254 costs of an S corporation that was formerly a C corporation.* In the case of a C corporation that holds natural resource recapture property and that elects to be an S corporation, each shareholder's section 1254 costs as of the beginning of the corporation's first taxable year as an S corporation include a pro rata share of the section 1254 costs of the corporation as of the close of the last taxable year that the corporation was a C corporation.

(2) *Examples.* The following examples illustrate the application of the provisions of paragraph (f)(1) of this section:

Example 1. Sale of natural resource recapture property held by an S corporation that was formerly a C corporation—(i) Y is a C corporation that elects to be an S corporation effective January 1, 1997. On that date, Y owns Oil Well, which is natural resource recapture property and a capital asset. Y has section 1254 costs of $20,000 as of the close of the last taxable year that it was a C corporation. On January 1, 1997, Oil Well has a value of $200,000 and a basis of $100,000. Thus, under section 1374, Y's net unrealized built-in gain is $100,000. Also on that date, Y's basis in Oil Well is allocated to A, Y's sole shareholder, under section 613A(c)(11) and the section 1254 costs are allocated to A under paragraph (f)(1) of this section. In addition, A has a basis in A's Y stock of $100,000.

(ii) On November 1, 1997, Y sells Oil Well for $250,000. During 1997, Y has taxable income greater than $100,000, and no other transactions or items treated as recognized built-in gain or loss. Under section 1374, Y has net recognized built-in gain of $100,000. Assuming a tax rate of 35 percent on capital gain, Y has a tax of $35,000 under section 1374. The tax of $35,000 is treated

as a capital loss under section 1366(f)(2). A has a realized gain on the sale of $150,000 ($250,000 minus $100,000) of which $20,000 is recognized as ordinary income under section 1254, and $130,000 is recognized as capital gain. Consequently, A recognizes ordinary income of $20,000 and net capital gain of $95,000 ($130,000 minus $35,000) on the sale.

Example 2. Sale of stock followed by sale of natural resource recapture property held by an S corporation that was formerly a C corporation—(i) Assume the same facts as in *Example 1*(i). On November 1, 1997, A sells all of A's Y stock to P for $250,000. A has a realized gain on the sale of $150,000 ($250,000 minus $100,000) of which $20,000 is recognized as ordinary income under section 1254, and $130,000 is recognized as capital gain.

(ii) On November 2, 1997, Y sells Oil Well for $250,000. During 1997, Y has taxable income greater than $100,000, and no other transactions or items treated as recognized built-in gain or loss. Under section 1374, Y has net recognized built-in gain of $100,000. Assuming a tax rate of 35 percent on capital gain, Y has a tax of $35,000 under section 1374. The tax of $35,000 is treated as a capital loss under section 1366(f)(2). P has a realized gain on the sale of $150,000 ($250,000 minus $100,000), which is recognized as capital gain. Consequently, P recognizes net capital gain of $115,000 ($150,000 minus $35,000) on the sale.

(3) *Section 1254 costs of a C corporation that was formerly an S corporation.* In the case of an S corporation that becomes a C corporation, the C corporation's section 1254 costs with respect to any natural resource recapture property held by the corporation as of the beginning of the corporation's first taxable year as a C corporation include the sum of its shareholders' section 1254 costs with respect to the property as of the close of the last taxable year that the corporation was an S corporation. In the case of an S termination year as defined in section 1362(e)(4), the shareholders' section 1254 costs are determined as of the close of the S short year as defined in section 1362(e)(1)(A). See paragraph (g)(5) of this section for rules on determining the aggregate amount of the shareholders' section 1254 costs.

(g) *Determination of a shareholder's section 1254 costs upon certain stock transactions*—(1) *Issuance of stock.* Upon an issuance of stock (whether such stock is newly-issued or had been held as treasury stock) by an S corporation in a reorganization described in section 368 or otherwise—

(i) Each recipient of shares must be allocated a pro rata share (determined solely with respect to the shares issued in the transaction) of the aggregate of the S corporation shareholders' section 1254 costs with respect to natural resource recapture property held by the S corporation immediately before the issuance (as determined pursuant to paragraph (g)(5) of this section); and

(ii) Each pre-existing shareholder must reduce his or her section 1254 costs with respect to natural resource recapture property held by the S corporation immediately before the issuance by an amount equal to the pre-existing shareholder's section 1254 costs immediately before the issuance multiplied by the percentage of stock of the corporation issued in the transaction.

(2) *Natural resource recapture property acquired in exchange for stock.* If natural resource recapture property is transferred to an S corporation in exchange for stock of the S corporation (for example, in a section 351 transaction, or in a reorganization described in section 368), the S corporation must allocate to its shareholders a pro rata share of the S corporation's section 1254 costs with respect to the property immediately after the transaction (as determined under § 1.1254– 3(b)(1)).

(3) *Treatment of nonvested stock.* Stock issued in connection with the performance of services that is substantially nonvested (within the meaning of § 1.83–3(b)) is treated as issued for purposes of this section at the first time it is treated as outstanding stock of the S corporation for purposes of section 1361.

(4) *Exception.* Paragraph (g)(1) of this section does not apply to stock issued in exchange for stock of the same S corporation (as for example, in a recapitalization described in section 368(a)(1)(E)).

(5) *Aggregate of S corporation shareholders' section 1254 costs with respect to natural resource recapture property held by the S corporation*—(i) *In general.* The aggregate of S corporation shareholders' section 1254 costs is equal to the sum of each shareholder's section 1254 costs. The S corporation must determine each shareholder's section 1254 costs under either paragraph (g)(5)(ii) (written data) or paragraph (g)(5)(iii) (assumptions) of this section. The S corporation may determine the section 1254 costs of some shareholders under paragraph (g)(5)(ii) of this section and of others under paragraph (g)(5)(iii) of this section.

(ii) *Written data.* An S corporation may determine a shareholder's section 1254 costs by using written data provided by a shareholder showing the shareholder's section 1254 costs with respect to natural resource recapture property held by the S corporation unless the S corporation knows or has reason to know that the written data is inaccurate. If an S corporation does not receive written data upon which it may rely, the S corporation must use the assumptions provided in paragraph (g)(5)(iii) of this section in determining a shareholder's section 1254 costs.

(iii) *Assumptions.* An S corporation that does not use written data pursuant to paragraph (g)(5)(ii) of this section to determine a shareholder's section 1254 costs must use the following assumptions to determine the shareholder's section 1254 costs—

(A) The shareholder deducted his or her share of the amount of deductions under sections 263(c), 616, and 617 in the first year in which the shareholder could claim a deduction for such amounts, unless in the case of expenditures under sections 263(c) or 616 the S corporation elected to capitalize such amounts;

(B) The shareholder was not subject to the following limitations with respect to the shareholder's depletion allowance under section 611, except to the extent a limitation applied at the corporate level: the taxable income limitation of section 613(a); the depletable quantity limitations of section 613A(c); or the limitations of sections 613A(d)(2), (3), and (4) (exclusion of retailers and refiners).

(6) *Examples.* The following examples illustrate the provisions of this paragraph (g):

Example 1. Transfer of natural resource recapture property to an S corporation in a section 351 transaction. As of January 1, 1997, A owns all the stock (20 shares) in X, an S corporation. X holds property that is not natural resource recapture property that has a fair market value of $2,000 and an adjusted basis of $2,000. On January 1, 1997, B transfers natural resource recapture property, Property P, to X in exchange for 80 shares of X stock in a transaction that qualifies under section 351. Property P has a fair market value of $8,000 and an adjusted basis of $5,000. Pursuant to section 351, B does not recognize gain on the transaction. Immediately prior to the transaction, B's section 1254 costs with respect to Property P equaled $6,000. Under § 1.1254–2(c)(1), B does not recognize any gain under section 1254 on the section 351 transaction and, under § 1.1254–3(b)(1), X's section 1254 costs with respect to Property P immediately after the contribution equal $6,000. Under paragraph (g)(2) of this section, each shareholder is allocated a pro rata share of X's section 1254 costs. The pro rata share of X's section 1254 costs that is allocated to A equals $1,200 (20 percent interest in X multiplied by X's $6,000 of section 1254 costs). The pro rata share of X's section 1254 costs that is allocated to B equals $4,800 (80 percent interest in X multiplied by X's $6,000 of section 1254 costs).

Example 2. Contribution of money in exchange for stock of an S corporation holding natural resource recapture property. As of January 1, 1997, A and B each own 50 percent of the stock (50 shares each) in X, an S corporation. X holds natural resource recapture property, Property P, which has a fair market value of $20,000 and an adjusted basis of $14,000. A's and B's section 1254 costs with respect to Property P are $4,000 and $1,500, respectively. On January 1, 1997, C contributes $20,000 to X in exchange for 100 shares of X's stock. Under paragraph (g)(1)(i) of this section, X must allocate to C a pro rata share of its shareholders' section 1254 costs. Using the assumptions set forth in paragraph (g)(5)(iii) of this section, X determines that A's section 1254 costs with respect to natural resource recapture property held by X equal $4,500. Using written data provided by B, X determines that B's section 1254 costs with respect to Property P equal $1,500. Thus, the aggregate of X's shareholders' section 1254 costs equals $6,000. C's pro rata share of the $6,000 of section 1254 costs equals $3,000 (C's 50 percent interest in X multiplied by $6,000). Under paragraph (g)(1)(ii) of this section, A's section 1254 costs are reduced by $2,000 (A's actual section 1254 costs ($4,000) multiplied by 50 percent). B's section 1254 costs are reduced by $750 (B's actual section 1254 costs ($1,500) multiplied by 50 percent).

Example 3. Merger involving an S corporation that holds natural resource recapture property. X, an S corporation with one shareholder, A, holds as its sole asset natural resource recapture property that has a fair market value of $120,000 and an adjusted basis of $40,000. A has section 1254 costs with respect to the property of $60,000. For valid business reasons, X merges into Y, an S corporation with one shareholder, B, in a reorganization described in section 368(a)(1)(A). Y holds property that is not natural resource recapture property that has a fair market value of $120,000 and basis of $120,000. Under paragraph (c) of this section, A does not recognize ordinary income under section 1254 upon the exchange of stock in the merger because A did not otherwise recognize gain on the merger. Under paragraph (g)(2) of this section, Y must allocate to A and B a pro rata share of its $60,000 of section 1254 costs. Thus, A and B are each allocated $30,000 of section 1254 costs (50 percent interest in X, each, multiplied by $60,000).

Par. 6. Section 1.1254–6 is amended by adding two sentences at the end of this section to read as follows:

§ 1.1254–6 Effective date of regulations.

* * * Section 1.1254–4 applies to dispositions of natural resource recapture property by an S corporation (and a corporation that was formerly an S corporation) and dispositions of S corporation stock occurring on or after October 10, 1996. Sections 1.1254–2(d)(1)(ii) and 1.1254–3(b)(1)(i) and (ii) and (d)(1)(i) and (ii) are effective for dispositions of property occurring on or after October 10, 1996.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 7. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 8. In § 602.101, paragraph (c) is amended by adding an entry in numerical order to the table to read as follows.

§ 602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part of section where identified and described	Current OMB control No.
* * * * *	
1.1254–4	1545–1493
* * * * *	

Michael P. Dolan,
Acting Commissioner of Internal Revenue.

Approved September 10, 1996.

Donald C. Lubick,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on October 9, 1996, 8:45 a.m., and published in the issue of the Federal Register for October 10, 1996, 61 F.R. 53062)

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, 412, 467, 468, 482, 483, 807, 846, 1288, 7520, 7872.)

Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate. For purposes of sections 1274, 1288, 382, and other sections of the Code, tables set forth the rates for July 1996.

Rev. Rul. 96–34

This revenue ruling provides various prescribed rates for federal income tax purposes for July 1996 (the current month.) Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520. Finally, Table 6 contains the blended annual rate for purposes of section 7872.

REV. RUL. 96–34 TABLE 1

Applicable Federal Rates (AFR) for July 1996

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	6.04%	5.95%	5.91%	5.88%
110% AFR	6.66%	6.55%	6.50%	6.46%
120% AFR	7.27%	7.14%	7.08%	7.04%
130% AFR	7.89%	7.74%	7.67%	7.62%

REV. RUL. 96–34 TABLE 1—Continued

Applicable Federal Rates (AFR) for July 1996

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Mid-Term				
AFR	6.74%	6.63%	6.58%	6.54%
110% AFR	7.42%	7.29%	7.22%	7.18%
120% AFR	8.12%	7.96%	7.88%	7.83%
130% AFR	8.81%	8.62%	8.53%	8.47%
150% AFR	10.20%	9.95%	9.83%	9.75%
175% AFR	11.94%	11.60%	11.44%	11.33%
Long-Term				
AFR	7.12%	7.00%	6.94%	6.90%
110% AFR	7.85%	7.70%	7.63%	7.58%
120% AFR	8.58%	8.40%	8.31%	8.26%
130% AFR	9.31%	9.10%	9.00%	8.93%

REV. RUL. 96–34 TABLE 2

Adjusted AFR for July 1996

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	3.88%	3.84%	3.82%	3.81%
Mid-term adjusted AFR	4.83%	4.77%	4.74%	4.72%
Long-term adjusted AFR	5.78%	5.70%	5.66%	5.63%

REV. RUL. 96–34 TABLE 3

Rates Under Section 382 for July 1996

Adjusted federal long-term rate for the current month	5.78%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months)	5.78%

REV. RUL. 96–34 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for July 1996

Appropriate percentage for the 70% present value low-income housing credit	8.63%
Appropriate percentage for the 30% present value low-income housing credit	3.70%

REV. RUL. 96–34 TABLE 5

Rate Under Section 7520 for July 1996

Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	8.2%

REV. RUL. 96–34 TABLE 6

Blended Annual Rate for 1996

Section 7872(e)(2) blended annual rate for 1996	5.77%

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

Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate. For purposes of sections 1274, 1288, 382, and other sections of the Code, tables set forth the rates for August 1996.

Rev. Rul. 96–37

This revenue ruling provides various prescribed rates for federal income tax purposes for August 1996 (the current month.) Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Finally, Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

REV. RUL. 96–37 TABLE 1

Applicable Federal Rates (AFR) for August 1996

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	6.15%	6.06%	6.01%	5.98%
110% AFR	6.78%	6.67%	6.62%	6.58%
120% AFR	7.40%	7.27%	7.21%	7.16%
130% AFR	8.04%	7.88%	7.80%	7.75%
Mid-Term				
AFR	6.84%	6.73%	6.67%	6.64%
110% AFR	7.54%	7.40%	7.33%	7.29%
120% AFR	8.24%	8.08%	8.00%	7.95%
130% AFR	8.94%	8.75%	8.66%	8.59%
150% AFR	10.36%	10.10%	9.98%	9.89%
175% AFR	12.13%	11.78%	11.61%	11.50%
Long-Term				
AFR	7.21%	7.08%	7.02%	6.98%
110% AFR	7.94%	7.79%	7.72%	7.67%
120% AFR	8.68%	8.50%	8.41%	8.35%
130% AFR	9.41%	9.20%	9.10%	9.03%

REV. RUL. 96–37 TABLE 2

Adjusted AFR for August 1996

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	3.97%	3.93%	3.91%	3.90%
Mid-term adjusted AFR	4.89%	4.83%	4.80%	4.78%
Long-term adjusted AFR	5.80%	5.72%	5.68%	5.65%

REV. RUL. 96–37 TABLE 3

Rates Under Section 382 for August 1996

Adjusted federal long-term rate for the current month	5.80%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months)	5.80%

REV. RUL. 96–37 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for August 1996

Appropriate percentage for the 70% present value low-income housing credit	8.65%
Appropriate percentage for the 30% present value low-income housing credit	3.71%

REV. RUL. 96–37 TABLE 5

Rate Under Section 7520 for August 1996

Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	8.2%

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

Federal rates; adjusted federal rates; adjusted federal long-term rate; and the long-term exempt rate. For purposes of sections 1274, 1288, 382, and other sections of the Code, tables set forth the rates for September 1996.

Rev. Rul. 96–43

This revenue ruling provides various prescribed rates for federal income tax purposes for September 1996 (the current month.) Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long- term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Finally, Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

REV. RUL. 96–43 TABLE 1

Applicable Federal Rates (AFR) for September 1996

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	6.02%	5.93%	5.89%	5.86%
110% AFR	6.63%	6.52%	6.47%	6.43%
120% AFR	7.25%	7.12%	7.06%	7.02%
130% AFR	7.86%	7.71%	7.64%	7.59%
Mid-Term				
AFR	6.64%	6.53%	6.48%	6.44%
110% AFR	7.31%	7.18%	7.12%	7.07%
120% AFR	7.99%	7.84%	7.76%	7.71%
130% AFR	8.67%	8.49%	8.40%	8.34%
150% AFR	10.04%	9.80%	9.68%	9.61%
175% AFR	11.76%	11.43%	11.27%	11.17%
Long-Term				
AFR	7.03%	6.91%	6.85%	6.81%
110% AFR	7.74%	7.60%	7.53%	7.48%
120% AFR	8.46%	8.29%	8.21%	8.15%
130% AFR	9.18%	8.98%	8.88%	8.82%

REV. RUL. 96–43 TABLE 2

Adjusted AFR for September 1996

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	4.00%	3.96%	3.94%	3.93%
Mid-term adjusted AFR	4.69%	4.64%	4.61%	4.60%
Long-term adjusted AFR	5.63%	5.55%	5.51%	5.49%

REV. RUL. 96–43 TABLE 3

Rates Under Section 382 for September 1996

Adjusted federal long-term rate for the current month	5.63%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.)	5.80%

REV. RUL. 96–43 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for September 1996

Appropriate percentage for the 70% present value low-income housing credit	8.61%
Appropriate percentage for the 30% present value low-income housing credit	3.69%

REV. RUL. 96–43 TABLE 5

Rate Under Section 7520 for September 1996

Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	8.0%

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

Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate. For purposes of sections 1274, 1288, 382, and other sections of the Code, tables set forth the rates for October 1996.

Rev. Rul. 96–49

This revenue ruling provides various prescribed rates for federal income tax purposes for October 1996 (the current month.) Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Finally, Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

REV. RUL. 96–49 TABLE 1

Applicable Federal Rates (AFR) for October 1996

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	6.07%	5.98%	5.94%	5.91%
110% AFR	6.69%	6.58%	6.53%	6.49%
120% AFR	7.31%	7.18%	7.12%	7.07%
130% AFR	7.92%	7.77%	7.70%	7.65%

REV. RUL. 96–49 TABLE 1—Continued

Applicable Federal Rates (AFR) for October 1996

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Mid-Term				
AFR	6.72%	6.61%	6.56%	6.52%
110% AFR	7.40%	7.27%	7.21%	7.16%
120% AFR	8.09%	7.93%	7.85%	7.80%
130% AFR	8.77%	8.59%	8.50%	8.44%
150% AFR	10.17%	9.92%	9.80%	9.72%
175% AFR	11.90%	11.57%	11.41%	11.30%
Long-Term				
AFR	7.13%	7.01%	6.95%	6.91%
110% AFR	7.86%	7.71%	7.64%	7.59%
120% AFR	8.59%	8.41%	8.32%	8.27%
130% AFR	9.32%	9.11%	9.01%	8.94%

REV. RUL. 96–49 TABLE 2

Adjusted AFR for October 1996

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	4.04%	4.00%	3.98%	3.97%
Mid-term adjusted AFR	4.71%	4.66%	4.63%	4.62%
Long-term adjusted AFR	5.64%	5.56%	5.52%	5.50%

REV. RUL. 96–49 TABLE 3

Rates Under Section 382 for October 1996

Adjusted federal long-term rate for the current month	5.64%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.)	5.80%

REV. RUL. 96–49 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for October 1996

Appropriate percentage for the 70% present value low-income housing credit	8.63%
Appropriate percentage for the 30% present value low-income housing credit	3.70%

REV. RUL. 96–49 TABLE 5

Rate Under Section 7520 for October 1996

Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	8.0%

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

Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate. For purposes of sections 1274, 1288, 382, and other sections of the Code, tables set forth the rates for November 1996.

Rev. Rul. 96–52

This revenue ruling provides various prescribed rates for federal income tax purposes for November 1996 (the current month.) Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Finally, Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

REV. RUL. 96–52 TABLE 1

Applicable Federal Rates (AFR) for November 1996

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	5.96%	5.87%	5.83%	5.80%
110% AFR	6.56%	6.46%	6.41%	6.37%
120% AFR	7.16%	7.04%	6.98%	6.94%
130% AFR	7.78%	7.63%	7.56%	7.51%
Mid-Term				
AFR	6.60%	6.49%	6.44%	6.40%
110% AFR	7.27%	7.14%	7.08%	7.04%
120% AFR	7.94%	7.79%	7.72%	7.67%
130% AFR	8.62%	8.44%	8.35%	8.30%
150% AFR	9.98%	9.74%	9.62%	9.55%
175% AFR	11.68%	11.36%	11.20%	11.10%
Long-Term				
AFR	7.02%	6.90%	6.84%	6.80%
110% AFR	7.73%	7.59%	7.52%	7.47%
120% AFR	8.45%	8.28%	8.20%	8.14%
130% AFR	9.17%	8.97%	8.87%	8.81%

REV. RUL. 96–52 TABLE 2

Adjusted AFR for November 1996

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	3.95%	3.91%	3.89%	3.88%
Mid-term adjusted AFR	4.73%	4.68%	4.65%	4.64%
Long-term adjusted AFR	5.60%	5.52%	5.48%	5.46%

REV. RUL. 96–52 TABLE 3

Rates Under Section 382 for November 1996

Adjusted federal long-term rate for the current month	5.60%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.)	5.64%

REV. RUL. 96–52 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for November 1996

Appropriate percentage for the 70% present value low-income housing credit	8.60%
Appropriate percentage for the 30% present value low-income housing credit	3.69%

REV. RUL. 96–52 TABLE 5

Rate Under Section 7520 for November 1996

Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	8.0%

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

Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate. For purposes of sections 1274, 1288, 382, and other sections of the Code, tables set forth the rates for December 1996.

Rev. Rul. 96–57

This revenue ruling provides various prescribed rates for federal income tax purposes for December 1996 (the current month.) Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520. Finally, Table 6 contains the 1997 interest rate for sections 846 and 807.

REV. RUL. 96–57 TABLE 1

Applicable Federal Rates (AFR) for December 1996

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	5.75%	5.67%	5.63%	5.60%
110% AFR	6.34%	6.24%	6.19%	6.16%
120% AFR	6.92%	6.80%	6.74%	6.71%
130% AFR	7.51%	7.37%	7.30%	7.26%
Mid-Term				
AFR	6.31%	6.21%	6.16%	6.13%
110% AFR	6.95%	6.83%	6.77%	6.73%
120% AFR	7.59%	7.45%	7.38%	7.34%
130% AFR	8.23%	8.07%	7.99%	7.94%
150% AFR	9.54%	9.32%	9.21%	9.14%
175% AFR	11.17%	10.87%	10.73%	10.63%
Long-Term				
AFR	6.77%	6.66%	6.61%	6.57%
110% AFR	7.46%	7.33%	7.26%	7.22%
120% AFR	8.15%	7.99%	7.91%	7.86%
130% AFR	8.85%	8.66%	8.57%	8.51%

REV. RUL. 96–57 TABLE 2

Adjusted AFR for December 1996

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	3.83%	3.79%	3.77%	3.76%
Mid-term adjusted AFR	4.58%	4.53%	4.50%	4.49%
Long-term adjusted AFR	5.48%	5.41%	5.37%	5.35%

REV. RUL. 96–57 TABLE 3

Rates Under Section 382 for December 1996

Adjusted federal long-term rate for the current month	5.48%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months)	5.64%

REV. RUL. 96–57 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for December 1996

Appropriate percentage for the 70% present value low-income housing credit	8.54%
Appropriate percentage for the 30% present value low-income housing credit	3.66%

REV. RUL. 96–57 TABLE 5

Rate Under Section 7520 for December 1996

Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	7.6%

REV. RUL. 96–57 TABLE 6

Rates Under Sections 846 and 807

Applicable rate of interest for 1997 for purposes of sections 846 and 807	6.33%

26 CFR 1.1274A–1: Special rules for certain transactions where stated principal amount does not exceed $2,800,000.

As defined by section 1274A, the definitions for both "qualified debt instruments" and "cash method debt instruments" have dollar ceilings on the stated principal amount. The limits to the stated principal amount are adjusted for inflation for sales or exchanges occurring in the 1997 calendar year. See Rev. Rul. 96–63, on this page.

Section 1274A.—Special Rules for Certain Transactions Where Stated Principal Amount Does Not Exceed $2,800,000.

(Also §§ 1274, 483; 1.1274A–1.)

Section 1274A inflation-adjusted numbers for 1997. This ruling provides the dollar amounts, increased by the 1997 inflation-adjustment, for section 1274A of the Code. Rev. Rul. 96–4 supplemented and superseded.

Rev. Rul. 96–63

This revenue ruling provides the dollar amounts, increased by the 1997 inflation adjustment, for § 1274A of the Internal Revenue Code.

BACKGROUND

In general, §§ 483 and 1274 of the Code determine the principal amount of a debt instrument given in consideration for the sale or exchange of nonpublicly traded property. In addition, any interest on a debt instrument subject to § 1274 is taken into account under the original issue discount provisions of the Code. Section 1274A, however, modifies the rules under §§ 483 and 1274 for certain types of debt instruments.

In the case of a "qualified debt instrument," the discount rate used for purposes of §§ 483 and 1274 of the Code may not exceed 9 percent, compounded semiannually. Section 1274A(b) defines a qualified debt instrument as any debt instrument given in consideration for the sale or exchange of property (other than new § 38 property within the meaning of § 48(b), as in effect on the day before the date of

enactment of the Revenue Reconciliation Act of 1990) if the stated principal amount of the instrument does not exceed the amount specified in § 1274A-(b). For debt instruments arising out of sales or exchanges before January 1, 1990, this amount is $2,800,000.

In the case of a "cash method debt instrument," as defined in § 1274A(c) of the Code, the borrower and lender may elect to use the cash receipts and disbursements method of accounting. In particular, for any cash method debt instrument, § 1274 does not apply, and interest on the instrument is accounted for by both the borrower and the lender under the cash method of accounting. A cash method debt instrument is a qualified debt instrument that meets the following additional requirements: (A) In the case of instruments arising out of sales or exchanges before January 1, 1990, the stated principal amount does not exceed $2,000,000, (B) The lender does not use an accrual method of accounting and is not a dealer with respect to the property sold or exchanged, (C) Section 1274 would have applied to the debt instrument but for an election under § 1274A(c); and (D) An election under § 1274A(c) is jointly made with respect to the debt instrument by the borrower and lender. Section 1.1274A–1(c)(1) of the Income Tax Regulations provides rules concerning the time for, and manner of, making this election.

Section 1274A(d)(2) of the Code provides that, for any debt instrument arising out of a sale or exchange during any calendar year after 1989, the dollar amounts stated in § 1274A(b) and § 1274A(c)(2)(A) are increased by the inflation adjustment for the calendar year. Any increase due to the inflation adjustment is rounded to the nearest multiple of $100 (or, if the increase is a multiple of $50 and not of $100, the increase is increased to the nearest multiple of $100). The inflation adjustment for any calendar year is the percentage (if any) by which the CPI for the preceding calendar year exceeds the CPI for calendar year 1988. Section 1274A-(d)(2)(B) defines the CPI for any calendar year as the average of the Consumer Price Index as of the close of the 12-month period ending on September 30 of that calendar year.

INFLATION-ADJUSTED AMOUNTS

For debt instruments arising out of sales or exchanges after December 31, 1989, the inflation-adjusted amounts under § 1274A are shown in Table 1.

Rev. Rul. 96–63 Table 1
Inflation-Adjusted Amounts Under § 1274A

Calendar Year of Sale or Exchange	*1274A(b) Amount (qualified debt instrument)*	*1274A(c)(2)(A) Amount (cash method debt instrument)*
1990	$2,933,200	$2,095,100
1991	$3,079,600	$2,199,700
1992	$3,234,900	$2,310,600
1993	$3,332,400	$2,380,300
1994	$3,433,500	$2,452,500
1995	$3,523,600	$2,516,900
1996	$3,622,500	$2,587,500
1997	$3,723,800	$2,659,900

Note: These inflation adjustments were computed using the All-Urban, Consumer Price Index, 1982–1984 base, published by the Bureau of Labor Statistics.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 96–4, 1996–3 I.R.B. 16, is supplemented and superseded.

Section 1275.—Other Definitions and Special Rules

26 CFR 1.1275–4: Contingent payment debt instruments.

T.D. 8674

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

Debt Instruments with Original Issue Discount; Contingent Payments; Anti-Abuse Rule

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the tax treatment of debt instruments that provide for one or more contingent payments. This document also contains final regulations that treat a debt instrument and a related hedge as an integrated transaction. In addition, this document contains amendments to the original issue discount regulations, and finalizes the anti-abuse rule relating to those regulations. The final regulations in this document provide needed guidance to holders and issuers of contingent payment debt instruments.

DATES: Except as noted below, the regulations are effective August 13, 1996. The amendments to §1.1275–5 are effective June 14, 1996, except for paragraphs (a)(6), (b)(2), and (c)(1), which are effective August 13, 1996. The removal of §1.483–2T is effective June 14, 1996. The removal of §1.1275–2T is effective August 13, 1996.

For dates of applicability of these regulations, see Effective Dates under Supplementary Information.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1450. Responses to these collections of information are required to determine a taxpayer's

interest income or deductions on a contingent payment debt instrument.

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

The estimated annual burden per respondent/recordkeeper varies from .3 hours to .5 hours, depending on individual circumstances, with an estimated average of .47 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224, and to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to the collections of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

Section 1275(d) of the Internal Revenue Code (Code) grants the Secretary the authority to prescribe regulations under the original issue discount (OID) provisions of the Code (sections 163(e) and 1271 through 1275), including regulations relating to debt instruments that provide for contingent payments. On February 2, 1994, the IRS published final OID regulations in the **Federal Register** (59 FR 4799 [TD 8517, 1994–1 C.B. 38]). However, the final OID regulations did not contain rules for contingent payment debt instruments.

On December 16, 1994, the IRS published a notice of proposed rulemaking in the **Federal Register** (59 FR 62884 [FI–59–91, 1995–1 C.B. 894]) relating to the tax treatment of debt instruments that provide for one or more contingent payments. The notice also contained proposed amendments to the regulations under sections 483 (relating to unstated interest), 1001 (relating to the amount realized on a sale, exchange, or other disposition of property), 1272 (relating to the accrual of OID), 1274 (relating to debt instruments issued for nonpublicly traded property), and 1275(c) (relating to OID information reporting requirements), and to §1.1275–5 (relating to variable rate debt instruments). In addition, the notice contained proposed regulations relating to the integration of a contingent payment or variable rate debt instrument with a related hedge. The notice withdrew the proposed regulations relating to contingent payment debt instruments that were previously published in the **Federal Register** on April 8, 1986 (51 FR 12087), and February 28, 1991 (56 FR 8308).

On March 16, 1995, the IRS held a public hearing on the proposed regulations. In addition, the IRS received a number of written comments on the proposed regulations. The proposed regulations, with certain changes to respond to comments, are adopted as final regulations. In addition, certain clarifying and conforming amendments are made to the OID regulations that were published in the **Federal Register** on February 2, 1994. The comments and significant changes are discussed below.

Explanation of Provisions

Section 1.1275–4 Contingent payment debt instruments

A. *Noncontingent bond method*

Under the noncontingent bond method in the proposed regulations, a taxpayer computes interest accruals on a contingent payment debt instrument by setting a payment schedule as of the issue date and applying the OID rules to the payment schedule. The payment schedule consists of all fixed payments on the debt instrument and a projected amount for each contingent payment. For market-based contingencies (*i.e.*, contingencies for which price quotes are readily available), the projected amount is the forward price of the contingency. For other contingencies, the issuer first determines a reasonable yield for the debt instrument and then sets projected amounts equal to the relative expected payments on the contingencies so that the payment schedule produces the reasonable yield. These rules were designed to produce a yield similar to the yield the issuer would obtain on a fixed rate debt instrument.

Commentators suggested that the regulations could be simplified if they used the same basic methodology for both market-based and non-market-based contingencies. In addition, commentators suggested that forward price quotes would be variable or manipulable and that taxpayers will set more appropriate payment schedules if they first determine yield and then set the payment schedule to fit the yield.

The final regulations adopt these suggestions and generally conform the treatment of debt instruments that provide for either market-based or non-market-based contingent payments. Thus, for any contingent payment debt instrument subject to the noncontingent bond method, a taxpayer first determines the yield on the instrument and then sets the payment schedule to fit the yield. The yield is determined by the yield at which the issuer would issue a fixed rate debt instrument with terms and conditions similar to the contingent payment debt instrument (the comparable yield). Relevant terms and conditions include the level of subordination, term, timing of payments, and general market conditions. For example, if a hedge is available such that the issuer or holder could integrate the debt instrument and the hedge into a synthetic fixed-rate debt instrument under the rules of §1.1275–6, the comparable yield is the yield that the synthetic fixed-rate debt instrument would have. If a §1.1275–6 hedge (or the substantial equivalent) is not available, but similar fixed rate debt instruments of the issuer trade at a price that reflects a spread above a benchmark rate, the comparable yield is the sum of the value of the benchmark rate on the issue date and the spread. In all cases, the yield must be a reasonable yield for the issuer and may not be less than the applicable Federal rate (AFR).

Once the comparable yield is determined, the payment schedule is set to produce the comparable yield. The final regulations retain the general approach of the proposed regulations in determining the payment schedule. Thus, for market-based payments, the projected payment is the forward price of the payment. For non-market-based payments, the projected payment is the expected amount of the payment as of the issue date.

Commentators were concerned that a taxpayer could overstate the yield on a contingent payment debt instrument and, therefore, claim excess interest deductions during the term of the instrument. They were particularly concerned about a long-term debt instru-

ment that has non-market-based payments because the taxpayer's determination would be hard to verify and any excess interest deductions would not be recaptured for a long time.

The final regulations address this concern by providing that the comparable yield for a debt instrument is presumed to be the AFR if the instrument provides for a non-market-based payment and is part of an issue that is marketed or sold in substantial part to tax-exempt investors or other investors for whom the treatment of the debt instrument is not expected to have a substantial effect on their U.S. tax liability. A taxpayer may overcome this presumption only with clear and convincing evidence that the comparable yield for the debt instrument should be a specific yield that is higher than the AFR. Appraisals and other valuations of nonpublicly traded property cannot be used to overcome the presumption, nor can references to general market rates. An issuer may, for example, overcome the presumption by showing that recently issued similar debt instruments of the issuer trade at a price that reflects a specific yield.

One commentator suggested that the use of the term *projected payment schedule* caused securities law problems because the issuer could be seen as making representations to the holder about the expected payments. The comparable yield and projected payment schedule determined under these regulations are for tax purposes only and are not assurances by the issuer with respect to the payments. The final regulations retain the term *projected payment schedule*, but an issuer may use a different term to describe the payment schedule (*e.g.*, payment schedule determined under §1.1275–4) if the language used by the issuer is clear.

Under the proposed regulations, projected payments rather than actual payments are used to determine the adjusted issue price of a debt instrument, the holder's basis in a debt instrument, and the amount of any contingent payment treated as made on the scheduled retirement of a debt instrument. One commentator questioned the use of projected payments to make these determinations. The approach in the proposed regulations is appropriate, however, because a positive or negative adjustment is used to take into account the difference between the actual amount and the projected amount of a contingent payment. This difference would be counted twice if the adjusted issue price, the holder's basis, and the amount deemed paid on retirement were based on the actual amount rather than the projected amount of a contingent payment. Thus, the approach used in the proposed regulations is retained in the final regulations.

B. *Tax-exempt obligations*

In response to comments, the rules contained in §1.1275–4(d) relating to tax-exempt contingent payment obligations have been revised. Under the proposed regulations, tax-exempt obligations are generally subject to the noncontingent bond method, with the following modifications: (1) The yield on which interest accruals are based may not exceed the greater of the yield on the obligation, determined without regard to the non-market-based contingent payments, and the tax-exempt AFR that applies to the obligation; (2) Positive adjustments are treated as gain from the sale or exchange of the obligation rather than as interest; and (3) Negative adjustments reduce the amount of tax-exempt interest, and, therefore, are generally not taken into account as deductible losses. These modifications to the noncontingent bond method for tax-exempt obligations were added because the IRS and Treasury believe that when a property right is embedded in a tax-exempt obligation it is generally inappropriate to treat payments on the right as interest on an obligation of a state or political subdivision.

Several commentators suggested that the proposed regulations relating to tax-exempt obligations are overly restrictive. These commentators questioned the reason for limiting the rate of accrual to the tax-exempt AFR and characterizing positive adjustments as taxable gain rather than interest. They also questioned the fairness of treating negative adjustments as nondeductible adjustments to tax-exempt interest when positive adjustments are treated as taxable gain. Some of the commentators suggested that, at a minimum, the interest limitations should not apply to contingent obligations that pay interest based on interest rate formulas that reflect the cost of funds rather than changes in the value of embedded property rights. Finally, commentators noted that programs involving municipal refinancings of real estate projects (for example, low-income multi-family housing projects) would be jeopardized by the proposed regulations because payments on tax-exempt obligations issued to finance these projects are in certain cases contingent in part on the revenues or appreciation in value of the project.

The IRS and Treasury continue to believe that gain from a property right should not be recharacterized as tax-exempt interest merely because the property right is embedded in a tax-exempt obligation. The IRS and Treasury nevertheless recognize that certain types of traditional tax-exempt financings should not be subject to the interest limitations of the proposed regulations (*e.g.*, financings on which interest is computed in a manner that relates to the cost of funds). Accordingly, §1.1275–4(d) has been revised to include a category of tax-exempt obligations that will be subject to the noncontingent bond method without the tax-exempt interest limitations contained in the proposed regulations. This category of tax-exempt obligations includes (1) obligations that would qualify as variable rate debt instruments (VRDIs) except for the failure to meet certain of the technical requirements of the VRDI definition (such as the cap and floor limitations, or the requirement that interest be paid or compounded at least annually), and (2) certain obligations issued to refinance an obligation, the proceeds of which were used to finance a project.

For other tax-exempt obligations, the interest restrictions of the proposed regulations are adopted in final form. Section 1.1275–4(d) has been revised, however, to provide that a negative adjustment is treated as a taxable loss from the sale or exchange of the obligation, rather than as a nondeductible adjustment to tax-exempt interest.

C. *Prepaid tuition plans*

A number of commentators asked whether contracts issued under state-sponsored prepaid tuition plans are subject to §1.1275–4. Although the terms of the contracts vary, the contracts generally are issued pursuant to a plan created by a state to enable the participants in the plan to save for post-secondary education for themselves or other designated beneficiaries. In addition, the plans generally provide protection against increases in the costs of higher education or otherwise subsidize these costs, often by providing for

contingent payments that are linked to the future costs of post-secondary education.

The commentators argue that §1.1275–4 does not apply to the contracts because the contracts are not debt instruments for federal income tax purposes. In addition, the commentators argue that, even if the contracts are debt instruments, the noncontingent bond method would be unduly burdensome and inappropriate for contracts of this type.

The final regulations under §1.1275–4 do not affect the treatment of contracts issued pursuant to state-sponsored prepaid tuition plans, whether or not the contracts are debt instruments. The final regulations, like the proposed regulations, only apply to debt instruments. Thus, the final regulations do not apply to contracts issued pursuant to a plan created by a state to enable participants to save for post-secondary education if the contracts are not debt instruments. In addition, the final regulations provide an exception for any debt instrument issued pursuant to a state-sponsored prepaid tuition plan.

This exception applies to a contract issued pursuant to a plan or arrangement if: The plan or arrangement is created by a state statute; the plan or arrangement has a primary objective of enabling the participants to pay for the costs of post-secondary education for themselves or their designated beneficiaries; and the contingencies under the contract are related to such purpose. These characteristics are intended to describe all existing state-sponsored prepaid tuition plans. Therefore, the final regulations do not change the tax treatment of a contract issued pursuant to these plans. As a result, if the contract is a debt instrument, the contingent payments on the contract are not taken into account by an individual until the payments are made.

The exception in the final regulations is intended to apply only to the existing state-sponsored prepaid tuition plans and to any future plans that are substantially similar to the existing plans. In addition, no inference is intended as to whether contracts issued by any state-sponsored prepaid tuition plan are debt instruments.

D. *Debt instruments subject to section 1274*

The proposed regulations provide a method for contingent payment debt instruments not subject to the noncontingent bond method (*i.e.*, a nonpublicly traded debt instrument issued in a sale or exchange of nonpublicly traded property). Under the method, a debt instrument's noncontingent payments are treated as a separate debt instrument, which is generally taxed under the rules for noncontingent debt instruments. The debt instrument's contingent payments are taken into account when made. A portion of each contingent payment is treated as principal, based on the amount determined by discounting the payment at the AFR from the payment date to the issue date, and the remainder is treated as interest. Special rules are provided if a contingent payment becomes fixed more than 6 months before it is due.

The final regulations generally adopt the method in the proposed regulations. In addition, the final regulations contain rules for a holder whose basis in a debt instrument is different from the instrument's adjusted issue price (*e.g.*, a subsequent holder).

E. *Inflation-indexed bonds*

The Treasury recently announced that it was considering issuing bonds indexed to inflation (61 FR 25164). Depending on their ultimate structure, the noncontingent bond method might be inappropriate for these bonds. If the Treasury issues these bonds, the Treasury and IRS may issue regulations to provide a simplified tax treatment for the bonds. The treatment would require current accrual of the inflation component.

Other amendments to the OID regulations

A. *Alternative payment schedules under §1.1272–1(c)*

Section 1.1272–1(c) provides rules to determine the yield and maturity of certain debt instruments that provide for one or more alternative payment schedules applicable upon the occurrence of a contingency (or contingencies), provided that the timing and amounts of the payments that comprise each payment schedule are known as of the issue date. Under these rules, the yield and maturity of a debt instrument are generally determined by assuming that the payments will be made under the payment schedule most likely to occur (based on all the facts and circumstances as of the issue date). Special rules are provided for unconditional options and mandatory sinking funds.

The general rules in §1.1272–1(c) produce a reasonable result when a debt instrument has one stated payment schedule that is very likely to occur and one or more alternative payment schedules that are unlikely to occur. In this case, adherence to the stated payment schedule will result in accruals on the debt instrument that reasonably reflect the expected return on the instrument. The rules can lead to unreasonable results, however, if a debt instrument provides for a stated payment schedule and one or more alternative payment schedules that differ significantly and that have a comparable likelihood of occurring. In this case, the accruals based on the payment schedule identified as most likely to occur could differ significantly from the expected return on the debt instrument, which would reflect all the payment schedules and their relative probabilities of occurrence.

Because the general rules of §1.1272–1(c) could produce unreasonable results, these rules have been modified. Under the final regulations, if a single payment schedule is significantly more likely than not to occur, the yield and maturity of the debt instrument are calculated based on that payment schedule. As a result, any other debt instrument that provides for an alternative payment schedule (other than because of an unconditional option or mandatory sinking fund) will generally be subject to the rules in §1.1275–4 for contingent payment debt instruments. The final regulations generally retain the rules for mandatory sinking funds and unconditional options.

B. *Remote and incidental contingencies*

The proposed regulations provide that a payment subject to a remote or incidental contingency is not considered a contingent payment for purposes of §1.1275–4. In response to a comment, the rule relating to remote and incidental contingencies has been broadened, through the addition of new §1.1275–2(h), to provide that remote and incidental contingencies are generally ignored for purposes of sections 163(e) (other than section 163(e)(5)) and 1271 through 1275 and the regulations thereunder. Thus, for example, if an otherwise fixed payment debt instrument provides for an additional pay-

ment that will be made upon the occurrence of a contingency and there is a remote likelihood that the contingency will occur, the contingent payment is ignored for purposes of computing OID accruals on the instrument. If the contingency occurs, however, then, solely for purposes of sections 1272 and 1273, the debt instrument is treated as reissued. Therefore, OID on the debt instrument is redetermined.

C. *Definition of qualified stated interest*

The addition of the rules for remote or incidental contingencies and the changes to the rules for alternative payment schedules allow simplification of the definition of qualified stated interest. Under §1.1273–1(c), as published in the **Federal Register** on February 2, 1994, qualified stated interest must be unconditionally payable in cash or property at least annually at a single fixed rate. Interest is unconditionally payable only if late payment (other than a late payment that occurs within a reasonable grace period) or nonpayment is expected to be penalized or reasonable remedies exist to compel payment.

This definition of unconditionally payable can be read to conflict with the alternative payment schedule rules. For example, if a debt instrument has two alternative payment schedules, one schedule can be stated as the required payment schedule and the other schedule can be stated as a penalty if the required payments are not made. The required payments might then be treated as unconditionally payable and, therefore, as being qualified stated interest even if they would not be qualified stated interest if treated under the alternative payment schedule rules. Under this treatment, if a payment is not made, the reissuance rules of the alternative payment schedule regime do not apply. Holders can thus argue that no OID would accrue with respect to the debt instrument even though OID would accrue if the instrument were treated as having an alternative payment schedule and holders fully expect any unmade payment to be made in the future.

The remote or incidental rules in §1.1275–2(h) provide a better mechanism for determining whether a payment is qualified stated interest and determining the treatment if no payment is made. Thus, the final regulations modify the definition of unconditionally payable so that interest is unconditionally payable only if reasonable legal remedies exist to compel payment or the debt instrument otherwise provides terms and conditions that make the likelihood of late payment (other than a late payment that occurs within a reasonable grace period) or nonpayment remote. If the payment is not made (other than because of insolvency, default, or similar circumstances), the final regulations require a deemed reissuance for OID purposes, which ensures that OID will accrue. This approach should simplify the treatment of many debt instruments and yet ensure that OID accrues in appropriate circumstances.

D. *OID anti-abuse rule*

On February 2, 1994, the IRS published in the **Federal Register** temporary and proposed regulations that contained an anti-abuse rule for purposes of the OID regulations (§1.1275–2T (59 FR 4831); §1.1275–2(g) (59 FR 4878)). Under the anti-abuse rule, the Commissioner can apply or depart from the regulations under section 163(e) or sections 1271 through 1275 as necessary to achieve a reasonable result if a principal purpose in structuring a debt instrument or engaging in a transaction is to achieve a result under the regulations that is unreasonable in light of the applicable statutes. This rule is adopted as a final regulation with some clarifying changes and the addition of an example to illustrate its application to certain contingent payment debt instruments.

E. *Determination of issue price under section 1274*

Under the proposed regulations, the issue price of a contingent payment debt instrument that is subject to section 1274 (*i.e.*, a debt instrument issued in exchange for nonpublicly traded property) is determined without taking into account the instrument's contingent payments. Thus, the issue price of the debt instrument (and the buyer's initial basis in the property) is limited to an amount determined by taking into account only the noncontingent payments. The buyer's basis in the property, however, is increased by the amount of a contingent payment treated as principal. This approach was adopted primarily because it is inappropriate to allow a buyer a basis in property that reflects anticipated contingent payments that are uncertain in amount. In addition, this approach limits the ability of the buyer to overstate interest deductions over the term of the debt instrument. The approach of the proposed regulations has been adopted in the final regulations for taxable debt instruments subject to section 1274. See §1.1274–2(g).

It is not appropriate, however, to apply this approach to tax-exempt contingent payment obligations subject to section 1274. Because the present value of projected contingent payments generally is not included in the issue price of a taxable debt instrument subject to section 1274, the instrument is accounted for under §1.1275–4(c). This regime is not appropriate for tax-exempt obligations because it does not distinguish between tax-exempt interest and gain attributable to an embedded property right. Thus, in order to permit tax-exempt obligations to be subject to the noncontingent bond method under §1.1275–4(b), the final regulations provide special rules to determine the issue price of a tax-exempt contingent payment obligation subject to section 1274.

Under these rules, the issue price of a tax-exempt contingent payment obligation subject to section 1274 is equal to the fair market value of the obligation on the issue date (or, in the case of an obligation that provides for interest-based or revenue-based payments, the greater of the obligation's fair market value or stated principal amount). In addition, the obligation is subject to the rules of §1.1275–4(d) (the noncontingent bond method for tax-exempt contingent payment obligations) rather than §1.1275–4(c). However, to ensure that the buyer's basis is the same as if the buyer had issued a taxable debt instrument, the final regulations limit the buyer's basis to the present value of the fixed payments.

§1.1275–6 Integration rules

Commentators generally approved of the integration rules in the proposed regulations, and those rules are adopted with only two significant changes.

First, the final regulations allow (but do not require) the integration of a hedge with a fixed rate debt instrument. For example, a taxpayer may integrate a fixed rate debt instrument and a swap into a VRDI. Although the hedging transaction regulations (§1.446–4)

cover many of these transactions, the integration rules provide more certain treatment. The final regulations, however, do not allow the Commissioner to integrate a hedge with either a fixed rate debt instrument or a VRDI that provides for interest at a qualified floating rate. In these cases, treating the hedge and the debt instrument separately is a longstanding rule that generally clearly reflects income.

Second, in limited circumstances, the final regulations allow a hedge to be entered into prior to the date the taxpayer issues or acquires the debt instrument. In these circumstances, however, the taxpayer must identify the hedge as part of an integrated transaction on the day the hedge is entered into by the taxpayer. Under the final regulations, if the hedging transaction has not yet had any cash flows (including amounts paid to enter into or purchase the hedge), the integration rules work appropriately so that any built-in gain or loss on the hedge at the time of integration is included over the term of the synthetic debt instrument. Thus, the final regulations put no restriction on the time the hedging transaction has to be entered into in this case. If there have been cash flows on the hedge, the final regulations require the hedge to be entered into no earlier than a date that is substantially contemporaneous with the date on which the debt instrument is acquired. This approach should allow commercially reasonable transactions to be integrated without the need to create complex rules to determine the treatment of prior cash flows on the hedging transaction.

The rules for remote and incidental contingencies in §1.1275–2(h) apply for purposes of the integration rules. Thus, if there is an incidental mismatch between a §1.1275–6 hedge and a qualifying debt instrument, a taxpayer may still integrate the hedge and the instrument. The mismatch is dealt with according to the rules for incidental contingencies.

The final regulations also clarify the timing of income, deductions, gains, and losses from a hedge of a contingent payment debt instrument not subject to integration. Under §1.446–4, the income, deductions, gains, and losses must match the income, deductions, gains, and losses from the debt instrument. The final regulations clarify that gain or loss realized on a transaction that hedges a contingent payment on a debt instrument subject to §1.1275–4(c) is taken into account when the contingent payment is taken into account under §1.1275–4(c). This treatment does not allow the taxpayer to change the timing of the income, deductions, gains, and losses from the debt instrument.

Effective Dates

In general, the final regulations apply to debt instruments issued on or after August 13, 1996. Section 1.1275–6 applies to a qualifying debt instrument issued on or after August 13, 1996. Section 1.1275–6 also applies to a qualifying debt instrument acquired by the taxpayer on or after August 13, 1996, if the qualifying debt instrument is a fixed rate debt instrument or a VRDI or if the qualifying debt instrument and the §1.1275–6 hedge are acquired by the taxpayer substantially contemporaneously. Except as otherwise provided in the regulations, the changes to §1.1275–5 apply to debt instruments issued on or after April 4, 1994.

Debt instruments issued before the effective date of the final regulations

For a contingent payment debt instrument issued before August 13, 1996, a taxpayer may use any reasonable method to account for the debt instrument, including a method that would have been required under the proposed regulations when the debt instrument was issued. However, unless §1.1275–6 applies to the debt instrument, integration is not a reasonable method to account for the instrument.

Consent to change accounting method

The Commissioner grants consent for a taxpayer to change its method of accounting to follow the final regulations in this document. This consent is granted, however, only for a change for the first taxable year in which the taxpayer must account for a debt instrument under the final regulations. The change is made on a cut-off basis (*i.e.*, the new method only applies to debt instruments issued on or after August 13, 1996). Therefore, no items of income or deduction are omitted or duplicated, and no adjustment under section 481 is allowed.

Special Analyses

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

* * * * * *

Adoption of Amendments to the Regulations

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

Part 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entry for §1.1275–2T and adding two entries in numerical order to read as follows:

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

Section 1.483–4 also issued under 26 U.S.C. 483(f). * * *

Section 1.1275–6 also issued under 26 U.S.C. 1275(d). * * *

Par. 2. Section 1.163–7 is amended by adding a sentence at the end of paragraph (a) to read as follows:

§1.163–7 Deduction for OID on certain debt instruments.

(a) * * * To determine the amount of interest (OID) that is deductible each year on a debt instrument that provides for contingent payments, see §1.1275–4.

* * * * * *

Par. 3. Section 1.446–4 is amended by:

1. Redesignating paragraphs (a)(2)-(ii) and (a)(2)(iii) as paragraphs (a)(2)-(iii) and (a)(2)(iv), respectively.

2. Adding a new paragraph (a)(2)(ii).

3. Adding a sentence at the end of paragraph (e)(4).

The additions read as follows:

§1.446–4 Hedging transactions.

(a) * * *

(2) * * *

(ii) An integrated transaction subject to §1.1275–6;

* * * * * *

(e) * * *

(4) * * * Similarly, gain or loss realized on a transaction that hedges a contingent payment on a debt instrument subject to §1.1275–4(c) (a contingent payment debt instrument issued for nonpublicly traded property) is taken into account when the contingent payment is taken into account under §1.1275–4(c).

* * * * * *

§1.483–2T [Removed]

Par. 4. Section 1.483–2T is removed effective June 14, 1996.

Par. 5. Section 1.483–4 is added to read as follows:

§1.483–4 Contingent payments.

(a) *In general.* This section applies to a contract for the sale or exchange of property (the overall contract) if the contract provides for one or more contingent payments and the contract is subject to section 483. This section applies even if the contract provides for adequate stated interest under §1.483–2. If this section applies to a contract, interest under the contract is generally computed and accounted for using rules similar to those that would apply if the contract were a debt instrument subject to §1.1275–4(c). Consequently, all noncontingent payments under the overall contract are treated as if made under a separate contract, and interest accruals on this separate contract are computed under rules similar to those contained in §1.1275–4(c)(3). Each contingent payment under the overall contract is characterized as principal and interest under rules similar to those contained in §1.1275–4(c)(4). However, any interest, or amount treated as interest, on a contract subject to this section is taken into account by a taxpayer under the taxpayer's regular method of accounting (*e.g.*, an accrual method or the cash receipts and disbursements method).

(b) *Examples.* The following examples illustrate the provisions of paragraph (a) of this section.

Example 1. Deferred payment sale with contingent interest—(i) *Facts.* On December 31, 1996, A sells depreciable personal property to B. As consideration for the sale, B issues to A a debt instrument with a maturity date of December 31, 2001. The debt instrument provides for a principal payment of $200,000 on the maturity date, and a payment of interest on December 31 of each year, beginning in 1997, equal to a percentage of the total gross income derived from the property in that year. However, the total interest payable on the debt instrument over its entire term is limited to a maximum of $50,000. Assume that on December 31, 1996, the short-term applicable Federal rate is 4 percent, compounded annually, and the mid-term applicable Federal rate is 5 percent, compounded annually.

(ii) *Treatment of noncontingent payment as separate contract.* Each payment of interest is a contingent payment. Accordingly, under paragraph (a) of this section, for purposes of applying section 483 to the debt instrument, the right to the noncontingent payment of $200,000 is treated as a separate contract. The amount of unstated interest on this separate contract is equal to $43,295, which is the amount by which the payment ($200,000) exceeds the present value of the payment ($156,705), calculated using the test rate of 5 percent, compounded annually. The $200,000 payment is thus treated as consisting of a payment of interest of $43,295 and a payment of principal of $156,705. The interest is includible in A's gross income, and deductible by B, under their respective methods of accounting.

(iii) *Treatment of contingent payments.* Assume that the amount of the contingent payment that is paid on December 31, 1997, is $20,000. Under paragraph (a) of this section, the $20,000 payment is treated as a payment of principal of $19,231 (the present value, as of the date of sale, of the $20,000 payment, calculated using a test rate equal to 4 percent, compounded annually) and a payment of interest of $769. The $769 interest payment is includible in A's gross income, and deductible by B, in their respective taxable years in which the payment occurs. The amount treated as principal gives B additional basis in the property on December 31, 1997. The remaining contingent payments on the debt instrument are accounted for similarly, using a test rate of 4 percent, compounded annually, for the payments made on December 31, 1998, and December 31, 1999, and a test rate of 5 percent, compounded annually, for the payments made on December 31, 2000, and December 31, 2001.

Example 2. Contingent stock payout—(i) *Facts.* M Corporation and N Corporation each owns one-half of the stock of O Corporation. On December 31, 1996, pursuant to a reorganization qualifying under section 368(a)(1)(B), M acquires the one-half interest of O held by N in exchange for 30,000 shares of M voting stock and a non-assignable right to receive up to 10,000 additional shares of M's voting stock during the next 3 years, provided the net profits of O exceed certain amounts specified in the contract. No interest is provided for in the contract. No additional shares are received in 1997 or in 1998. In 1999, the annual earnings of O exceed the specified amount, and, on December 31, 1999, an additional 3,000 M voting shares are transferred to N. The fair market value of the 3,000 shares on December 31, 1999, is $300,000. Assume that on December 31, 1996, the short-term applicable Federal rate is 4 percent, compounded annually. M and N are calendar year taxpayers.

(ii) *Allocation of interest.* Section 1274 does not apply to the right to receive the additional shares because the right is not a debt instrument for federal income tax purposes. As a result, the transfer of the 3,000 M voting shares to N is a deferred payment subject to section 483 and a portion of the shares is treated as unstated interest under that section. The amount of interest allocable to the shares is equal to the excess of $300,000 (the fair market value of the shares on December 31, 1999) over $266,699 (the present value of $300,000, determined by discounting the payment at the test rate of 4 percent, compounded annually, from December 31, 1999, to December 31, 1996). As a result, the amount of interest allocable to the payment of the shares is $33,301 ($300,000 – $266,699). Both M and N take the interest into account in 1999.

(c) *Effective date.* This section applies to sales and exchanges that occur on or after August 13, 1996.

Par. 6. Section 1.1001–1 is amended by revising paragraph (g) to read as follows:

§1.1001–1 Computation of gain or loss.

* * * * * *

(g) *Debt instruments issued in exchange for property*—(1) *In general.* If a debt instrument is issued in exchange for property, the amount realized attributable to the debt instrument is the issue price of the debt instrument as determined under §1.1273–2 or §1.1274–2, whichever is applicable. If, however, the issue price of the debt instrument is determined under section 1273(b)(4), the amount realized attributable to the debt instrument is its stated principal amount reduced by any unstated interest (as determined under section 483).

(2) *Certain debt instruments that provide for contingent payments*—(i) *In general.* Paragraph (g)(1) of this section does not apply to a debt instrument subject to either §1.483–4 or §1.1275–4(c) (certain contingent payment debt instruments issued for nonpublicly traded property).

(ii) *Special rule to determine amount realized.* If a debt instrument subject to §1.1275–4(c) is issued in exchange for property, and the income from the

exchange is not reported under the installment method of section 453, the amount realized attributable to the debt instrument is the issue price of the debt instrument as determined under §1.1274–2(g), increased by the fair market value of the contingent payments payable on the debt instrument. If a debt instrument subject to §1.483–4 is issued in exchange for property, and the income from the exchange is not reported under the installment method of section 453, the amount realized attributable to the debt instrument is its stated principal amount, reduced by any unstated interest (as determined under section 483), and increased by the fair market value of the contingent payments payable on the debt instrument. This paragraph (g)(2)(ii), however, does not apply to a debt instrument if the fair market value of the contingent payments is not reasonably ascertainable. Only in rare and extraordinary cases will the fair market value of the contingent payments be treated as not reasonably ascertainable.

(3) *Coordination with section 453.* If a debt instrument is issued in exchange for property, and the income from the exchange is not reported under the installment method of section 453, this paragraph (g) applies rather than §15a.453–1(d)(2) to determine the taxpayer's amount realized attributable to the debt instrument.

(4) *Effective date.* This paragraph (g) applies to sales or exchanges that occur on or after August 13, 1996.

Par. 7. Section 1.1012–1 is amended by revising paragraph (g) to read as follows:

§1.1012–1 Basis of property.

* * * * * *

(g) *Debt instruments issued in exchange for property*—(1) *In general.* For purposes of paragraph (a) of this section, if a debt instrument is issued in exchange for property, the cost of the property that is attributable to the debt instrument is the issue price of the debt instrument as determined under §1.1273–2 or §1.1274–2, whichever is applicable. If, however, the issue price of the debt instrument is determined under section 1273(b)(4), the cost of the property attributable to the debt instrument is its stated principal amount reduced by any unstated interest (as determined under section 483).

(2) *Certain tax-exempt obligations.* This paragraph (g)(2) applies to a tax-exempt obligation (as defined in section 1275(a)(3)) that is issued in exchange for property and that has an issue price determined under §1.1274–2(j) (concerning tax-exempt contingent payment obligations and certain tax-exempt variable rate debt instruments subject to section 1274). Notwithstanding paragraph (g)(1) of this section, if this paragraph (g)(2) applies to a tax-exempt obligation, for purposes of paragraph (a) of this section, the cost of the property that is attributable to the obligation is the sum of the present values of the noncontingent payments (as determined under §1.1274–2(c)).

(3) *Effective date.* This paragraph (g) applies to sales or exchanges that occur on or after August 13, 1996.

Par. 8. Section 1.1271–0(b) is amended by:

1. Revising the entries for paragraphs (c)(2), (c)(3), (c)(4), and (d) of §1.1272–1.

2. Adding an entry for paragraph (c)(7) of §1.1272–1.

3. Revising the entry for paragraph (g) and adding entries for paragraphs (i) and (j) of §1.1274–2.

4. Removing the language "[Reserved]" from the entry for paragraph (g) and adding entries for paragraphs (g), (h), (i), and (j) of §1.1275–2.

5. Removing the entries for §1.1275–2T.

6. Adding entries for §1.1275–4.

7. Adding entries for paragraphs (a)(5) and (a)(6) of §1.1275–5.

8. Revising the entries for paragraphs (c)(1) and (c)(5) of §1.1275–5.

9. Adding entries for §1.1275–6.

The revisions and additions read as follows:

§1.1271–0 Original issue discount; effective date; table of contents.

* * * * * *

(b) * * *

* * * * * *

§1.1272–1 Current inclusion of OID in income.

* * * * * *

(c) * * *

(2) Payment schedule that is significantly more likely than not to occur.

(3) Mandatory sinking fund provision.

(4) Consistency rule. [Reserved]

* * * * * *

(7) Effective date.

(d) Certain debt instruments that provide for a fixed yield.

* * * * * *

§1.1274–2 Issue price of debt instruments to which section 1274 applies.

* * * * * *

(g) Treatment of contingent payment debt instruments.

* * * * * *

(i) [Reserved]

(j) Special rules for tax-exempt obligations.

(1) Certain variable rate debt instruments.

(2) Contingent payment debt instruments.

(3) Effective date.

* * * * * *

§1.1275–2 Special rules relating to debt instruments.

* * * * * *

(g) Anti-abuse rule.

(1) In general.

(2) Unreasonable result.

(3) Examples.

(4) Effective date.

(h) Remote and incidental contingencies.

(1) In general.

(2) Remote contingencies.

(3) Incidental contingencies.

(4) Aggregation rule.

(5) Consistency rule.

(6) Subsequent adjustments.

(7) Effective date.

(i) [Reserved]

(j) Treatment of certain modifications.

* * * * * *

§1.1275–4 Contingent payment debt instruments.

(a) Applicability.

(1) In general.

(2) Exceptions.

(3) Insolvency and default.

(4) Convertible debt instruments.

(5) Remote and incidental contingencies.

(b) Noncontingent bond method.

(1) Applicability.

(2) In general.

(3) Description of method.

(4) Comparable yield and projected payment schedule.

(5) Qualified stated interest.

(6) Adjustments.

(7) Adjusted issue price, adjusted basis, and retirement.
(8) Character on sale, exchange, or retirement.
(9) Operating rules.
(c) Method for debt instruments not subject to the noncontingent bond method.
(1) Applicability.
(2) Separation into components.
(3) Treatment of noncontingent payments.
(4) Treatment of contingent payments.
(5) Basis different from adjusted issue price.
(6) Treatment of a holder on sale, exchange, or retirement.
(7) Examples.
(d) Rules for tax-exempt obligations.
(1) In general.
(2) Certain tax-exempt obligations with interest-based or revenue-based payments
(3) All other tax-exempt obligations.
(4) Basis different from adjusted issue price.
(e) Amounts treated as interest under this section.
(f) Effective date.

§1.1275–5 Variable rate debt instruments.

(a) * * *
(5) No contingent principal payments.
(6) Special rule for debt instruments issued for nonpublicly traded property.

* * * * * *

(c) * * *
(1) Definition.

* * * * * *

(5) Tax-exempt obligations.

* * * * * *

§1.1275–6 Integration of qualifying debt instruments.

(a) In general.
(b) Definitions.
(1) Qualifying debt instrument.
(2) Section 1.1275–6 hedge.
(3) Financial instrument.
(4) Synthetic debt instrument.
(c) Integrated transaction.
(1) Integration by taxpayer.
(2) Integration by Commissioner.
(d) Special rules for legging into and legging out of an integrated transaction.
(1) Legging into.
(2) Legging out.
(e) Identification requirements.
(f) Taxation of integrated transactions.
(1) General rule.
(2) Issue date.
(3) Term.
(4) Issue price.
(5) Adjusted issue price.
(6) Qualified stated interest.
(7) Stated redemption price at maturity.
(8) Source of interest income and allocation of expense.
(9) Effectively connected income.
(10) Not a short-term obligation.
(11) Special rules in the event of integration by the Commissioner.
(12) Retention of separate transaction rules for certain purposes.
(13) Coordination with consolidated return rules.
(g) Predecessors and successors.
(h) Examples.
(i) [Reserved]
(j) Effective date.

Par. 9. Section 1.1272–1 is amended by:

1. Revising paragraphs (b)(2)(ii), (c), and (d).

2. Adding a sentence at the end of paragraph (f)(2).

3. Removing the language "determining yield and maturity" from the first sentence of paragraph (j) *Example 5* (iii) and adding the language "sections 1272 and 1273" in its place.

4. Removing the language "determining yield and maturity" from the second sentence of paragraph (j) *Example 7* (v) and adding the language "sections 1272 and 1273" in its place.

The revisions and addition read as follows:

§1.1272–1 Current inclusion of OID in income.

* * * * * *

(b) * * *

(2) * * *

(ii) A debt instrument that provides for contingent payments, other than a debt instrument described in paragraph (c) or (d) of this section or except as provided in §1.1275–4; or

* * * * * *

(c) *Yield and maturity of certain debt instruments subject to contingencies*—(1) *Applicability.* This paragraph (c) provides rules to determine the yield and maturity of certain debt instruments that provide for an alternative payment schedule (or schedules) applicable upon the occurrence of a contingency (or contingencies). This paragraph (c) applies, however, only if the timing and amounts of the payments that comprise each payment schedule are known as of the issue date and the debt instrument is subject to paragraph (c)(2), (3), or (5) of this section. A debt instrument does not provide for an alternative payment schedule merely because there is a possibility of impairment of a payment (or payments) by insolvency, default, or similar circumstances. See §1.1275–4 for the treatment of a debt instrument that provides for a contingency that is not described in this paragraph (c). See §1.1273–1(c) to determine whether stated interest on a debt instrument subject to this paragraph (c) is qualified stated interest.

(2) *Payment schedule that is significantly more likely than not to occur.* If, based on all the facts and circumstances as of the issue date, a single payment schedule for a debt instrument, including the stated payment schedule, is significantly more likely than not to occur, the yield and maturity of the debt instrument are computed based on this payment schedule.

(3) *Mandatory sinking fund provision.* Notwithstanding paragraph (c)(2) of this section, if a debt instrument is subject to a mandatory sinking fund provision, the provision is ignored for purposes of computing the yield and maturity of the debt instrument if the use and terms of the provision meet reasonable commercial standards. For purposes of the preceding sentence, a mandatory sinking fund provision is a provision that meets the following requirements:

(i) The provision requires the issuer to redeem a certain amount of debt instruments in an issue prior to maturity.

(ii) The debt instruments actually redeemed are chosen by lot or purchased by the issuer either in the open market or pursuant to an offer made to all holders (with any proration determined by lot).

(iii) On the issue date, the specific debt instruments that will be redeemed on any date prior to maturity cannot be identified.

(4) *Consistency rule.* [Reserved]

(5) *Treatment of certain options.* Notwithstanding paragraphs (c)(2) and (3) of this section, the rules of this paragraph (c)(5) determine the yield and maturity of a debt instrument that provides the holder or issuer with an unconditional option or options, exercisable on one or more dates during the term of the debt instrument, that, if exercised, require payments to be made on the debt instrument under an alternative payment schedule or schedules (*e.g.*, an option to extend or an option to call a debt instrument at a fixed premium). Under this paragraph (c)(5), an issuer is deemed to exercise or not exercise an option or combination of options in a manner that minimizes the yield on the debt instrument, and a holder is deemed to exercise or not exercise an option or combination of options in a manner that maximizes the yield on the debt instrument. If both the issuer and the holder have options, the rules of this paragraph (c)(5) are applied to the options in the order that they may be exercised. See paragraph (j) *Example 5* through *Example 8* of this section.

(6) *Subsequent adjustments.* If a contingency described in this paragraph (c) (including the exercise of an option described in paragraph (c)(5) of this section) actually occurs or does not occur, contrary to the assumption made pursuant to this paragraph (c) (a change in circumstances), then, solely for purposes of sections 1272 and 1273, the debt instrument is treated as retired and then reissued on the date of the change in circumstances for an amount equal to its adjusted issue price on that date. See paragraph (j) *Example 5* and *Example 7* of this section. If, however, the change in circumstances results in a substantially contemporaneous pro-rata prepayment as defined in §1.1275–2(f)(2), the pro-rata prepayment is treated as a payment in retirement of a portion of the debt instrument, which may result in gain or loss to the holder. See paragraph (j) *Example 6* and *Example 8* of this section.

(7) *Effective date.* This paragraph (c) applies to debt instruments issued on or after August 13, 1996.

(d) *Certain debt instruments that provide for a fixed yield.* If a debt instrument provides for one or more contingent payments but all possible payment schedules under the terms of the instrument result in the same fixed yield, the yield of the debt instrument is the fixed yield. For example, the yield of a debt instrument with principal payments that are fixed in total amount but that are uncertain as to time (such as a demand loan) is the stated interest rate if the issue price of the instrument is equal to the stated principal amount and interest is paid or compounded at a fixed rate over the entire term of the instrument. This paragraph (d) applies to debt instruments issued on or after August 13, 1996.

* * * * * *

(f) * * *

(2) * * * For purposes of the preceding sentence, the last possible date that the debt instrument could be outstanding is determined without regard to §1.1275–2(h) (relating to payments subject to remote or incidental contingencies).

* * * * * *

Par. 10. Section 1.1273–1 is amended by:

1. Removing the language "principal payments uncertain as to time" in the fourth sentence of paragraph (a) and adding the language "a fixed yield" in its place.

2. Revising paragraph (c)(1)(ii).

3. Revising paragraph (f) *Example 4.*

The revisions read as follows:

§1.1273–1 Definition of OID.

* * * * * *

(c) * * * (1) * * *

(ii) *Unconditionally payable.* Interest is unconditionally payable only if reasonable legal remedies exist to compel timely payment or the debt instrument otherwise provides terms and conditions that make the likelihood of late payment (other than a late payment that occurs within a reasonable grace period) or nonpayment a remote contingency (within the meaning of §1.1275–2(h)). For purposes of the preceding sentence, remedies or other terms and conditions are not taken into account if the lending transaction does not reflect arm's length dealing and the holder does not intend to enforce the remedies or other terms and conditions. For purposes of determining whether interest is unconditionally payable, the possibility of nonpayment due to default, insolvency, or similar circumstances, or due to the exercise of a conversion option described in §1.1272–1(c) is ignored. This paragraph (c)(1)(ii) applies to debt instruments issued on or after August 13, 1996.

* * * * * *

(f) * * *

Example 4. Qualified stated interest on a debt instrument that is subject to an option—(i) *Facts.* On January 1, 1997, A issues, for $100,000, a 10-year debt instrument that provides for a $100,000 principal payment at maturity and for annual interest payments of $10,000. Under the terms of the debt instrument, A has the option, exercisable on January 1, 2002, to lower the annual interest payments to $8,000. In addition, the debt instrument gives the holder an unconditional right to put the debt instrument back to A, exercisable on January 1, 2002, in return for $100,000.

(ii) *Amount of qualified stated interest.* Under paragraph (c)(2) of this section, the debt instrument provides for qualified stated interest to the extent of the lowest fixed rate at which qualified stated interest would be payable under any payment schedule. If the payment schedule determined by assuming that the issuer's option will be exercised and the put option will not be exercised were treated as the debt instrument's sole payment schedule, only $8,000 of each annual interest payment would be qualified stated interest. Under any other payment schedule, the debt instrument would provide for annual qualified stated interest payments of $10,000. Accordingly, only $8,000 of each annual interest payment is qualified stated interest. Any excess of each annual interest payment over $8,000 is included in the debt instrument's stated redemption price at maturity.

* * * * * *

Par. 11. Section 1.1274–2 is amended by:

1. Removing the language "§1.1272–1(c)(3)(ii)" from paragraph (c) and adding the language "§1.1272–1(c)(3)" in its place.

2. Revising paragraph (g).

3. Adding and reserving paragraph (i) and adding paragraph (j).

The revisions and additions read as follows:

§1.1274–2 Issue price of debt instruments to which section 1274 applies.

* * * * * *

(g) *Treatment of contingent payment debt instruments.* Notwithstanding paragraph (b) of this section, if a debt instrument subject to section 1274 provides for one or more contingent payments, the issue price of the debt instrument is the lesser of the instrument's noncontingent principal payments and the sum of the present values of the noncontingent payments (as determined under paragraph (c) of

this section). However, if the debt instrument is issued in a potentially abusive situation, the issue price of the debt instrument is the fair market value of the noncontingent payments. For additional rules relating to a debt instrument that provides for one or more contingent payments, see §1.1275–4. This paragraph (g) applies to debt instruments issued on or after August 13, 1996.

* * * * * *

(i) [Reserved]

(j) *Special rules for tax-exempt obligations*—(1) *Certain variable rate debt instruments.* Notwithstanding paragraph (b) of this section, if a tax-exempt obligation (as defined in section 1275(a)(3)) is a variable rate debt instrument (within the meaning of §1.1275–5) that pays interest at an objective rate and is subject to section 1274, the issue price of the obligation is the greater of the obligation's fair market value and its stated principal amount.

(2) *Contingent payment debt instruments.* Notwithstanding paragraphs (b) and (g) of this section, if a tax-exempt obligation (as defined in section 1275(a)(3)) is subject to section 1274 and §1.1275–4, the issue price of the obligation is the fair market value of the obligation. However, in the case of a tax-exempt obligation that is subject to §1.1275–4(d)(2) (an obligation that provides for interest-based or revenue-based payments), the issue price of the obligation is the greater of the obligation's fair market value and its stated principal amount.

(3) *Effective date.* This paragraph (j) applies to debt instruments issued on or after August 13, 1996.

Par. 12. Section 1.1275–2 is amended by adding the text of paragraph (g), adding paragraph (h), adding and reserving paragraph (i), and adding paragraph (j) to read as follows:

§1.1275–2 Special rules relating to debt instruments.

* * * * * *

(g) *Anti-abuse rule*—(1) *In general.* If a principal purpose in structuring a debt instrument or engaging in a transaction is to achieve a result that is unreasonable in light of the purposes of section 163(e), sections 1271 through 1275, or any related section of the Code, the Commissioner can apply or depart from the regulations under the applicable sections as necessary or appropriate to achieve a reasonable result. For example, if this paragraph (g) applies to a debt instrument that provides for a contingent payment, the Commissioner can treat the contingency as if it were a separate position.

(2) *Unreasonable result.* Whether a result is unreasonable is determined based on all the facts and circumstances. In making this determination, a significant fact is whether the treatment of the debt instrument is expected to have a substantial effect on the issuer's or a holder's U.S. tax liability. In the case of a contingent payment debt instrument, another significant fact is whether the result is obtainable without the application of §1.1275–4 and any related provisions (*e.g.*, if the debt instrument and the contingency were entered into separately). A result will not be considered unreasonable, however, in the absence of an expected substantial effect on the present value of a taxpayer's tax liability.

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

Example 1. A issues a current-pay, increasing-rate note that provides for an early call option. Although the option is deemed exercised on the call date under §1.1272–1(c)(5), the option is not expected to be exercised by A. In addition, a principal purpose of including the option in the terms of the note is to limit the amount of interest income includible by the holder in the period prior to the call date by virtue of the option rules in §1.1272–1(c)(5). Moreover, the application of the option rules is expected to substantially reduce the present value of the holder's tax liability. Based on these facts, the application of §1.1272–1(c)(5) produces an unreasonable result. Therefore, under this paragraph (g), the Commissioner can apply the regulations (in whole or in part) to the note without regard to §1.1272–1(c)(5).

Example 2. C, a foreign corporation not subject to U.S. taxation, issues to a U.S. holder a debt instrument that provides for a contingent payment. The debt instrument is issued for cash and is subject to the noncontingent bond method in §1.1275–4(b). Six months after issuance, C and the holder modify the debt instrument so that there is a deemed reissuance of the instrument under section 1001. The new debt instrument is subject to the rules of §1.1275–4(c) rather than §1.1275–4(b). The application of §1.1275–4(c) is expected to substantially reduce the present value of the holder's tax liability as compared to the application of §1.1275–4(b). In addition, a principal purpose of the modification is to substantially reduce the present value of the holder's tax liability through the application of §1.1275–4(c). Based on these facts, the application of §1.1275–4(c) produces an unreasonable result. Therefore, under this paragraph (g), the Commissioner can apply the noncontingent bond method to the modified debt instrument.

Example 3. D issues a convertible debt instrument rather than an economically equivalent investment unit consisting of a debt instrument and a warrant. The convertible debt instrument is issued at par and provides for annual payments of interest. D issues the convertible debt instrument rather than the investment unit so that the debt instrument would not have OID. See §1.1273–2(j). In general, this is a reasonable result in light of the purposes of the applicable statutes. Therefore, the Commissioner generally will not use the authority under this paragraph (g) to depart from the application of §1.1273-2(j) in this case.

(4) *Effective date.* This paragraph (g) applies to debt instruments issued on or after August 13, 1996.

(h) *Remote and incidental contingencies*—(1) *In general.* This paragraph (h) applies to a debt instrument if one or more payments on the instrument are subject to either a remote or incidental contingency. Whether a contingency is remote or incidental is determined as of the issue date of the debt instrument, including any date there is a deemed reissuance of the debt instrument under paragraph (h)(6)(ii) or (j) of this section or §1.1272–1(c)(6). Except as otherwise provided, the treatment of the contingency under this paragraph (h) applies for all purposes of sections 163(e) (other than section 163(e)(5)) and 1271 through 1275 and the regulations thereunder. For purposes of this paragraph (h), the possibility of impairment of a payment by insolvency, default, or similar circumstances is not a contingency.

(2) *Remote contingencies.* A contingency is remote if there is a remote likelihood either that the contingency will occur or that the contingency will not occur. If there is a remote likelihood that the contingency will occur, it is assumed that the contingency will not occur. If there is a remote likelihood that the contingency will not occur, it is assumed that the contingency will occur.

(3) *Incidental contingencies*—(i) *Contingency relating to amount.* A contingency relating to the amount of a payment is incidental if, under all reasonably expected market conditions, the potential amount of the payment is insignificant relative to the total expected amount of the remaining payments on the debt instrument. If a payment on a debt instrument is subject to an incidental contingency described in this paragraph (h)(3)(i), the payment is ignored until the payment is made.

However, see paragraph (h)(6)(i)(B) of this section for the treatment of the debt instrument if a change in circumstances occurs prior to the date the payment is made.

(ii) *Contingency relating to time.* A contingency relating to the timing of a payment is incidental if, under all reasonably expected market conditions, the potential difference in the timing of the payment (from the earliest date to the latest date) is insignificant. If a payment on a debt instrument is subject to an incidental contingency described in this paragraph (h)(3)(ii), the payment is treated as made on the earliest date that the payment could be made pursuant to the contingency. If the payment is not made on this date, a taxpayer makes appropriate adjustments to take into account the delay in payment. However, see paragraph (h)(6)(i)(C) of this section for the treatment of the debt instrument if the delay is not insignificant.

(4) *Aggregation rule.* For purposes of paragraph (h)(2) of this section, if a debt instrument provides for multiple contingencies each of which has a remote likelihood of occurring but, when all of the contingencies are considered together, there is a greater than remote likelihood that at least one of the contingencies will occur, none of the contingencies is treated as a remote contingency. For purposes of paragraph (h)(3)(i) of this section, if a debt instrument provides for multiple contingencies each of which is incidental but the potential total amount of all of the payments subject to the contingencies is not, under reasonably expected market conditions, insignificant relative to the total expected amount of the remaining payments on the debt instrument, none of the contingencies is treated as incidental.

(5) *Consistency rule.* For purposes of paragraphs (h)(2) and (3) of this section, the issuer's determination that a contingency is either remote or incidental is binding on all holders. However, the issuer's determination is not binding on a holder that explicitly discloses that its determination is different from the issuer's determination. Unless otherwise prescribed by the Commissioner, the disclosure must be made on a statement attached to the holder's timely filed federal income tax return for the taxable year that includes the acquisition date of the debt instrument. See §1.1275–2(e) for rules relating to the issuer's obligation to disclose certain information to holders.

(6) *Subsequent adjustments*—(i) *Applicability.* This paragraph (h)(6) applies to a debt instrument when there is a change in circumstances. For purposes of the preceding sentence, there is a change in circumstances if—

(A) A remote contingency actually occurs or does not occur, contrary to the assumption made in paragraph (h)(2) of this section;

(B) A payment subject to an incidental contingency described in paragraph (h)(3)(i) of this section becomes fixed in an amount that is not insignificant relative to the total expected amount of the remaining payments on the debt instrument; or

(C) A payment subject to an incidental contingency described in paragraph (h)(3)(ii) of this section becomes fixed such that the difference between the assumed payment date and the due date of the payment is not insignificant.

(ii) *In general.* If a change in circumstances occurs, solely for purposes of sections 1272 and 1273, the debt instrument is treated as retired and then reissued on the date of the change in circumstances for an amount equal to the instrument's adjusted issue price on that date.

(iii) *Contingent payment debt instruments.* Notwithstanding paragraph (h)(6)(ii) of this section, in the case of a contingent payment debt instrument subject to §1.1275–4, if a change in circumstances occurs, no retirement or reissuance is treated as occurring, but any payment that is fixed as a result of the change in circumstances is governed by the rules in §1.1275–4 that apply when the amount of a contingent payment becomes fixed.

(7) *Effective date.* This paragraph (h) applies to debt instruments issued on or after August 13, 1996.

(i) [Reserved]

(j) *Treatment of certain modifications.* If the terms of a debt instrument are modified to defer one or more payments, and the modification does not cause an exchange under section 1001, then, solely for purposes of sections 1272 and 1273, the debt instrument is treated as retired and then reissued on the date of the modification for an amount equal to the instrument's adjusted issue price on that date. This paragraph (j) applies to debt instruments issued on or after August 13, 1996.

§1.1275–2T [Removed]

Par. 13. Section 1.1275–2T is removed effective August 13, 1996.

Par. 14. In §1.1275–3, paragraph (b)(1)(i) is revised to read as follows:

§1.1275–3 OID information reporting requirements.

* * * * * *

(b) * * * (1) * * *

(i) Set forth on the face of the debt instrument the issue price, the amount of OID, the issue date, the yield to maturity, and, in the case of a debt instrument subject to the rules of §1.1275–4(b), the comparable yield and projected payment schedule; or

* * * * * *

Par. 15. Section 1.1275–4 is added to read as follows:

§1.1275–4 Contingent payment debt instruments.

(a) *Applicability*—(1) *In general.* Except as provided in paragraph (a)(2) of this section, this section applies to any debt instrument that provides for one or more contingent payments. In general, paragraph (b) of this section applies to a contingent payment debt instrument that is issued for money or publicly traded property and paragraph (c) of this section applies to a contingent payment debt instrument that is issued for nonpublicly traded property. Paragraph (d) of this section provides special rules for tax-exempt obligations. See §1.1275–6 for a taxpayer's treatment of a contingent payment debt instrument and a hedge.

(2) *Exceptions.* This section does not apply to—

(i) A debt instrument that has an issue price determined under section 1273(b)(4) (*e.g.*, a debt instrument subject to section 483);

(ii) A variable rate debt instrument (as defined in §1.1275–5);

(iii) A debt instrument subject to §1.1272–1(c) (a debt instrument that provides for certain contingencies) or §1.1272–1(d) (a debt instrument that provides for a fixed yield);

(iv) A debt instrument subject to section 988 (except as provided in section 988 and the regulations thereunder);

(v) A debt instrument to which section 1272(a)(6) applies (certain in-

terests in or mortgages held by a REMIC, and certain other debt instruments with payments subject to acceleration);

(vi) A debt instrument (other than a tax-exempt obligation) described in section 1272(a)(2) (*e.g.*, U.S. savings bonds, certain loans between natural persons, and short-term taxable obligations); or

(vii) A debt instrument issued pursuant to a plan or arrangement if—

(A) The plan or arrangement is created by a state statute;

(B) A primary objective of the plan or arrangement is to enable the participants to pay for the costs of post-secondary education for themselves or their designated beneficiaries; and

(C) Contingent payments on the debt instrument are related to such objective.

(3) *Insolvency and default.* A payment is not contingent merely because of the possibility of impairment by insolvency, default, or similar circumstances.

(4) *Convertible debt instruments.* A debt instrument does not provide for contingent payments merely because it provides for an option to convert the debt instrument into the stock of the issuer, into the stock or debt of a related party (within the meaning of section 267(b) or 707(b)(1)), or into cash or other property in an amount equal to the approximate value of such stock or debt.

(5) *Remote and incidental contingencies.* A payment is not a contingent payment merely because of a contingency that, as of the issue date, is either remote or incidental. See §1.1275–2(h) for the treatment of remote and incidental contingencies.

(b) *Noncontingent bond method*—(1) *Applicability.* The noncontingent bond method described in this paragraph (b) applies to a contingent payment debt instrument that has an issue price determined under §1.1273–2 (*e.g.*, a contingent payment debt instrument that is issued for money or publicly traded property).

(2) *In general.* Under the noncontingent bond method, interest on a debt instrument must be taken into account whether or not the amount of any payment is fixed or determinable in the taxable year. The amount of interest that is taken into account for each accrual period is determined by constructing a projected payment schedule for the debt instrument and applying rules similar to those for accruing OID on a noncontingent debt instrument. If the actual amount of a contingent payment is not equal to the projected amount, appropriate adjustments are made to reflect the difference.

(3) *Description of method.* The following steps describe how to compute the amount of income, deductions, gain, and loss under the noncontingent bond method:

(i) *Step one: Determine the comparable yield.* Determine the comparable yield for the debt instrument under the rules of paragraph (b)(4) of this section. The comparable yield is determined as of the debt instrument's issue date.

(ii) *Step two: Determine the projected payment schedule.* Determine the projected payment schedule for the debt instrument under the rules of paragraph (b)(4) of this section. The projected payment schedule is determined as of the issue date and remains fixed throughout the term of the debt instrument (except under paragraph (b)(9)(ii) of this section, which applies to a payment that is fixed more than 6 months before it is due).

(iii) *Step three: Determine the daily portions of interest.* Determine the daily portions of interest on the debt instrument for a taxable year as follows. The amount of interest that accrues in each accrual period is the product of the comparable yield of the debt instrument (properly adjusted for the length of the accrual period) and the debt instrument's adjusted issue price at the beginning of the accrual period. See paragraph (b)(7)(ii) of this section to determine the adjusted issue price of the debt instrument. The daily portions of interest are determined by allocating to each day in the accrual period the ratable portion of the interest that accrues in the accrual period. Except as modified by paragraph (b)(3)(iv) of this section, the daily portions of interest are includible in income by a holder for each day in the holder's taxable year on which the holder held the debt instrument and are deductible by the issuer for each day during the issuer's taxable year on which the issuer was primarily liable on the debt instrument.

(iv) *Step four: Adjust the amount of income or deductions for differences between projected and actual contingent payments.* Make appropriate adjustments to the amount of income or deductions attributable to the debt instrument in a taxable year for any differences between projected and actual contingent payments. See paragraph (b)(6) of this section to determine the amount of an adjustment and the treatment of the adjustment.

(4) *Comparable yield and projected payment schedule.* This paragraph (b)(4) provides rules for determining the comparable yield and projected payment schedule for a debt instrument. The comparable yield and projected payment schedule must be supported by contemporaneous documentation showing that both are reasonable, are based on reliable, complete, and accurate data, and are made in good faith.

(i) *Comparable yield*—(A) *In general.* Except as provided in paragraph (b)(4)(i)(B) of this section, the comparable yield for a debt instrument is the yield at which the issuer would issue a fixed rate debt instrument with terms and conditions similar to those of the contingent payment debt instrument (the comparable fixed rate debt instrument), including the level of subordination, term, timing of payments, and general market conditions. For example, if a §1.1275–6 hedge (or the substantial equivalent) is available, the comparable yield is the yield on the synthetic fixed rate debt instrument that would result if the issuer entered into the §1.1275–6 hedge. If a §1.1275–6 hedge (or the substantial equivalent) is not available, but similar fixed rate debt instruments of the issuer trade at a price that reflects a spread above a benchmark rate, the comparable yield is the sum of the value of the benchmark rate on the issue date and the spread. In determining the comparable yield, no adjustments are made for the riskiness of the contingencies or the liquidity of the debt instrument. The comparable yield must be a reasonable yield for the issuer and must not be less than the applicable Federal rate (based on the overall maturity of the debt instrument).

(B) *Presumption for certain debt instruments.* This paragraph (b)(4)(i)(B) applies to a debt instrument if the instrument provides for one or more contingent payments not based on market information and the instrument is part of an issue that is marketed or sold in substantial part to persons for whom the inclusion of interest under this paragraph (b) is not expected to have a substantial effect on their U.S. tax liability. If this paragraph (b)(4)(i)(B) applies to a debt instrument, the instrument's comparable yield is presumed to be the applicable

Federal rate (based on the overall maturity of the debt instrument). A taxpayer may overcome this presumption only with clear and convincing evidence that the comparable yield for the debt instrument should be a specific yield (determined using the principles in paragraph (b)(4)(i)(A) of this section) that is higher than the applicable Federal rate. The presumption may not be overcome with appraisals or other valuations of nonpublicly traded property. Evidence used to overcome the presumption must be specific to the issuer and must not be based on comparable issuers or general market conditions.

(ii) *Projected payment schedule.* The projected payment schedule for a debt instrument includes each noncontingent payment and an amount for each contingent payment determined as follows:

(A) *Market-based payments.* If a contingent payment is based on market information (a market-based payment), the amount of the projected payment is the forward price of the contingent payment. The forward price of a contingent payment is the amount one party would agree, as of the issue date, to pay an unrelated party for the right to the contingent payment on the settlement date (*e.g.*, the date the contingent payment is made). For example, if the right to a contingent payment is substantially similar to an exchange-traded option, the forward price is the spot price of the option (the option premium) compounded at the applicable Federal rate from the issue date to the date the contingent payment is due.

(B) *Other payments.* If a contingent payment is not based on market information (a non-market-based payment), the amount of the projected payment is the expected value of the contingent payment as of the issue date.

(C) *Adjustments to the projected payment schedule.* The projected payment schedule must produce the comparable yield. If the projected payment schedule does not produce the comparable yield, the schedule must be adjusted consistent with the principles of this paragraph (b)(4) to produce the comparable yield. For example, the adjusted amounts of non-market-based payments must reasonably reflect the relative expected values of the payments and must not be set to accelerate or defer income or deductions. If the debt instrument contains both market-based and non-market-based payments, adjustments are generally made first to the non-market-based payments because more objective information is available for the market-based payments.

(iii) *Market information.* For purposes of this paragraph (b), market information is any information on which an objective rate can be based under §1.1275–5(c)(1) or (2).

(iv) *Issuer/holder consistency.* The issuer's projected payment schedule is used to determine the holder's interest accruals and adjustments. The issuer must provide the projected payment schedule to the holder in a manner consistent with the issuer disclosure rules of §1.1275–2(e). If the issuer does not create a projected payment schedule for a debt instrument or the issuer's projected payment schedule is unreasonable, the holder of the debt instrument must determine the comparable yield and projected payment schedule for the debt instrument under the rules of this paragraph (b)(4). A holder that determines its own projected payment schedule must explicitly disclose this fact and the reason why the holder set its own schedule (*e.g.*, why the issuer's projected payment schedule is unreasonable). Unless otherwise prescribed by the Commissioner, the disclosure must be made on a statement attached to the holder's timely filed federal income tax return for the taxable year that includes the acquisition date of the debt instrument.

(v) *Issuer's determination respected*—(A) *In general.* If the issuer maintains the contemporaneous documentation required by this paragraph (b)(4), the issuer's determination of the comparable yield and projected payment schedule will be respected unless either is unreasonable.

(B) *Unreasonable determination.* For purposes of paragraph (b)(4)(v)(A) of this section, a comparable yield or projected payment schedule generally will be considered unreasonable if it is set with a purpose to overstate, understate, accelerate, or defer interest accruals on the debt instrument. In a determination of whether a comparable yield or projected payment schedule is unreasonable, consideration will be given to whether the treatment of the debt instrument under this section is expected to have a substantial effect on the issuer's or holder's U.S. tax liability. For example, if a taxable issuer markets a debt instrument to a holder not subject to U.S. taxation, the comparable yield will be given close scrutiny and will not be respected unless contemporaneous documentation shows that the yield is not too high.

(C) *Exception.* Paragraph (b)(4)(v)(A) of this section does not apply to a debt instrument subject to paragraph (b)(4)(i)(B) of this section (concerning a yield presumption for certain debt instruments that provide for non-market-based payments).

(vi) *Examples.* The following examples illustrate the provisions of this paragraph (b)(4). In each example, assume that the instrument described is a debt instrument for federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for federal income tax purposes.

Example 1. Market-based payment—(i) *Facts.* On December 31, 1996, X corporation issues for $1,000,000 a debt instrument that matures on December 31, 2006. The debt instrument provides for annual payments of interest, beginning in 1997, at the rate of 6 percent and for a payment at maturity equal to $1,000,000 plus the excess, if any, of the price of 10,000 shares of publicly traded stock in an unrelated corporation on the maturity date over $350,000, or less the excess, if any, of $350,000 over the price of 10,000 shares of the stock on the maturity date. On the issue date, the forward price to purchase 10,000 shares of the stock on December 31, 2006, is $350,000.

(ii) *Comparable yield.* Under paragraph (b)(4)(i) of this section, the debt instrument's comparable yield is the yield on the synthetic debt instrument that would result if X corporation entered into a §1.1275–6 hedge. A §1.1275–6 hedge in this case is a forward contract to purchase 10,000 shares of the stock on December 31, 2006. If X corporation entered into this hedge, the resulting synthetic debt instrument would yield 6 percent, compounded annually. Thus, the comparable yield on the debt instrument is 6 percent, compounded annually.

(iii) *Projected payment schedule.* Under paragraph (b)(4)(ii) of this section, the projected payment schedule for the debt instrument consists of 10 annual payments of $60,000 and a projected amount for the contingent payment at maturity. Because the right to the contingent payment is based on market information, the projected amount of the contingent payment is the forward price of the payment. The right to the contingent payment is substantially similar to a right to a payment of $1,000,000 combined with a cash-settled forward contract for the purchase of 10,000 shares of the stock for $350,000 on December 31, 2006. Because the forward price to purchase 10,000 shares of the stock on December 31, 2006, is $350,000, the amount to be received or paid under the forward contract is projected to be zero. As a result, the projected amount of the contingent payment at maturity is $1,000,000, consisting of the $1,000,000 base amount and no additional amount to be received or paid under the forward contract.

(A) Assume, alternatively, that on the issue date the forward price to purchase 10,000 shares

of the stock on December 31, 2006, is $370,000. If X corporation entered into a §1.1275–6 hedge (a forward contract to purchase the shares for $370,000), the resulting synthetic debt instrument would yield 6.15 percent, compounded annually. Thus, the comparable yield on the debt instrument is 6.15 percent, compounded annually. The projected payment schedule for the debt instrument consists of 10 annual payments of $60,000 and a projected amount for the contingent payment at maturity. The projected amount of the contingent payment is $1,020,000, consisting of the $1,000,000 base amount plus the excess $20,000 of the forward price of the stock over the purchase price of the stock under the forward contract.

(B) Assume, alternatively, that on the issue date the forward price to purchase 10,000 shares of the stock on December 31, 2006, is $330,000. If X corporation entered into a §1.1275–6 hedge, the resulting synthetic debt instrument would yield 5.85 percent, compounded annually. Thus, the comparable yield on the debt instrument is 5.85 percent, compounded annually. The projected payment schedule for the debt instrument consists of 10 annual payments of $60,000 and a projected amount for the contingent payment at maturity. The projected amount of the contingent payment is $980,000, consisting of the $1,000,000 base amount minus the excess $20,000 of the purchase price of the stock under the forward contract over the forward price of the stock.

Example 2. Non-market-based payments—(i) *Facts.* On December 31, 1996, Y issues to Z for $1,000,000 a debt instrument that matures on December 31, 2000. The debt instrument has a stated principal amount of $1,000,000, payable at maturity, and provides for payments on December 31 of each year, beginning in 1997, of $20,000 plus 1 percent of Y's gross receipts, if any, for the year. On the issue date, Y has outstanding fixed rate debt instruments with maturities of 2 to 10 years that trade at a price that reflects an average of 100 basis points over Treasury bonds. These debt instruments have terms and conditions similar to those of the debt instrument. Assume that on December 31, 1996, 4-year Treasury bonds have a yield of 6.5 percent, compounded annually, and that no §1.1275–6 hedge is available for the debt instrument. In addition, assume that the interest inclusions attributable to the debt instrument are expected to have a substantial effect on Z's U.S. tax liability.

(ii) *Comparable yield.* The comparable yield for the debt instrument is equal to the value of the benchmark rate (*i.e.*, the yield on 4-year Treasury bonds) on the issue date plus the spread. Thus, the debt instrument's comparable yield is 7.5 percent, compounded annually.

(iii) *Projected payment schedule.* Y anticipates that it will have no gross receipts in 1997, but that it will have gross receipts in later years, and those gross receipts will grow each year for the next three years. Based on its business projections, Y believes that it is not unreasonable to expect that its gross receipts in 1999 and each year thereafter will grow by between 6 percent and 13 percent over the prior year. Thus, Y must take these expectations into account in establishing a projected payment schedule for the debt instrument that results in a yield of 7.5 percent, compounded annually. Accordingly, Y could reasonably set the following projected payment schedule for the debt instrument:

Date	*Noncontingent payment*	*Contingent payment*
12/31/1997	$ 20,000	$ 0
12/31/1998	20,000	70,000
12/31/1999	20,000	75,600
12/31/2000	1,020,000	83,850

(5) *Qualified stated interest.* No amounts payable on a debt instrument to which this paragraph (b) applies are qualified stated interest within the meaning of §1.1273–1(c).

(6) *Adjustments.* This paragraph (b)(6) provides rules for the treatment of positive and negative adjustments under the noncontingent bond method. A taxpayer takes into account only those adjustments that occur during a taxable year while the debt instrument is held by the taxpayer or while the taxpayer is primarily liable on the debt instrument.

(i) *Determination of positive and negative adjustments.* If the amount of a contingent payment is more than the projected amount of the contingent payment, the difference is a positive adjustment on the date of the payment. If the amount of a contingent payment is less than the projected amount of the contingent payment, the difference is a negative adjustment on the date of the payment (or on the scheduled date of the payment if the amount of the payment is zero).

(ii) *Treatment of net positive adjustments.* The amount, if any, by which total positive adjustments on a debt instrument in a taxable year exceed the total negative adjustments on the debt instrument in the taxable year is a net positive adjustment. A net positive adjustment is treated as additional interest for the taxable year.

(iii) *Treatment of net negative adjustments.* The amount, if any, by which total negative adjustments on a debt instrument in a taxable year exceed the total positive adjustments on the debt instrument in the taxable year is a net negative adjustment. A taxpayer's net negative adjustment on a debt instrument for a taxable year is treated as follows:

(A) *Reduction of interest accruals.* A net negative adjustment first reduces interest for the taxable year that the taxpayer would otherwise account for on the debt instrument under paragraph (b)(3)(iii) of this section.

(B) *Ordinary income or loss.* If the net negative adjustment exceeds the interest for the taxable year that the taxpayer would otherwise account for on the debt instrument under paragraph (b)(3)(iii) of this section, the excess is treated as ordinary loss by a holder and ordinary income by an issuer. However, the amount treated as ordinary loss by a holder is limited to the amount by which the holder's total interest inclusions on the debt instrument exceed the total amount of the holder's net negative adjustments treated as ordinary loss on the debt instrument in prior taxable years. The amount treated as ordinary income by an issuer is limited to the amount by which the issuer's total interest deductions on the debt instrument exceed the total amount of the issuer's net negative adjustments treated as ordinary income on the debt instrument in prior taxable years.

(C) *Carryforward.* If the net negative adjustment exceeds the sum of the amounts treated by the taxpayer as a reduction of interest and as ordinary income or loss (as the case may be) on the debt instrument for the taxable year, the excess is a negative adjustment carryforward for the taxable year. In general, a taxpayer treats a negative adjustment carryforward for a taxable year as a negative adjustment on the debt instrument on the first day of the succeeding taxable year. However, if a holder of a debt instrument has a negative adjustment carryforward on the debt instrument in a taxable year in which the debt instrument is sold, exchanged, or retired, the negative adjustment carryforward reduces the holder's amount realized on the sale, exchange, or retirement. If an issuer of a debt instrument has a negative adjustment carryforward on the debt instrument for a taxable year in which the debt instrument is retired, the issuer takes the negative adjustment carryforward into account as ordinary income.

(D) *Treatment under section 67.* A net negative adjustment is not subject to section 67 (the 2-percent floor on miscellaneous itemized deductions).

(iv) *Cross-references.* If a holder has a basis in a debt instrument that is different from the debt instrument's adjusted issue price, the holder may have additional positive or negative adjustments under paragraph (b)(9)(i) of this section. If the amount of a contingent payment is fixed more than 6 months before the date it is due, the amount and timing of the adjustment are determined under paragraph (b)(9)(ii) of this section.

(7) *Adjusted issue price, adjusted*

basis, and retirement—(i) *In general.* If a debt instrument is subject to the noncontingent bond method, this paragraph (b)(7) provides rules to determine the adjusted issue price of the debt instrument, the holder's basis in the debt instrument, and the treatment of any scheduled or unscheduled retirements. In general, because any difference between the actual amount of a contingent payment and the projected amount of the payment is taken into account as an adjustment to income or deduction, the projected payments are treated as the actual payments for purposes of making adjustments to issue price and basis and determining the amount of any contingent payment made on a scheduled retirement.

(ii) *Definition of adjusted issue price.* The adjusted issue price of a debt instrument is equal to the debt instrument's issue price, increased by the interest previously accrued on the debt instrument under paragraph (b)(3)(iii) of this section (determined without regard to any adjustments taken into account under paragraph (b)(3)(iv) of this section), and decreased by the amount of any noncontingent payment and the projected amount of any contingent payment previously made on the debt instrument. See paragraph (b)(9)(ii) of this section for special rules that apply when a contingent payment is fixed more than 6 months before it is due.

(iii) *Adjustments to basis.* A holder's basis in a debt instrument is increased by the interest previously accrued by the holder on the debt instrument under paragraph (b)(3)(iii) of this section (determined without regard to any adjustments taken into account under paragraph (b)(3)(iv) of this section), and decreased by the amount of any noncontingent payment and the projected amount of any contingent payment previously made on the debt instrument to the holder. See paragraph (b)(9)(i) of this section for special rules that apply when basis is different from adjusted issue price and paragraph (b)(9)(ii) of this section for special rules that apply when a contingent payment is fixed more than 6 months before it is due.

(iv) *Scheduled retirements.* For purposes of determining the amount realized by a holder and the repurchase price paid by the issuer on the scheduled retirement of a debt instrument, a holder is treated as receiving, and the issuer is treated as paying, the projected amount of any contingent payment due at maturity. If the amount paid or received is different from the projected amount, see paragraph (b)(6) of this section for the treatment of the difference by the taxpayer. Under paragraph (b)(6)(iii)(C) of this section, the amount realized by a holder on the retirement of a debt instrument is reduced by any negative adjustment carryforward determined in the taxable year of the retirement.

(v) *Unscheduled retirements.* An unscheduled retirement of a debt instrument (or the receipt of a pro-rata prepayment that is treated as a retirement of a portion of a debt instrument under §1.1275-2(f)) is treated as a repurchase of the debt instrument (or a pro-rata portion of the debt instrument) by the issuer from the holder for the amount paid by the issuer to the holder.

(vi) *Examples.* The following examples illustrate the provisions of paragraphs (b)(6) and (7) of this section. In each example, assume that the instrument described is a debt instrument for federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for federal income tax purposes.

Example 1. Treatment of positive and negative adjustments—(i) *Facts.* On December 31, 1996, Z, a calendar year taxpayer, purchases a debt instrument subject to this paragraph (b) at original issue for $1,000. The debt instrument's comparable yield is 10 percent, compounded annually, and the projected payment schedule provides for payments of $500 on December 31, 1997 (consisting of a noncontingent payment of $375 and a projected amount of $125) and $660 on December 31, 1998 (consisting of a noncontingent payment of $600 and a projected amount of $60). The debt instrument is a capital asset in the hands of Z.

(ii) *Adjustment in 1997.* Based on the projected payment schedule, Z's total daily portions of interest on the debt instrument are $100 for 1997 (issue price of $1,000 x 10 percent). Assume that the payment actually made on December 31, 1997, is $375, rather than the projected $500. Under paragraph (b)(6)(i) of this section, Z has a negative adjustment of $125 on December 31, 1997, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Because Z has no positive adjustments for 1997, Z has a net negative adjustment of $125 on the debt instrument for 1997. This net negative adjustment reduces to zero the $100 total daily portions of interest Z would otherwise include in income in 1997. Accordingly, Z has no interest income on the debt instrument for 1997. Because Z had no interest inclusions on the debt instrument for prior taxable years, the remaining $25 of the net negative adjustment is a negative adjustment carryforward for 1997 that results in a negative adjustment of $25 on January 1, 1998.

(iii) *Adjustment to issue price and basis.* Z's total daily portions of interest on the debt instrument are $100 for 1997. The adjusted issue price of the debt instrument and Z's adjusted basis in the debt instrument are increased by this amount, despite the fact that Z does not include this amount in income because of the net negative adjustment for 1997. In addition, the adjusted issue price of the debt instrument and Z's adjusted basis in the debt instrument are decreased on December 31, 1997, by the projected amount of the payment on that date ($500). Thus, on January 1, 1998, Z's adjusted basis in the debt instrument and the adjusted issue price of the debt instrument are $600.

(iv) *Adjustments in 1998.* Based on the projected payment schedule, Z's total daily portions of interest are $60 for 1998 (adjusted issue price of $600 × 10 percent). Assume that the payment actually made on December 31, 1998, is $700, rather than the projected $660. Under paragraph (b)(6)(i) of this section, Z has a positive adjustment of $40 on December 31, 1998, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Because Z also has a negative adjustment of $25 on January 1, 1998, Z has a net positive adjustment of $15 on the debt instrument for 1998 (the excess of the $40 positive adjustment over the $25 negative adjustment). As a result, Z has $75 of interest income on the debt instrument for 1998 (the $15 net positive adjustment plus the $60 total daily portions of interest that are taken into account by Z in that year).

(v) *Retirement.* Based on the projected payment schedule, Z's adjusted basis in the debt instrument immediately before the payment at maturity is $660 ($600 plus $60 total daily portions of interest for 1998). Even though Z receives $700 at maturity, for purposes of determining the amount realized by Z on retirement of the debt instrument, Z is treated as receiving the projected amount of the contingent payment on December 31, 1998. Therefore, Z is treated as receiving $660 on December 31, 1998. Because Z's adjusted basis in the debt instrument immediately before its retirement is $660, Z recognizes no gain or loss on the retirement.

Example 2. Negative adjustment carryforward for year of sale—(i) *Facts.* Assume the same facts as in *Example 1* of this paragraph (b)(7)(vi), except that Z sells the debt instrument on January 1, 1998, for $630.

(ii) *Gain on sale.* On the date the debt instrument is sold, Z's adjusted basis in the debt instrument is $600. Because Z has a negative adjustment of $25 on the debt instrument on January 1, 1998, and has no positive adjustments on the debt instrument in 1998, Z has a net negative adjustment for 1998 of $25. Because Z has not included in income any interest on the debt instrument, the entire $25 net negative adjustment is a negative adjustment carryforward for the taxable year of the sale. Under paragraph (b)(6)(iii)(C) of this section, the $25 negative adjustment carryforward reduces the amount realized by Z on the sale of the debt instrument from $630 to $605. Thus, Z has a gain on the sale of $5 ($605 − $600). Under paragraph (b)(8)(i) of this section, the gain is treated as interest income.

Example 3. Negative adjustment carryforward for year of retirement—(i) *Facts.* Assume the same facts as in *Example 1* of this paragraph (b)(7)(vi), except that the payment actually made on December 31, 1998, is $615, rather than the projected $660.

(ii) *Adjustments in 1998.* Under paragraph

(b)(6)(i) of this section, Z has a negative adjustment of $45 on December 31, 1998, attributable to the difference between the amount of the actual payment and the amount of the projected payment. In addition, Z has a negative adjustment of $25 on January 1, 1998. See *Example 1* (ii) of this paragraph (b)(7)(vi). Because Z has no positive adjustments in 1998, Z has a net negative adjustment of $70 for 1998. This net negative adjustment reduces to zero the $60 total daily portions of interest Z would otherwise include in income for 1998. Therefore, Z has no interest income on the debt instrument for 1998. Because Z had no interest inclusions on the debt instrument for 1997, the remaining $10 of the net negative adjustment is a negative adjustment carryforward for 1998 that reduces the amount realized by Z on retirement of the debt instrument.

(iii) *Loss on retirement.* Immediately before the payment at maturity, Z's adjusted basis in the debt instrument is $660. Under paragraph (b)(7)(iv) of this section, Z is treated as receiving the projected amount of the contingent payment, or $660, as the payment at maturity. Under paragraph (b)(6)(iii)(C) of this section, however, this amount is reduced by any negative adjustment carryforward determined for the taxable year of retirement to calculate the amount Z realizes on retirement of the debt instrument. Thus, Z has a loss of $10 on the retirement of the debt instrument, equal to the amount by which Z's adjusted basis in the debt instrument ($660) exceeds the amount Z realizes on the retirement of the debt instrument ($660 minus the $10 negative adjustment carryforward). Under paragraph (b)(8)(ii) of this section, the loss is a capital loss.

(8) *Character on sale, exchange, or retirement*—(i) *Gain.* Any gain recognized by a holder on the sale, exchange, or retirement of a debt instrument subject to this paragraph (b) is interest income.

(ii) *Loss.* Any loss recognized by a holder on the sale, exchange, or retirement of a debt instrument subject to this paragraph (b) is ordinary loss to the extent that the holder's total interest inclusions on the debt instrument exceed the total net negative adjustments on the debt instrument the holder took into account as ordinary loss. Any additional loss is treated as loss from the sale, exchange, or retirement of the debt instrument. However, any loss that would otherwise be ordinary under this paragraph (b)(8)(ii) and that is attributable to the holder's basis that could not be amortized under section 171(b)(4) is loss from the sale, exchange, or retirement of the debt instrument.

(iii) *Special rule if there are no remaining contingent payments on the debt instrument*—(A) *In general.* Notwithstanding paragraphs (b)(8)(i) and (ii) of this section, if, at the time of the sale, exchange, or retirement of the debt instrument, there are no remaining contingent payments due on the debt instrument under the projected payment schedule, any gain or loss recognized by the holder is gain or loss from the sale, exchange, or retirement of the debt instrument. See paragraph (b)(9)(ii) of this section to determine whether there are no remaining contingent payments on a debt instrument that provides for fixed but deferred contingent payments.

(B) *Exception for certain positive adjustments.* Notwithstanding paragraph (b)(8)(iii)(A) of this section, if a positive adjustment on a debt instrument is spread under paragraph (b)(9)(ii)(F) or (G) of this section, any gain recognized by the holder on the sale, exchange, or retirement of the instrument is treated as interest income to the extent of the positive adjustment that has not yet been accrued and included in income by the holder.

(iv) *Examples.* The following examples illustrate the provisions of this paragraph (b)(8). In each example, assume that the instrument described is a debt instrument for federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for federal income tax purposes.

Example 1. Gain on sale—(i) *Facts.* On January 1, 1998, D, a calendar year taxpayer, sells a debt instrument that is subject to paragraph (b) of this section for $1,350. The projected payment schedule for the debt instrument provides for contingent payments after January 1, 1998. On January 1, 1998, D has an adjusted basis in the debt instrument of $1,200. In addition, D has a negative adjustment carryforward of $50 for 1997 that, under paragraph (b)(6)(iii)(C) of this section, results in a negative adjustment of $50 on January 1, 1998. D has no positive adjustments on the debt instrument on January 1, 1998.

(ii) *Character of gain.* Under paragraph (b)(6) of this section, the $50 negative adjustment on January 1, 1998, results in a negative adjustment carryforward for 1998, the taxable year of the sale of the debt instrument. Under paragraph (b)(6)(iii)(C) of this section, the negative adjustment carryforward reduces the amount realized by D on the sale of the debt instrument from $1,350 to $1,300. As a result, D realizes a $100 gain on the sale of the debt instrument, equal to the $1,300 amount realized minus D's $1,200 adjusted basis in the debt instrument. Under paragraph (b)(8)(i) of this section, the gain is interest income to D.

Example 2. Loss on sale—(i) *Facts.* On December 31, 1996, E, a calendar year taxpayer, purchases a debt instrument at original issue for $1,000. The debt instrument is a capital asset in the hands of E. The debt instrument provides for a single payment on December 31, 1998 (the maturity date of the instrument), of $1,000 plus an amount based on the increase, if any, in the price of a specified commodity over the term of the instrument. The comparable yield for the debt instrument is 9.54 percent, compounded annually, and the projected payment schedule provides for a payment of $1,200 on December 31, 1998. Based on the projected payment schedule, the total daily portions of interest are $95 for 1997 and $105 for 1998.

(ii) *Ordinary loss.* Assume that E sells the debt instrument for $1,050 on December 31, 1997. On that date, E has an adjusted basis in the debt instrument of $1,095 ($1,000 original basis, plus total daily portions of $95 for 1997). Therefore, E realizes a $45 loss on the sale of the debt instrument ($1,050 – $1,095). The loss is ordinary to the extent E's total interest inclusions on the debt instrument ($95) exceed the total net negative adjustments on the instrument that E took into account as an ordinary loss. Because E has not had any net negative adjustments on the debt instrument, the $45 loss is an ordinary loss.

(iii) *Capital loss.* Alternatively, assume that E sells the debt instrument for $990 on December 31, 1997. E realizes a $105 loss on the sale of the debt instrument ($990 – $1,095). The loss is ordinary to the extent E's total interest inclusions on the debt instrument ($95) exceed the total net negative adjustments on the instrument that E took into account as an ordinary loss. Because E has not had any net negative adjustments on the debt instrument, $95 of the $105 loss is an ordinary loss. The remaining $10 of the $105 loss is a capital loss.

(9) *Operating rules.* The rules of this paragraph (b)(9) apply to a debt instrument subject to the noncontingent bond method notwithstanding any other rule of this paragraph (b).

(i) *Basis different from adjusted issue price.* This paragraph (b)(9)(i) provides rules for a holder whose basis in a debt instrument is different from the adjusted issue price of the debt instrument (*e.g.*, a subsequent holder that purchases the debt instrument for more or less than the instrument's adjusted issue price).

(A) *General rule.* The holder accrues interest under paragraph (b)(3)(iii) of this section and makes adjustments under paragraph (b)(3)(iv) of this section based on the projected payment schedule determined as of the issue date of the debt instrument. However, upon acquiring the debt instrument, the holder must reasonably allocate any difference between the adjusted issue price and the basis to daily portions of interest or projected payments over the remaining term of the debt instrument. Allocations are taken into account under paragraphs (b)(9)(i)(B) and (C) of this section.

(B) *Basis greater than adjusted issue price.* If the holder's basis in the debt instrument exceeds the debt instrument's adjusted issue price, the amount of the difference allocated to a daily portion of interest or to a projected

payment is treated as a negative adjustment on the date the daily portion accrues or the payment is made. On the date of the adjustment, the holder's adjusted basis in the debt instrument is reduced by the amount the holder treats as a negative adjustment under this paragraph (b)(9)(i)(B). See paragraph (b)(9)(ii)(E) of this section for a special rule that applies when a contingent payment is fixed more than 6 months before it is due.

(C) *Basis less than adjusted issue price.* If the holder's basis in the debt instrument is less than the debt instrument's adjusted issue price, the amount of the difference allocated to a daily portion of interest or to a projected payment is treated as a positive adjustment on the date the daily portion accrues or the payment is made. On the date of the adjustment, the holder's adjusted basis in the debt instrument is increased by the amount the holder treats as a positive adjustment under this paragraph (b)(9)(i)(C). See paragraph (b)(9)(ii)(E) of this section for a special rule that applies when a contingent payment is fixed more than 6 months before it is due.

(D) *Premium and discount rules do not apply.* The rules for accruing premium and discount in sections 171, 1272(a)(7), 1276, and 1281 do not apply. Other rules of those sections, such as section 171(b)(4), continue to apply to the extent relevant.

(E) *Safe harbor for exchange listed debt instruments.* If the debt instrument is exchange listed property (within the meaning of §1.1273–2(f)(2)), it is reasonable for the holder to allocate any difference between the holder's basis and the adjusted issue price of the debt instrument pro-rata to daily portions of interest (as determined under paragraph (b)(3)(iii) of this section) over the remaining term of the debt instrument. A pro-rata allocation is not reasonable, however, to the extent the holder's yield on the debt instrument, determined after taking into account the amounts allocated under this paragraph (b)(9)(i)(E), is less than the applicable Federal rate for the instrument. For purposes of the preceding sentence, the applicable Federal rate for the debt instrument is determined as if the purchase date were the issue date and the remaining term of the instrument were the term of the instrument.

(F) *Examples.* The following examples illustrate the provisions of this paragraph (b)(9)(i). In each example, assume that the instrument described is a debt instrument for federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for federal income tax purposes. In addition, assume that each instrument is not exchange listed property.

Example 1. Basis greater than adjusted issue price—(i) *Facts.* On July 1, 1998, Z purchases for $1,405 a debt instrument that matures on December 31, 1999, and promises to pay on the maturity date $1,000 plus the increase, if any, in the price of a specified amount of a commodity from the issue date to the maturity date. The debt instrument was originally issued on December 31, 1996, for an issue price of $1,000. The comparable yield for the debt instrument is 10.25 percent, compounded semiannually, and the projected payment schedule for the debt instrument (determined as of the issue date) provides for a single payment at maturity of $1,350. At the time of the purchase, the debt instrument has an adjusted issue price of $1,162, assuming semiannual accrual periods ending on December 31 and June 30 of each year. The increase in the value of the debt instrument over its adjusted issue price is due to an increase in the expected amount of the contingent payment and not to a decrease in market interest rates. The debt instrument is a capital asset in the hands of Z. Z is a calendar year taxpayer.

(ii) *Allocation of the difference between basis and adjusted issue price.* Z's basis in the debt instrument on July 1, 1998, is $1,405. Under paragraph (b)(9)(i)(A) of this section, Z allocates the $243 difference between basis ($1,405) and adjusted issue price ($1,162) to the contingent payment at maturity. Z's allocation of the difference between basis and adjusted issue price is reasonable because the increase in the value of the debt instrument over its adjusted issue price is due to an increase in the expected amount of the contingent payment.

(iii) *Treatment of debt instrument for 1998.* Based on the projected payment schedule, $60 of interest accrues on the debt instrument from July 1, 1998 to December 31, 1998 (the product of the debt instrument's adjusted issue price on July 1, 1998 ($1,162) and the comparable yield properly adjusted for the length of the accrual period (10.25 percent/2)). Z has no net negative or positive adjustments for 1998. Thus, Z includes in income $60 of total daily portions of interest for 1998. On December 31, 1998, Z's adjusted basis in the debt instrument is $1,465 ($1,405 original basis, plus total daily portions of $60 for 1998).

(iv) *Effect of allocation to contingent payment at maturity.* Assume that the payment actually made on December 31, 1999, is $1,400, rather than the projected $1,350. Thus, under paragraph (b)(6)(i) of this section, Z has a positive adjustment of $50 on December 31, 1999. In addition, under paragraph (b)(9)(i)(B) of this section, Z has a negative adjustment of $243 on December 31, 1999, which is attributable to the difference between Z's basis in the debt instrument on July 1, 1998, and the instrument's adjusted issue price on that date. As a result, Z has a net negative adjustment of $193 for 1999. This net negative adjustment reduces to zero the $128 total daily portions of interest Z would otherwise include in income in 1999. Accordingly, Z has no interest income on the debt instrument for 1999. Because Z had $60 of interest inclusions for 1998, $60 of the remaining $65 net negative adjustment is treated by Z as an ordinary loss for 1999. The remaining $5 of the net negative adjustment is a negative adjustment carryforward for 1999 that reduces the amount realized by Z on the retirement of the debt instrument from $1,350 to $1,345.

(v) *Loss at maturity.* On December 31, 1999, Z's basis in the debt instrument is $1,350 ($1,405 original basis, plus total daily portions of $60 for 1998 and $128 for 1999, minus the negative adjustment of $243). As a result, Z realizes a loss of $5 on the retirement of the debt instrument (the difference between the amount realized on the retirement ($1,345) and Z's adjusted basis in the debt instrument ($1,350)). Under paragraph (b)(8)(ii) of this section, the $5 loss is treated as loss from the retirement of the debt instrument. Consequently, Z realizes a total loss of $65 on the debt instrument for 1999 (a $60 ordinary loss and a $5 capital loss).

Example 2. Basis less than adjusted issue price—(i) *Facts.* On January 1, 1999, Y purchases for $910 a debt instrument that pays 7 percent interest semiannually on June 30 and December 31 of each year, and that promises to pay on December 31, 2001, $1,000 plus or minus $10 times the positive or negative difference, if any, between a specified amount and the value of an index on December 31, 2001. However, the payment on December 31, 2001, may not be less than $650. The debt instrument was originally issued on December 31, 1996, for an issue price of $1,000. The comparable yield for the debt instrument is 9.80 percent, compounded semiannually, and the projected payment schedule for the debt instrument (determined as of the issue date) provides for semiannual payments of $35 and a contingent payment at maturity of $1,175. On January 1, 1999, the debt instrument has an adjusted issue price of $1,060, assuming semiannual accrual periods ending on December 31 and June 30 of each year. Y is a calendar year taxpayer.

(ii) *Allocation of the difference between basis and adjusted issue price.* Y's basis in the debt instrument on January 1, 1999, is $910. Under paragraph (b)(9)(i)(A) of this section, Y must allocate the $150 difference between basis ($910) and adjusted issue price ($1,060) to daily portions of interest or to projected payments. These amounts will be positive adjustments taken into account at the time the daily portions accrue or the payments are made.

(A) Assume that, because of a decrease in the relevant index, the expected value of the payment at maturity has declined by about 9 percent. Based on forward prices on January 1, 1999, Y determines that approximately $105 of the difference between basis and adjusted issue price is allocable to the contingent payment. Y allocates the remaining $45 to daily portions of interest on a pro-rata basis (i.e., the amount allocated to an accrual period equals the product of $45 and a fraction, the numerator of which is the total daily portions for the accrual period and the denominator of which is the total daily portions remaining on the debt instrument on January 1, 1999). This allocation is reasonable.

(B) Assume alternatively that, based on yields of comparable debt instruments and its purchase price for the debt instrument, Y determines that an appropriate yield for the debt instrument is 13 percent, compounded semiannually. Based on this determination, Y allocates $55.75 of the difference between basis and adjusted issue price to daily portions of interest as follows: $15.19 to

the daily portions of interest for the taxable year ending December 31, 1999; $18.40 to the daily portions of interest for the taxable year ending December 31, 2000; and $22.16 to the daily portions of interest for the taxable year ending December 31, 2001. Y allocates the remaining $94.25 to the contingent payment at maturity. This allocation is reasonable.

(ii) *Fixed but deferred contingent payments.* This paragraph (b)(9)(ii) provides rules that apply when the amount of a contingent payment becomes fixed before the payment is due. For purposes of paragraph (b) of this section, if a contingent payment becomes fixed within the 6-month period ending on the due date of the payment, the payment is treated as a contingent payment even after the payment is fixed. If a contingent payment becomes fixed more than 6 months before the payment is due, the following rules apply to the debt instrument.

(A) *Determining adjustments.* The amount of the adjustment attributable to the contingent payment is equal to the difference between the present value of the amount that is fixed and the present value of the projected amount of the contingent payment. The present value of each amount is determined by discounting the amount from the date the payment is due to the date the payment becomes fixed, using a discount rate equal to the comparable yield on the debt instrument. The adjustment is treated as a positive or negative adjustment, as appropriate, on the date the contingent payment becomes fixed. See paragraph (b)(9)-(ii)(G) of this section to determine the timing of the adjustment if all remaining contingent payments on the debt instrument become fixed substantially contemporaneously.

(B) *Payment schedule.* The contingent payment is no longer treated as a contingent payment after the date the amount of the payment becomes fixed. On the date the contingent payment becomes fixed, the projected payment schedule for the debt instrument is modified prospectively to reflect the fixed amount of the payment. Therefore, no adjustment is made under paragraph (b)(3)(iv) of this section when the contingent payment is actually made.

(C) *Accrual period.* Notwithstanding the determination under §1.1272–1(b)-(1)(ii) of accrual periods for the debt instrument, an accrual period ends on the day the contingent payment becomes fixed, and a new accrual period begins on the day after the day the contingent payment becomes fixed.

(D) *Adjustments to basis and adjusted issue price.* The amount of any positive adjustment on a debt instrument determined under paragraph (b)-(9)(ii)(A) of this section increases the adjusted issue price of the instrument and the holder's adjusted basis in the instrument. Similarly, the amount of any negative adjustment on a debt instrument determined under paragraph (b)(9)(ii)(A) of this section decreases the adjusted issue price of the instrument and the holder's adjusted basis in the instrument.

(E) *Basis different from adjusted issue price.* If a holder's basis in a debt instrument exceeds the debt instrument's adjusted issue price, the amount allocated to a projected payment under paragraph (b)(9)(i) of this section is treated as a negative adjustment on the date the payment becomes fixed. If a holder's basis in a debt instrument is less than the debt instrument's adjusted issue price, the amount allocated to a projected payment under paragraph (b)(9)(i) of this section is treated as a positive adjustment on the date the payment becomes fixed.

(F) *Special rule for certain contingent interest payments.* Notwithstanding paragraph (b)(9)(ii)(A) of this section, this paragraph (b)(9)(ii)(F) applies to contingent stated interest payments that are adjusted to compensate for contingencies regarding the reasonableness of the debt instrument's stated rate of interest. For example, this paragraph (b)(9)(ii)(F) applies to a debt instrument that provides for an increase in the stated rate of interest if the credit quality of the issuer or liquidity of the debt instrument deteriorates. Contingent stated interest payments of this type are recognized over the period to which they relate in a reasonable manner.

(G) *Special rule when all contingent payments become fixed.* Notwithstanding paragraph (b)(9)(ii)(A) of this section, if all the remaining contingent payments on a debt instrument become fixed substantially contemporaneously, any positive or negative adjustments on the instrument are taken into account in a reasonable manner over the period to which they relate. For purposes of the preceding sentence, a payment is treated as a fixed payment if all remaining contingencies with respect to the payment are remote or incidental (within the meaning of §1.1275–2(h)).

(H) *Example.* The following example illustrates the provisions of this paragraph (b)(9)(ii). In this example, assume that the instrument described is a debt instrument for federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for federal income tax purposes.

Example. Fixed but deferred payments—(i) *Facts.* On December 31, 1996, B, a calendar year taxpayer, purchases a debt instrument at original issue for $1,000. The debt instrument matures on December 31, 2002, and provides for a payment of $1,000 at maturity. In addition, on December 31, 1999, and December 31, 2002, the debt instrument provides for payments equal to the excess of the average daily value of an index for the 6-month period ending on September 30 of the preceding year over a specified amount. The debt instrument's comparable yield is 10 percent, compounded annually, and the instrument's projected payment schedule consists of a payment of $250 on December 31, 1999, and a payment of $1,439 on December 31, 2002. B uses annual accrual periods.

(ii) *Interest accrual for 1997.* Based on the projected payment schedule, B includes a total of $100 of daily portions of interest in income in 1997. B's adjusted basis in the debt instrument and the debt instrument's adjusted issue price on December 31, 1997, is $1,100.

(iii) *Interest accrual for 1998*—(A) *Adjustment.* Based on the projected payment schedule, B would include $110 of total daily portions of interest in income in 1998. However, assume that on September 30, 1998, the payment due on December 31, 1999, fixes at $300, rather than the projected $250. Thus, on September 30, 1998, B has an adjustment equal to the difference between the present value of the $300 fixed amount and the present value of the $250 projected amount of the contingent payment. The present values of the two payments are determined by discounting each payment from the date the payment is due (December 31, 1999) to the date the payment becomes fixed (September 30, 1998), using a discount rate equal to 10 percent, compounded annually. The present value of the fixed payment is $266.30 and the present value of the projected amount of the contingent payment is $221.91. Thus, on September 30, 1998, B has a positive adjustment of $44.39 ($266.30 − $221.91).

(B) *Effect of adjustment.* Under paragraph (b)(9)(ii)(C) of this section, B's accrual period ends on September 30, 1998. The daily portions of interest on the debt instrument for the period from January 1, 1998 to September 30, 1998 total $81.51. The adjusted issue price of the debt instrument and B's adjusted basis in the debt instrument are thus increased over this period by $125.90 (the sum of the daily portions of interest of $81.51 and the positive adjustment of $44.39 made at the end of the period) to $1,225.90. For purposes of all future accrual periods, including the new accrual period from October 1, 1998, to December 31, 1998, the debt instrument's projected payment schedule is modified to reflect a fixed payment of $300 on December 31, 1999. Based on the new adjusted issue price of the debt instrument and the new projected payment schedule, the yield on the debt instrument does not change.

(C) *Interest accrual for 1998.* Based on the modified projected payment schedule, $29.56 of interest accrues during the accrual period that ends on December 31, 1998. Because B has no

other adjustments during 1998, the $44.39 positive adjustment on September 30, 1998, results in a net positive adjustment for 1998, which is additional interest for that year. Thus, B includes $155.46 ($81.51 + $29.56 + $44.39) of interest in income in 1998. B's adjusted basis in the debt instrument and the debt instrument's adjusted issue price on December 31, 1998, is $1,255.46 ($1,225.90 from the end of the prior accrual period plus $29.56 total daily portions for the current accrual period).

(iii) *Timing contingencies.* This paragraph (b)(9)(iii) provides rules for debt instruments that have payments that are contingent as to time.

(A) *Treatment of certain options.* If a taxpayer has an unconditional option to put or call the debt instrument, to exchange the debt instrument for other property, or to extend the maturity date of the debt instrument, the projected payment schedule is determined by using the principles of §1.1272–1(c)(5).

(B) *Other timing contingencies.* [Reserved]

(iv) *Cross-border transactions*—(A) *Allocation of deductions.* For purposes of §1.861–8, the holder of a debt instrument shall treat any deduction or loss treated as an ordinary loss under paragraph (b)(6)(iii)(B) or (b)(8)(ii) of this section as a deduction that is definitely related to the class of gross income to which income from such debt instrument belongs. Accordingly, if a U.S. person holds a debt instrument issued by a related controlled foreign corporation and, pursuant to section 904(d)(3) and the regulations thereunder, any interest accrued by such U.S. person with respect to such debt instrument would be treated as foreign source general limitation income, any deductions relating to a net negative adjustment will reduce the U.S. person's foreign source general limitation income. The holder shall apply the general rules relating to allocation and apportionment of deductions to any other deduction or loss realized by the holder with respect to the debt instrument.

(B) *Investments in United States real property.* Notwithstanding paragraph (b)(8)(i) of this section, gain on the sale, exchange, or retirement of a debt instrument that is a United States real property interest is treated as gain for purposes of sections 897, 1445, and 6039C.

(v) *Coordination with subchapter M and related provisions.* For purposes of sections 852(c)(2) and 4982 and §1.852–11, any positive adjustment, negative adjustment, income, or loss on a debt instrument that occurs after October 31 of a taxable year is treated in the same manner as foreign currency gain or loss that is attributable to a section 988 transaction.

(vi) *Coordination with section 1092.* A holder treats a negative adjustment and an issuer treats a positive adjustment as a loss with respect to a position in a straddle if the debt instrument is a position in a straddle and the contingency (or any portion of the contingency) to which the adjustment relates would be part of the straddle if entered into as a separate position.

(c) *Method for debt instruments not subject to the noncontingent bond method*—(1) *Applicability.* This paragraph (c) applies to a contingent payment debt instrument (other than a tax-exempt obligation) that has an issue price determined under §1.1274–2. For example, this paragraph (c) generally applies to a contingent payment debt instrument that is issued for nonpublicly traded property.

(2) *Separation into components.* If paragraph (c) of this section applies to a debt instrument (the overall debt instrument), the noncontingent payments are subject to the rules in paragraph (c)(3) of this section, and the contingent payments are accounted for separately under the rules in paragraph (c)(4) of this section.

(3) *Treatment of noncontingent payments.* The noncontingent payments are treated as a separate debt instrument. The issue price of the separate debt instrument is the issue price of the overall debt instrument, determined under §1.1274–2(g). No interest payments on the separate debt instrument are qualified stated interest payments (within the meaning of §1.1273–1(c)) and the de minimis rules of section 1273(a)(3) and §1.1273–1(d) do not apply to the separate debt instrument.

(4) *Treatment of contingent payments*—(i) *In general.* Except as provided in paragraph (c)(4)(iii) of this section, the portion of a contingent payment treated as interest under paragraph (c)(4)(ii) of this section is includible in gross income by the holder and deductible from gross income by the issuer in their respective taxable years in which the payment is made.

(ii) *Characterization of contingent payments as principal and interest*—(A) *General rule.* A contingent payment is treated as a payment of principal in an amount equal to the present value of the payment, determined by discounting the payment at the test rate from the date the payment is made to the issue date. The amount of the payment in excess of the amount treated as principal under the preceding sentence is treated as a payment of interest.

(B) *Test rate.* The test rate used for purposes of paragraph (c)(4)(ii)(A) of this section is the rate that would be the test rate for the overall debt instrument under §1.1274–4 if the term of the overall debt instrument began on the issue date of the overall debt instrument and ended on the date the contingent payment is made. However, in the case of a contingent payment that consists of a payment of stated principal accompanied by a payment of stated interest at a rate that exceeds the test rate determined under the preceding sentence, the test rate is the stated interest rate.

(iii) *Certain delayed contingent payments*—(A) *General rule.* Notwithstanding paragraph (c)(4)(ii) of this section, if a contingent payment becomes fixed more than 6 months before the payment is due, the issuer and holder are treated as if the issuer had issued a separate debt instrument on the date the payment becomes fixed, maturing on the date the payment is due. This separate debt instrument is treated as a debt instrument to which section 1274 applies. The stated principal amount of this separate debt instrument is the amount of the payment that becomes fixed. An amount equal to the issue price of this debt instrument is characterized as interest or principal under the rules of paragraph (c)(4)(ii) of this section and accounted for as if this amount had been paid by the issuer to the holder on the date that the amount of the payment becomes fixed. To determine the issue price of the separate debt instrument, the payment is discounted at the test rate from the maturity date of the separate debt instrument to the date that the amount of the payment becomes fixed.

(B) *Test rate.* The test rate used for purposes of paragraph (c)(4)(iii)(A) of this section is determined in the same manner as the test rate under paragraph (c)(4)(ii)(B) of this section is determined except that the date the contingent payment is due is used rather than the date the contingent payment is made.

(5) *Basis different from adjusted issue price.* This paragraph (c)(5) provides rules for a holder whose basis in a debt instrument is different from the instrument's adjusted issue price (*e.g.*, a subsequent holder). This paragraph (c)(5), however, does not apply if the holder is reporting income under the installment method of section 453.

(i) *Allocation of basis.* The holder must allocate basis to the noncontingent component (*i.e.*, the right to the noncontingent payments) and to any separate debt instruments described in paragraph (c)(4)(iii) of this section in an amount up to the total of the adjusted issue price of the noncontingent component and the adjusted issue prices of the separate debt instruments. The holder must allocate the remaining basis, if any, to the contingent component (*i.e.*, the right to the contingent payments).

(ii) *Noncontingent component.* Any difference between the holder's basis in the noncontingent component and the adjusted issue price of the noncontingent component, and any difference between the holder's basis in a separate debt instrument and the adjusted issue price of the separate debt instrument, is taken into account under the rules for market discount, premium, and acquisition premium that apply to a noncontingent debt instrument.

(iii) *Contingent component.* Amounts received by the holder that are treated as principal payments under paragraph (c)(4)(ii) of this section reduce the holder's basis in the contingent component. If the holder's basis in the contingent component is reduced to zero, any additional principal payments on the contingent component are treated as gain from the sale or exchange of the debt instrument. Any basis remaining on the contingent component on the date the final contingent payment is made increases the holder's adjusted basis in the noncontingent component (or, if there are no remaining noncontingent payments, is treated as loss from the sale or exchange of the debt instrument).

(6) *Treatment of a holder on sale, exchange, or retirement.* This paragraph (c)(6) provides rules for the treatment of a holder on the sale, exchange, or retirement of a debt instrument subject to paragraph (c) of this section. Under this paragraph (c)(6), the holder must allocate the amount received from the sale, exchange, or retirement of a debt instrument first to the noncontingent component and to any separate debt instruments described in paragraph (c)(4)(iii) of this section in an amount up to the total of the adjusted issue price of the noncontingent component and the adjusted issue prices of the separate debt instruments. The holder must allocate the remaining amount received, if any, to the contingent component.

(i) *Amount allocated to the noncontingent component.* The amount allocated to the noncontingent component and any separate debt instruments is treated as an amount realized from the sale, exchange, or retirement of the noncontingent component or separate debt instrument.

(ii) *Amount allocated to the contingent component.* The amount allocated to the contingent component is treated as a contingent payment that is made on the date of the sale, exchange, or retirement and is characterized as interest and principal under the rules of paragraph (c)(4)(ii) of this section.

(7) *Examples.* The following examples illustrate the provisions of this paragraph (c). In each example, assume that the instrument described is a debt instrument for federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for federal income tax purposes.

Example 1. Contingent interest payments—(i) *Facts.* A owns Blackacre, unencumbered depreciable real estate. On January 1, 1997, A sells Blackacre to B. As consideration for the sale, B makes a downpayment of $1,000,000 and issues to A a debt instrument that matures on December 31, 2001. The debt instrument provides for a payment of principal at maturity of $5,000,000 and a contingent payment of interest on December 31 of each year equal to a fixed percentage of the gross rents B receives from Blackacre in that year. Assume that the debt instrument is not issued in a potentially abusive situation. Assume also that on January 1, 1997, the short-term applicable Federal rate is 5 percent, compounded annually, and the mid-term applicable Federal rate is 6 percent, compounded annually.

(ii) *Determination of issue price.* Under §1.1274-2(g), the issue price of the debt instrument is $3,736,291, which is the present value, as of the issue date, of the $5,000,000 noncontingent payment due at maturity, calculated using a discount rate equal to the mid-term applicable Federal rate. Under §1.1012-1(g)(1), B's basis in Blackacre on January 1, 1997, is $4,736,291 ($1,000,000 down payment plus the $3,736,291 issue price of the debt instrument).

(iii) *Noncontingent payment treated as separate debt instrument.* Under paragraph (c)(3) of this section, the right to the noncontingent payment of principal at maturity is treated as a separate debt instrument. The issue price of this separate debt instrument is $3,736,291 (the issue price of the overall debt instrument). The separate debt instrument has a stated redemption price at maturity of $5,000,000 and, therefore, OID of $1,263,709.

(iv) *Treatment of contingent payments.* Assume that the amount of contingent interest that is fixed and paid on December 31, 1997, is $200,000. Under paragraph (c)(4)(ii) of this section, this payment is treated as consisting of a payment of principal of $190,476, which is the present value of the payment, determined by discounting the payment at the test rate of 5 percent, compounded annually, from the date the payment is made to the issue date. The remainder of the $200,000 payment ($9,524) is treated as interest. The additional amount treated as principal gives B additional basis in Blackacre on December 31, 1997. The portion of the payment treated as interest is includible in gross income by A and deductible by B in their respective taxable years in which December 31, 1997 occurs. The remaining contingent payments on the debt instrument are accounted for similarly, using a test rate of 5 percent, compounded annually, for the contingent payments due on December 31, 1998, and December 31, 1999, and a test rate of 6 percent, compounded annually, for the contingent payments due on December 31, 2000, and December 31, 2001.

Example 2. Fixed but deferred payment—(i) *Facts.* The facts are the same as in paragraph (c)(7) *Example 1* of this section, except that the contingent payment of interest that is fixed on December 31, 1997, is not payable until December 31, 2001, the maturity date.

(ii) *Treatment of deferred contingent payment.* Assume that the amount of the payment that becomes fixed on December 31, 1997, is $200,000. Because this amount is not payable until December 31, 2001, under paragraph (c)(4)(iii) of this section, a separate debt instrument to which section 1274 applies is treated as issued by B on December 31, 1997 (the date the payment is fixed). The maturity date of this separate debt instrument is December 31, 2001 (the date on which the payment is due). The stated principal amount of this separate debt instrument is $200,000, the amount of the payment that becomes fixed. The imputed principal amount of the separate debt instrument is $158,419, which is the present value, as of December 31, 1997, of the $200,000 payment, computed using a discount rate equal to the test rate of the overall debt instrument (6 percent, compounded annually). An amount equal to the issue price of the separate debt instrument is treated as an amount paid on December 31, 1997, and characterized as interest and principal under the rules of paragraph (c)(4)(ii) of this section. The amount of the deemed payment characterized as principal is equal to $150,875, which is the present value, as of January 1, 1997 (the issue date of the overall debt instrument), of the deemed payment, computed using a discount rate of 5 percent, compounded annually. The amount of the deemed payment characterized as interest is $7,544 ($158,419 – $150,875), which is includible in gross income by A and deductible by B in their respective taxable years in which December 31, 1997 occurs.

(d) *Rules for tax-exempt obligations*—(1) *In general.* Except as modified by this paragraph (d), the noncontingent bond method described in paragraph (b) of this section applies to a tax-exempt obligation (as defined

in section 1275(a)(3)) to which this section applies. Paragraph (d)(2) of this section applies to certain tax-exempt obligations that provide for interest-based payments or revenue-based payments and paragraph (d)(3) of this section applies to all other obligations. Paragraph (d)(4) of this section provides rules for a holder whose basis in a tax-exempt obligation is different from the adjusted issue price of the obligation.

(2) *Certain tax-exempt obligations with interest-based or revenue-based payments*—(i) *Applicability.* This paragraph (d)(2) applies to a tax-exempt obligation that provides for interest-based payments or revenue-based payments.

(ii) *Interest-based payments.* A tax-exempt obligation provides for interest-based payments if the obligation would otherwise qualify as a variable rate debt instrument under §1.1275–5 except that—

(A) The obligation provides for more than one fixed rate;

(B) The obligation provides for one or more caps, floors, or governors (or similar restrictions) that are fixed as of the issue date;

(C) The interest on the obligation is not compounded or paid at least annually; or

(D) The obligation provides for interest at one or more rates equal to the product of a qualified floating rate and a fixed multiple greater than zero and less than .65, or at one or more rates equal to the product of a qualified floating rate and a fixed multiple greater than zero and less than .65, increased or decreased by a fixed rate.

(iii) *Revenue-based payments.* A tax-exempt obligation provides for revenue-based payments if the obligation—

(A) Is issued to refinance (including a series of refinancings) an obligation (in a series of refinancings, the original obligation), the proceeds of which were used to finance a project or enterprise; and

(B) Would otherwise qualify as a variable rate debt instrument under §1.1275–5 except that it provides for stated interest payments at least annually based on a single fixed percentage of the revenue, value, change in value, or other similar measure of the performance of the refinanced project or enterprise.

(iv) *Modifications to the noncontingent bond method.* If a tax-exempt obligation is subject to this paragraph (d)(2), the following modifications to the noncontingent bond method described in paragraph (b) of this section apply to the obligation.

(A) *Daily portions and net positive adjustments.* The daily portions of interest determined under paragraph (b)(3)(iii) of this section and any net positive adjustment on the obligation are interest for purposes of section 103.

(B) *Net negative adjustments.* A net negative adjustment for a taxable year reduces the amount of tax-exempt interest the holder would otherwise account for on the obligation for the taxable year under paragraph (b)(3)(iii) of this section. If the net negative adjustment exceeds this amount, the excess is a nondeductible, noncapitalizable loss. If a regulated investment company (RIC) within the meaning of section 851 has a net negative adjustment in a taxable year that would be a nondeductible, noncapitalizable loss under the prior sentence, the RIC must use this loss to reduce its tax-exempt interest income on other tax-exempt obligations held during the taxable year.

(C) *Gains.* Any gain recognized on the sale, exchange, or retirement of the obligation is gain from the sale or exchange of the obligation.

(D) *Losses.* Any loss recognized on the sale, exchange, or retirement of the obligation is treated the same as a net negative adjustment under paragraph (d)(2)(iv)(B) of this section.

(E) *Special rule for losses and net negative adjustments.* Notwithstanding paragraphs (d)(2)(iv)(B) and (D) of this section, on the sale, exchange, or retirement of the obligation, the holder may claim a loss from the sale or exchange of the obligation to the extent the holder has not received in cash or property the sum of its original investment in the obligation and any amounts included in income under paragraph (d)(4)(ii) of this section.

(3) *All other tax-exempt obligations*—(i) *Applicability.* This paragraph (d)(3) applies to a tax-exempt obligation that is not subject to paragraph (d)(2) of this section.

(ii) *Modifications to the noncontingent bond method.* If a tax-exempt obligation is subject to this paragraph (d)(3), the following modifications to the noncontingent bond method described in paragraph (b) of this section apply to the obligation.

(A) *Modification to projected payment schedule.* The comparable yield for the obligation is the greater of the obligation's yield, determined without regard to the contingent payments, and the tax-exempt applicable Federal rate that applies to the obligation. The Internal Revenue Service publishes the tax-exempt applicable Federal rate for each month in the Internal Revenue Bulletin (see §601.601(d)(2)(ii) of this chapter).

(B) *Daily portions.* The daily portions of interest determined under paragraph (b)(3)(iii) of this section are interest for purposes of section 103.

(C) *Adjustments.* A net positive adjustment on the obligation is treated as gain to the holder from the sale or exchange of the obligation in the taxable year of the adjustment. A net negative adjustment on the obligation is treated as a loss to the holder from the sale or exchange of the obligation in the taxable year of the adjustment.

(D) *Gains and losses.* Any gain or loss recognized on the sale, exchange, or retirement of the obligation is gain or loss from the sale or exchange of the obligation.

(4) *Basis different from adjusted issue price.* This paragraph (d)(4) provides rules for a holder whose basis in a tax-exempt obligation is different from the adjusted issue price of the obligation. The rules of paragraph (b)(9)(i) of this section do not apply to tax-exempt obligations.

(i) *Basis greater than adjusted issue price.* If the holder's basis in the obligation exceeds the obligation's adjusted issue price, the holder, upon acquiring the obligation, must allocate this difference to daily portions of interest on a yield to maturity basis over the remaining term of the obligation. The amount allocated to a daily portion of interest is not deductible by the holder. However, the holder's basis in the obligation is reduced by the amount allocated to a daily portion of interest on the date the daily portion accrues.

(ii) *Basis less than adjusted issue price.* If the holder's basis in the obligation is less than the obligation's adjusted issue price, the holder, upon acquiring the obligation, must allocate this difference to daily portions of interest on a yield to maturity basis over the remaining term of the obligation. The amount allocated to a daily portion of interest is includible in income by the holder as ordinary income on the date the daily portion

accrues. The holder's adjusted basis in the obligation is increased by the amount includible in income by the holder under this paragraph (d)(4)(ii) on the date the daily portion accrues.

(iii) *Premium and discount rules do not apply.* The rules for accruing premium and discount in sections 171, 1276, and 1288 do not apply. Other rules of those sections continue to apply to the extent relevant.

(e) *Amounts treated as interest under this section.* Amounts treated as interest under this section are treated as OID for all purposes of the Internal Revenue Code.

(f) *Effective date.* This section applies to debt instruments issued on or after August 13, 1996.

Par. 16. Section 1.1275–5 is amended by:

1. Revising paragraph (a)(1).

2. Removing the language "The debt instrument must provide for stated interest" from the introductory language of paragraph (a)(3)(i) and adding the language "The debt instrument must not provide for any stated interest other than stated interest" in its place.

3. Removing the language "less than 1 year" from the first sentence of paragraph (a)(3)(ii) and adding the language "1 year or less" in its place.

4. Adding paragraphs (a)(5) and (a)(6).

5. Revising paragraph (b)(2).

6. Revising paragraphs (c)(1) and (c)(5).

7. Removing the language "cost of newly borrowed funds" from paragraph (c)(3)(ii) and adding the language "qualified floating rate" in its place.

8. Revising paragraph (d) introductory text; revising *Examples 4* through *9*; and adding *Example 10.*

9. Revising paragraph (e)(2).

10. Revising paragraph (e)(3)(v) introductory text; revising *Example 3* (ii); and removing *Example 3* (iii).

The revisions and additions read as follows:

§1.1275–5 Variable rate debt instruments.

(a) *Applicability*—(1) *In general.* This section provides rules for variable rate debt instruments. Except as provided in paragraph (a)(6) of this section, a variable rate debt instrument is a debt instrument that meets the conditions described in paragraphs (a)(2), (3), (4), and (5) of this section. If a debt instrument that provides for a variable rate of interest does not qualify as a variable rate debt instrument, the debt instrument is a contingent payment debt instrument. See §1.1275–4 for the treatment of a contingent payment debt instrument. See §1.1275–6 for a taxpayer's treatment of a variable rate debt instrument and a hedge.

* * * * * *

(5) *No contingent principal payments.* Except as provided in paragraph (a)(2) of this section, the debt instrument must not provide for any principal payments that are contingent (within the meaning of §1.1275–4(a)).

(6) *Special rule for debt instruments issued for nonpublicly traded property.* A debt instrument (other than a tax-exempt obligation) that would otherwise qualify as a variable rate debt instrument under this section is not a variable rate debt instrument if section 1274 applies to the instrument and any stated interest payments on the instrument are treated as contingent payments under §1.1274–2. This paragraph (a)(6) applies to debt instruments issued on or after August 13, 1996.

(b) * * *

(2) *Certain rates based on a qualified floating rate.* For a debt instrument issued on or after August 13, 1996, a variable rate is a qualified floating rate if it is equal to either—

(i) The product of a qualified floating rate described in paragraph (b)(1) of this section and a fixed multiple that is greater than .65 but not more than 1.35; or

(ii) The product of a qualified floating rate described in paragraph (b)(1) of this section and a fixed multiple that is greater than .65 but not more than 1.35, increased or decreased by a fixed rate.

* * * * * *

(c) *Objective rate*—(1) *Definition*—(i) *In general.* For debt instruments issued on or after August 13, 1996, an objective rate is a rate (other than a qualified floating rate) that is determined using a single fixed formula and that is based on objective financial or economic information. For example, an objective rate generally includes a rate that is based on one or more qualified floating rates or on the yield of actively traded personal property (within the meaning of section 1092(d)(1)).

(ii) *Exception.* For purposes of paragraph (c)(1)(i) of this section, an objective rate does not include a rate based on information that is within the control of the issuer (or a related party within the meaning of section 267(b) or 707(b)(1)) or that is unique to the circumstances of the issuer (or a related party within the meaning of section 267(b) or 707(b)(1)), such as dividends, profits, or the value of the issuer's stock. However, a rate does not fail to be an objective rate merely because it is based on the credit quality of the issuer.

* * * * * *

(5) *Tax-exempt obligations.* Notwithstanding paragraph (c)(1) of this section, in the case of a tax-exempt obligation (within the meaning of section 1275(a)(3)), a variable rate is an objective rate only if it is a qualified inverse floating rate or a qualified inflation rate. A rate is a qualified inflation rate if the rate measures contemporaneous changes in inflation based on a general inflation index.

(d) *Examples.* The following examples illustrate the rules of paragraphs (b) and (c) of this section. For purposes of these examples, assume that the debt instrument is not a tax-exempt obligation. In addition, unless otherwise provided, assume that the rate is not reasonably expected to result in a significant front-loading or back-loading of interest and that the rate is not based on objective financial or economic information that is within the control of the issuer (or a related party) or that is unique to the circumstances of the issuer (or a related party).

* * * * * *

Example 4. Rate based on changes in the value of a commodity index. On January 1, 1997, X issues a debt instrument that provides for annual interest payments at the end of each year at a rate equal to the percentage increase, if any, in the value of an index for the year immediately preceding the payment. The index is based on the prices of several actively traded commodities. Variations in the value of this interest rate cannot reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds. Accordingly, the rate is not a qualified floating rate. However, because the rate is based on objective financial information using a single fixed formula, the rate is an objective rate.

Example 5. Rate based on a percentage of S&P 500 Index. On January 1, 1997, X issues a debt instrument that provides for annual interest payments at the end of each year based on a fixed percentage of the value of the S&P 500 Index. Variations in the value of this interest rate

cannot reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds and, therefore, the rate is not a qualified floating rate. Although the rate is described in paragraph (e)(1)(i) of this section, the rate is not an objective rate because, based on historical data, it is reasonably expected that the average value of the rate during the first half of the instrument's term will be significantly less than the average value of the rate during the final half of the instrument's term.

Example 6. Rate based on issuer's profits. On January 1, 1997, Z issues a debt instrument that provides for annual interest payments equal to 1 percent of Z's gross profits earned during the year immediately preceding the payment. Variations in the value of this interest rate cannot reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds. Accordingly, the rate is not a qualified floating rate. In addition, because the rate is based on information that is unique to the issuer's circumstances, the rate is not an objective rate.

Example 7. Rate based on a multiple of an interest index. On January 1, 1997, Z issues a debt instrument with annual interest payments at a rate equal to two times the value of 1-year LIBOR as of the payment date. Because the rate is a multiple greater than 1.35 times a qualified floating rate, the rate is not a qualified floating rate. However, because the rate is based on objective financial information using a single fixed formula, the rate is an objective rate.

Example 8. Variable rate based on the cost of borrowed funds in a foreign currency. On January 1, 1997, Y issues a 5-year dollar denominated debt instrument that provides for annual interest payments at a rate equal to the value of 1-year French franc LIBOR as of the payment date. Variations in the value of French franc LIBOR do not measure contemporaneous changes in the cost of newly borrowed funds in dollars. As a result, the rate is not a qualified floating rate for an instrument denominated in dollars. However, because the rate is based on objective financial information using a single fixed formula, the rate is an objective rate.

Example 9. Qualified inverse floating rate. On January 1, 1997, X issues a debt instrument that provides for annual interest payments at the end of each year at a rate equal to 12 percent minus the value of 1-year LIBOR as of the payment date. On the issue date, the value of 1-year LIBOR is 6 percent. Because the rate can reasonably be expected to inversely reflect contemporaneous variations in 1-year LIBOR, it is a qualified inverse floating rate. However, if the value of 1-year LIBOR on the issue date were 11 percent rather than 6 percent, the rate would not be a qualified inverse floating rate because the rate could not reasonably be expected to inversely reflect contemporaneous variations in 1-year LIBOR.

Example 10. Rate based on an inflation index. On January 1, 1997, X issues a debt instrument that provides for annual interest payments at the end of each year at a rate equal to 400 basis points (4 percent) plus the annual percentage change in a general inflation index (*e.g.*, the Consumer Price Index, U.S. City Average, All Items, for all Urban Consumers, seasonally unadjusted). The rate, however, may not be less than zero. Variations in the value of this interest rate cannot reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds. Accordingly, the rate is not a qualified floating rate. However, because the rate is based on objective economic information using a single fixed formula, the rate is an objective rate.

(e) * * *

(2) *Variable rate debt instrument that provides for annual payments of interest at a single variable rate.* If a variable rate debt instrument provides for stated interest at a single qualified floating rate or objective rate and the interest is unconditionally payable in cash or in property (other than debt instruments of the issuer), or will be constructively received under section 451, at least annually, the following rules apply to the instrument:

(i) All stated interest with respect to the debt instrument is qualified stated interest.

(ii) The amount of qualified stated interest and the amount of OID, if any, that accrues during an accrual period is determined under the rules applicable to fixed rate debt instruments by assuming that the variable rate is a fixed rate equal to—

(A) In the case of a qualified floating rate or qualified inverse floating rate, the value, as of the issue date, of the qualified floating rate or qualified inverse floating rate; or

(B) In the case of an objective rate (other than a qualified inverse floating rate), a fixed rate that reflects the yield that is reasonably expected for the debt instrument.

(iii) The qualified stated interest allocable to an accrual period is increased (or decreased) if the interest actually paid during an accrual period exceeds (or is less than) the interest assumed to be paid during the accrual period under paragraph (e)(2)(ii) of this section.

(3) * * *

(v) *Examples.* The following examples illustrate the rules in paragraphs (e)(2) and (3) of this section.

* * * * * *

Example 3. * * *

(ii) *Accrual of OID and qualified stated interest.* Under paragraph (e)(2) of this section, the variable rate debt instrument is treated as a 2-year debt instrument that has an issue price of $90,000, a stated principal amount of $100,000, and interest payments of $5,000 at the end of each year. The debt instrument has $10,000 of OID and the annual interest payments of $5,000 are qualified stated interest payments. Under §1.1272–1, the debt instrument has a yield of 10.82 percent, compounded annually. The amount of OID allocable to the first annual accrual period (assuming Z uses annual accrual periods) is $4,743.25 (($90,000 × .1082) − $5,000), and the amount of OID allocable to the second annual accrual period is $5,256.75 ($100,000 − $94,743.25). Under paragraph (e)(2)(iii) of this section, the $2,000 difference between the $7,000 interest payment actually made at maturity and the $5,000 interest payment assumed to be made at maturity under the equivalent fixed rate debt instrument is treated as additional qualified stated interest for the period.

* * * * * *

Par. 17. Section 1.1275–6 is added to read as follows:

§1.1275–6 Integration of qualifying debt instruments.

(a) *In general.* This section generally provides for the integration of a qualifying debt instrument with a hedge or combination of hedges if the combined cash flows of the components are substantially equivalent to the cash flows on a fixed or variable rate debt instrument. The integrated transaction is generally subject to the rules of this section rather than the rules to which each component of the transaction would be subject on a separate basis. The purpose of this section is to permit a more appropriate determination of the character and timing of income, deductions, gains, or losses than would be permitted by separate treatment of the components. The rules of this section affect only the taxpayer who holds (or issues) the qualifying debt instrument and enters into the hedge.

(b) *Definitions*—(1) *Qualifying debt instrument.* A qualifying debt instrument is any debt instrument (including an integrated transaction as defined in paragraph (c) of this section) other than—

(i) A tax-exempt obligation as defined in section 1275(a)(3);

(ii) A debt instrument to which section 1272(a)(6) applies (certain interests in or mortgages held by a REMIC, and certain other debt instruments with payments subject to acceleration); or

(iii) A debt instrument that is subject to §1.483–4 or §1.1275–4(c) (certain contingent payment debt instruments issued for nonpublicly traded property).

(2) *Section 1.1275–6 hedge*—(i) *In general.* A §1.1275–6 hedge is any financial instrument (as defined in paragraph (b)(3) of this section) if the combined cash flows of the financial instrument and the qualifying debt instrument permit the calculation of a yield to maturity (under the principles

of section 1272), or the right to the combined cash flows would qualify under §1.1275–5 as a variable rate debt instrument that pays interest at a qualified floating rate or rates (except for the requirement that the interest payments be stated as interest). A financial instrument is not a §1.1275–6 hedge, however, if the resulting synthetic debt instrument does not have the same term as the remaining term of the qualifying debt instrument. A financial instrument that hedges currency risk is not a §1.1275–6 hedge.

(ii) *Limitations*—(A) A debt instrument issued by a taxpayer and a debt instrument held by the taxpayer cannot be part of the same integrated transaction.

(B) A debt instrument can be a §1.1275–6 hedge only if it is issued substantially contemporaneously with, and has the same maturity (including rights to accelerate or delay payments) as, the qualifying debt instrument.

(3) *Financial instrument.* For purposes of this section, a financial instrument is a spot, forward, or futures contract, an option, a notional principal contract, a debt instrument, or a similar instrument, or combination or series of financial instruments. Stock is not a financial instrument for purposes of this section.

(4) *Synthetic debt instrument.* The synthetic debt instrument is the hypothetical debt instrument with the same cash flows as the combined cash flows of the qualifying debt instrument and the §1.1275–6 hedge.

(c) *Integrated transaction*—(1) *Integration by taxpayer.* Except as otherwise provided in this section, a qualifying debt instrument and a §1.1275–6 hedge are an integrated transaction if all of the following requirements are satisfied:

(i) The taxpayer satisfies the identification requirements of paragraph (e) of this section on or before the date the taxpayer enters into the §1.1275–6 hedge.

(ii) None of the parties to the §1.1275–6 hedge are related within the meaning of section 267(b) or 707(b)(1), or, if the parties are related, the party providing the hedge uses, for federal income tax purposes, a mark-to-market method of accounting for the hedge and all similar or related transactions.

(iii) Both the qualifying debt instrument and the §1.1275–6 hedge are entered into by the same individual, partnership, trust, estate, or corporation (regardless of whether the corporation is a member of an affiliated group of corporations that files a consolidated return).

(iv) If the taxpayer is a foreign person engaged in a U.S. trade or business and the taxpayer issues or acquires a qualifying debt instrument, or enters into a §1.1275–6 hedge, through the trade or business, all items of income and expense associated with the qualifying debt instrument and the §1.1275–6 hedge (other than interest expense that is subject to §1.882–5) would have been effectively connected with the U.S. trade or business throughout the term of the qualifying debt instrument had this section not applied.

(v) Neither the qualifying debt instrument, nor any other debt instrument that is part of the same issue as the qualifying debt instrument, nor the §1.1275–6 hedge was, with respect to the taxpayer, part of an integrated transaction that was terminated or otherwise legged out of within the 30 days immediately preceding the date that would be the issue date of the synthetic debt instrument.

(vi) The qualifying debt instrument is issued or acquired by the taxpayer on or before the date of the first payment on the §1.1275–6 hedge, whether made or received by the taxpayer (including a payment made to purchase the hedge). If the qualifying debt instrument is issued or acquired by the taxpayer after, but substantially contemporaneously with, the date of the first payment on the §1.1275–6 hedge, the qualifying debt instrument is treated, solely for purposes of this paragraph (c)(1)(vi), as meeting the requirements of the preceding sentence.

(vii) Neither the §1.1275–6 hedge nor the qualifying debt instrument was, with respect to the taxpayer, part of a straddle (as defined in section 1092(c)) prior to the issue date of the synthetic debt instrument.

(2) *Integration by Commissioner.* The Commissioner may treat a qualifying debt instrument and a financial instrument (whether entered into by the taxpayer or by a related party) as an integrated transaction if the combined cash flows on the qualifying debt instrument and financial instrument are substantially the same as the combined cash flows required for the financial instrument to be a §1.1275–6 hedge. The Commissioner, however, may not integrate a transaction unless the qualifying debt instrument either is subject to §1.1275–4 or is subject to §1.1275–5 and pays interest at an objective rate. The circumstances under which the Commissioner may require integration include, but are not limited to, the following:

(i) A taxpayer fails to identify a qualifying debt instrument and the §1.1275–6 hedge under paragraph (e) of this section.

(ii) A taxpayer issues or acquires a qualifying debt instrument and a related party (within the meaning of section 267(b) or 707(b)(1)) enters into the §1.1275–6 hedge.

(iii) A taxpayer issues or acquires a qualifying debt instrument and enters into the §1.1275–6 hedge with a related party (within the meaning of section 267(b) or 707(b)(1)).

(iv) The taxpayer legs out of an integrated transaction and within 30 days enters into a new §1.1275–6 hedge with respect to the same qualifying debt instrument or another debt instrument that is part of the same issue.

(d) *Special rules for legging into and legging out of an integrated transaction*—(1) *Legging into*—(i) *Definition.* Legging into an integrated transaction under this section means that a §1.1275–6 hedge is entered into after the date the qualifying debt instrument is issued or acquired by the taxpayer, and the requirements of paragraph (c)(1) of this section are satisfied on the date the §1.1275–6 hedge is entered into (the leg-in date).

(ii) *Treatment.* If a taxpayer legs into an integrated transaction, the taxpayer treats the qualifying debt instrument under the applicable rules for taking interest and OID into account up to the leg-in date, except that the day before the leg-in date is treated as the end of an accrual period. As of the leg-in date, the qualifying debt instrument is subject to the rules of paragraph (f) of this section.

(iii) *Anti-abuse rule.* If a taxpayer legs into an integrated transaction with a principal purpose of deferring or accelerating income or deductions on the qualifying debt instrument, the Commissioner may—

(A) Treat the qualifying debt instrument as sold for its fair market value on the leg-in date; or

(B) Refuse to allow the taxpayer to

integrate the qualifying debt instrument and the §1.1275–6 hedge.

(2) *Legging out*—(i) *Definition*—(A) *Legging out if the taxpayer has integrated.* If a taxpayer has integrated a qualifying debt instrument and a §1.1275–6 hedge under paragraph (c)(1) of this section, legging out means that, prior to the maturity of the synthetic debt instrument, the §1.1275–6 hedge ceases to meet the requirements for a §1.1275–6 hedge, the taxpayer fails to meet any requirement of paragraph (c)(1) of this section, or the taxpayer disposes of or otherwise terminates all or a part of the qualifying debt instrument or §1.1275–6 hedge. If the taxpayer fails to meet the requirements of paragraph (c)(1) of this section but meets the requirements of paragraph (c)(2) of this section, the Commissioner may treat the taxpayer as not legging out.

(B) *Legging out if the Commissioner has integrated.* If the Commissioner has integrated a qualifying debt instrument and a financial instrument under paragraph (c)(2) of this section, legging out means that, prior to the maturity of the synthetic debt instrument, the requirements for Commissioner integration under paragraph (c)(2) of this section are not met or the taxpayer fails to meet the requirements for taxpayer integration under paragraph (c)(1) of this section and the Commissioner agrees to allow the taxpayer to be treated as legging out.

(C) *Exception for certain nonrecognition transactions.* If, in a single nonrecognition transaction, a taxpayer disposes of, or ceases to be primarily liable on, the qualifying debt instrument and the §1.1275–6 hedge, the taxpayer is not treated as legging out. Instead, the integrated transaction is treated under the rules governing the nonrecognition transaction. For example, if a holder of an integrated transaction is acquired in a reorganization under section 368(a)(1)(A), the holder is treated as disposing of the synthetic debt instrument in the reorganization rather than legging out. If the successor holder is not eligible for integrated treatment, the successor is treated as legging out.

(ii) *Operating rules.* If a taxpayer legs out (or is treated as legging out) of an integrated transaction, the following rules apply:

(A) The transaction is treated as an integrated transaction during the time the requirements of paragraph (c)(1) or (2) of this section, as appropriate, are satisfied.

(B) Immediately before the taxpayer legs out, the taxpayer is treated as selling or otherwise terminating the synthetic debt instrument for its fair market value and, except as provided in paragraph (d)(2)(ii)(D) of this section, any income, deduction, gain, or loss is realized and recognized at that time.

(C) If, immediately after the taxpayer legs out, the taxpayer holds or remains primarily liable on the qualifying debt instrument, adjustments are made to reflect any difference between the fair market value of the qualifying debt instrument and the adjusted issue price of the qualifying debt instrument. If, immediately after the taxpayer legs out, the taxpayer is a party to a §1.1275–6 hedge, the §1.1275–6 hedge is treated as entered into at its fair market value.

(D) If a taxpayer legs out of an integrated transaction by disposing of or otherwise terminating a §1.1275–6 hedge within 30 days of legging into the integrated transaction, then any loss or deduction determined under paragraph (d)(2)(ii)(B) of this section is not allowed. Appropriate adjustments are made to the qualifying debt instrument for any disallowed loss. The adjustments are taken into account on a yield to maturity basis over the remaining term of the qualifying debt instrument.

(E) If a holder of a debt instrument subject to §1.1275–4 legs into an integrated transaction with respect to the instrument and subsequently legs out of the integrated transaction, any gain recognized under paragraph (d)(2)-(ii)(B) or (C) of this section is treated as interest income to the extent determined under the principles of §1.1275–4(b)(8)(iii)(B) (rules for determining the character of gain on the sale of a debt instrument all of the payments on which have been fixed). If the synthetic debt instrument would qualify as a variable rate debt instrument, the equivalent fixed rate debt instrument determined under §1.1275–5(e) is used for this purpose.

(e) *Identification requirements.* For each integrated transaction, a taxpayer must enter and retain as part of its books and records the following information—

(1) The date the qualifying debt instrument was issued or acquired (or is expected to be issued or acquired) by the taxpayer and the date the §1.1275–6 hedge was entered into by the taxpayer;

(2) A description of the qualifying debt instrument and the §1.1275–6 hedge; and

(3) A summary of the cash flows and accruals resulting from treating the qualifying debt instrument and the §1.1275–6 hedge as an integrated transaction (*i.e.*, the cash flows and accruals on the synthetic debt instrument).

(f) *Taxation of integrated transactions*—(1) *General rule.* An integrated transaction is generally treated as a single transaction by the taxpayer during the period that the transaction qualifies as an integrated transaction. Except as provided in paragraph (f)(12) of this section, while a qualifying debt instrument and a §1.1275–6 hedge are part of an integrated transaction, neither the qualifying debt instrument nor the §1.1275–6 hedge is subject to the rules that would apply on a separate basis to the debt instrument and the §1.1275–6 hedge, including section 1092 or §1.446–4. The rules that would govern the treatment of the synthetic debt instrument generally govern the treatment of the integrated transaction. For example, the integrated transaction may be subject to section 263(g) or, if the synthetic debt instrument would be part of a straddle, section 1092. Generally, the synthetic debt instrument is subject to sections 163(e) and 1271 through 1275, with terms as set forth in paragraphs (f)(2) through (13) of this section.

(2) *Issue date.* The issue date of the synthetic debt instrument is the first date on which the taxpayer entered into all of the components of the synthetic debt instrument.

(3) *Term.* The term of the synthetic debt instrument is the period beginning on the issue date of the synthetic debt instrument and ending on the maturity date of the qualifying debt instrument.

(4) *Issue price.* The issue price of the synthetic debt instrument is the adjusted issue price of the qualifying debt instrument on the issue date of the synthetic debt instrument. If, as a result of entering into the §1.1275–6 hedge, the taxpayer pays or receives one or more payments that are substantially contemporaneous with the issue date of the synthetic debt instrument, the payments reduce or increase the issue price as appropriate.

(5) *Adjusted issue price.* In general, the adjusted issue price of the synthetic

debt instrument is determined under the principles of §1.1275–1(b).

(6) *Qualified stated interest.* No amounts payable on the synthetic debt instrument are qualified stated interest within the meaning of §1.1273–1(c).

(7) *Stated redemption price at maturity*—(i) *Synthetic debt instruments that are borrowings.* In general, if the synthetic debt instrument is a borrowing, the instrument's stated redemption price at maturity is the sum of all amounts paid or to be paid on the qualifying debt instrument and the §1.1275–6 hedge, reduced by any amounts received or to be received on the §1.1275–6 hedge.

(ii) *Synthetic debt instruments that are held by the taxpayer.* In general, if the synthetic debt instrument is held by the taxpayer, the instrument's stated redemption price at maturity is the sum of all amounts received or to be received by the taxpayer on the qualifying debt instrument and the §1.1275–6 hedge, reduced by any amounts paid or to be paid by the taxpayer on the §1.1275–6 hedge.

(iii) *Certain amounts ignored.* For purposes of this paragraph (f)(7), if an amount paid or received on the §1.1275–6 hedge is taken into account under paragraph (f)(4) of this section to determine the issue price of the synthetic debt instrument, the amount is not taken into account to determine the synthetic debt instrument's stated redemption price at maturity.

(8) *Source of interest income and allocation of expense.* The source of interest income from the synthetic debt instrument is determined by reference to the source of income of the qualifying debt instrument under sections 861(a)(1) and 862(a)(1). For purposes of section 904, the character of interest from the synthetic debt instrument is determined by reference to the character of the interest income from the qualifying debt instrument. Interest expense is allocated and apportioned under regulations under section 861 or under §1.882–5.

(9) *Effectively connected income.* If the requirements of paragraph (c)(1)(iv) of this section are satisfied, any interest income resulting from the synthetic debt instrument entered into by the foreign person is treated as effectively connected with a U.S. trade or business, and any interest expense resulting from the synthetic debt instrument entered into by the foreign person is allocated and apportioned under §1.882–5.

(10) *Not a short-term obligation.* For purposes of section 1272(a)(2)(C), a synthetic debt instrument is not treated as a short-term obligation.

(11) *Special rules in the event of integration by the Commissioner.* If the Commissioner requires integration, appropriate adjustments are made to the treatment of the synthetic debt instrument, and, if necessary, the qualifying debt instrument and financial instrument. For example, the Commissioner may treat a financial instrument that is not a §1.1275–6 hedge as a §1.1275–6 hedge when applying the rules of this section. The issue date of the synthetic debt instrument is the date determined appropriate by the Commissioner to require integration.

(12) *Retention of separate transaction rules for certain purposes.* This paragraph (f)(12) provides for the retention of separate transaction rules for certain purposes. In addition, by publication in the Internal Revenue Bulletin (see §601.601(d)(2)(ii) of this chapter), the Commissioner may require use of separate transaction rules for any aspect of an integrated transaction.

(i) *Foreign persons that enter into integrated transactions giving rise to U.S. source income not effectively connected with a U.S. trade or business.* If a foreign person enters into an integrated transaction that gives rise to U.S. source interest income (determined under the source rules for the synthetic debt instrument) not effectively connected with a U.S. trade or business of the foreign person, paragraph (f) of this section does not apply for purposes of sections 871(a), 881, 1441, 1442, and 6049. These sections of the Internal Revenue Code are applied to the qualifying debt instrument and the §1.1275–6 hedge on a separate basis.

(ii) *Relationship between taxpayer and other persons.* Because the rules of this section affect only the taxpayer that enters into an integrated transaction (*i.e.*, either the issuer or a particular holder of a qualifying debt instrument), any provisions of the Internal Revenue Code or regulations that govern the relationship between the taxpayer and any other person are applied on a separate basis. For example, taxpayers must comply with any reporting or disclosure requirements on any qualifying debt instrument as if it were not part of an integrated transaction. Thus, if required under §1.1275–4(b)(4), an issuer of a contingent payment debt instrument subject to integrated treatment must provide the projected payment schedule to holders. Similarly, if a U.S. corporation enters into an integrated transaction that includes a notional principal contract, the source of any payment received by the counterparty on the notional principal contract is determined under §1.863–7 as if the contract were not part of an integrated transaction, and, if received by a foreign person who is not engaged in a U.S. trade or business, the payment is non-U.S. source income that is not subject to U.S. withholding tax.

(13) *Coordination with consolidated return rules.* If a taxpayer enters into a §1.1275–6 hedge with a member of the same consolidated group (the counterparty) and the §1.1275–6 hedge is part of an integrated transaction for the taxpayer, the §1.1275–6 hedge is not treated as an intercompany transaction for purposes of §1.1502–13. If the taxpayer legs out of integrated treatment, the taxpayer and the counterparty are each treated as disposing of its position in the §1.1275–6 hedge under the principles of paragraph (d)(2) of this section. If the §1.1275–6 hedge remains in existence after the leg-out date, the §1.1275–6 hedge is treated under the rules that would otherwise apply to the transaction (including §1.1502–13 if the transaction is between members).

(g) *Predecessors and successors.* For purposes of this section, any reference to a taxpayer, holder, issuer, or person includes, where appropriate, a reference to a predecessor or successor. For purposes of the preceding sentence, a predecessor is a transferor of an asset or liability (including an integrated transaction) to a transferee (the successor) in a nonrecognition transaction. Appropriate adjustments, if necessary, are made in the application of this section to predecessors and successors.

(h) *Examples.* The following examples illustrate the provisions of this section. In each example, assume that the qualifying debt instrument is a debt instrument for federal income tax purposes. No inference is intended, however, as to whether the debt instrument is a debt instrument for federal income tax purposes.

Example 1. Issuer hedge—(i) *Facts.* On January 1, 1997, V, a domestic corporation, issues a 5-year debt instrument for $1,000. The

debt instrument provides for annual payments of interest at a rate equal to the value of 1-year LIBOR and a principal payment of $1,000 at maturity. On the same day, V enters into a 5-year interest rate swap agreement with an unrelated party. Under the swap, V pays 6 percent and receives 1-year LIBOR on a notional principal amount of $1,000. The payments on the swap are fixed and made on the same days as the payments on the debt instrument. On January 1, 1997, V identifies the debt instrument and the swap as an integrated transaction in accordance with the requirements of paragraph (e) of this section.

(ii) *Eligibility for integration.* The debt instrument is a qualifying debt instrument. The swap is a §1.1275–6 hedge because it is a financial instrument and a yield to maturity on the combined cash flows of the swap and the debt instrument can be calculated. V has met the identification requirements, and the other requirements of paragraph (e)(1) of this section are satisfied. Therefore, the transaction is an integrated transaction under this section.

(iii) *Treatment of the synthetic debt instrument.* The synthetic debt instrument is a 5-year debt instrument that has an issue price of $1,000 and provides for annual interest payments of $60 and a principal payment of $1,000 at maturity. Under paragraph (f)(6) of this section, no amounts payable on the synthetic debt instrument are qualified stated interest. Thus, under paragraph (f)(7)(i) of this section, the synthetic debt instrument has a stated redemption price at maturity of $1,300 (the sum of all amounts to be paid on the qualifying debt instrument and the swap, reduced by amounts to be received on the swap). The synthetic debt instrument, therefore, has $300 of OID.

Example 2. Issuer hedge with an option—(i) *Facts.* On December 31, 1996, W, a domestic corporation, issues for $1,000 a debt instrument that matures on December 31, 1999. The debt instrument has a stated principal amount of $1,000 payable at maturity. The debt instrument also provides for a payment at maturity equal to $10 times the increase, if any, in the value of a nationally known composite index of stocks from December 31, 1996, to the maturity date. On December 31, 1996, W purchases from an unrelated party an option that pays $10 times the increase, if any, in the stock index from December 31, 1996, to December 31, 1999. W pays $250 for the option. On December 31, 1996, W identifies the debt instrument and option as an integrated transaction in accordance with the requirements of paragraph (e) of this section.

(ii) *Eligibility for integration.* The debt instrument is a qualifying debt instrument. The option is a §1.1275–6 hedge because it is a financial instrument and a yield to maturity on the combined cash flows of the option and the debt instrument can be calculated. W has met the identification requirements, and the other requirements of paragraph (e)(1) of this section are satisfied. Therefore, the transaction is an integrated transaction under this section.

(iii) *Treatment of the synthetic debt instrument.* Under paragraph (f)(4) of this section, the issue price of the synthetic debt instrument is equal to the issue price of the debt instrument ($1,000) reduced by the payment for the option ($250). As a result, the synthetic debt instrument is a 3-year debt instrument with an issue price of $750. Under paragraph (f)(7) of this section, the synthetic debt instrument has a stated redemption price at maturity of $1,000 (the $250 payment for the option is not taken into account). The synthetic debt instrument, therefore, has $250 of OID.

Example 3. Hedge with prepaid swap—(i) *Facts.* On January 1, 1997, H purchases for £1,000 a 5-year debt instrument that provides for semiannual payments based on 6-month pound LIBOR and a payment of the £1,000 principal at maturity. On the same day, H enters into a swap with an unrelated third party under which H receives semiannual payments, in pounds, of 10 percent, compounded semiannually, and makes semiannual payments, in pounds, of 6-month pound LIBOR on a notional principal amount of £1,000. Payments on the swap are fixed and made on the same dates as the payments on the debt instrument. H also makes a £162 prepayment on the swap. On January 1, 1997, H identifies the swap and the debt instrument as an integrated transaction in accordance with the requirements of paragraph (e) of this section.

(ii) *Eligibility for integration.* The debt instrument is a qualifying debt instrument. The swap is a §1.1275–6 hedge because it is a financial instrument and a yield to maturity on the combined cash flows of the swap and the debt instrument can be calculated. Although the debt instrument is denominated in pounds, the swap hedges only interest rate risk, not currency risk. Therefore, the transaction is an integrated transaction under this section. See §1.988–5(a) for the treatment of a debt instrument and a swap if the swap hedges currency risk.

(iii) *Treatment of the synthetic debt instrument.* Under paragraph (f)(4) of this section, the issue price of the synthetic debt instrument is equal to the issue price of the debt instrument (£1,000) increased by the prepayment on the swap (£162). As a result, the synthetic debt instrument is a 5-year debt instrument that has an issue price of £1,162 and provides for semiannual interest payments of £50 and a principal payment of £1,000 at maturity. Under paragraph (f)(6) of this section, no amounts payable on the synthetic debt instrument are qualified stated interest. Thus, under paragraph (f)(7)(ii) of this section, the synthetic debt instrument's stated redemption price at maturity is £1,500 (the sum of all amounts to be received on the qualifying debt instrument and the §1.1275–6 hedge, reduced by all amounts to be paid on the §1.1275–6 hedge other than the £162 prepayment for the swap). The synthetic debt instrument, therefore, has £338 of OID.

Example 4. Legging into an integrated transaction by a holder—(i) *Facts.* On December 31, 1996, X corporation purchases for $1,000,000 a debt instrument that matures on December 31, 2006. The debt instrument provides for annual payments of interest at the rate of 6 percent and for a payment at maturity equal to $1,000,000, increased by the excess, if any, of the price of 1,000 units of a commodity on December 31, 2006, over $350,000, and decreased by the excess, if any, of $350,000 over the price of 1,000 units of the commodity on that date. The projected amount of the payment at maturity determined under §1.1275–4(b)(4) is $1,020,000. On December 31, 1999, X enters into a cash-settled forward contract with an unrelated party to sell 1,000 units of the commodity on December 31, 2006, for $450,000. On December 31, 1999, X also identifies the debt instrument and the forward contract as an integrated transaction in accordance with the requirements of paragraph (e) of this section.

(ii) *Eligibility for integration.* X meets the requirements for integration as of December 31, 1999. Therefore, X legged into an integrated transaction on that date. Prior to that date, X treats the debt instrument under the applicable rules of §1.1275–4.

(iii) *Treatment of the synthetic debt instrument.* As of December 31, 1999, the debt instrument and the forward contract are treated as an integrated transaction. The issue price of the synthetic debt instrument is equal to the adjusted issue price of the qualifying debt instrument on the leg-in date, $1,004,804 (assuming one year accrual periods). The term of the synthetic debt instrument is from December 31, 1999, to December 31, 2006. The synthetic debt instrument provides for annual interest payments of $60,000 and a principal payment at maturity of $1,100,000 ($1,000,000 + $450,000 – $350,000). Under paragraph (f)(6) of this section, no amounts payable on the synthetic debt instrument are qualified stated interest. Thus, under paragraph (f)(7)(ii) of this section, the synthetic debt instrument's stated redemption price at maturity is $1,520,000 (the sum of all amounts to be received by X on the qualifying debt instrument and the §1.1275–6 hedge, reduced by all amounts to be paid by X on the §1.1275–6 hedge). The synthetic debt instrument, therefore, has $515,196 of OID.

Example 5. Abusive leg-in—(i) *Facts.* On January 1, 1997, Y corporation purchases for $1,000,000 a debt instrument that matures on December 31, 2001. The debt instrument provides for annual payments of interest at the rate of 6 percent, a payment on December 31, 1999, of the increase, if any, in the price of a commodity from January 1, 1997, to December 31, 1999, and a payment at maturity of $1,000,000 and the increase, if any, in the price of the commodity from December 31, 1999 to maturity. Because the debt instrument is a contingent payment debt instrument subject to §1.1275–4, Y accrues interest based on the projected payment schedule.

(ii) *Leg-in.* By late 1999, the price of the commodity has substantially increased, and Y expects a positive adjustment on December 31, 1999. In late 1999, Y enters into an agreement to exchange the two commodity based payments on the debt instrument for two payments on the same dates of $100,000 each. Y identifies the transaction as an integrated transaction in accordance with the requirements of paragraph (e) of this section. Y disposes of the hedge in early 2000.

(iii) *Treatment.* The legging into an integrated transaction has the effect of deferring the positive adjustment from 1999 to 2000. Because Y legged into the integrated transaction with a principal purpose to defer the positive adjustment, the Commissioner may treat the debt instrument as sold for its fair market value on the leg-in date or refuse to allow integration.

Example 6. Integration of offsetting debt instruments—(i) *Facts.* On January 1, 1997, Z issues two 10-year debt instruments. The first, Issue 1, has an issue price of $1,000, pays interest annually at 6 percent, and, at maturity, pays $1,000, increased by $1 times the increase, if any, in the value of the S&P 100 Index over the term of the instrument and reduced by $1 times the decrease, if any, in the value of the S&P 100 Index over the term of the instrument. However, the amount paid at maturity may not be less than $500 or more than $1,500. The second, Issue 2, has an issue price of $1,000, pays interest annually at 8 percent, and, at maturity, pays $1,000, reduced by $1 times the increase, if any, in the value of the S&P 100 Index over the term of the instrument and increased by $1 times the decrease, if any, in the value of the S&P 100 Index over the term of the

instrument. The amount paid at maturity may not be less than $500 or more than $1,500. On January 1, 1997, Z identifies Issue 1 as the qualifying debt instrument, Issue 2 as a §1.1275–6 hedge, and otherwise meets the identification requirements of paragraph (c) of this section.

(ii) *Eligibility for integration.* Both Issue 1 and Issue 2 are qualifying debt instruments. Z has met the identification requirements by identifying Issue 1 as the qualifying debt instrument and Issue 2 as the §1.1275–6 hedge. The other requirements of paragraph (c)(1) of this section are satisfied. Therefore, the transaction is an integrated transaction under this section.

(iii) *Treatment of the synthetic debt instrument.* The synthetic debt instrument has an issue price of $2,000, provides for a payment at maturity of $2,000, and, in addition, provides for annual payments of $140. Under paragraph (f)(6) of this section, no amounts payable on the synthetic debt instrument are qualified stated interest. Thus, under paragraph (f)(7)(i) of this section, the synthetic debt instrument's stated redemption price at maturity is $3,400 (the sum of all amounts to be paid on the qualifying debt instrument and the §1.1275–6 hedge, reduced by amounts to be received on the §1.1275–6 hedge other than the $1,000 payment received on the issue date). The synthetic debt instrument, therefore, has $1,400 of OID.

Example 7. Integrated transaction entered into by a foreign person—(i) *Facts.* X, a foreign person, enters into an integrated transaction by purchasing a qualifying debt instrument that pays U.S. source interest and entering into a notional principal contract with a U.S. corporation. Neither the income from the qualifying debt instrument nor the income from the notional principal contract is effectively connected with a U.S. trade or business. The notional principal contract is a §1.1275–6 hedge.

(ii) *Treatment of integrated transaction.* Under paragraph (f)(8) of this section, X will receive U.S. source income from the integrated transaction. However, under paragraph (f)(12)(i) of this section, the qualifying debt instrument and the notional principal contract are treated as if they are not part of an integrated transaction for purposes of determining whether tax is due and must be withheld on income. Accordingly, because the §1.1275–6 hedge would produce foreign source income under §1.863–7 to X if it were not part of an integrated transaction, any income on the §1.1275–6 hedge generally will not be subject to tax under sections 871(a) and 881, and the U.S. corporation that is the counterparty will not be required to withhold tax on payments under the §1.1275–6 hedge under sections 1441 and 1442.

(i) [Reserved]

(j) *Effective date.* This section applies to a qualifying debt instrument issued on or after August 13, 1996. This section also applies to a qualifying debt instrument acquired by the taxpayer on or after August 13, 1996, if—

(1) The qualifying debt instrument is a fixed rate debt instrument or a variable rate debt instrument; or

(2) The qualifying debt instrument and the §1.1275–6 hedge are acquired by the taxpayer substantially contemporaneously.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 18. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 19. Section 602.101, paragraph (c) is amended by:

1. Removing the following entries from the table:

§602.101 OMB Control numbers.

* * * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control number
* * * * * *	
1.1272–1(c)(4)	1545–1353
* * * * * *	
1.1275–3(b)	1545–1353
1.1275–3(c)	1545–0887
* * * * * *	

2. Adding entries in numerical order to the table to read as follows:

§602.101 OMB Control numbers.

* * * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control number
* * * * * *	
1.1275–2(h)	1545–1450
1.1275–3	1545–0887 1545–1353 1545–1450
1.1275–4(b)	1545–1450
1.1275–6(e)	1545–1450
* * * * * *	

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved March 22, 1996.

Leslie Samuels,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on June 11, 1996, 8:45 a.m., and published in the issue of the Federal Register for June 14, 1996, 61 F.R. 30133)

Subpart D.—Miscellaneous Provisions

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

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1996. See Rev. Rul. 96–34, page 75.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1996. See Rev. Rul. 96–37, page 77.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1996. See Rev. Rul. 96–43, page 78.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1996. See Rev. Rul. 96–49, page 79.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1996. See Rev. Rul. 96–52, page 81.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1996. See Rev. Rul. 96–57, page 82.

Subchapter U.—Designation and Treatment of Empowerment Zones, Enterprise Communities, and Rural Developmemt Investment Areas

Part II.—Tax-Exempt Facility Bonds for Empowerment Zones and Enterprise Communities

Section 1394.—Tax Exempt Enterprise Zone Facility Bonds

26 CFR 1.1394–1: Enterprise zone facility bonds.

T.D. 8673

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Entrprise Zone Facility Bonds

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to enterprise zone facility bonds issued by State and local governments. These regulations reflect changes to the law made by the Omnibus Budget Reconciliation Act of 1993. These regulations affect issuers of enterprise zone facility bonds.

EFFECTIVE DATE: These regulations are effective May 31, 1996.

For dates of applicability of these regulations to enterprise zone facility bond issues, see §1.1394–1(q) of these regulations.

SUPPLEMENTARY INFORMATION:

Background

On December 30, 1994, proposed regulations (FI–72–88 [1995–1 C.B. 859]) were published in the **Federal Register** (59 FR 67658) to provide guidance under sections 141 (relating to private activity bonds and to qualified bonds), 145 (relating to qualified 501(c)(3) bonds), 148 (relating to arbitrage), 150 (relating to change of use), and 1394 (relating to enterprise zone facility bonds). On June 8, 1995, the IRS held a public hearing on the proposed regulations. Written comments responding to the proposed regulations were received.

This Treasury decision addresses the issues relating to enterprise zone facility bonds. Later guidance will be published relating to sections 141, 145, 148, and 150. After consideration of all the comments, the proposed regulations under section 1394 (relating to enterprise zone facility bonds) are adopted as revised by this Treasury decision. The principal revisions to the proposed regulations under section 1394 are discussed below.

Explanation of Provisions

Section 1394 applies to bonds issued to provide enterprise zone facilities in both empowerment zones and enterprise communities (zones).

A. *Period of compliance.*

The proposed regulations in general require compliance with the requirements applicable to enterprise zone facility bonds throughout the term of the enterprise zone facility bonds. The proposed regulations provide two exceptions to this general rule: (i) a business that is first established in connection with the issuance of enterprise zone facility bonds does not need to meet the requirements of an enterprise zone business and enterprise zone property until the "testing date," which is the later of one year after the issue date or one year after the date on which the financed property is placed in service, and (ii) the issuer and principal user of the facility are permitted a one-year period to cure noncompliance.

The final regulations modify the general rule to require compliance with the requirements applicable to enterprise zone facility bonds throughout the greater of (i) the remainder of the period during which the zone designation is in effect under section 1391 (zone designation period), and (ii) the period that ends on the weighted average maturity date of the enterprise zone facility bonds. The final regulations also provide that, in general, compliance with the requirements applicable to enterprise zone facility bonds is not required after the date on which the last of the enterprise zone facility bonds of the issue cease to be outstanding.

1. *Start of compliance period.*

Commentators requested that the testing date provisions be extended to all businesses, not just start-up businesses. Commentators also suggested lengthening the start-up period. The final regulations follow the recommendation to expand the testing date provisions to all issuers and principal users of property financed with enterprise zone facility bonds if the issuer and the principal user reasonably expect that the requirements will be met by the testing date and proceed with due diligence to comply with the requirements. The start-up period is increased to the later of 18 months after the issue date or 18 months after the date on which the financed property is placed in service.

2. *Compliance period for certain requirements.*

Commentators suggested that compliance with the requirements for an enterprise zone business should be based only on reasonable expectations on the issue date. Commentators suggested that, alternatively, the required compliance period should be reduced to either (i) three years (similar to the test period for qualified small issue manufacturing bonds), or (ii) the remainder of the zone designation period.

Issuers and principal users should be required to meet the requirements applicable to enterprise zone facility bonds for a meaningful period of time in order to further the goals of economic development in the zones. Therefore, for purposes of meeting the requirements applicable to enterprise zone facility bonds, the final regulations in general require issuers and principal users of financed property to meet the requirements throughout the greater of (i) the remainder of the zone designation period, and (ii) the period that ends on the weighted average maturity date of the enterprise zone facility bonds.

While compliance is generally not required after the enterprise zone facility bonds are retired, the final regulations do require issuers and principal users to meet the requirements of an enterprise zone business and enterprise zone property for a minimum compliance period of at least three years after the initial testing date. The final regulations permit the issuer to identify an alternative initial testing date. This alternative initial testing date is a date after the issue date of the enterprise zone facility bonds and prior to the initial testing date that would have been otherwise determined under the final regulations.

Principal users are subject to the change in use penalty of section 1394(e) throughout the greater of (i) the remainder of the zone designation period, and (ii) the period that ends on the weighted average maturity date of the enterprise zone facility bonds.

3. *Measurement of compliance.*

The proposed regulations provide guidance on meeting the enterprise zone business definitions. Commentators pointed out several difficulties in meeting the tests in the proposed regulations and in curing noncompliance within a one-year period. Commentators also asked for guidance

on how part-time employees are to be treated for the 35 percent resident employee requirement.

In general, each of the enterprise zone business requirements applies over taxable year periods. The beginning and end of the period of required compliance, however, may not correspond to the beginning and ending dates of the principal user's taxable year. The proposed regulations do not address the treatment of a taxable year only a part of which falls in a required compliance period. The final regulations provide that a taxable year is disregarded if the part of the year that falls in a required compliance period does not exceed 90 days.

Although the final regulations generally require annual compliance for the requirements under sections 1397B and 1397C, the final regulations allow a five-year averaging, taking into account only immediately preceding years going back to the taxable year that includes the initial testing date. The requirements under sections 1397B and 1397C include requirements relating to location of performance of employee services, location of tangible and intangible property, source of gross income from the active conduct of business, and the residence of employees. The averaging approach permits principal users who exceed the requirements to provide a cushion for future unanticipated noncompliance (for example, a non-recurring extraordinary payment for services performed outside the zone).

The final regulations allow the 35 percent resident employee requirement to be met on any reasonable basis (for example, on a per-employee basis or on the basis of employee actual work hours). For purposes of the per-employee fraction, employees working less than 15 hours a week are not included in the numerator or the denominator. The principal user must consistently apply the method to determine compliance with the 35 percent resident employee requirement throughout the required compliance period.

The final regulations also provide that a zone employee who moves out of the zone may continue to be treated as a resident of the zone, provided that employee was a bona fide resident of the zone, that employee continues to perform services for the principal user in an enterprise zone business in the zone and substantially all of those services are performed in the zone, and the principal user hires a resident of the zone for the next available comparable (or lesser) position.

The final regulations reduce the "substantially all" requirement for purposes of various tests under sections 1397B and 1397C from 90 percent to 85 percent.

B. *Qualified zone property definition.*

The proposed regulations provide that property that has been abandoned for more than one year meets the original use requirement. The final regulations provide that if real property is vacant for at least a one-year period including the date of zone designation, use prior to that period is disregarded for purposes of determining original use.

C. *Other rules.*

Commentators requested guidance on the appropriate method for treating activities within the zone as though they constituted a separately incorporated business for purposes of the enterprise zone business test.

The final regulations allow a business to treat its activities within a zone as part of a separately incorporated business if it allocates income and activities attributable to the business within the zone using a reasonable allocation method and has evidence of its allocations sufficient to establish compliance with the various requirements.

D. *Principal user.*

The proposed regulations do not address the requirement that "the principal user" of the enterprise zone facility bond proceeds be an enterprise zone business. Commentators suggested that principal user generally be defined in the same manner as in the regulations applicable to qualified small issue bonds and qualified 501(c)(3) bonds, which relate to use of bond proceeds by "any" principal user, but without applying the definition to customers. One commentator (relying on the definition of a qualifying business) suggested that financing for commercial real estate owned by a business that is not an enterprise zone business should be permitted, so long as 50 percent of the gross rental income comes from lessees that are enterprise zone businesses.

The final regulations provide that an owner of financed property is the principal user except that, in the case of commercial real estate, the lessee may be treated as the principal user if the rental of the property is a qualified business under section 1397B(d)(2).

Special Analyses

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

* * * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Section 1.1394–1 also issued under 26 U.S.C. 1397D.

Par. 2. Sections 1.1394–0 and 1.1394–1 are added under the undesignated centerheading "DEFINITIONS; SPECIAL RULES" to read as follows:

§1.1394–0 Table of contents.

This section lists the major paragraph headings contained in §1.1394–1.

§1.1394–1 Enterprise zone facility bonds.

(a) Scope.
(b) Period of compliance.
  (1) In general.
  (2) Compliance after an issue is retired.
  (3) Deemed compliance.
(c) Special rules for requirements of sections 1397B and 1397C.
  (1) Start of compliance period.
  (2) Compliance period for certain prohibited activities.
  (3) Minimum compliance period.
  (4) Initial testing date.
(d) Testing on an average basis.
(e) Resident employee requirements.
  (1) Determination of employee status.
  (2) Employee treated as zone resident.
  (3) Resident employee percentage.
(f) Application to pooled financing bond and loan recycling programs.
(g) Limitation on amount of bonds.
  (1) Determination of outstanding amount.
  (2) Pooled financing bond programs.
(h) Original use requirement for purposes of qualified zone property.
(i) Land.
(j) Principal user.
  (1) In general.
  (2) Rental of real property.
  (3) Pooled financing bond program.
(k) Treatment as separately incorporated business.
(l) Substantially all.
(m) Application of sections 142 and 146 through 150.
  (1) In general.
  (2) Maturity limitation.
  (3) Volume cap.
  (4) Remedial actions.
(n) Continuing compliance and change of use penalties.
  (1) In general.
  (2) Coordination with deemed compliance provisions.
  (3) Application to pooled financing bond and loan recycling programs.
  (4) Section 150(b)(4) inapplicable.
(o) Refunding bonds.
  (1) In general.
  (2) Maturity limitation.
(p) Examples.
(q) Effective dates.
  (1) In general.
  (2) Elective retroactive application in whole.

§1.1394–1 Enterprise zone facility bonds.

(a) *Scope.* This section contains rules relating to tax-exempt bonds under section 1394 (enterprise zone facility bonds) to provide enterprise zone facilities in both empowerment zones and enterprise communities (zones). See sections 1394, 1397B, and 1397C for other rules and definitions.

(b) *Period of compliance*—(1) *In general.* Except as provided in paragraphs (b)(2) and (c) of this section, the requirements under sections 1394(a) and (b) applicable to enterprise zone facility bonds must be complied with throughout the greater of the following—

(i) The remainder of the period during which the zone designation is in effect under section 1391 (zone designation period); and

(ii) The period that ends on the weighted average maturity date of the enterprise zone facility bonds.

(2) *Compliance after an issue is retired.* Except as provided in paragraph (c)(3) of this section, the requirements applicable to enterprise zone facility bonds do not apply to an issue after the date on which no enterprise zone facility bonds of the issue are outstanding.

(3) *Deemed compliance*—(i) *General rule.* An issue is deemed to comply with the requirements of sections 1394(a) and (b) if—

(A) The issuer and the principal user in good faith attempt to meet the requirements of sections 1394(a) and (b) throughout the period of compliance required under this section; and

(B) Any failure to meet these requirements is corrected within a one-year period after the failure is first discovered.

(ii) *Exception.* The provisions of paragraph (b)(3)(i) of this section do not apply to the requirements of section 1397B(d)(5)(A) (relating to certain prohibited business activities).

(iii) *Good faith.* In order to satisfy the good faith requirement of paragraph (b)(3)(i)(A) of this section, the principal user must at least annually demonstrate to the issuer the principal user's monitoring of compliance with the requirements of sections 1394(a) and (b).

(c) *Special rules for requirements of sections 1397B and 1397C*—(1) *Start of compliance period.* Except as provided in paragraph (c)(2) of this section, the requirements of sections 1397B (relating to qualification as an enterprise zone business) and 1397C (relating to satisfaction of the rules for qualified zone property) do not apply prior to the *initial testing date* (as defined in paragraph (c)(4) of this section) if—

(i) The issuer and the principal user reasonably expect on the issue date of the enterprise zone facility bonds that those requirements will be met by the principal user on or before the initial testing date; and

(ii) The issuer and the principal user exercise due diligence to meet those requirements prior to the initial testing date.

(2) *Compliance period for certain prohibited activities.* The requirements of section 1397B(d)(5)(A) (relating to certain prohibited business activities) must be complied with throughout the term of the enterprise zone facility bonds.

(3) *Minimum compliance period.* The requirements of sections 1397B(b) or (c) and 1397C must be satisfied for a continuous period of at least three years after the initial testing date, notwithstanding that—

(i) The period of compliance required under paragraph (b)(1) of this section expires before the end of the three-year period; or

(ii) The enterprise zone facility bonds are retired before the end of the three-year period.

(4) *Initial testing date*—(i) *In general.* Except as otherwise provided in paragraph (c)(4)(ii) of this section, the initial testing date is the date that is 18 months after the later of the issue date of the enterprise zone facility bonds or the date on which the financed property is placed in service; provided, however, it is not later than—

(A) Three years after the issue date; or

(B) Five years after the issue date, if the issue finances a construction project for which both the issuer and a licensed architect or engineer certify on or before the issue date of the enterprise zone facility bonds that more than three years after the issue date is necessary to complete construction of the project.

(ii) *Alternative initial testing date.* If the issuer identifies as the initial testing date a date after the issue date of the enterprise zone facility bonds and prior to the initial testing date that would

have been determined under paragraph (c)(4)(i) of this section, that earlier date is treated as the initial testing date.

(d) *Testing on an average basis.* Compliance with each of the requirements of section 1397B(b) or (c) is tested each taxable year. Compliance with any of the requirements may be tested on an average basis, taking into account up to four immediately preceding taxable years plus the current taxable year. The earliest taxable year that may be taken into account for purposes of the preceding sentence is the taxable year that includes the initial testing date. A taxable year is disregarded if the part of the taxable year that falls in a required compliance period does not exceed 90 days.

(e) *Resident employee requirements*—(1) *Determination of employee status.* For purposes of the requirement of section 1397B(b)(6) or (c)(5) that at least 35 percent of the employees are residents of the zone, the issuer and the principal user may rely on a certification, signed under penalties of perjury by the employee, provided—

(i) The certification provides to the principal user the address of the employee's principal residence;

(ii) The employee is required by the certification to notify the principal user of a change of the employee's principal residence; and

(iii) Neither the issuer nor the principal user has actual knowledge that the principal residence set forth in the certification is not the employee's principal residence.

(2) *Employee treated as zone resident.* If an issue fails to comply with the requirement of section 1397B(b)(6) or (c)(5) because an employee who initially resided in the zone moves out of the zone, that employee is treated as still residing in the zone if—

(i) That employee was a bona fide resident of the zone at the time of the certification described in paragraph (e)(1) of this section;

(ii) That employee continues to perform services for the principal user in an enterprise zone business and substantially all of those services are performed in the zone; and

(iii) A resident of the zone meeting the requirements of section 1397B(b)-(5) or (c)(4) is hired by the principal user for the next available comparable (or lesser) position.

(3) *Resident employee percentage.* For purposes of meeting the requirement of section 1397B(b)(6) or (c)(5) that at least 35 percent of the employees of an enterprise zone business are residents of a zone, paragraphs (e)(3)(i) and (ii) of this section apply.

(i) The term *employee* includes a self-employed individual within the meaning of section 401(c)(1).

(ii) The resident employee percentage is determined on any reasonable basis consistently applied throughout the period of compliance required under this section. The per-employee fraction (as defined in paragraph (e)(3)(ii)(A) of this section) or the employee actual work hour fraction (as defined in paragraph (e)(3)(ii)(B) of this section) are both reasonable methods.

(A) The term *per-employee fraction* means the fraction, the numerator of which is, during the taxable year, the number of employees who work at least 15 hours a week for the principal user, who reside in the zone, and who are employed for at least 90 days, and the denominator of which is, during the same taxable year, the aggregate number of all employees who work at least 15 hours a week for the principal user and who are employed for at least 90 days.

(B) The term *employee actual work hour fraction* means the fraction, the numerator of which is the aggregate total actual hours of work for the principal user of employees who reside in the zone during a taxable year, and the denominator of which is the aggregate total actual hours of work for the principal user of all employees during the same taxable year.

(f) *Application to pooled financing bond and loan recycling programs.* In the case of a pooled financing bond program described in paragraph (g)(2) of this section or a loan recycling program described in paragraph (m)(2)-(ii) of this section, the requirements of paragraphs (b) through (e) of this section apply on a loan-by-loan basis. See also paragraphs (g)(2) (relating to limitation on amount of bonds), (m)(2) (relating to maturity limitations), (m)(3) (relating to volume cap), and (m)(4) (relating to remedial actions) of this section.

(g) *Limitation on amount of bonds*—(1) *Determination of outstanding amount.* Whether an issue satisfies the requirements of section 1394(c) (relating to the $3 million and $20 million aggregate limitations on the amount of outstanding enterprise zone facility bonds) is determined as of the issue date of that issue, based on the issue price of that issue and the adjusted issue price of outstanding enterprise zone facility bonds. Amounts of outstanding enterprise zone facility bonds allocable to any entity are determined under rules contained in section 144(a)-(10)(C) and the underlying regulations. Thus, the definition of *principal user* for purposes of section 1394(c) is different from the definition of *principal user* for purposes of paragraph (j) of this section.

(2) *Pooled financing bond programs*—(i) *In general.* The limitations of section 1394(c) for an issue for a pooled financing bond program are determined with regard to the amount of the actual loans to enterprise zone businesses rather than the amount lent to *intermediary lenders* as defined in paragraph (g)(2)(ii) of this section. This paragraph (g)(2) applies only to the extent the proceeds of those enterprise zone facility bonds are loaned to one or more enterprise zone businesses within 42 months of the issue date of the enterprise zone facility bonds or are used to redeem enterprise zone facility bonds of the issue within that 42-month period.

(ii) *Pooled financing bond program defined.* For purposes of this section, a *pooled financing bond program* is a program in which the issuer of enterprise zone facility bonds, in order to provide loans to enterprise zone businesses, lends the proceeds of the enterprise zone facility bonds to a bank or similar intermediary (intermediary lender) which must then relend the proceeds to two or more enterprise zone businesses.

(h) *Original use requirement for purposes of qualified zone property.* In general, for purposes of section 1397C(a)(1)(B), the term *original use* means the first use to which the property is put within the zone. For purposes of section 1394, if property is vacant for at least a one-year period including the date of zone designation, use prior to that period is disregarded for purposes of determining original use. For this purpose, *de minimis* incidental uses of property, such as renting the side of a building for a billboard, are disregarded.

(i) *Land.* The determination of whether land is functionally related and subordinate to qualified zone property is made in a manner consistent with the

rules for exempt facilities under section 142.

(j) *Principal user*—(1) *In general.* Except as provided in paragraph (j)(2) of this section, the term *principal user* means the owner of financed property.

(2) *Rental of real property*—(i) *A lessee as the principal user.* If an owner of real property financed with enterprise zone facility bonds is not an enterprise zone business within the meaning of section 1397B, but the rental of the property is a qualified business within the meaning of section 1397B(d)(2), the term *principal user* for purposes of sections 1394(b) and (c) means the lessee or lessees.

(ii) *Allocation of enterprise zone facility bonds.* If a lessee is the principal user of real property under paragraph (j)(2)(i) of this section, then proceeds of enterprise zone facility bonds may be allocated to expenditures for real property only to the extent of the property allocable to the lessee's leased space, including expenditures for common areas.

(3) *Pooled financing bond program.* An intermediary lender in a pooled financing bond program described in paragraph (g)(2) of this section is not treated as the principal user.

(k) *Treatment as separately incorporated business.* For purposes of section 1394(b)(3)(B), a trade or business may be treated as separately incorporated if allocations of income and activities attributable to the business conducted within the zone are made using a reasonable allocation method and if that trade or business has evidence of those allocations sufficient to establish compliance with the requirements of paragraphs (b) through (f) of this section. Whether an allocation method is reasonable will depend upon the facts and circumstances. An allocation method will not be considered to be reasonable unless the allocation method is applied consistently by the trade or business and is consistent with the purposes of section 1394.

(l) *Substantially all.* For purposes of sections 1397B and 1397C(a), the term *substantially all* means 85 percent.

(m) *Application of sections 142 and 146 through 150*—(1) *In general.* Except as provided in this paragraph (m), enterprise zone facility bonds are treated as exempt facility bonds that are described in section 142(a), and all regulations generally applicable to exempt facility bonds apply to enterprise zone facility bonds. For this purpose, enterprise zone businesses are treated as meeting the public use requirement. Sections 147(c)(1)(A) (relating to limitations on financing the acquisition of land), 147(d) (relating to financing the acquisition of existing property), and 142(b)(2) (relating to limitations on financing office space) do not apply to enterprise zone facility bonds. See also paragraph (n)(4) of this section.

(2) *Maturity limitation*—(i) *Requirements.* An issue of enterprise zone facility bonds, the proceeds of which are to be used as part of a loan recycling program, satisfies the requirements of section 147(b) if—

(A) Each loan satisfies the requirements of section 147(b) (determined by treating each separate loan as a separate issue); and

(B) The term of the issue does not exceed 30 years.

(ii) *Loan recycling program defined.* A *loan recycling program* is a program in which—

(A) The issuer reasonably expects as of the issue date of the enterprise zone facility bonds that loan repayments from principal users will be used to make additional loans during the zone designation period;

(B) Repayments of principal on loans (including prepayments) received during the zone designation period are used within six months of the date of receipt either to make new loans to enterprise zone businesses or to redeem enterprise zone facility bonds that are part of the issue; and

(C) Repayments of principal on loans (including prepayments) received after the zone designation period are used to redeem enterprise zone facility bonds that are part of the issue within six months of the date of receipt.

(3) *Volume cap.* For purposes of applying section 146(f)(5)(A) (relating to elective carryforward of unused volume limitation), issuing enterprise zone facility bonds is a carryforward purpose.

(4) *Remedial actions.* In the case of a pooled financing bond program described in paragraph (g)(2) of this section or a loan recycling program described in paragraph (m)(2)(ii) of this section, if a loan fails to meet the requirements of paragraphs (b) through (f) of this section, within six months of noncompliance (after taking into account the deemed compliance provisions of paragraph (b)(3) of this section, if applicable), an amount equal to the outstanding loan principal must be prepaid and the issuer must—

(i) Reloan the amount of the prepayment; or

(ii) Use the prepayment to redeem an amount of outstanding enterprise zone facility bonds equal to the outstanding principal amount of the loan that no longer meets those requirements.

(n) *Continuing compliance and change of use penalties*—(1) *In general.* The penalty provisions of section 1394(e) apply throughout the period of compliance required under paragraph (b)(1) of this section.

(2) *Coordination with deemed compliance provisions.* Section 1394(c)(2) does not apply during any period during which the issue is deemed to comply with the requirements of section 1394 under the deemed compliance provisions of paragraph (b)(3) of this section.

(3) *Application to pooled financing bond and loan recycling programs.* In the case of a pooled financing bond program described in paragraph (g)(2) of this section or a loan recycling program described in paragraph (m)(2)(ii) of this section, section 1394(c) applies on a loan-by-loan basis.

(4) *Section 150(b)(4) inapplicable.* Section 150(b)(4) does not apply to enterprise zone facility bonds.

(o) *Refunding bonds*—(1) *In general.* An issue of bonds issued after the zone designation period to refund enterprise zone facility bonds (other than in an advance refunding) are treated as enterprise zone facility bonds if the refunding issue and the prior issue, if treated as a single combined issue, would meet all of the requirements for enterprise zone facility bonds, except the requirements in section 1394(c). For example, the compliance period described in paragraph (b)(1) of this section is calculated taking into account any extension of the weighted average maturity of the refunding issue compared to the remaining weighted average maturity of the prior issue. The proceeds of the refunding issue are allocated to the same expenditures and purpose investments as the prior issue.

(2) *Maturity limitation.* The maturity limitation of section 147(b) is applied to a refunding issue by taking into account the issuer's reasonable expectations about the economic life of the financed property as of the issue date of the prior issue and the actual

weighted average maturity of the combined refunding issue and prior issue.

(p) *Examples.* The following examples illustrate paragraphs (a) through (o) of this section:

Example 1. Averaging of enterprise zone business requirements. City C issues enterprise zone facility bonds, the proceeds of which are loaned by C to Corporation B to finance the acquisition of equipment for its existing business located in a zone. On the issue date of the enterprise zone facility bonds, B meets all of the requirements of section 1397B(b), except that only 25% of B's employees reside in the zone. C and B reasonably expect on the issue date to meet all requirements of section 1397B(b) by the date that is 18 months after the equipment is placed in service (the initial testing date). In each of the first, second, and third taxable years after the initial testing date, 35%, 40% and 45%, respectively, of B's employees are zone residents. In the fourth year after the testing date, only 25% of B's employees are zone residents. B continues to meet the 35% resident employee requirement, because the average of zone resident employees for those four taxable years is approximately 36%. The percentage of zone residents employed by B before the initial testing date is not included in determining whether B continues to comply with the 35% resident employee requirement.

Example 2. Measurement of resident employee percentage. Authority D issues enterprise zone facility bonds, the proceeds of which are loaned to Sole Proprietor F to establish an accounting business in a zone. In the first year after the initial testing date, the staff working for F includes F, who works 40 hours per week and does not live in the zone, one employee who resides in the zone and works 40 hours per week, one employee who does not reside in the zone and works 20 hours per week, and one employee who does not reside in the zone and works 10 hours per week. F meets the 35% resident employee test by calculating the percentage on the basis of employee actual work hours as described in paragraph (e)(3)(ii)(B) of this section. If F uses the per-employee basis as described in paragraph (e)(3)(ii)(A) of this section to determine if the resident employee test is met, the percentage of employees who are zone residents on a per-employee basis is only 33% because F must exclude from the numerator and the denominator the employee who works only 10 hours per week. If F calculates the resident employee test as a percentage of employee actual work hours as described in paragraph (e)(3)(ii)(B) of this section in the first year, F must calculate the resident employee test as a percentage of employee actual work hours each year.

Example 3. Active conduct of business within the zone. State G issues enterprise zone facility bonds and loans the proceeds to Corporation H to finance the acquisition of equipment for H's mail order clothing business, which is located in a zone. H purchases the supplies for its clothing business from suppliers located both within and outside of the zone and expects that orders will be received both from customers who will reside or work within the zone and from others outside the zone. All orders are received and filled at, and are shipped from, H's clothing business located in the zone. H meets the requirement that at least 80% of its gross income is derived from the active conduct of business within the zone.

Example 4. Enterprise zone business definition. City J issues enterprise zone facility bonds, the proceeds of which are loaned to Partnership K to finance the acquisition of equipment for its printing operation located in the zone. All orders are taken and completed, and all billing and accounting activities are performed, at the print shop located in the zone. K, on occasion, uses its equipment (including its trucks) and employees to deliver large print jobs to customers who reside outside of the zone. So long as K is able to establish that its trucks are used in the zone at least 85% of the time and its employees perform at least 85% of services for K in the zone, K meets the requirements of sections 1397B(b)(3) and (5).

Example 5. Treatment as a separately incorporated business. The facts are the same as in *Example 4* except that six years after the issue date of the enterprise zone facility bonds, K determines to expand its operations to a second location outside of the boundaries of the zone. Although the expansion would result in the failure of K to meet the tests of 1397B(b), K, using a reasonable allocation method, allocates income and activities to its operations within the zone and has evidence of these allocations sufficient to establish compliance with the requirements of paragraphs (b) through (f) of this section. The bonds will not fail to be enterprise zone facility bonds merely because of the expansion.

Example 6. Treatment of pooled financing bond programs. Authority L issues bonds in the aggregate principal amount of $5,000,000 and loans the proceeds to Bank M pursuant to a loans-to-lenders program. M does not meet the definition of enterprise zone business contained in section 1397B. Prior to the issue date of the bonds, L held a public hearing regarding issuance of the bonds for the loans-to-lenders program, describing the projects of identified borrowers to be financed initially with $4,000,000 of the proceeds of the bonds. The applicable elected representative of L approved issuance of the bonds subsequent to the public hearing. The loan agreement between L and M provides that the other proceeds of the bonds will be held by M and loaned to borrowers that qualify as enterprise zone businesses, following a public hearing and approval by the applicable elected representative of L of each loan by M to an enterprise zone business. None of the loans will be in principal amounts in excess of $3,000,000. The loans by M will otherwise meet the requirements of section 1394. The bonds will be enterprise zone facility bonds.

Example 7. Original use requirement for purposes of qualified zone property. City N issues enterprise zone facility bonds, the proceeds of which are loaned to Corporation P to finance the acquisition of equipment. P uses the proceeds after the zone designation date to purchase used equipment located outside of the zone and places the equipment in service at its location in the zone. Substantially all of the use of the equipment is in the zone and is in the active conduct of a qualified business by P. The equipment is treated as qualified enterprise zone property under section 1397C because P makes the first use of the property within the zone after the zone designation date.

Example 8. Principal user. State R issues enterprise zone facility bonds and loans the proceeds to Partnership S to finance the construction of a small shopping center to be located in a zone. S is in the business of commercial real estate. S is not an enterprise zone business, but has secured one anchor lessee, Corporation T, for the shopping center. T would qualify as an enterprise zone business. S will derive 60% of its gross rental income of the shopping center from T. S does not anticipate that the remaining rental income will come from enterprise zone businesses. T will occupy 60% of the total rentable space in the shopping center. S can use enterprise zone facility bond proceeds to finance the portion of the costs of the shopping center allocable to T (60%) because T is treated as the principal user of the enterprise zone facility bond proceeds.

Example 9. Remedial actions. State W issues pooled financing enterprise zone facility bonds, the proceeds of which will be loaned to several enterprise zone businesses in the two enterprise communities and one empowerment zone in W. Proceeds of the pooled financing bonds are loaned to Corporation X, an enterprise zone business, for a term of 10 years. Six years after the date of the loan, X expands its operations beyond the empowerment zone and is no longer able to meet the requirements of section 1394. X does not reasonably expect to be able to cure the noncompliance. The loan documents provide that X must prepay its loan in the event of noncompliance. W does not expect to be able to reloan the prepayment by X within six months of noncompliance. X's noncompliance will not affect the qualification of the pooled financing bonds as enterprise zone facility bonds if W uses the proceeds from the loan prepayment to redeem outstanding enterprise zone facility bonds within six months of noncompliance in an amount comparable to the outstanding amount of the loan immediately prior to prepayment. X will be denied an interest expense deduction for the interest accruing from the first day of the taxable year in which the noncompliance began.

(q) *Effective dates*—(1) *In general.* Except as otherwise provided in this section, the provisions of this section apply to all issues issued after July 30, 1996, and subject to section 1394.

(2) *Elective retroactive application in whole.* An issuer may apply the provisions of this section in whole, but not in part, to any issue that is outstanding on July 30, 1996, and is subject to section 1394.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved May 22, 1996.

Leslie Samuels,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on May 30, 1996, 8:45 a.m., and published in the issue of the Federal Register for May 31, 1996, 61 F.R. 27258)

Chapter 5.—Tax on Transfers to Avoid Income Tax

Section 1491.—Imposition of Tax

If the status of a trust changes from domestic to foreign, what are the consequences for purposes of the section 1491 excise tax? See Notice 96–65, page 232.

Chapter 6.—Consolidated Returns
Subchapter A.—Returns and Payment of Tax

Section 1502.—Regulations

26 CFR 1.1502–21T: Net operating losses (temporary).

T.D. 8677

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

Consolidated Returns—Limitations on the Use of Certain Losses and Deductions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary amendments to the consolidated return regulations relating to deductions and losses of members. The temporary amendments concern the method for computing the limitations with respect to separate return limitation year (SRLY) losses. They also concern the rules relating to carryover and carryback of losses to consolidated and separate return years and to the built-in deduction rules. Final amendments are made amending definitions and redesignating sections displaced by temporary regulations. The text of these temporary regulations also serves as the text of the proposed regulations set forth in CO–24–96 on page 437.

DATES: These amendments are effective Thursday, June 27, 1996. For dates of application and special transition rules, see Effective Dates under SUPPLEMENTARY INFORMATION.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in the temporary regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under the control number 1545–1237. Section 1.1502–21T(b)(3) requires a response from certain consolidated groups. The IRS requires the information to assure that an election to relinquish a carryback period is properly documented. Reponses to this collection of information are required to obtain a benefit (relating to the carryover of losses which would otherwise be carried back).

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

For further information concerning this collection of information, and where to submit comments on the collection of information and the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble to the cross-referencing notice of proposed rulemaking published in this issue of the Bulletin.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background and Explanation of Provisions

On February 4, 1991, the IRS and Treasury published in the **Federal Register** a notice of proposed rulemaking (CO–078–90, 56 FR 4228) setting forth amendments to the rules regarding the net operating losses, built-in deductions, and capital losses of consolidated groups, including rules regarding the carryover and carryback of losses to consolidated and separate return years. Some of the amendments are clarifying, and some change the existing rules. The principal changes related to losses arising in (or carried to) SRLY years. The preamble to the proposed amendments explains the proposed changes in detail. The IRS and Treasury also published Notice 91–27 (1991–2 C.B. 629) to advise of intended modifications to the proposed amendments.

Generally, section 1503(a) requires that a consolidated group determine its tax in accordance with the regulations under section 1502 prescribed before the last day prescribed by law for the filing of its tax return. Many of the proposed amendments have proposed effective dates of January 29, 1991, and other transitional rules for their application. Because of this effective date, consolidated groups have been uncertain whether the existing rules or the proposed rules (if adopted) will determine their use of losses for consolidated return years ending on or after January 29, 1991.

To address the uncertainty, the IRS and Treasury are issuing this Treasury decision to adopt temporary amendments to the rules regarding a consolidated group's losses, including the carryover and carryback of SRLY losses. The temporary amendments are substantially identical to the rules proposed on January 29, 1991. A more detailed discussion of the effective dates of the temporary amendments, including special transitional rules, is set forth below under *Effective Dates.*

These temporary amendments primarily address the uncertainty created by the proposed effective dates. They do not address the comments on the proposed amendments. Many of these comments are still under consideration.

As companions to this Treasury decision, the IRS and Treasury also issue two other sets of temporary regulations under sections 382 and 383 concerning the use of losses and deductions by consolidated groups and by members of controlled groups. See TD 8678 on page 134 and TD 8679 on page 25.

Effective Date

The temporary amendments are generally effective for consolidated return years beginning on or after January 1, 1997. However, two important changes are made to the effective date provisions set forth in the proposed rules.

As proposed, the amendments generally applied to consolidated return years ending on or after January 29, 1991, without regard to the year in which the losses arose and without regard to whether the losses are subject to the SRLY rules. An exception to the general effective date rules was made for the proposed SRLY rules and built-in deduction rules, which generally applied only to losses and deductions of corporations that became members (and acquisitions occurring) on or after January 29, 1991, without regard to when they arose. Thus, the proposed amendments required the losses and deductions of members acquired before January 29, 1991, to remain subject to the existing SRLY limitations.

The temporary amendments revise this treatment. Losses and deductions of a member (including SRLY losses) carried to consolidated return years beginning on or after January 1, 1997, are governed by the temporary amendments, regardless of the year in which the loss or deduction was recognized, and regardless of when the member with the SRLY loss became a member of the group.

The temporary amendments also contain rules relating to consolidated return years ending on or after January 29, 1991, and beginning before January 1, 1997. Specifically, a consolidated group may apply the temporary amendments to those consolidated return years provided that three principal conditions are met: (1) all the temporary amendments must be applied consistently on the group's final return (original or amended return) for each such year for which the statute of limitations does not preclude the filing of an amended return on January 1, 1997; (2) the temporary amendments relating to the treatment of built-in deductions and SRLY losses must be applied with respect to the losses and deductions of those corporations that became members of the group, and to acquisitions occurring, on or after January 29, 1991, and only with respect to such losses and deductions; and (3) appropriate adjustments must be made in the earliest subsequent open year to reflect any inconsistency in a year for which the statute of limitations precludes the filing of an amended return on January 1, 1997. Until consolidated return years beginning on or after January 1, 1997, the rules of the existing regulations relating to the treatment of built-in deductions and SRLY losses continue to apply to corporations that became members before, and to acquisitions occurring before, January 29, 1991. See § 1.1502–21T(g)(3).

SPECIAL ANALYSIS

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations do not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations will primarily affect affiliated groups of corporations that have elected to file consolidated returns, which tend to be larger businesses. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations were sent to the Small Business Administration for comment on their impact on small business.

Adoption of Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Section 1.1502–0 also issued under 26 U.S.C. 1502.* * *

Section 1.1502–11T also issued under 26 U.S.C. 1502.

Section 1.1502–2 also issued under 26 U.S.C. 1502.* * *

Section 1.1502–15T also issued under 26 U.S.C. 1502.* * *

Section 1.1502–21T also issued under 26 U.S.C. 1502.

Section 1.1502–22T also issued under 26 U.S.C. 1502.

Section 1.1502–23T also issued under 26 U.S.C. 1502.* * *

Section 1.1502–79 also issued under 26 U.S.C. 1502.

Section 1.1502–15A also issued under 26 U.S.C. 1502.

Section 1.1502–21A also issued under 26 U.S.C. 1502.

Section 1.1502–22A also issued under 26 U.S.C. 1502. Section 1.1502–23A also issued under 26 U.S.C. 1502.

Section 1.1502–41A also issued under 26 U.S.C. 1502.

Section 1.1502–79A also issued under 26 U.S.C. 1502.* * *

Par. 2. In the list below, for each section indicated in the left column, remove the wording indicated in the middle column, and add the wording indicated in the right column.

Affected Section	*Remove*	*Add*
1.469–1(h)(2)	1.1502–21 (consolidated net operating loss), and 1.1502–22 (consolidated net capital gain or loss)	1.1502–21T (Net operating losses (temporary)), and 1.1502–22T (consolidated net capital gain and loss (temporary))
1.597–2(c)(5), first sentence	§§ 1.1502–15, 1.1502–21, and 1.1502–22	§§ 1.1502–15T, 1.1502–21T, and 1.1502–22T (or §§ 1.1502–15A, 1.1502–21A, and 1.1502–22A, as appropriate)
1.597–2(c)(5), second sentence	§§ 1.1502–15, 1.1502–21 or 1.1502–22	§§ 1.1502–15T, 1.1502–21T or 1.1502–22T (or §§ 1.1502–15A, 1.1502–21A or 1.1502–22A, as appropriate)
1.597–4(g)(3), fifth sentence	§§ 1.1502–15, 1.1502–21 and 1.1502–22	§§ 1.1502–15T, 1.1502–21T and 1.1502–22T (or §§ 1.1502–15A, 1.1502–21A and 1.1502–22A, as appropriate)
1.597–4(g)(3), sixth sentence	§§ 1.1502–15, 1.1502–21, or 1.1502–22	§§ 1.1502–15T, 1.1502–21T, or 1.1502–22T (or §§ 1.1502–15A, 1.1502–21A, or 1.1502–22A, as appropriate)
1.904(f)–3(a)	(or §§ 1.1502–21(b) and 1.1502–79(a)) (or § 1.1502–21T(b)	(or §§ 1.1502–21A(b) and 1.1502–79A(a), as appropriate))

Affected Section	*Remove*	*Add*
1.904(f)–3(b)	(or §§ 1.1502–22 and 1.1502–79(b)	(or § 1.1502–22T(b) (or §§ 1.1502–22A and 1.1502–79A(b), as appropriate))
1.1341–1(f)(2)(i)	§ 1.1502–2A	§ 1.1502–2A (as contained in the 26 C.F.R. edition revised as of April 1, 1996)
1.1502–9(a), seventh sentence	§ 1.1502–79	§ 1.1502–21T(b)(2) (or § 1.1502–79A, as appropriate)
1.1502–9(a), eighth sentence	§ 1.1502–79	§ 1.1502–21T(b)(1) (or § 1.1502–79A, as appropriate)
1.1502–9(f) Example 5(ii)	§ 1.1502–21(c)	§ 1.1502–21A(c)
1.1502–11(a)(2)	§ 1.1502–21	§§ 1.1502–21T (or 1.1502–21A, as appropriate)
1.1502–11(a)(3)	§ 1.1502–22	§§ 1.1502–22T (or 1.1502–22A, as appropriate)
1.1502–11(a)(4)	§ 1.1502–23	§§ 1.1502–23T (or 1.1502–23A, as appropriate)
1.1502–11(b)(2)(iii) Example 1(c)	§ 1.1502–79	§ 1.1502–21T (or § 1.1502–79A, as appropriate)
1.1502–11(b)(2)(iii) Example 2(d)	§ 1.1502–79	§§ 1.1502–21T and 1.1502–22T, respectively (or § 1.1502–79A, as appropriate),
1.1502–11(b)(2)(iii) Example 3(e)	§ 1.1502–79	§ 1.1502–21T (or § 1.1502–79A, as appropriate)
1.1502–12(b)	§ 1.1502–15 shall be taken into account as provided in that section	§§ 1.1502–15A or 1.1502–15T shall be taken into account as provided in those sections
1.1502–13(c)(7)(ii) Example 10(d)	§ 1.1502–21(c)	§ 1.1502–21T(c)
1.1502–13(g)(5) Example 4(b)	§ 1.1502–15	§ 1.1502–15T (or § 1.1502–15A, as appropriate)
1.1502–13(h)(2), Example 1(a)	§ 1.1502–21(c)	§ 1.1502–21T(c)
1.1502–13(h)(2) Example 1(b)	§ 1.1502–21(c)	§ 1.1502–21T(c)
1.1502–13(h)(2) Example 2(a)	§ 1.1502–15	§ 1.1502–15T
1.1502–13(h)(2) Example 2(b)	§ 1.1502–22(c)	§ 1.1502–22T
1.1502–15(a)(1), first sentence	§ 1.1502–21(c)	§ 1.1502–21A(c)
1.1502–15(a)(1), first sentence	§ 1.1502–22(c)	§ 1.1502–22A(c)
1.1502–15(a)(1), second sentence	under §§ 1.1502–21, 1.1502–22, and 1.1502–79	under §§ 1.1502–21A, 1.1502–22A, and 1.1502–79A (or §§ 1.1502–21T and 1.1502–22T, as appropriate)
1.1502–15(a)(1), second sentence	in § 1.1502–21(c) or § 1.1502–22(c) (as the case may be)	in §§ 1.1502–21T(c) or 1.1502–22T(c) (or §§ 1.1502–21A(c) or 1.1502–22A(c), as appropriate), as the case may be
1.1502–15(a)(3)	§ 1.1502–31A(b)(9)	§ 1.1502–31A(b)(9) (as contained in the 26 C.F.R. edition revised as of April 1, 1996)
1.1502–18(f)(1)(ii), (1)(iii), (2)(i), (2)(ii), and (4) Example (i) and (ii)	§ 1.1502–39A	§ 1.1502–39A (as contained in the 26 C.F.R. edition revised as of April 1, 1996)
1.1502–18(f)(5)	§ 1.1502–31A(b)(1)	§ 1.1502–31A(b)(1) (as contained in the 26 C.F.R. edition revised as of April 1, 1996)
1.1502–20(a)(1)	1.1502–15(b)	1.1502–11(c)
1.1502–20(c)(4), Example 7(iii)	§ 1.1502–21	§§ 1.1502–21A or 1.1502–21T

Affected Section	*Remove*	*Add*
1.1502–20(g)(3), Example 1(i)	§ 1.1502–21	§§ 1.1502–21A or 1.1502–21T
1.1502–20(g)(3), Example 2(i)	§ 1.1502–21	§§ 1.1502–21A or 1.1502–21T
1.1502–21(b)(1)	paragraph (a) of § 1.1502–79	§§ 1.1502–79A(a)
1.1502–21(b)(1)	§ 1.1502–15	§ 1.1502–15A (or § 1.1502–11(c), as appropriate)
1.1502–21(b)(2)(i)	paragraph (a)(4) of § 1.1502–79	this paragraph
1.1502–21(e)(1)(i)	paragraph (a)(3) of § 1.1502–79	this paragraph
1.1502–22(a)(1)(ii)	§ 1.1502–23	§§ 1.1502–23A or 1.1502–23T
1.1502–22(a)(3)	§ 1.1502–15	§§ 1.1502–15A and 1.1502–11(c)
1.1502–22(b)(1)	paragraph (b) of § 1.1502–79	§ 1.1502–79A(b) (or § 1.1502–22T(b), as appropriate)
1.1502–23	§§ 1.1502–21(c) and 1.1502–22(c), as provided in § 1.1502–15(a)	§§ 1.1502–21A(c) and 1.1502–22A(c), as provided in § 1.1502–15A(a) (or §§ 1.1502–21T(c) and 1.1502–22T(c), as provided in § 1.1502-15T(a), as appropriate)
1.1502–26(a)(1)(ii) concluding text	paragraph (f) of § 1.1502–21	§§ 1.1502–21T(e) or 1.1502–21A(f), as appropriate,
1.1502–32(b)(5) Example 2(b)	1.1502–79	1.1502–21T(b)
1.1502–41(a)	paragraph (a)(1) of § 1.1502–22	§ 1.1502–22A(a)
1.1502–41(a)	§ 1.1502–23	§ 1.1502–23A
1.1502–41(b)	paragraph (a)(1) of § 1.1502–22	§ 1.1502–22A(a)
1.1502–41(b)	paragraph (b) of § 1.1502–22	§ 1.1502–22A(b)
1.1502–42(f)(4)(i)(A)	§ 1.1502–79(a)(3)	§ 1.1502–21T(b) (or § 1.1502–79A(a)(3), as appropriate)
1.1502–42(j) Example 4(b)	§ 1.1502–79(a)(3)	§ 1.1502–79A(a)(3)
1.1502–42(j) Example 4(c)	§ 1.1502–21(b)(3)	§ 1.1502–21A(b)(3)
1.1502–42(j) Example 4(c)	§ 1.1502–79(a)(3)	§ 1.1502–79A(a)(3)
1.1502–43(b)(2)(iv)	§ 1.1502–21(a)	§§ 1.1502–21T(a) or 1.1502–21A(a), as appropriate
1.1502–43(b)(2)(v)	§ 1.1502–22(a)	§§ 1.1502–22T(a) or 1.1502–22A(a), as appropriate
1.1502–43(b)(2)(vi)	§ 1.1502–41(a)	§§ 1.1502–22T(a) or 1.1502–41A, as appropriate
1.1502–43(b)(2)(vi)	§ 1.1502–41(b)	§§ 1.1502–22T(a) or 1.1502–41A, as appropriate
1.1502–43(b)(2)(vii)	§ 1.1502–22(b)	§§ 1.1502–22T(b) or 1.1502–22A(b), as appropriate
1.1502–43(b)(2)(vi ii)	Section 1.1502–15 (built-in deductions) does	Sections 1.1502–15A (Limitations on built-in deductions not subject to § 1.1502–15T) and 1.1502–15T (SRLY limitation on built-in losses (temporary)) do
1.1502–44(b)(2)	§ 1.1502–21	§§ 1.1502–21T or 1.1502–21A (as appropriate)
1.1502–44(b)(3)	§ 1.1502–22	§§ 1.1502–22T or 1.1502–22A (as appropriate)
1.1502–47(h)(2)(i)	§ 1.1502–21	§§ 1.1502–21T or 1.1502–21A (as appropriate)

Affected Section	*Remove*	*Add*
1.1502–47(h)(2)(ii)	§ 1.1502–21(f)	§§ 1.1502–21(A)(f) or 1.1502–21T(e) (as appropriate)
1.1502–47(h)(2)(iii)	§ 1.1502–21	§§ 1.1502–21A or 1.1502–21T (as appropriate)
1.1502–47(h)(2)(iv)	§ 1.1502–21	§§ 1.1502–21A or 1.1502–21T (as appropriate)
1.1502–47(h)(2)(vii) Example	§§ 1.1502–21 and 1.1502–79	§§ 1.1502–21A and 1.1502–79A
1.1502–47(h)(3)(iii)	§ 1.1502–21(c)	§§ 1.1502–21A(c) or 1.1502–21T(c) (as appropriate)
1.1502–47(h)(3)(iv) and (v)	§ 1.1502–21(d)	§ 1.1502–21A(d)
1.1502–47(h)(4)(i), first sentence	§ 1.1502–22	§§ 1.1502–22T or 1.1502–22A (as appropriate)
1.1502–47(h)(4)(i), second sentence	§ 1.1502–22(a)	§§ 1.1502–22T or 1.1502–22A(a) (as appropriate)
1.1502–47(h)(4)(ii), first sentence	§ 1.1502–22	§§ 1.1502–22A or 1.1502–22T
1.1502–47(h)(4)(ii), first sentence	§ 1.1502–21	§§ 1.1502–21T or 1.1502–21A (as appropriate)
1.1502–47(h)(4)(ii), second sentence	"§ 1.1502–22(d)"	"§ 1.1502–22A(d)"
1.1502–47(h)(4)(ii), second sentence	"§ 1.1502–21(d)"	"§ 1.1502–21A(d)"
1.1502–47(h)(4)(iii)	§ 1.1502–22(b)(1)	§§ 1.1502–22A(b)(1) or 1.1502–22T(b)
1.1502–47(k)(5)	§ 1.1502–22	§§ 1.1502–22T or 1.1502–22A (as appropriate)
1.1502–47(l)(3)(i)	§ 1.1502–21	§§ 1.1502–21T or 1.1502–21A (as appropriate)
1.1502–47(m)(2)(ii)	§ 1.1502–21	§§ 1.1502–21T or 1.1502–21A (as appropriate)
1.1502–47(m)(2)(ii)	§ 1.1502–22	§§ 1.1502–22T or 1.1502–22A (as appropriate)
1.1502–47(m)(3)(i)	§§ 1.1502–21 and 1.1502–22	§§ 1.1502–21T and 1.1502–22T (or §§ 1.1502–21A and 1.1502–22A, as appropriate)
1.1502–47(m)(3)(vi)(A), both instances	§ 1.1502–79(a)(3)	§§ 1.1502–21T(b) or 1.1502–79A(a)(3) (as appropriate)
1.1502–47(m)(3)(vii)	§ 1.1502–21(b)(3)(ii)	§ 1.1502–21A(b)(3)(ii)
1.1502–47(m)(3)(ix)	§ 1.1502–15 (including the exceptions in paragraph (a)(4) thereof)	§§ 1.1502–15T and 1.1502–15A (including applicable exceptions thereto)
1.1502–47(m)(5) Example 4	§ 1.1502–15	§ 1.1502–15A
1.1502–47(o)(2)(i)	§ 1.1502–41	§§ 1.1502–41A or 1.1502–22T (as appropriate)
1.1502–47(o)(2)(ii)	§ 1.1502–41	§§ 1.1502–41A or 1.1502–22T (as appropriate)
1.1502–47(q)	§ 1.1502–21(b)(3) and § 1.1502–79(a)(3)	§§ 1.1502–21A(b)(3) and 1.1502–79A(a)(3) (or § 1.1502–21T, as appropriate)
1.1502–78(a)	§ 1.1502–79 (a), (b), or (c)	§§ 1.1502–21T(b), 1.1502–22T(b), or 1.1502–79(c) (or §§ 1.1502–79A(a), 1.1502–79A(b), or 1.1502–79(c), as appropriate)
1.1502–79(a)(1)(i)	§ 1.1502–21	§ 1.1502–21A
1.1502–79(b)(1)	1.1502–22	1.1502–22A

Affected Section	*Remove*	*Add*
1.1502–79(c)(1)	paragraph (a)(1) and (2) of this section	§ 1.1502–21T(b) (or §§ 1.1502–79A(a)(1) and (2), as appropriate)
1.1502–79(d)(1)	paragraph (a)(1) and (2) of this section	§ 1.1502–21T(b) (or §§ 1.1502–79A(a)(1) and (2), as appropriate)
1.1502–79(e)(1)	paragraph (a)(1) and (2) of this section	§ 1.1502–21T(b) (or §§ 1.1502–79A(a)(1) and (2), as appropriate)
1.1502–80(c)	§ 1.1502–15(b)	§ 1.1502–11(c)
1.1502–100(c)(2)	§ 1.1502–21	§§ 1.1502–21A or 1.1502–21T (as appropriate)
1.1503–2(d)(2)(i)	§ 1.1502–21(c)	§§ 1.1502–21A(c) or 1.1502–21T(c), as appropriate
1.1503–2(d)(2)(ii)	§ 1.1502–21(c)	§§ 1.1502–21A(c) or 1.1502–21T(c), as appropriate
1.1503–2(d)(4) Example 1(iv)	1.1502–22	1.1502–22T(c)
1.1503–2(d)(4) Example 2(iv)	§ 1.1502–21(c)	§ 1.1502–21A(c)
1.1503–2(g)(2)(vii)(B)(1)	§ 1.1502–21(c)	§§ 1.1502–21A(c) or 1.1502–21T(c) (as appropriate)
1.1503–2(g)(2)(vii)(B)(2)	§ 1.1502–21(c)	§§ 1.1502–21A(c) or 1.1502–21T(c) (as appropriate)
1.1503–2(g)(2)(vii)(E)	§ 1.1502–21(c)	§§ 1.1502–21A(c) or 1.1502–21T(c) (as appropriate)
1.1503–2(g)(2)(vii)(G) Example 1	§ 1.1502–21(c)	§§ 1.1502–21A(c) or 1.1502–21T(c), as appropriate
1.1503–2(g)(2)(vii)(G) Example 2	§ 1.1502–21(c)	§§ 1.1502–21A(c) or 1.1502–21T(c), as appropriate
1.1503–2(h)(3)	§ 1.1502–21(c)	§§ 1.1502–21A(c) or 1.1502–21T(c) (as appropriate)
1.1503–2A(f)(1)(i) intro text	§ 1.1502–79(a)(3)	§ 1.1502–21T(b)
1.1503–2A(f)(1)(i)(C)	§ 1.1502–79	§ 1.1502–22T(b)
1.1503–2A(f)(2)(i)	§ 1.1502–21(c)(2)	§§ 1.1502–21A(c)(2) or 1.1502–21T(c) (as appropriate)
1.1503–2A(f)(2)(ii)	§ 1.1502–21(c)(2)	§§ 1.1502–21A(c)(2) or 1.1502–21T(c) (as appropriate)
1.1503–2A(f)(4) Example 2(iv), first sentence	§ 1.1502–21(c)(2)	§ 1.1502–21A(c)(2)
1.1503–2A(f)(4) Example 2(iv), second sentence	§ 1.1502–21(c)	§ 1.1502–21A(c)
1.1552–1(a)(3)(i)	§ 1.1502–30A	§ 1.1502–30A (as contained in the 26 C.F.R. edition revised as of April 1, 1996)
1.1552–1(b)(1)	§ 1.1502–30A	§ 1.1502–30A (as contained in the 26 C.F.R. edition revised as of April 1, 1996)
301.6402–7(g)(2)(iii)	§ 1.1502–21(b)	§§ 1.1502–21T(b) or 1.1502–21A(b) (as appropriate)
301.6402–7(g)(3) Example 2, second sentence	§ 1.1502–21	§ 1.1502–21T
301.6402–7(g)(3) Example 2, third sentence	§ 1.1502–21(c)	§ 1.1502–21T(c)
301.6402–7(h)(1)(ii) Example(B)	1.1502–21(b)	1.1502–21T(b)
301.6402–7(h)(1)(ii) Example(B)	1.1502–22(b)	1.1502–22T(b)

§ 1.1501–1 [Removed]

Par. 3. Section 1.1501–1 is removed.

Par. 4. The undesignated centerheading immediately following § 1.1504–4 is revised from "REGULATIONS APPLICABLE TO TAXABLE YEARS PRIOR TO JANUARY 1, 1966" to "REGULATIONS APPLICABLE TO TAXABLE YEARS BEFORE JANUARY 1, 1997".

§§ 1.1502–0A through 1.1502–3A, 1.1502–10A through 1.1502–19A and 1.1502–30A through 1.1502–51A [Removed]

Par. 5. Sections 1.1502–0A through 1.1502–3A, 1.1502–10A through 1.1502–19A, and 1.1502–30A through 1.1502–51A are removed.

Par. 6. Section 1.1502–0 is revised to read as follows:

§ 1.1502–0 Effective dates.

(a) The regulations under section 1502 are applicable to taxable years beginning after December 31, 1965, except as otherwise provided therein.

(b) The provisions of §§ 1.1502–0A through 1.1502–3A, 1.1502–10A through 1.1502–19A, and 1.1502–30A through 1.1502–51A (as contained in the 26 CFR part 1 edition revised April 1, 1996) are applicable to taxable years beginning before January 1, 1966.

Par. 7. Section 1.1502–1 is amended by revising paragraphs (b), (f)(1), and (f)(2) introductory text, and adding paragraphs (f)(4) and (j), and reserving paragraph (i) to read as follows:

§ 1.1502–1 Definitions

* * * * *

(b) *Member.* The term *member* means a corporation (including the common parent) that is included in the group, or as the context may require, a corporation that is included in a subgroup.

* * * * *

(f) *Separate return limitation year*—(1) *In general.* Except as provided in paragraphs (f)(2) and (3) of this section, the term *separate return limitation year* (or *SRLY*) means any separate return year of a member or of a predecessor of a member.

(2) *Exceptions.* The term *separate return limitation year* (or *SRLY*) does not include:

* * * * *

(4) *Predecessors and successors.* The term *predecessor* means a transferor or distributor of assets to a member (the *successor*) in a transaction—

(i) To which section 381(a) applies; or

(ii) That occurs on or after January 1, 1997, in which the successor's basis for the assets is determined, directly or indirectly, in whole or in part, by reference to the basis of the assets of the transferor or distributor, but only if the amount by which basis differs from value, in the aggregate, is material. In the case of such a transaction, only one member may be considered a predecessor to or a successor of one other member.

* * * * *

(i) [Reserved]

(j) *Affiliated.* Corporations are affiliated if they are members of a group with each other.

Par. 8. In § 1.1502–2, paragraph (h) is revised to read as follows:

§ 1.1502–2 Computation of tax liability.

* * * * *

(h) The tax imposed by section 1201, instead of the taxes computed under paragraphs (a) and (g) of this section, computed by reference to the net capital gain of the group (see § 1.1502–22T) (or, for consolidated return years to which § 1.1502–22T does not apply, computed by reference to the excess of the consolidated net long-term capital gain over the consolidated net short-term capital loss (see § 1.1502–41A for the determination of the consolidated net long-term capital gain and the consolidated net short-term capital loss));

* * * * *

Par. 9. In § 1.1502–15, paragraph (b) is redesignated as paragraph (c) of § 1.1502–11, and the heading of newly designated § 1.1502–11, paragraph (c) is revised to read as follows:

§ 1.1502–11 Consolidated taxable income.

* * * * *

(c) *Disallowance of loss attributable to pre-1966 distributions.* * * *

Par. 10. Section 1.1502–15 is redesignated as § 1.1502–15A; the section heading of the newly designated § 1.1502–15A is revised; and paragraph (b) is added to read as follows:

§ 1.1502–15A Limitations on the allowance of built-in deductions for consolidated return years beginning before January 1, 1997.

* * * * *

(b) *Effective date.* This section applies to any consolidated return years to which § 1.1502–21T does not apply. See § 1.1502–21T(g) for effective dates of that section.

Par. 11. Section 1.1502–15T is added to read as follows:

§ 1.1502–15T SRLY limitation on built-in losses (temporary).

(a) *SRLY limitation.* Built-in losses are subject to the SRLY limitation under §§ 1.1502–21T(c) and 1.1502–22T(c) (including applicable subgroup principles). Built-in losses are treated as deductions or losses in the year recognized, except for the purpose of determining the amount of, and the extent to which the built-in loss is limited by, the SRLY limitation for the year in which it is recognized. Solely for such purpose, a built-in loss is treated as a hypothetical net operating loss carryover or net capital loss carryover arising in a SRLY, instead of as a deduction or loss in the year recognized. To the extent that a built-in loss is allowed as a deduction under this section in the year it is recognized, it offsets any consolidated taxable income for the year before any loss carryovers or carrybacks are allowed as a deduction. To the extent not so allowed, it is treated as a separate net operating loss or net capital loss carryover or carryback arising in the year of recognition and, under § 1.1502–21T(c) or § 1.1502–22T(c), the year of recognition is treated as a SRLY.

(b) *Built-in losses*—(1) *Defined.* If a corporation has a net unrealized built-in loss under section 382(h)(3) (as modified by this section) on the day it becomes a member of the group (whether or not the group is a consolidated group), its deductions and losses are built-in losses under this section to the extent they are treated as recognized built-in losses under section 382(h)(2)(B) (as modified by this section). This paragraph (b) generally applies separately with respect to each member, but see paragraph (c) of this section for circumstances in which it is applied on a subgroup basis.

(2) *Operating rules.* Solely for purposes of applying paragraph (b)(1) of this section, the principles of § 1.1502–94T(c) apply with appropriate adjustments, including the following:

(i) *Ownership change.* A corporation is treated as having an ownership change under section 382(g) on the day the corporation becomes a member of a group, and no other events (e.g., a subsequent ownership change under sec-

tion 382(g) while it is a member) are treated as causing an ownership change. In the case of an asset acquisition by a group, the assets and liabilities acquired directly from the same transferor pursuant to the same plan are treated as the assets and liabilities of a corporation that becomes a member of the group (and has an ownership change) on the date of the acquisition.

(ii) *Recognized built-in gain or loss.* A loss that is included in the determination of net unrealized built-in gain or loss and that is recognized but disallowed or deferred (e.g., under § 1.1502–20 or section 267) is not treated as a built-in loss unless and until the loss would be allowed during the recognition period without regard to the application of this section. Section 382(h)(1)(B)(ii) does not apply to the extent it limits the amount of recognized built-in loss that may be treated as a pre-change loss to the amount of the net unrealized built-in loss.

(c) *Built-in losses of subgroups*—(1) *In general.* In the case of a subgroup, the principles of paragraph (b) of this section apply to the subgroup, and not separately to its members. Thus, the net unrealized built-in loss and recognized built-in loss for purposes of paragraph (b) of this section are based on the aggregate amounts for each member of the subgroup.

(2) *Members of subgroups.* A subgroup is composed of those members that have been continuously affiliated with each other for the 60 consecutive month period ending immediately before they become members of the group in which the loss is recognized. A member remains a member of the subgroup until it ceases to be affiliated with the loss member. For this purpose, the principles of § 1.1502–21T(c)(2)(iv) through (vi) apply with appropriate adjustments.

(3) *Built-in amounts.* Solely for purposes of determining whether the subgroup has a net unrealized built-in loss or whether it has a recognized built-in loss, the principles of §§ 1.1502–91T(g) and (h) apply with appropriate adjustments.

(d) *Examples.* For purposes of the examples in this section, unless otherwise stated, all groups file consolidated returns, all corporations have calendar taxable years, the facts set forth the only corporate activity, value means fair market value and the adjusted basis of each asset equals its value, all transactions are with unrelated persons, and the application of any limitation or threshold under section 382 is disregarded. The principles of this section are illustrated by the following examples:

Example 1. Determination of recognized built-in loss. (a) P buys all the stock of T during Year 1 for $100, and T becomes a member of the P group. T has three depreciable assets. Asset 1 has an unrealized loss of $20 (basis $45, value $25), asset 2 has an unrealized loss of $25 (basis $50, value $25), and asset 3 has an unrealized gain of $25 (basis $25, value $50).

(b) Under paragraph (b)(2)(i) of this section, T is treated as having an ownership change under section 382(g) on becoming a member of the P group. This treatment does not depend on whether P's acquisition of the T stock actually constitutes an ownership change under section 382(g), or whether T is subject to any limitation under section 382. Under paragraph (b)(1) of this section, none of T's $45 of unrealized loss is treated as a built-in loss unless T has a net unrealized built-in loss under section 382(h)(3) on becoming a member of the P group.

(c) Under section 382(h)(3)(A), T has a $20 net unrealized built-in loss on becoming a member of the P group (($20) + ($25) + $25 = ($20)). Assume that this amount exceeds the threshold requirement in section 382(h)(3)(B). Under section 382(h)(2)(B), the entire amount of T's $45 unrealized loss is treated as a built-in loss to the extent it is recognized during the 5-year recognition period described in section 382(h)(7). Under paragraph (b)(2)(ii) of this section, the restriction under section 382(h)(1)(B)(ii), which limits the amount of recognized built-in loss that is treated as pre-change loss to the amount of the net unrealized built-in loss, is inapplicable for this purpose. Consequently, the entire $45 of unrealized loss (not just the $20 net unrealized loss) is treated under paragraph (b)(1) of this section as a built-in loss to the extent it is recognized within 5 years of T's becoming a member of the P group. Under paragraph (a) of this section, a built-in loss is subject to the SRLY limitation under § 1.1502–21T(c)(1).

(d) Under paragraph (b)(2)(i) of this section, the results would be the same if T transferred all of its assets and liabilities to a subsidiary of the P group in a single transaction described in section 351.

Example 2. Actual application of section 382 not relevant. (a) The facts are the same as in *Example 1*, except that P buys 55 percent of the stock of T during Year 1, resulting in an ownership change of T under section 382(g). During Year 2, P buys the 45 percent balance of the T stock, and T becomes a member of the P group.

(b) Although T has an ownership change for purposes of section 382 in Year 1 and not Year 2, T's joining the P group in Year 2 is treated as an ownership change under section 382(g) for purposes of this section. Consequently, for purposes of this section, whether T has a net unrealized built-in loss under section 382(h)(3) is determined as if the day T joined the P group were a change date. Thus, the results are the same as in *Example 1*.

Example 3. Determination of a recognized built-in loss of a subgroup. (a) During Year 1, P buys all of the stock of S for $100, and S becomes a member of the P group. M is the common parent of another group. At the beginning of Year 7, M acquires all of the stock of P, and P and S become members of the M group. At the time of M's acquisition of the P stock, P has (disregarding the stock of S) a $10 net unrealized built-in gain (two depreciable assets, asset 1 with a basis of $35 and a value of $55, and asset 2 with a basis of $55 and a value of $45), and S has a $75 net unrealized built-in loss (two depreciable assets, asset 3 with a basis of $95 and a value of $10, and asset 4 with a basis of $10 and a value of $20).

(b) Under paragraph (c) of this section, P and S compose a subgroup on becoming members of the M group because P and S were continuously affiliated for the 60 month period ending immediately before they became members of the M group. Consequently, paragraph (b) of this section does not apply to P and S separately. Instead, their separately computed unrealized gains and losses are aggregated for purposes of determining whether and the extent to which any unrealized loss is treated as built-in loss under this section and is subject to the SRLY limitation under § 1.1502–21T(c).

(c) Under paragraph (c) of this section, the P subgroup has a net unrealized built-in loss on the day P and S become members of the M group determined by treating the day they become members as a change date. The net unrealized built-in loss is the aggregate of P's net unrealized built-in gain of $10 and S's net unrealized built-in loss of $75, or an aggregate net unrealized built-in loss of $65. (The stock of S owned by P is disregarded for purposes of determining the net unrealized built- in loss. However, any loss allowed on the sale of the stock within the recognition period is taken into account in determining recognized built-in loss.) Assume that the $65 net unrealized built-in loss exceeds the threshold requirement under section 382(h)(3)(B).

(d) Under paragraphs (b)(1), (b)(2)(ii), and (c) of this section, a loss recognized during the 5-year recognition period on an asset of P or S held on the day that P and S became members of the M group is a built-in loss except to the extent the group establishes that such loss exceeds the amount by which the adjusted basis of such asset on the day the member became a member exceeded the fair market value of such asset on that same day. If P sells asset 2 for $45 in Year 7 and recognizes a $10 loss, the entire $10 loss is treated as a built-in loss under paragraphs (b)(2)(ii) and (c) of this section. If S sells asset 3 for $10 in Year 7 and recognizes an $85 loss, the entire $85 loss is treated as a built-in loss under paragraphs (b)(2)(ii) and (c) of this section (not just the $55 balance of the P subgroup's $65 net unrealized built-in loss).

(e) The determination of whether P and S constitute a SRLY subgroup for purposes of loss carryovers and carrybacks, and the extent to which built-in losses are not allowed under the SRLY limitation, is made under § 1.1502–21T(c).

Example 4. Computation of SRLY limitation. (a) During Year 1, individual A forms T by contributing $300 and T sustains a $100 net operating loss. During Year 2, T's assets decline in value to $100. At the beginning of Year 3, P buys all the stock of T for $100, and T becomes a member of the P group with a net unrealized built-in loss of $100. Assume that $100 exceeds the threshold requirements of section 382(h)(3)(B). During Year 3, T recognizes its unrealized built-in loss as a $100 ordinary loss. The members of the P group contribute the following net income to the consolidated taxable income of the P group (disregarding T's recognized built-in loss and any consolidated net operating loss deduction under § 1.1502–21T) for Years 3 and 4:

	Year 3	*Year 4*	*Total*
P group			
(without T)	$100	$100	$200
T	60	40	100
CTI	$160	$140	$300.

(b) Under paragraph (b) of this section, T's $100 ordinary loss in Year 3 (not taken into account in the consolidated taxable income computations above) is a built-in loss. Under paragraph (a) of this section, the built-in loss is treated as a net operating loss carryover for purposes of determining the SRLY limitation under § 1.1502–21T(c).

(c) For Year 3, § 1.1502–21T(c) limits T's $100 built-in loss and $100 net operating loss carryover from Year 1 to the aggregate of the P group's consolidated taxable income through Year 3 determined by reference to only T's items. For this purpose, consolidated taxable income is determined without regard to any consolidated net operating loss deductions under § 1.1502–21T(a).

(d) The P group's consolidated taxable income through Year 3 is $60 when determined by reference to only T's items. Under § 1.1502–21T(c), the SRLY limitation for Year 3 is therefore $60.

(e) Under paragraph (a) of this section, the $100 built- in loss is treated as a current deduction for all purposes other than determination of the SRLY limitation under § 1.1502–21T(c). Consequently, a deduction for the built-in loss is allowed in Year 3 before T's loss carryover from Year 1 is allowed, but only to the extent of the $60 SRLY limitation. None of T's Year 1 loss carryover is allowed because the built-in loss ($100) exceeds the SRLY limitation for Year 3.

(f) The $40 balance of the built-in loss that is not allowed in Year 3 because of the SRLY limitation is treated as a $40 net operating loss arising in Year 3 that is carried to other years in accordance with the rules of § 1.1502–21T(b). The $40 net operating loss is treated under paragraph (a) of this section and § 1.1502–21T(c)(1)(ii) as a loss carryover or carryback from Year 3 that arises in a SRLY, and is subject to the rules of § 1.1502–21T (including § 1.1502–21T(c)) rather than this section.

(g) The facts are the same as in paragraphs (a) through (f) of this *Example 4*, except that T also recognizes additional built-in losses in Year 4. For purposes of determining the SRLY limitation for these additional losses in Year 4 (or any subsequent year), the $60 of built-in loss allowed as a deduction in Year 3 is treated under paragraph (a) of this section as a deduction in Year 3 that reduces the P group's consolidated taxable income when determined by reference to only T's items.

Example 5. Built-in loss exceeding consolidated taxable income in the year recognized. (a) P buys all the stock of T during Year 1, and T becomes a member of the P group. At the time of acquisition, T has a depreciable asset with an unrealized loss of $45 (basis $100, value $55), which exceeds the threshold requirements of section 382(h)(3)(B). During Year 2, T sells its asset for $55 and recognizes the unrealized built-in loss. The P group has $10 of consolidated taxable income in Year 2, computed by disregarding T's recognition of the $45 built-in loss and the consolidated net operating loss deduction, while the consolidated taxable income would be $25 if determined by reference to only T's items (other than the $45 loss).

(b) T's $45 loss is recognized in Year 2 and, under paragraph (b) of this section, constitutes a built-in loss. Under paragraph (a) of this section and § 1.1502–21T(c)(1)(ii), the loss is treated as a net operating loss carryover to Year 2 for purposes of applying the SRLY limitation under § 1.1502–21T(c).

(c) For Year 2, T's SRLY limitation is the aggregate of the P group's consolidated taxable income through Year 2 determined by reference to only T's items. For this purpose, consolidated taxable income is determined by disregarding any built-in loss that is treated as a net operating loss carryover, and any consolidated net operating loss deductions under § 1.1502–21T(a). Consolidated taxable income so determined is $25.

(d) Under § 1.1502–21T(c), $25 of the $45 built-in loss could be deducted in Year 2. Because the P group has only $10 of consolidated taxable income (determined without regard to the $45), the $25 loss creates a consolidated net operating loss of $15. This loss is carried back or over under the rules of § 1.1502-21T(b) and absorbed under the rules of § 1.1502–21T(a). This loss is not treated as arising in a SRLY (see § 1.1502–21T(c)(1)(ii)) and therefore is not subject to the SRLY limitation under § 1.1502–21T(c) in any consolidated return year of the group to which it is carried. The remaining $20 is treated as a loss carryover arising in a SRLY and is subject to the limitation of § 1.1502–21T(c) in the year to which it is carried.

(e) *Predecessors and successors.* For purposes of this section, any reference to a corporation or member includes, as the context may require, a reference to a successor or predecessor, as defined in § 1.1502–1(f)(4).

(f) *Effective date*—(1) *In general.* This section applies to built-in losses recognized in consolidated return years beginning on or after January 1, 1997.

(2) *Application to prior periods.* See § 1.1502–21T(g)(3) for rules generally permitting a group to apply the rules of this section to consolidated return years ending on or after January 29, 1991, and beginning before January 1, 1997. A group must treat all corporations that were affiliated on January 1, 1987, and continuously thereafter as having met the 60 consecutive month requirement of paragraph (c)(2) of this section on any day before January 1, 1992, on which the determination of net unrealized built-in gain or loss of a subgroup is made.

Par. 12. Section 1.1502–21 is redesignated as § 1.1502–21A; the heading of the newly designated § 1.1502–21A is revised; and paragraphs (d)(4), (e)(3) and (h) are added to read as follows:

§ 1.1502–21A Consolidated net operating loss deduction generally applicable for consolidated return years beginning before January 1, 1997.

* * * * *

(d) * * *

(4) *Cross-reference.* See § 1.1502–21T(d)(1) for the rule that applies the principles of this paragraph (d) in consolidated return years beginning on or after January 1, 1997, with respect to a consolidated return change of ownership occurring before January 1, 1997.

(e) * * *

(3) *Effective date.* This paragraph (e) disallows or reduces the net operating loss carryovers of a member as a result of a transaction to which old section 382 (as defined in § 1.382–2T(f)(21)) applies. See § 1.1502–21T(d)(2) for the rule that applies the principles of this paragraph (e) in consolidated return years beginning on or after January 1, 1997, with respect to such a transaction.

* * * * *

(h) *Effective date.* Except as provided in § 1.1502–21T(d)(1), (d)(2), and (g)(3), this section applies to consolidated return years beginning before January 1, 1997.

Par. 13. Section 1.1502–21T is added to read as follows:

§ 1.1502–21T Net operating losses (temporary).

(a) *Consolidated net operating loss deduction.* The consolidated net operating loss deduction (or CNOL deduction) for any consolidated return year is the aggregate of the net operating loss carryovers and carrybacks to the year. The net operating loss carryovers and carrybacks consist of—

(1) Any CNOLs (as defined in paragraph (e) of this section) of the consolidated group; and

(2) Any net operating losses of the members arising in separate return years.

(b) *Net operating loss carryovers and carrybacks to consolidated return and separate return years.* Net operating losses of members arising during a consolidated return year are taken into account in determining the group's CNOL under paragraph (e) of this section for that year. Losses taken into account in determining the CNOL may be carried to other taxable years (whether consolidated or separate) only under this paragraph (b).

(1) *Carryovers and carrybacks generally.* The net operating loss carryovers and carrybacks to a taxable year are determined under the principles of section 172 and this section. Thus, losses permitted to be absorbed in a consolidated return year generally are absorbed in the order of the taxable years in which they arose, and losses carried from taxable years ending on the same date, and which are available to offset

consolidated taxable income for the year, generally are absorbed on a pro rata basis. See *Example 2* of paragraph (c)(1)(iii) of this section for an illustration of pro rata absorption of losses subject to a SRLY limitation. Additional rules provided under the Code or regulations also apply. See, e.g., section 382(l)(2)(B).

(2) *Carryovers and carrybacks of CNOLs to separate return years*—(i) *In general.* If any CNOL that is attributable to a member may be carried to a separate return year of the member, the amount of the CNOL that is attributable to the member is apportioned to the member (apportioned loss) and carried to the separate return year. If carried back to a separate return year, the apportioned loss may not be carried back to an equivalent, or earlier, consolidated return year of the group; if carried over to a separate return year, the apportioned loss may not be carried over to an equivalent, or later, consolidated return year of the group. For rules permitting the reattribution of losses of a subsidiary to the common parent when loss is disallowed on the disposition of subsidiary stock, see § 1.1502–20(g).

(ii) *Special rules*—(A) *Year of departure from group.* If a corporation ceases to be a member during a consolidated return year, net operating loss carryovers attributable to the corporation are first carried to the consolidated return year, and only the amount so attributable that is not absorbed by the group in that year is carried to the corporation's first separate return year.

(B) *Offspring rule.* In the case of a member that has been a member continuously since its organization, the CNOL attributable to the member is included in the carrybacks to consolidated return years before the member's existence. See paragraph (f) of this section for applications to predecessors and successors. If the group did not file a consolidated return for a carryback year, the loss may be carried back to a separate return year of the common parent under paragraph (b)(2)(i) of this section, but only if the common parent was not a member of a different consolidated group or of an affiliated group filing separate returns for the year to which the loss is carried or any subsequent year in the carryback period. Following an acquisition described in § 1.1502–75(d)(2) or (3), references to the common parent are to the corporation that was the common parent immediately before the acquisition.

(iii) *Equivalent years.* Taxable years are equivalent if they bear the same numerical relationship to the consolidated return year in which a CNOL arises, counting forward or backward from the year of the loss. For example, in the case of a member's third taxable year (which was a separate return year) that preceded the consolidated return year in which the loss arose, the equivalent year is the third consolidated return year preceding the consolidated return year in which the loss arose. See paragraph (b)(3)(iii) of this section for certain short taxable years that are disregarded in making this determination.

(iv) *Amount of CNOL attributable to a member.* The amount of a CNOL that is attributable to a member is determined by a fraction the numerator of which is the separate net operating loss of the member for the year of the loss and the denominator of which is the sum of the separate net operating losses for that year of all members having such losses. For this purpose, the separate net operating loss of a member is determined by computing the CNOL by reference to only the member's items of income, gain, deduction, and loss, including the member's losses and deductions actually absorbed by the group in the taxable year (whether or not absorbed by the member).

(v) *Examples.* For purposes of the examples in this section, unless otherwise stated, all groups file consolidated returns, all corporations have calendar taxable years, the facts set forth the only corporate activity, value means fair market value and the adjusted basis of each asset equals its value, all transactions are with unrelated persons, and the application of any limitation or threshold under section 382 is disregarded. The principles of this paragraph (b)(2) are illustrated by the following examples:

Example 1. Offspring rule. (a) P is formed at the beginning of Year 1 and files a separate return. P forms S on March 15 of Year 2, and P and S file a consolidated return. P purchases all the stock of T at the beginning of Year 3, and T becomes a member of the P group. T was formed in Year 2 and filed a separate return for that year. P, S, and T sustain a $1,100 CNOL in Year 3 and, under paragraph (b)(2)(iv) of this section, the loss is attributable $200 to P, $300 to S, and $600 to T.

(b) Of the $1,100 CNOL in Year 3, the $500 amount of the CNOL that is attributable to P and S ($200 + $300) may be carried to P's separate return in Year 1. Even though S was not in existence in Year 1, the $300 amount of the CNOL attributable to S may be carried back to P's separate return in Year 1 because S (unlike T) has been a member of the P group since its organization and P is a qualified parent under paragraph (b)(2)(ii)(B) of this section. To the extent not absorbed in that year, the loss may then be carried to the P group's return in Year 2. The $600 amount of the CNOL attributable to T is a net operating loss carryback to T's separate return in Year 2.

Example 2. Departing members. (a) The facts are the same as in *Example 1.* In addition, on June 15 of Year 4, P sells all the stock of T. The P group's consolidated return for Year 4 includes the income of T through June 15. T files a separate return for the period from June 16 through December 31.

(b) $600 of the Year 3 CNOL attributable to T is appor- tioned to T and is carried back to its separate return in Year 2. To the extent the $600 is not absorbed in T's separate return in Year 2, it is carried to the consolidated return in Year 4 before being carried to T's separate return in Year 4. Any portion of the loss not absorbed in T's Year 2 or in the P group's Year 4 is then carried to T's separate return in Year 4.

(3) *Special rules*—(i) *Election to relinquish carry-back.* A group may make an irrevocable election under section 172(b)(3) to relinquish the entire carryback period with respect to a CNOL for any consolidated return year. The election may not be made separately for any member (whether or not it remains a member), and must be made in a separate statement entitled "THIS IS AN ELECTION UNDER SECTION 1.1502–21T(b)(3)(i) TO WAIVE THE ENTIRE CARRYBACK PERIOD PURSUANT TO SECTION 172(b)(3) FOR THE [insert consolidated return year] CNOLs OF THE CONSOLIDATED GROUP OF WHICH [insert name and employer identification number of common parent] IS THE COMMON PARENT." The statement must be signed by the common parent and filed with the group's income tax return for the consolidated return year in which the loss arises.

(ii) *Special election for groups that include insolvent financial institutions.* For rules applicable to relinquishing the entire carryback period with respect to losses attributable to insolvent financial institutions, see § 301.6402–7 of this chapter.

(iii) *Short years in connection with transactions to which section 381(a) applies.* If a member distributes or transfers assets to a corporation that is a member immediately after the distribution or transfer in a transaction to which section 381(a) applies, the transaction does not cause the distributor or transferor to have a short year within the consolidated return year of the group in which the transaction occurred that is counted as a separate year for purposes of determining the years to which a net operating loss may be carried.

(iv) *Special status losses.* [Reserved]

(c) *Limitations on net operating loss carryovers and carrybacks from separate return limitation years*—(1) *SRLY limitation*—(i) *General rule.* The aggregate of the net opera- ting loss carryovers and carrybacks of a member arising (or treated as arising) in SRLYs that are included in the CNOL deductions for all consolidated return years of the group under paragraph (a) of this section may not exceed the aggregate consolidated taxable income for all consolidated return years of the group determined by reference to only the member's items of income, gain, deduction, and loss. For this purpose—

(A) Consolidated taxable income is computed without regard to CNOL deductions;

(B) Consolidated taxable income takes into account the member's losses and deductions (including capital losses) actual- ly absorbed by the group in consolidated return years (whether or not absorbed by the member);

(C) In computing consolidated taxable income, the consolidated return years of the group include only those years, including the year to which the loss is carried, that the member has been continuously included in the group's consolidated return, but exclude:

(*1*) For carryovers, any years ending after the year to which the loss is carried; and

(*2*) For carrybacks, any years ending after the year in which the loss arose; and

(D) The treatment under § 1.1502–15T of a built-in loss as a hypothetical net operating loss carryover in the year recognized is solely for purposes of determining the limitation under this paragraph (c) with respect to the loss in that year and not for any other purpose. Thus, for purposes of determining consolidated taxable income for any other losses, a built-in loss allowed under this section in the year it arises is taken into account.

(ii) *Losses treated as arising in SRLYs.* If a net operating loss carryover or carryback did not arise in a SRLY but is attributable to a built-in loss (as defined under § 1.1502–15T), the carryover or carryback is treated for purposes of this paragraph (c) as arising in a SRLY if the built-in loss was not allowed, after application of the SRLY limitation, in the year it arose. For an illustration, see § 1.1502–15T(d), *Example 5.*

(iii) *Examples.* The principles of this paragraph (c)(1) are illustrated by the following examples:

Example 1. Determination of SRLY limitation. (a) In Year 1, individual A forms T and T sustains a $100 net operating loss that is carried forward. P buys all the stock of T at the beginning of Year 2, and T becomes a member of the P group. The P group has $300 of consolidated taxable income in Year 2 (com- puted without regard to the CNOL deduction). Such consolidated taxable income would be $70 if determined by reference to only T's items.

(b) T's $100 net operating loss carryover from Year 1 arose in a SRLY. See § 1.1502–1(f)(2)(iii). Thus, the $100 net operating loss carryover is subject to the SRLY limitation in paragraph (c)(1) of this section. The SRLY limitation for Year 2 is consolidated taxable income determined by reference to only T's items, or $70. Thus, $70 of the loss is included under paragraph (a) of this section in the P group's CNOL deduction for Year 2.

(c) The facts are the same as in paragraph (a) of this *Example 1*, except that such consolidated taxable income (computed without regard to the CNOL deduction and by reference to only T's items) is a loss (a CNOL) of $370. Because the SRLY limitation may not exceed the consolidated taxable income determined by reference to only T's items, and such items aggregate to a CNOL, T's $100 net operating loss carryover from Year 1 is not allowed under the SRLY limitation in Year 2. Moreover, if consolidated taxable income (computed without regard to the CNOL deduction and by reference to only T's items) did not exceed $370 in Year 3, the carryover would still be restricted under § 1.1502–21T(c) in Year 3, because the aggregate consolidated taxable income for all consolidated return years of the group computed by reference to only T's items would not be a positive amount.

Example 2. Net operating loss carryovers. (a) In Year 1, individual A forms P and P sustains a $40 net operating loss that is carried forward. P has no income in Year 2. Unrelated corporation T sustains a net operating loss of $50 in Year 2 that is carried forward. P buys the stock of T during Year 3, but T is not a member of the P group for each day of the year. P and T file separate returns and sustain net operating losses of $120 and $60, respectively, for Year 3. The P group files consolidat- ed returns beginning in Year 4. During Year 4, the P group has $160 of consolidated taxable income (computed without regard to the CNOL deduction). Such consolidated taxable income would be $70 if determined by reference to only T's items. These results are summarized as follows:

	Separate Year 1	*Separate Year 2*	*Separate/ Affiliated Year 3*	*Consolidated Year 4*
P	$(40)	$0	$(120)	$90
T	0	(50)	(60)	70
CTI				$160.

(b) P's Year 1, Year 2, and Year 3 are not SRLYs with respect to the P group. See § 1.1502–1(f)(2)(i). Thus, P's $40 net operating loss arising in Year 1 and $120 net operating loss arising in Year 3 are not subject to the SRLY limitation under paragraph (c) of this section. Under the principles of section 172, paragraph (b) of this section requires that the loss arising in Year 1 be the first loss absorbed by the P group in Year 4. Absorption of this loss leaves $120 of the group's consolidated taxable income available for offset by other loss carryovers.

(c) T's Year 2 and Year 3 are SRLYs with respect to the P group. See § 1.1502–1(f)(2)(ii). Thus, T's $50 net operating loss arising in Year 2 and $60 net operating loss arising in Year 3 are subject to the SRLY limitation. Under paragraph (c)(1) of this section, the SRLY limitation for Year 4 is $70, and under paragraph (b) of this section, T's $50 loss from Year 2 must be included under paragraph (a) of this section in the P group's CNOL deduction for Year 4. The absorption of this loss leaves $70 of the group's consolidated taxable income available for offset by other loss carryovers.

(d) P and T each carry over net operating losses to Year 4 from a taxable year ending on the same date (Year 3). The losses carried over from Year 3 total $180. Under paragraph (b) of this section, the losses carried over from Year 3 are absorbed on a pro rata basis, even though one arises in a SRLY and the other does not. However, the group cannot absorb more than $20 of T's $60 net operating loss arising in Year 3 because its $70 SRLY limitation for Year 4 is reduced by T's $50 Year 2 SRLY loss already included in the CNOL deduction for Year 4. Thus, the absorption of Year 3 losses is as follows:

Amount of P's Year 3 losses absorbed = $120/($120 + $20) x $70 = $60

Amount of T's Year 3 losses absorbed = $ 20/($120 + $20) x $70 = $10.

(e) The absorption of $10 of T's Year 3 loss further reduces T's SRLY limitation to $10 ($70 of initial SRLY limita- tion, reduced by the $60 net operating loss already included in the CNOL deductions for Year 4 under paragraph (a) of this section).

(f) P carries its remaining $60 Year 3 net operating loss and T carries its remaining $50 Year 3 net operating loss over to Year 5. Assume that, in Year 5, the P group has $90 of consolidated taxable income (computed without regard to the CNOL deduction). The group's CTI determined by reference to only T's items is a CNOL of $4. For Year 5, the CNOL deduction includes $60 of P's Year 3 loss but only $6 of T's Year 3 loss (the aggregate consolidated taxable income for Years 4 and 5 deter- mined by reference to T's items, or $66, reduced by T's SRLY losses actually absorbed by the group in Year 4, or $60).

Example 3. Net operating loss carrybacks. (a)(1) P owns all of the stock of S and T. The members of the P group contribute the following to the consolidated taxable income of the P group for Years 1, 2, and 3:

	Year 1	*Year 2*	*Year 3*	*Total*
P	$100	$60	$80	$240
	Year 1	Year 2	Year 3	Total
S	20	20	30	70
T	30	10	(50)	(10)
CTI	$150	$90	$60	$300.

(2) P sells all of the stock of T to individual A at the beginning of Year 4. For its Year 4 separate return year, T has a net operating loss of $30.

(b) T's Year 4 is a SRLY with respect to the P group. See § 1.1502–1(f)(1). T's $30 net operating loss carryback to the P group from Year 4 is not allowed under § 1.1502–21T(c) to be included in the CNOL deduction under paragraph (a) of this section for Year 1, 2, or 3, because the P group's consolidated taxable income would not be a positive amount if determined by reference to only T's items for all consolidated return years through Year 4 (without regard to the $30 net operating loss). However, the $30 loss is carried forward to T's Year 5 and succeeding taxable years as provided under the Code.

Example 4. Computation of SRLY limitation for built-in losses treated as net operating loss carryovers. (a) In Year 1, individual A forms T by contributing $300 and T sustains a $100 net operating loss. During Year 2, T's assets decline in value by $100. At the beginning of Year 3, P buys all the stock of T for $100, and T becomes a member of the P group. At the time of the acquisition, T has a $100 net unrealized built-in loss, which exceeds the threshold requirements of section 382(h)(3)(B). During Year 3, T recognizes its unrealized loss as a $100 or- dinary loss. The members of the P group contribute the following to the consolidated taxable income of the P group for Years 3 and 4 (computed without regard to T's recognition of its unrealized loss and any CNOL deduction under § 1.1502–21T):

	Year 3	*Year 4*	*Total*
P group (without T)	$100	$100	$200
T	60	40	100
CTI	$160	$140	$300.

(b) Under § 1.1502–15T(a), T's $100 of ordinary loss in Year 3 constitutes a built-in loss that is subject to the SRLY limitation under § 1.1502–21T(c). The amount of the limitation is determined by treating the deduction as a net operating loss carryover from a SRLY. The built-in loss is therefore subject to a $60 SRLY limitation for Year 3. The built-in loss is treated as a net operating loss carryover solely for purposes of deter- mining the extent to which the loss is not allowed by reason of the SRLY limitation, and for all other purposes the loss remains a loss arising in Year 3. Consequently, under paragraph (b) of this section, the $60 allowed under the SRLY limitation is absorbed by the P group before T's $100 net operating loss carryover from Year 1 is allowed.

(c) Under § 1.1502–15T(a), the $40 balance of the built- in loss that is not allowed in Year 3 because of the SRLY limi- tation is treated as a $40 net operating loss arising in Year 3 that is subject to the SRLY limitation because, under § 1.1502–21T(c)(1)(ii), Year 3 is treated as a SRLY, and is carried to other years in accordance with the rules of paragraph (b) of this section. The SRLY limitation for Year 4 is the P group's consolidated taxable income for Year 3 and Year 4 determined by reference to only T's items and without regard to the group's CNOL deductions ($60 + $40), reduced by T's loss actually absorbed by the group in Year 3 ($60). The SRLY limitation for Year 4 is $40.

(d) Under paragraph (c) of this section and the prin- ciples of section 172(b), $40 of T's $100 net operating loss carryover from Year 1 is included in the CNOL deduction under paragraph (a) of this section in Year 4.

(2) *SRLY subgroup limitation.* In the case of a net operating loss carryover or carryback for which there is a SRLY subgroup, the principles of paragraph (c)(1) of this section apply to the SRLY subgroup, and not separately to its members. Thus, the contribution to consolidated taxable income and the net operating loss carryovers and carrybacks arising (or treated as arising) in SRLYs that are included in the CNOL deductions for all consolidated return years of the group under paragraph (a) of this section are based on the aggregate amounts of income, gain, deduction, and loss of the members of the SRLY subgroup for the relevant consolidated return years (as provided in paragraph (c)(1)(i)(C) of this section). For an illustration of aggregate amounts during the relevant consolidated return years following the year in which a member of a SRLY subgroup ceases to be a member of the group, see paragraph (c)(2)(vii) *Example 4* of this section. A SRLY subgroup may exist only for a carryover or carryback arising in a year that is not a SRLY (and is not treated as a SRLY under paragraph (c)(1)(ii) of this section) with respect to another group (the former group), whether or not the group is a consolidated group. A separate SRLY subgroup is determined for each such carryover or carryback. A consolidated group may include more than one SRLY subgroup and a member may be a member of more than one SRLY subgroup. Solely for purposes of determining the members of a SRLY subgroup with respect to a loss:

(i) *Carryovers.* In the case of a carryover, the SRLY subgroup is composed of the member carrying over the loss (the loss member) and each other member that was a member of the former group that becomes a member of the group at the same time as the loss member. A member remains a member of the SRLY subgroup until it ceases to be affiliated with the loss member. The aggregate determination described in paragraph (c)(1) of this section and this paragraph (c)(2) includes the amounts of income, gain, deduction, and loss of each member of the SRLY subgroup for the consolidated return years during which it remains a member of the SRLY subgroup. For an illustration of the aggregate deter- mination of a SRLY subgroup, see paragraph (c)(2)(vii) *Example 2* of this section.

(ii) *Carrybacks.* In the case of a carryback, the SRLY subgroup is composed of the member carrying back the loss (the loss member) and each other member of the group from which the loss is carried back that has been continuously affiliated with the loss member from the year to which the loss is carried through the year in which the loss arises.

(iii) *Built-in losses.* In the case of a built-in loss, the SRLY subgroup is composed of the member recognizing the loss (the loss member) and each other member that was part of the subgroup with respect to the loss determined under § 1.1502–15T(c)(2) immediately before the members became members of the group. The principles of paragraphs (c)(2)(i) and (ii) of this section apply to determine the SRLY subgroup for the built-in loss that is, under paragraph (c)(1)(ii) of this section, treated as arising in a SRLY with respect to the group in which the loss is recognized. For this purpose and as the context requires, a reference in those paragraphs to a group or former group is a reference to the subgroup determined under § 1.1502–15T(c)(2).

(iv) *Principal purpose of avoiding or increasing a SRLY limitation.* The members composing a SRLY subgroup are not treated as a SRLY subgroup if any of them is formed, acquired, or availed of with a principal purpose of avoiding the application of, or increasing any limitation under, this paragraph (c). Any member excluded from a SRLY subgroup, if excluded with a prin- cipal purpose of so avoiding or increasing any SRLY limitation, is treated as included in the SRLY subgroup.

(v) *Coordination with other limitations.* This paragraph (c)(2) does not allow a net operating loss to offset income to the extent inconsistent with other limitations or restrictions on the use of losses, such as a limitation based on the nature or activities of members. For example, any dual consolidated loss may not reduce the taxable income to an extent greater than that allowed under section 1503(d) and § 1.1503–2. See also § 1.1502–47(q) (relating to preemption of rules for life-nonlife groups).

(vi) *Anti-duplication.* If the same item of income or deduction could be taken into account more than once in determining a limitation under this paragraph (c), or in a manner inconsistent with any other provision of the Code or regulations incorporating this paragraph (c), the item of income or deduction is taken into account only once and in such manner that losses are absorbed in accordance with the ordering rules in paragraph (b) of this section and the underlying purposes of this section.

(vii) *Examples.* The principles of this paragraph (c)(2) are illustrated by the following examples:

Example 1. Members of SRLY subgroups. (a) During Year 1, P sustains a $50 net operating loss. At the beginning of Year 2, P buys all the stock of S at a time when the aggregate basis of S's assets exceeds their aggregate value by $70 (as determined under § 1.1502–15T). At the beginning of Year 3, P buys all the stock of T, T has a $60 net operating loss carryover at the time of the acquisition, and T becomes a member of the P group. During Year 4, S forms S1 and T forms T1, each by contributing assets with built-in gains which

are, in the aggregate, material. S1 and T1 become members of the P group. M is the common parent of another group. During Year 7, M acquires all of the stock of P, and the members of the P group become members of the M group for the balance of Year 7. The $50 and $60 loss carryovers of P and T are carried to Year 7 of the M group, and the value and basis of S's assets did not change after it became a member of the former P group.

(b) Under paragraph (c)(2) of this section, a separate SRLY subgroup is determined for each loss carryover and built-in loss. In the P group, P's $50 loss carryover is not treated as arising in a SRLY. See § 1.1502–1(f). Consequently, the carryover is not subject to limitation under paragraph (c) of this section in the P group.

(c) In the M group, P's $50 loss carryover is treated as arising in a SRLY and is subject to the limitation under paragraph (c) of this section. A SRLY subgroup with respect to that loss is composed of members which were members of the P group, the group as to which the loss was not a SRLY. The SRLY subgroup is composed of P, the member carrying over the loss, and each other member of the P group that became a member of the M group at the same time as P. A member of the SRLY subgroup remains a member until it ceases to be affiliated with P. For Year 7, the SRLY subgroup is composed of P, S, T, S1, and T1.

(d) In the P group, S's $70 unrealized loss, if recognized within the 5-year recognition period after S becomes a member of the P group, is subject to limitation under paragraph (c) of this section. See § 1.1502–15T and paragraph (c)(1)(ii) of this section. Because S was not continuously affiliated with P, T, or T1 for 60 consecutive months prior to joining the P group, these corporations cannot be included in a SRLY subgroup with respect to S's unrealized loss in the P group. See paragraph (c)(2)(iii) of this section. As a successor to S, S1 is included in a subgroup with S in the P group. Because S did not cease to exist, however, S1's contribution to consolidated taxable income may not be used to increase the consolidated taxable income of the P group that may be offset by the built-in loss. See paragraph (f) of this section.

(e) In the M group, S's $70 unrealized loss, if recognized within the 5-year recognition period after S becomes a member of the M group, is subject to limitation under paragraph (c) of this section. Prior to becoming a member of the M group, S had been continuously affiliated with P (but not T or T1) for 60 consecutive months and S1 is a successor that has remained continuously affiliated with S. Those members had a net unrealized built-in loss immediately before they became members of the group under § 1.1502–15T(c). Consequently, in Year 7, S, S1, and P compose a subgroup in the M group with respect to S's unrealized loss. S1's contribution to consolidated taxable income may not be used to increase the consolidated taxable income of the M group that may be offset by the recognized built- in loss. See paragraph (f) of this section.

(f) In the P group, T's $60 loss carryover arose in a SRLY and is subject to limitation under paragraph (c) of this section. P, S, and S1 were not members of the group in which T's loss arose and cannot be members of a SRLY subgroup with respect to the carryover in the P group. See paragraph (c)(2)(i) of this section. As a successor to T, T1 is included in a SRLY subgroup with T in the P group; however, because T did not cease to exist, T1's contribution to consolidated taxable income may not be used to increase the consolidated taxable income of the P group that may be offset by the carryover. See paragraph (f) of this section.

(g) In the M group, T's $60 loss carryover arose in a SRLY and is subject to limitation under paragraph (c) of this section. T and T1 remain the only members of a SRLY subgroup with respect to the carryover, but T1's contribution to consolidated taxable income may not be used to increase consolidated taxable income of the M group that may be offset by the carryover. See paragraph (f) of this section.

Example 2. Computation of SRLY subgroup limitation. (a) Individual A forms S. Individual B forms T. In Year 2, P buys all the stock of S and T from A and B, and S and T become members of the P group. For Year 3, the P group has a $45 CNOL, which is attributable to P, and which P carries forward. M is the common parent of another group. At the beginning of Year 4, M acquires all of the stock of P and the former members of the P group become members of the M group.

(b) P's year to which the loss is attributable, Year 3, is a SRLY with respect to the M group. See § 1.1502–1(f)(1). However, P, S, and T compose a SRLY subgroup with respect to the Year 3 loss under paragraph (c)(2)(i) of this section because Year 3 is not a SRLY (and is not treated as a SRLY) with respect to the P group. P's loss is carried over to the M group's Year 4 and is therefore subject to the SRLY subgroup limitation in paragraph (c)(2) of this section.

(c) In Year 4, the M group has $10 of consolidated taxable income (computed without regard to the CNOL deduction for Year 4). However, such consolidated taxable income would be $45 if determined by reference to only the items of P, S, and T, the members included in the SRLY subgroup with respect to P's loss carryover. Therefore, the SRLY subgroup limitation under paragraph (c)(2) of this section for P's net operating loss carryover from Year 3 is $45. Because the M group has only $10 of consolidated taxable income in Year 4, however, only $10 of P's net operating loss carryover is included in the CNOL deduction under paragraph (a) of this section in Year 4.

(d) In Year 5, the M group has $100 of consolidated taxable income (computed without regard to the CNOL deduction for Year 5). Neither P, S, nor T has any items of income, gain, deduction, or loss in Year 5. Although the members of the SRLY subgroup do not contribute to the $100 of consolidated taxable income in Year 5, the SRLY subgroup limitation for Year 5 is $35 (the sum of SRLY subgroup consolidated taxable income of $45 in Year 4 and $0 in Year 5, less the $10 net operating loss carryover actually absorbed by the M group in Year 4). Therefore, $35 of P's net operating loss carryover is included in the CNOL deduction under paragraph (a) of this section in Year 5.

Example 3. Inclusion in more than one SRLY subgroup. (a) At the beginning of Year 1, S buys all the stock of T, and T becomes a member of the S group. For Year 1, the S group has a CNOL of $10, all of which is attributable to S and is carried over to Year 2. At the beginning of Year 2, P buys all the stock of S, and S and T become members of the P group. For Year 2, the P group has a CNOL of $35, all of which is attributable to P and is carried over to Year 3. At the beginning of Year 3, M acquires all of the stock of P and the former members of the P group become members of the M group.

(b) P's and S's net operating losses arising in SRLYs with respect to the M group are subject to limitation under paragraph (c) of this section. P, S, and T compose a SRLY subgroup for purposes of determining the limitation for P's $35 net operating loss carryover arising in Year 2 because, under paragraph (c)(2)(i) of this section, Year 2 is not a SRLY with respect to the P group. Similarly, S and T compose a SRLY subgroup for purposes of determining the limitation for S's $10 net operating loss carryover arising in Year 1 because Year 1 is not a SRLY with respect to the S group.

(c) S and T are members of both the SRLY subgroup with respect to P's losses and the SRLY subgroup with respect to S's losses. Under paragraph (c)(2) of this section, S's and T's items cannot be included in the determination of the SRLY subgroup limitation for both SRLY subgroups for the same consolidated return year; paragraph (c)(2)(vi) of this section requires the M group to consider the items of S and T only once so that the losses are absorbed in the order of the taxable years in which they were sustained. Because S's loss was incurred in Year 1, while P's loss was incurred in Year 2, the items will be added in the determination of the consolidated taxable income of the S and T SRLY subgroup to enable S's loss to be absorbed first. The taxable income of the P, S, and T SRLY subgroup is then computed by including the consolidated taxable income for the S and T SRLY subgroup less the amount of any net operating loss carryover of S that is absorbed after applying this section to the S subgroup for the year.

Example 4. Corporation ceases to be affiliated with a SRLY subgroup. (a) P and S are members of the P group and the P group has a CNOL of $30 in Year 1, all of which is attributable to P and carried over to Year 2. At the beginning of Year 2, M acquires all of the stock of P, and P and S become members of the M group. P and S compose a SRLY subgroup with respect to P's net operating loss carryover. For Year 2, consolidated taxable income of the M group determined by reference to only the items of P (and without regard to the CNOL deduction for Year 2) is $40. However, such consolidated taxable income of the M group determined by reference to the items of both P and S is a loss of $20. Thus, the SRLY subgroup limitation under paragraph (c)(2) of this section prevents the M group from including any of P's net operating loss carryover in the CNOL deduction under paragraph (a) of this section in Year 2, and P carries the loss to Year 3.

(b) At the end of Year 2, P sells all of the S stock and S ceases to be a member of the M group and, in turn, ceases to be affiliated with the P subgroup. For Year 3, consolidated taxable income of the M group is $50 (determined without regard to the CNOL deduction for Year 3), and such consolidated taxable income would be $10 if determined by reference to only items of P. However, the limitation under paragraph (c) of this section for Year 3 for P's net operating loss carryover still prevents the M group from including any of P's loss in the CNOL deduction under paragraph (a) of this section. The limitation results from the inclusion of S's items for Year 2 in the determination of the SRLY subgroup limitation for Year 3 even though S ceased to be a member of the M group (and the P subgroup) at the end of Year 2. Thus, the M group's consolidated taxable income determined by reference to only the SRLY subgroup members' items for all consolidated return years of the group through Year 3 (determined without regard to the CNOL deduction) is not a positive amount.

(d) *Coordination with consolidated return change of ownership limitation and transactions subject to old section*

382—(1) *Consolidated return changes of ownership.* If a consolidated return change of ownership occurred before January 1, 1997, the principles of § 1.1502–21A(d) apply to determine the amount of the aggregate of the net operating losses attributable to old members of the group that may be included in the consolidated net operating loss deduction under paragraph (a) of this section. For this purpose, § 1.1502–1(g) is applied by treating that date as the end of the year of change.

(2) *Old section 382.* The principles of § 1.1502–21A(e) apply to disallow or reduce the amount of a net operating loss carryover of a member as a result of a transaction subject to old section 382.

(e) *Consolidated net operating loss.* Any excess of deductions over gross income, as determined under § 1.1502–11(a) (without regard to any consolidated net operating loss deduction), is also referred to as the consolidated net operating loss (or CNOL).

(f) *Predecessors and successors*—(1) *In general.* For purposes of this section, any reference to a corporation, member, common parent, or subsidiary, includes, as the context may require, a reference to a successor or predecessor, as defined in § 1.1502–1(f)(4).

(2) *Limitation on SRLY subgroups.* Except as the Commissioner may otherwise determine, any increase in the consolidated taxable income of a SRLY subgroup that is attributable to a successor is disregarded unless the successor acquires substantially all the assets and liabilities of its predecessor and the predecessor ceases to exist.

(g) *Effective date*—(1) *In general.* This section generally applies to consolidated return years beginning on or after January 1, 1997.

(2) *SRLY limitation.* Except in the case of those members (including members of a SRLY subgroup) described in paragraph (g)(3)(iii) of this section, a group does not take into account a consolidated taxable year beginning before January 1, 1997, in determining the aggregate of the consolidated taxable income under paragraph (c)(1) of this section (including for purposes of § 1.1502–15T and § 1.1502–22T(c)) for the members (or SRLY subgroups).

(3) *Application to prior periods.* A consolidated group may apply the rules of this section to all consolidated return years ending on or after January 29, 1991, and beginning before January 1, 1997, provided that—

(i) The group's tax liability as shown on an original or an amended return is consistent with the application of the rules of this section (other than this paragraph (g)) and §§ 1.1502–15T, 1.1502–22T, 1.1502–23T, 1.1502–91T through 1.1502–96T, and 1.1502–98T for each such year for which the statute of limitations does not preclude the filing of an amended return on January 1, 1997;

(ii) Each section described in paragraph (g)(3)(i) of this section and § 1.1502–1(f)(4)(ii) is applied by substituting "taxable years ending on or after January 29, 1991" for "taxable years beginning on or after January 1, 1997" (and "before January 29, 1991" for "before January 1, 1997" in the case of consolidated return changes of ownership) as the context requires.

(iii) The rules of paragraph (c) of this section and §§ 1.1502–15T and 1.1502–22T(c) are applied only with respect to the losses and deductions of those corporations that became members of the group (including members of a subgroup), and to acquisitions occurring, on or after January 29, 1991, (and only with respect to such losses and deductions);

(iv) The rules of §§ 1.1502–15A, 1.1502–21A(c) and 1.1502–22A(c) are applied with respect to the losses and deductions of those corporations that became members of the group, and to acquisitions occurring, before January 29, 1991; and

(v) Appropriate adjustments are made in the earliest subsequent open year to reflect any inconsistency in a year for which the statute of limitations precludes the filing of an amended return on January 1, 1997.

(4) *Waiver of carrybacks.* Paragraph (b)(3)(i) of this section (relating to the waiver of carrybacks) applies to net operating losses arising in a consolidated return year for which the due date of the income tax return (without regard to extensions) is on or after Monday, August 26, 1996.

Par. 14. Section 1.1502–22 is redesignated as § 1.1502–22A; the heading of the newly designated § 1.1502–22A is revised; and paragraphs (d)(3) and (e) are added to read as follows:

§ 1.1502–22A Consolidated net capital gain or loss generally applicable for consolidated return years beginning before January 1, 1997.

* * * * *

(d) * * *

(3) *Cross-reference.* See § 1.1502–22T(d) for the rule that applies the principles of this paragraph (d) in consolidated return years beginning on or after January 1, 1997, with respect to a consolidated return change of ownership occurring before January 1, 1997.

(e) *Effective date.* This section applies to any consolidated return years to which § 1.1502–21T(g) does not apply. See § 1.1502–21T(g) for effective dates of that section.

Par. 15. Section 1.1502–22T is added to read as follows:

§ 1.1502–22T Consolidated capital gain and loss (temporary).

(a) *Capital gain.* The determinations under section 1222, including capital gain net income, net long-term capital gain, and net capital gain, with respect to members during consolidated return years are not made separately. Instead, consolidated amounts are determined for the group as a whole. The consolidated capital gain net income for any consolidated return year is determined by reference to—

(1) The aggregate gains and losses of members from sales or exchanges of capital assets for the year (other than gains and losses to which section 1231 applies);

(2) The consolidated net section 1231 gain for the year (determined under § 1.1502–23T); and

(3) The net capital loss carryovers or carrybacks to the year.

(b) *Net capital loss carryovers and carrybacks*—(1) *In general.* The determinations under section 1222, including net capital loss and net short-term capital loss, with respect to members during consolidated return years are not made separately. Instead, consolidated amounts are determined for the group as a whole. Losses included in the consolidated net capital loss may be carried to consolidated return years, and, after apportionment, may be carried to separate return years. The net capital loss carryovers and carrybacks consist of—

(i) Any consolidated net capital losses of the group; and

(ii) Any net capital losses of the members arising in separate return years.

(2) *Carryovers and carrybacks generally.* The net capital loss carryovers and carrybacks to a taxable year are determined under the principles of section 1212 and this section. Thus, losses permitted to be absorbed in a consolidated

return year generally are absorbed in the order of the taxable years in which they were sustained, and losses carried from taxable years ending on the same date, and which are available to offset consolidated capital gain net income, generally are absorbed on a pro rata basis. Additional rules provided under the Code or regulations also apply, as well as the SRLY limitation under paragraph (c) of this section. See, e.g., section 382(l)(2)(B).

(3) *Carryovers and carrybacks of consolidated net capital losses to separate return years.* If any consolidated net capital loss that is attributable to a member may be carried to a separate return year under the principles of § 1.1502–21T(b)(2), the amount of the consolidated net capital loss that is attributable to the member is apportioned and carried to the separate return year (apportioned loss).

(4) *Special rules*—(i) *Short years in connection with transactions to which section 381(a) applies.* If a member distributes or transfers assets to a corporation that is a member immediately after the distribution or transfer in a transaction to which section 381(a) applies, the transaction does not cause the distributor or transferor to have a short year within the consolidated return year of the group in which the transaction occurred that is counted as a separate year for purposes of determining the years to which a net capital loss may be carried.

(ii) *Special status losses.* [Reserved]

(c) *Limitations on net capital loss carryovers and carrybacks from separate return limitation years.* The aggregate of the net capital losses of a member arising (or treated as arising) in SRLYs that are included in the determination of consolidated capital gain net income for all consolidated return years of the group under paragraph (a) of this section may not exceed the aggregate of the consolidated capital gain net income for all consolidated return years of the group determined by reference to only the member's items of gain and loss from capital assets as defined in section 1221 and trade or business assets defined in section 1231(b), including the member's losses actually absorbed by the group in the taxable year (whether or not absorbed by the member). The principles of § 1.1502–21T(c)(including the SRLY subgroup principles under § 1.1502–21T(c)(2)) apply with appropriate adjustments for purposes of applying this paragraph (c).

(d) *Coordination with respect to consolidated return change of ownership limitation occurring in consolidated return years beginning before January 1, 1997.* If a consolidated return change of ownership occurred before January 1, 1997, the principles of § 1.1502–22A(d) apply to determine the amount of the aggregate of the net capital loss attributable to old members of the group (as those terms are defined in § 1.1502–1(g)), that may be included in the net capital loss carryover under paragraph (b) of this section. For this purpose, § 1.1502–1(g) is applied by treating that date as the end of the year of change.

(e) *Consolidated net capital loss.* Any excess of losses over gains, as determined under paragraph (a) of this section (without regard to any carryovers or carrybacks), is also referred to as the consolidated net capital loss.

(f) *Predecessors and successors.* For purposes of this section, the principles of § 1.1502–21T(f) apply with appropriate adjustments.

(g) *Effective date*—(1) *In general.* This section applies to consolidated return years beginning on or after January 1, 1997.

(2) *Application to prior periods.* See § 1.1502–21T(g)(3) for rules generally permitting a group to apply the rules of this section to consolidated return years ending on or after January 29, 1991, and beginning before January 1, 1997.

Par. 16. Section 1.1502–23 is redesignated § 1.1502–23A; the section heading of the newly designated § 1.1502–23A is revised; the current text of the section is designated as paragraph (a) and paragraph (b) is added to read as follows:

§ 1.1502–23A Consolidated net section 1231 gain or loss generally applicable for consolidated return years beginning before January 1, 1997.

* * * * *

(b) *Effective date.* This section applies to any consolidated return years to which § 1.1502–21T(g) does not apply. See § 1.1502–21T(g) for effective dates of that section.

Par. 17. Section 1.1502–23T is added to read as follows:

§ 1.1502–23T Consolidated net section 1231 gain or loss (temporary).

(a) *In general.* Net section 1231 gains and losses of members arising during consolidated return years are not determined separately. Instead, the consolidated net section 1231 gain or loss is determined under this section for the group as a whole.

(b) *Recapture of ordinary loss.* [Reserved]

(c) *Effective date*—(1) *In general.* This section applies to gains and losses arising in the determination of consolidated net section 1231 gain or loss for taxable years beginning on or after January 1, 1997.

(2) *Application to prior periods.* See § 1.1502–21T(g)(3) for rules generally permitting a group to apply the rules of this section to consolidated return years ending on or after January 29, 1991, and beginning before January 1, 1997.

Par. 18. Section 1.1502–41 is redesignated as § 1.1502–41A; the section heading of the newly designated § 1.1502–41A is revised; and paragraph (c) is added to read as follows:

§ 1.1502–41A Determination of consolidated net long-term capital gain and consolidated net short-term capital loss generally applicable for consolidated return years beginning before January 1, 1997.

* * * * *

(c) *Effective date.* This section applies to any consolidated return years to which § 1.1502–21T(g) does not apply. See § 1.1502–21T(g) for effective dates of that section.

Par. 19. Section 1.1502–79A is added to read as follows:

§ 1.1502–79A Separate return years generally applicable for consolidated return years beginning before January 1, 1997.

(a) through (e) [Reserved]

(f) *Effective date.* Paragraphs (a) and (b) of this section apply to losses arising in consolidated return years to which § 1.1502–21T(g) does not apply. For this purpose net operating loss deductions, carryovers, and carrybacks arise in the year from which they are carried. See § 1.1502–21T(g) for effective dates of that section.

Par. 20. In § 1.1502–79, paragraphs (a) and (b) are redesignated as § 1.1502–79A, paragraphs (a) and (b).

Par. 21. Section 1.1502–79 is amended by adding new paragraphs (a) and (b) to read as follows:

§ 1.1502–79 Separate return years.

(a) *Carryover and carryback of consolidated net operating losses to separate return years.* For losses arising in

consolidated return years beginning before January 1, 1997, see § 1.1502–79A(a). For later years, see § 1.1502–21T(b).

(b) *Carryover and carryback of consolidated net capital loss to separate return years.* For losses arising in consolidated return years beginning before January 1, 1997, see § 1.1502–79A(b). For later years, see § 1.1502–22T(b).

* * * * *

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 22. The authority citation for part 602 continues to read in part as follows:

Authority: 26 U.S.C. 7805.

Par. 23. In § 602.101, paragraph (c) is amended by adding an entry in numerical order to the table to read as follows:

§ 602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified or described	Current OMB control No.
* * * * *	
1.1502–21T.....	1545–1237
* * * * *	

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved May 31, 1996.

Leslie Samuels,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on June 26, 1996, 8:45 a.m., and published in the issue of the Federal Register for June 27, 1996, 61 F.R. 33321)

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26 CFR 1.1502–91T: Application of section 382 with respect to a consolidated group (temporary).

T.D. 8678

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

Regulations Under Section 1502 of the Internal Revenue Code of 1986; Limitations on Net Operating Loss Carryforwards and Certain Built-in Losses and Credits Following an Ownership Change of a Consolidated Group

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations regarding the operation of sections 382 and 383 of the Internal Revenue Code of 1986 (relating to limitations on net operating loss carryforwards and certain built-in losses and credits following an ownership change) with respect to consolidated groups. The regulations include rules for determining whether a loss group or a loss subgroup has an ownership change, for computing a consolidated section 382 limitation or subgroup section 382 limitation, and for applying sections 382 and 383 to corporations that join or leave a group. The rules are necessary to provide guidance to such groups on the use of certain of their tax attributes. The text of these temporary regulations also serves as the text of CO–25–96, page 439.

DATES: These regulations are effective Thursday, June 27, 1996.

For dates of application and special transition rules, see Effective Dates under SUPPLEMENTARY INFORMATION.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in the temporary regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under the control number 1545–1218. The collection requires a response from certain consolidated groups. The IRS requires the information described in § 1.1502–95T(e) to assure that a section 382 limitation is properly determined in cases of corporations that cease to be members of a group. Responses to this collection of information are required to obtain a benefit (relating to the section 382 limition applicable to the departing member(s)).

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

For further information concerning this collection of information, and where to submit comments on the collection of information and the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble to CO–25–96, page 439.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background and Explanation of Provisions

On February 4, 1991, the IRS and Treasury issued three notices of proposed rulemaking, CO–132–87 (56 FR 4194), CO–077–90 (56 FR 4183), and CO–078–90 (56 FR 4228), setting forth rules regarding the application of sections 382 and 383 by consolidated groups and by controlled groups, and regarding the use of built-in deductions and net operating losses and capital losses, including the carryover and carryback of separate return limitation year (SRLY) losses of members of consolidated groups. The preambles to the three proposed regulations explain their rules in detail. The IRS and Treasury also published Notice 91–27 (1991–2 C.B. 629) to advise of intended modifications to the proposed regulations.

For reasons explained in the preamble to TD 8677 (published on page 119), the IRS and Treasury are issuing temporary amendments concerning the use of built-in deductions and net operating losses and capital losses of members of consolidated groups. Some of the rules in those temporary amendments are closely related to rules regarding the application of section 382 to members of consolidated groups (for example, rules relating to built-in deductions and subgroups). Because of the close relationship, and in order to give consolidated groups immediate guidance on the application of sections 382 and 383, the IRS and Treasury are issuing these temporary amendments. The temporary amendments are substantially identical to the rules proposed on January 29, 1991.

These temporary amendments do not address the comments on the proposed amendments. Many of these comments are still under consideration.

As a companion to this Treasury decision, the IRS and Treasury are also issuing temporary regulations relating to the application of sections 382 and 383 by members of controlled groups. See TD 8679 published on page 25.

Effective Dates.

The temporary regulations are generally effective for testing dates that occur on or after January 1, 1997. Transition rules contained in the proposed amendments are retained and made applicable to testing dates before January 1, 1997.

SPECIAL ANALYSIS

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations do not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations will primarily affect affiliated groups of corporations that have elected to file consolidated returns, which tend to be larger businesses. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations were sent to the Small Business Administration for comment on their impact on small business.

Adoption of Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Section 1.1502–91T also issued under 26 U.S.C. 382(m) and 26 U.S.C. 1502.

Section 1.1502–92T also issued under 26 U.S.C. 382(m) and 26 U.S.C. 1502.

Section 1.1502–93T also issued under 26 U.S.C. 382(m) and 26 U.S.C. 1502.

Section 1.1502–94T also issued under 26 U.S.C. 382(m) and 26 U.S.C. 1502.

Section 1.1502–95T also issued under 26 U.S.C. 382(m) and 26 U.S.C. 1502.

Section 1.1502–96T also issued under 26 U.S.C. 382(m) and 26 U.S.C. 1502.

Section 1.1502–98T also issued under 26 U.S.C. 382(m) and 26 U.S.C. 1502.

Section 1.1502–99T also issued under 26 U.S.C. 382(m) and 26 U.S.C. 1502.

* * *

Par. 2. Sections 1.1502–90T through 1.1502–99T are added to read as follows:

§ 1.1502–90T Table of contents (temporary). The following table contains the major headings in §§ 1.1502–91T through 1.1502–99T.

§ 1.1502–91T Application of section 382 with respect to a consolidated group (temporary).

(a) Determination and effect of an ownership change.
(1) In general.
(2) Special rule for post-change year that includes the change date.
(3) Cross reference.
(b) Definitions and nomenclature.
(c) Loss group.
(1) Defined.
(2) Coordination with rule that ends separate tracking.
(3) Example.
(d) Loss subgroup.
(1) Net operating loss carryovers.
(2) Net unrealized built-in loss.
(3) Loss subgroup parent.
(4) Principal purpose of avoiding a limitation.
(5) Special rules.
(6) Examples.
(e) Pre-change consolidated attribute.
(1) Defined.
(2) Example.
(f) Pre-change subgroup attribute.
(1) Defined.
(2) Example.
(g) Net unrealized built-in gain and loss.
(1) In general.
(2) Members included.
(i) Consolidated group.
(ii) Loss subgroup.
(3) Acquisitions of built-in gain or loss assets.
(4) Indirect ownership.
(h) Recognized built-in gain or loss.
(1) In general.
(2) Disposition of stock or an intercompany obligation of a member.
(3) Deferred gain or loss.
(4) Exchanged basis property.
(i) [Reserved]
(j) Predecessor and successor corporations.

§ 1.1502–92T Ownership change of a loss group or a loss subgroup (temporary).

(a) Scope.
(b) Determination of an ownership change.
(1) Parent change method.
(i) Loss group.
(ii) Loss subgroup.
(2) Examples.
(3) Special adjustments.
(i) Common parent succeeded by a new common parent.
(ii) Newly created loss subgroup parent.
(iii) Examples.
(4) End of separate tracking of certain losses.
(c) Supplemental rules for determining ownership change.
(1) Scope.
(2) Cause for applying supplemental rule.
(3) Operating rules.
(4) Supplemental ownership change rules.
(i) Additional testing dates for the common parent (or loss subgroup parent).
(ii) Treatment of subsidiary stock as stock of the common parent (or loss subgroup parent).
(iii) 5-percent shareholder of the common parent (or loss subgroup parent).
(5) Examples.
(d) Testing period following ownership change under this section.
(e) Information statements.
(1) Common parent of a loss group.
(2) Abbreviated statement with respect to loss subgroups.

§ 1.1502–93T Consolidated section 382 limitation (or subgroup section 382 limitation) (temporary).

(a) Determination of the consolidated section 382 limitation (or subgroup section 382 limitation).
(1) In general.
(2) Coordination with apportionment rule.
(b) Value of the loss group (or loss subgroup).
(1) Stock value immediately before ownership change.
(2) Adjustment to value.
(3) Examples.
(c) Recognized built-in gain of a loss group or loss subgroup.
(d) Continuity of business.
(1) In general.
(2) Example.
(e) Limitations of losses under other rules.

§ 1.1502–94T Coordination with section 382 and the regulations thereunder when a corporation becomes a member of a consolidated group (temporary).

(a) Scope.
(1) In general.
(2) Successor corporation as new loss member.

(3) Coordination in the case of a loss subgroup.
(4) End of separate tracking of certain losses.
(5) Cross-reference.
(b) Application of section 382 to a new loss member.
(1) In general.
(2) Adjustment to value.
(3) Pre-change separate attribute defined.
(4) Examples.
(c) Built-in gains and losses.
(d) Information statements.

§ 1.1502–95T Rules on ceasing to be a member of a consolidated group (or loss subgroup) (temporary).

(a) In general.
(1) Consolidated group.
(2) Election by common parent.
(3) Coordination with §§ 1.1502–91T through 1.1502–93T.
(b) Separate application of section 382 when a member leaves a consolidated group.
(1) In general.
(2) Effect of a prior ownership change of the group.
(3) Application in the case of a loss subgroup.
(4) Examples.
(c) Apportionment of a consolidated section 382 limitation.
(1) In general.
(2) Amount of apportionment.
(3) Effect of apportionment on the consolidated section 382 limitation.
(4) Effect on corporations to which the consolidated section 382 limitation is apportioned.
(5) Deemed apportionment when loss group terminates.
(6) Appropriate adjustments when former member leaves during the year.
(7) Examples.
(d) Rules pertaining to ceasing to be a member of a loss subgroup.
(1) In general.
(2) Examples.
(e) Filing the election to apportion.
(1) Form of the election to apportion.
(2) Signing of the election.
(3) Filing of the election.
(4) Revocation of election.

§ 1.1502–96T Miscellaneous rules (temporary).

(a) End of separate tracking of losses.
(1) Application.
(2) Effect of end of separate tracking.
(3) Continuing effect of end of separate tracking.
(4) Special rule for testing period.
(5) Limits on effects of end of separate tracking.
(b) Ownership change of subsidiary.
(1) Ownership change of a subsidiary because of options or plan or arrangement.
(2) Effect of the ownership change.
(i) In general.
(ii) Pre-change losses.
(3) Coordination with §§ 1.1502–91T, 1.1502–92T, and 1.1502–94T.
(4) Example.
(c) Continuing effect of an ownership change.

§ 1.1502–97T Special rules under section 382 for members under the jurisdiction of a court in a title 11 or similar case (temporary). [Reserved]

§ 1.1502–98T Coordination with section 383 (temporary).

§ 1.1502–99T Effective dates (temporary).

(a) Effective date.
(b) Testing period may include a period beginning before January 1, 1997.
(c) Transition rules. (1) Methods permitted. (i) In general.
(ii) Adjustments to offset excess limitation.
(iii) Coordination with effective date.
(2) Permitted methods.
(d) Amended returns.
(e) Section 383.

§ 1.1502–91T Application of section 382 with respect to a consolidated group (temporary).

(a) *Determination and effect of an ownership change*—(1) *In general.* This section and §§ 1.1502–92T and 1.1502–93T set forth the rules for determining an ownership change under section 382 for members of consolidated groups and the section 382 limitations with respect to attributes described in paragraphs (e) and (f) of this section. These rules generally provide that an ownership change and the section 382 limitation are determined with respect to these attributes for the group (or loss subgroup) on a single entity basis and not for its members separately. Following an ownership change of a loss group (or a loss subgroup) under § 1.1502–92T, the amount of consolidated taxable income for any post-change year which may be offset by pre-change consolidated attributes (or pre-change subgroup attributes) shall not exceed the consolidated section 382 limitation (or subgroup section 382 limitation) for such year as determined under § 1.1502–93T.

(2) *Special rule for post-change year that includes the change date.* If the post-change year includes the change date, section 382(b)(3)(A) is applied so that the consolidated section 382 limitation (or subgroup section 382 limitation) does not apply to the portion of consolidated taxable income that is allocable to the period in the year on or before the change date. See generally § 1.382–6 (relating to the allocation of income and loss). The allocation of consolidated taxable income for the post-change year that includes the change date must be made before taking into account any consolidated net operating loss deduction (as defined in § 1.1502–21T(a)).

(3) *Cross reference.* See §§ 1.1502–94T and 1.1502–95T for rules that apply section 382 to a corporation that becomes or ceases to be a member of a group or loss subgroup.

(b) *Definitions and nomenclature.* For purposes of this section and §§ 1.1502–92T through 1.1502–99T, unless otherwise stated:

(1) The definitions and nomenclature contained in section 382 and the regulations thereunder (including the nomenclature and assumptions relating to the examples in § 1.382–2T(b)) and this section and §§ 1.1502–92T through 1.1502–99T apply; and

(2) In all examples, all groups file consolidated returns, all corporations file their income tax returns on a calendar year basis, the only 5-percent shareholder of a corporation is a public group, the facts set forth the only owner shifts during the testing period, and each asset of a corporation has a value equal to its adjusted basis.

(c) *Loss group*—(1) *Defined.* A loss group is a consolidated group that:

(i) Is entitled to use a net operating loss carryover to the taxable year that did not arise (and is not treated under § 1.1502–21T(c) as arising) in a SRLY;

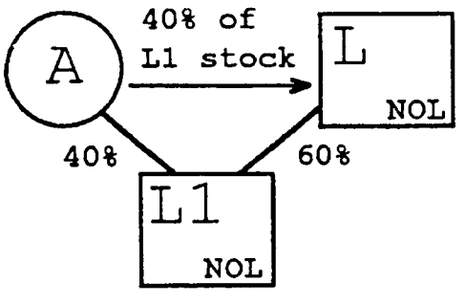
(ii) Has a consolidated net operating loss for the taxable year in which a testing date of the common parent occurs (determined by treating the common parent as a loss corporation); or

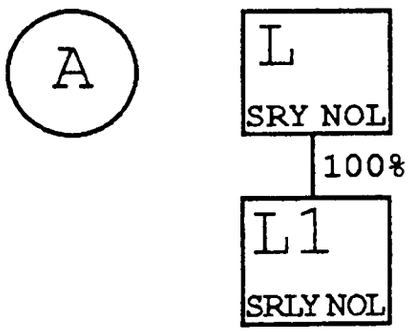
(iii) Has a net unrealized built-in loss (determined under paragraph (g) of this section by treating the date on which the determination is made as though it were a change date).

(2) *Coordination with rule that ends separate tracking.* A consolidated group may be a loss group because a member's losses that arose in (or are treated as arising in) a SRLY are treated as described in paragraph (c)(1)(i) of this section. See § 1.1502–96T(a).

(3) *Example.* The following example illustrates the principles of this paragraph (c).

Example. Loss group. (a) L and L1 file separate returns and each has a net operating loss carryover arising in Year 1 that is carried over to Year 2. A owns 40 shares and L owns 60 shares of the 100 outstanding shares of L1 stock. At the close of Year 1, L buys the 40 shares of L1 stock from A. For Year 2, L and L1 file a consolidated return. The following is a graphic illustration of these facts:





(b) L and L1 become a loss group at the beginning of Year 2 because the group is entitled to use the Year 1 net operating loss carryover of L, the common parent, which did not arise (and is not treated under § 1.1502–21T(c) as arising) in a SRLY. See § 1.1502–94T for rules relating to the application of section 382 with respect to L1's net operating loss carryover from Year 1 which did arise in a SRLY.

(d) *Loss subgroup*—(1) *Net operating loss carryovers.* Two or more corporations that become members of a consolidated group (the current group) compose a loss subgroup if:

(i) They were affiliated with each other in another group (the former group), whether or not the group was a consolidated group;

(ii) They bear the relationship described in section 1504(a)(1) to each other through a loss subgroup parent immediately after they become members of the current group; and

(iii) At least one of the members carries over a net operating loss that did not arise (and is not treated under § 1.1502–21T(c) as arising) in a SRLY with respect to the former group.

(2) *Net unrealized built-in loss.* Two or more corporations that become members of a consolidated group compose a loss subgroup if they:

(i) Have been continuously affiliated with each other for the 5 consecutive year period ending immediately before they become members of the group;

(ii) Bear the relationship described in section 1504(a)(1) to each other through a loss subgroup parent immediately after they become members of the current group; and

(iii) Have a net unrealized built-in loss (determined under paragraph (g) of this section on the day they become members of the group by treating that day as though it were a change date).

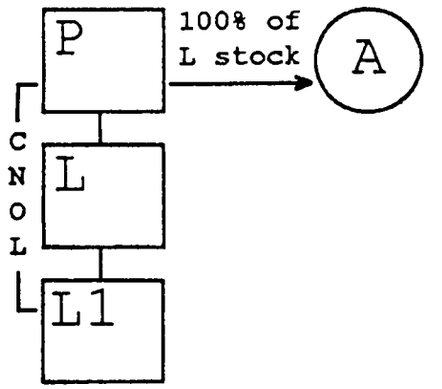
(3) *Loss subgroup parent.* A loss subgroup parent is the corporation that bears the same relationship to the other members of the loss subgroup as a common parent bears to the members of a group.

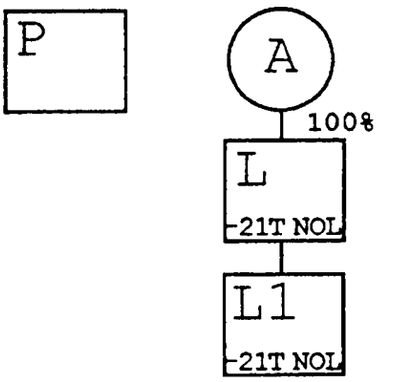
(4) *Principal purpose of avoiding a limitation.* The corporations described in paragraph (d)(1) or (2) of this section do not compose a loss subgroup if any one of them is formed, acquired, or availed of with a principal purpose of avoiding the application of, or increasing any limitation under, section 382. Instead, § 1.1502–94T applies with respect to the attributes of each such corporation. This paragraph (d)(4) does not apply solely because, in connection with becoming members of the group, the members of a group (or loss subgroup) are rearranged to bear a relationship to the other members described in section 1504(a)(1).

(5) *Special rules.* See § 1.1502–95T(d) for rules concerning when a corporation ceases to be a member of a loss subgroup. See also § 1.1502–96T(a) for a special rule regarding the end of separate tracking of SRLY losses of a member that has an ownership change or that has been a member of a group for at least 5 consecutive years.

(6) *Examples.* The following examples illustrate the principles of this paragraph (d).

Example 1. Loss subgroup. (a) P owns all the L stock and L owns all the L1 stock. The P group has a consolidated net operating loss arising in Year 1 that is carried to Year 2. On May 2, Year 2, P sells all the stock of L to A, and L and L1 thereafter file consolidated returns. A portion of the Year 1 consolidated net operating loss is apportioned under § 1.1502–21T(b) to each of L and L1, which they carry over to Year 2. The following is a graphic illustration of these facts:





(b)(1) L and L1 compose a loss subgroup within the meaning of paragraph (d)(1) of this section because—

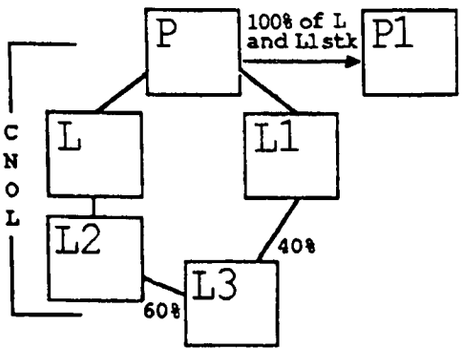
(i) They were affiliated with each other in the P group (the former group);

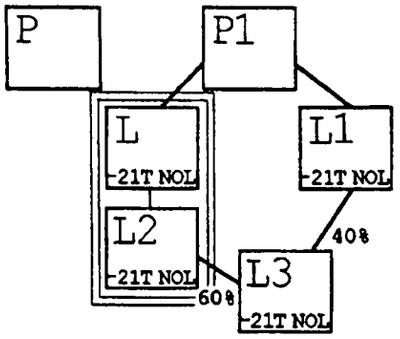
(ii) They bear a relationship described in section 1504(a)(1) to each other through a loss subgroup parent (L) immediately after they became members of the L group; and

(iii) At least one of the members (here, both L and L1) carries over a net operating loss to the L group (the current group) that did not arise in a SRLY with respect to the P group.

(2) Under paragraph (d)(3) of this section, L is the loss subgroup parent of the L loss subgroup.

Example 2. Loss subgroup—section 1504(a)(1) relationship. (a) P owns all the stock of L and L1. L owns all the stock of L2. L1 and L2 own 40 percent and 60 percent of the stock of L3, respectively. The P group has a consolidated net operating loss arising in Year 1 that is carried over to Year 2. On May 22, Year 2, P sells all the stock of L and L1 to P1, the common parent of another consolidated group. The Year 1 consolidated net operating loss is apportioned under § 1.1502–21T(b), and each of L, L1, L2, and L3 carries over a portion of such loss to the first consolidated return year of the P1 group ending after the acquisition. The following is a graphic illustration of these facts:





(b) L and L2 compose a loss subgroup within the meaning of paragraph (d)(1) of this section. Neither L1 nor L3 is included in a loss subgroup because neither bears a relationship described in section 1504(a)(1) through a loss subgroup parent to any other member of the former group immediately after becoming members of the P1 group.

Example 3. Loss subgroup—section 1504(a)(1) relationship. The facts are the same as in *Example 2*, except that the stock of L1 is transferred to L in connection with the sale of the L stock to P1. L, L1, L2, and L3 compose a loss subgroup within the meaning of paragraph (d)(1) of this section because—

(1) They were affiliated with each other in the P group (the former group);

(2) They bear a relationship described in section 1504(a)(1) to each other through a loss subgroup parent (L) immediately after they become members of the P1 group; and

(3) At least one of the members (here, each of L, L1, L2, and L3) carries over to the P1 group (the current group) a net operating loss that did not arise in a SRLY with respect to the P group (the former group).

(e) *Pre-change consolidated attribute*—(1) *Defined.* A pre-change consolidated attribute of a loss group is—

(i) Any loss described in paragraph (c)(1)(i) or (ii) of this section (relating to the definition of loss group) that is allocable to the period ending on or before the change date; and

(ii) Any recognized built-in loss of the loss group.

(2) *Example.* The following example illustrates the principle of this paragraph (e).

Example. Pre-change consolidated attribute. (a) The L group has a consolidated net operating loss arising in Year 1 that is carried over to Year 2. The L loss group has an ownership change at the beginning of Year 2.

(b) The net operating loss carryover of the L loss group from Year 1 is a pre-change consolidated attribute because the L group was entitled to use the loss in Year 2, the loss did not arise in a SRLY with respect to the L group, and therefore the loss was described in paragraph (c)(1)(i) of this section. Under paragraph (a) of this section, the amount of consolidated taxable income of the L group for Year 2 that may be offset by this loss carryover may not exceed the consolidated section 382 limitation of the L group for that year. See § 1.1502-93T for rules relating to the computation of the consolidated section 382 limitation.

(f) *Pre-change subgroup attribute*—(1) *Defined.* A pre-change subgroup attribute of a loss subgroup is—

(i) Any net operating loss carryover described in paragraph (d)(1)(iii) of this section (relating to the definition of loss subgroup); and

(ii) Any recognized built-in loss of the loss subgroup.

(2) *Example.* The following example illustrates the principle of this paragraph (f).

Example. Pre-change subgroup attribute. (a) P is the common parent of a consolidated group. P owns all the stock of L, and L owns all the stock of L1. L2 is not a member of an affiliated group, and has a net operating loss arising in Year 1 that is carried over to Year 2. On December 11, Year 2, L1 acquires all the stock of L2, causing an ownership change of L2. During Year 2, the P group has a consolidated net operating loss that is carried over to Year 3. On November 2, Year 3, M acquires all the L stock from P. M, L, L1, and L2 thereafter file consolidated returns. All of the P group Year 2 consolidated net operating loss is apportioned under § 1.1502-21T(b) to L and L2, which they carry over to the M group.

(b)(1) L, L1, and L2 compose a loss subgroup because—

(i) They were affiliated with each other in the P group (the former group);

(ii) They bore a relationship described in section 1504(a)(1) to each other through a loss subgroup parent (L) immediately after they became members of the L group; and

(iii) At least one of the members (here, both L and L2) carries over a net operating loss to the M group (the current group) that is described in paragraph (d)(1)(iii) of this section.

(2) For this purpose, L2's loss from Year 1 that was a SRLY loss with respect to the P group (the former group) is treated as described in paragraph (d)(1)(iii) of this section because of the application of the principles of § 1.1502-96T(a). See paragraph (d)(5) of this section. M's acquisition results in an ownership change of L, and therefore the L loss subgroup under § 1.1502-92T(a)(2). See § 1.1502-93T for rules governing the computation of the subgroup section 382 limitation.

(c) In the M group, L2's Year 1 loss continues to be subject to a section 382 limitation resulting from the ownership change that occurred on December 11, Year 2. See § 1.1502-96T(c).

(g) *Net unrealized built-in gain and loss*—(1) *In general.* The determination whether a consolidated group (or loss subgroup) has a net unrealized built-in gain or loss under section 382(h)(3) is based on the aggregate amount of the separately computed net unrealized built-in gains or losses of each member that is included in the group (or loss subgroup) under paragraph (g)(2) of this section, including items of built-in income and deduction described in section 382(h)(6). Thus, for example, amounts deferred under section 267, or under § 1.1502-13 (other than amounts deferred with respect to the stock of a member (or an intercompany obligation) included in the group (or loss subgroup) under paragraph (g)(2) of this section) are built-in items. The threshold requirement under section 382(h)(3)(B) applies on an aggregate basis and not on a member-by-member basis. The separately computed amount of a member included in a group or loss subgroup does not include any unrealized built-in gain or loss on stock (including stock described in section 1504(a)(4) and § 1.382-2T(f)(18)(ii) and (iii)) of another member included in the group or loss subgroup (or on an intercompany obligation). However, a member of a group or loss subgroup includes in its separately computed amount the unrealized built-in gain or loss on stock of another member (or on an intercompany obligation) not included in the group or loss subgroup. If a member is not included in a group (or loss subgroup) under paragraph (g)(2) of this section, the determination of whether the member has a net unrealized built-in gain or loss under section 382(h)(3) is made on a separate entity basis. See § 1.1502-94(c) (relating to built-in gain or loss of a new loss member) and § 1.1502-96(a) (relating to the end of separate tracking of certain losses).

(2) *Members included*—(i) *Consolidated group.* The members included in the determination whether a consolidated group has a net unrealized built-in gain or loss are all members of the group on the day that the determination is made other than—

(A) A new loss member with a net unrealized built-in loss described in § 1.1502-94T(a)(1)(ii); and

(B) Members included in a loss subgroup described in § 1.1502-91T(d)(2).

(ii) *Loss subgroup.* The members included in the determination whether a loss subgroup has a net unrealized built-in gain or loss are those members described in paragraphs (d)(2)(i) and (ii) of this section.

(3) *Acquisitions of built-in gain or loss assets.* A member of a consolidated group (or loss subgroup) may not, in determining its separately computed net

unrealized built-in gain or loss, include any gain or loss with respect to assets acquired with a principal purpose to affect the amount of its net unrealized built-in gain or loss. A group (or loss subgroup) may not, in determining its net unrealized built-in gain or loss, include any gain or loss of a member acquired with a principal purpose to affect the amount of its net unrealized built-in gain or loss.

(4) *Indirect ownership.* A member's separately computed net unrealized built-in gain or loss is adjusted to the extent necessary to prevent any duplication of unrealized gain or loss attributable to the member's indirect ownership interest in another member through a nonmember if the member has a 5-percent or greater ownership interest in the nonmember.

(h) *Recognized built-in gain or loss*—(1) *In general.* [Reserved]

(2) *Disposition of stock or an intercompany obligation of a member.* Gain or loss recognized by a member on the disposition of stock (including stock described in section 1504(a)(4) and § 1.382–2T(f)(18)(ii) and (iii)) of another member or an intercompany obligation is treated as a recognized built-in gain or loss under section 382(h)(2) (unless disallowed under § 1.1502–20 or otherwise), even though gain or loss on such stock or obligation was not included in the determination of a net unrealized built-in gain or loss under paragraph (g)(1) of this section.

(3) *Deferred gain or loss.* Gain or loss that is deferred under provisions such as section 267 and § 1.1502–13 is treated as recognized built-in gain or loss only to the extent taken into account by the group during the recognition period.

(4) *Exchanged basis property.* If the adjusted basis of any asset is determined, directly or indirectly, in whole or in part, by reference to the adjusted basis of another asset held by the member at the beginning of the recognition period, the asset is treated, with appropriate adjustments, as held by the member at the beginning of the recognition period.

(i) [Reserved]

(j) *Predecessor and successor corporations.* A reference in this section and §§ 1.1502–92T through 1.1502–99T to a corporation, member, common parent, loss subgroup parent, or subsidiary includes, as the context may require, a reference to a predecessor or successor corporation. For example, the determination whether a successor satisfies the continuous affiliation requirement of paragraph (d)(2)(i) of this section is made by reference to its predecessor.

§ 1.1502–92T Ownership change of a loss group or a loss subgroup (temporary).

(a) *Scope.* This section provides rules for determining if there is an ownership change for purposes of section 382 with respect to a loss group or a loss subgroup. See § 1.1502–94T for special rules for determining if there is an ownership change with respect to a new loss member and § 1.1502–96T(b) for special rules for determining if there is an ownership change of a subsidiary.

(b) *Determination of an ownership change*—(1) *Parent change method*—(i) *Loss group.* A loss group has an ownership change if the loss group's common parent has an ownership change under section 382 and the regulations thereunder. Solely for purposes of determining whether the common parent has an ownership change—

(A) The losses described in § 1.1502–91T(c) are treated as net operating losses (or a net unrealized built-in loss) of the common parent; and

(B) The common parent determines the earliest day that its testing period can begin by reference to only the attributes that make the group a loss group under § 1.1502–91T(c).

(ii) *Loss subgroup.* A loss subgroup has an ownership change if the loss subgroup parent has an ownership change under section 382 and the regulations thereunder. The principles of § 1.1502–95T(b) (relating to ceasing to be a member of a consolidated group) apply in determining whether the loss subgroup parent has an ownership change. Solely for purposes of determining whether the loss subgroup parent has an ownership change—

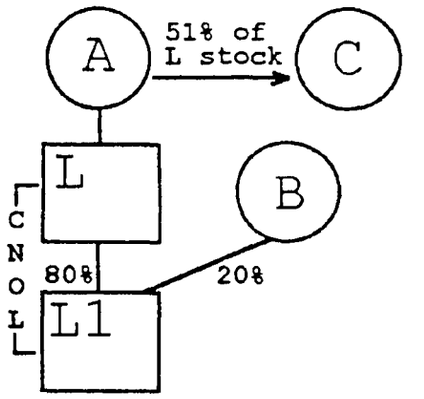
(A) The losses described in § 1.1502–91T(d) are treated as net operating losses (or a net unrealized built-in loss) of the loss subgroup parent;

(B) The day that the members of the loss subgroup become members of the group (or a loss subgroup) is treated as a testing date within the meaning of § 1.382–2(a)(4); and

(C) The loss subgroup parent determines the earliest day that its testing period can begin under § 1.382–2T(d)(3) by reference to only the attributes that make the members a loss subgroup under § 1.1502–91T(d).

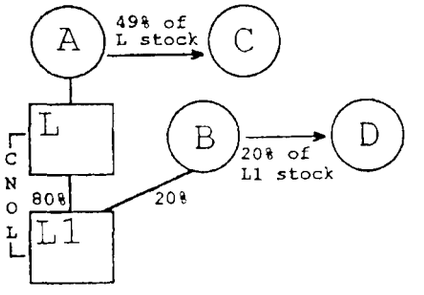
(2) *Examples.* The following examples illustrate the principles of this paragraph (b).

Example 1. Loss group—ownership change of the common parent. (a) A owns all the L stock. L owns 80 percent and B owns 20 percent of the L1 stock. For Year 1, the L group has a consolidated net operating loss that resulted from the operations of L1 and that is carried over to Year 2. The value of the L stock is $1000. The total value of the L1 stock is $600 and the value of the L1 stock held by B is $120. The L group is a loss group under § 1.1502–91T(c)(1) because it is entitled to use its net operating loss carryover from Year 1. On August 15, Year 2, A sells 51 percent of the L stock to C. The following is a graphic illustration of these facts:



(b) Under paragraph (b)(1)(i) of this section, section 382 and the regulations thereunder are applied to L to determine whether it (and therefore the L loss group) has an ownership change with respect to its net operating loss carryover from Year 1 attributable to L1 on August 15, Year 2. The sale of the L stock to C causes an ownership change of L under § 1.382–2T and of the L loss group under paragraph (b)(1)(i) of this section. The amount of consolidated taxable income of the L loss group for any post-change taxable year that may be offset by its pre-change consolidated attributes (that is, the net operating loss carryover from Year 1 attributable to L1) may not exceed the consolidated section 382 limitation for the L loss group for the taxable year.

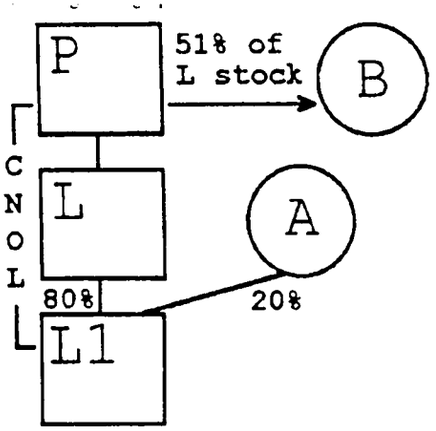
Example 2. Loss group—owner shifts of subsidiaries disregarded. (a) The facts are the same as in *Example 1*, except that on August 15, Year 2, A sells only 49 percent of the L stock to C and, on December 12, Year 3, in an unrelated transaction, B sells the 20 percent of the L1 stock to D. A's sale of the L stock to C does not cause an ownership change of L under § 1.382–2T nor of the L loss group under paragraph (b)(1)(i) of this section. The following is a graphic illustration of these facts:

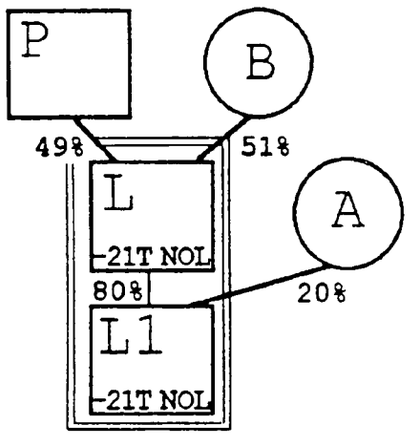


(b) B's subsequent sale of L1 stock is not taken into account for purposes of determining whether the L loss group has an ownership change under

paragraph (b)(1)(i) of this section, and, accordingly, there is no ownership change of the L loss group. See paragraph (c) of this section, however, for a supplemental ownership change method that would apply to cause an ownership change if the purchases by C and D were pursuant to a plan or arrangement.

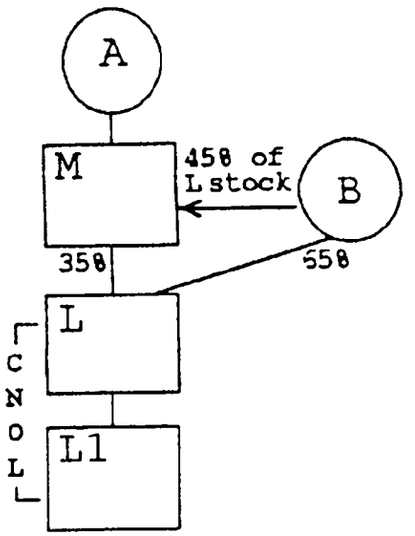
Example 3. Loss subgroup—ownership change of loss subgroup parent controls. (a) P owns all the L stock. L owns 80 percent and A owns 20 percent of the L1 stock. The P group has a consolidated net operating loss arising in Year 1 that is carried over to Year 2. On September 9, Year 2, P sells 51 percent of the L stock to B, and L1 is apportioned a portion of the Year 1 consolidated net operating loss under § 1.1502-21T(b), which it carries over to its next taxable year. L and L1 file a consolidated return for their first taxable year ending after the sale to B. The following is a graphic illustration of these facts:

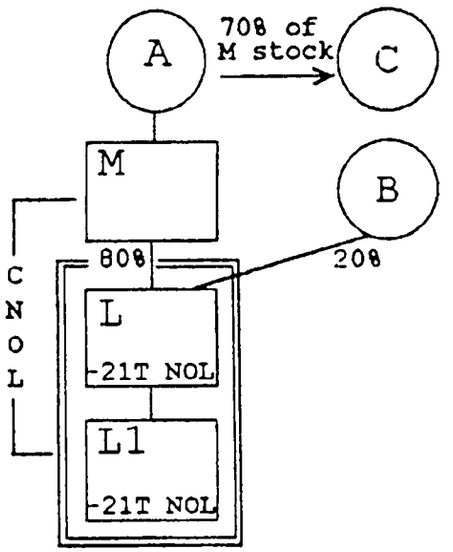




(b) Under § 1.1502-91T(d)(1), L and L1 compose a loss subgroup on September 9, Year 2, the day that they become members of the L group. Under paragraph (b)(1)(ii) of this section, section 382 and the regulations thereunder are applied to L to determine whether it (and therefore the L loss subgroup) has an ownership change with respect to the portion of the Year 1 consolidated net operating loss that is apportioned to L1 on September 9, Year 2. L has an ownership change resulting from P's sale of 51 percent of the L stock to A. Therefore, the L loss subgroup has an ownership change with respect to that loss.

Example 4. Loss group and loss subgroup—contemporaneous ownership changes. (a) A owns all the stock of corporation M, M owns 35 percent and B owns 65 percent of the L stock, and L owns all the L1 stock. The L group has a consolidated net operating loss arising in Year 1 that is carried over to Year 2. On May 19, Year 2, B sells 45 percent of the L stock to M for cash. M, L, and L1 thereafter file consolidated returns. L and L1 are each apportioned a portion of the Year 1 consolidated net operating loss, which they carry over to the M group's Year 2 and Year 3 consolidated return years. The M group has a consolidated net operating loss arising in Year 2 that is carried over to Year 3. On June 9, Year 3, A sells 70 percent of the M stock to C. The following is a graphic illustration of these facts:





(b) Under § 1.1502-91T(d)(1), L and L1 compose a loss subgroup on May 19, Year 2, the day they become members of the M group. Under paragraph (b)(1)(ii) of this section, section 382 and the regulations thereunder are applied to L to determine whether L (and therefore the L loss subgroup) has an ownership change with respect to the loss carryovers from Year 1 on May 19, Year 2, a testing date because of B's sale of L stock to M. The sale of L stock to M results in only a 45 percentage point increase in A's ownership of L stock. Thus, there is no ownership change of L (or the L loss subgroup) with respect to those loss carryovers under paragraph (b)(1)(ii) of this section on that day.

(c) June 9, Year 3, is also a testing date with respect to the L loss subgroup because of A's sale of M stock to C. The sale results in a 56 percentage point increase in C's ownership of L stock, and L has an ownership change. Therefore, the L loss subgroup has an ownership change on that day with respect to the loss carryovers from Year 1.

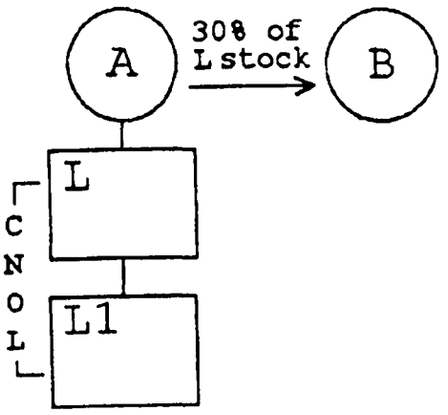
(d) Paragraph (b)(1)(i) of this section requires that section 382 and the regulations thereunder be applied to M to determine whether M (and therefore the M loss group) has an ownership change with respect to the net operating loss carryover from Year 2 on June 9, Year 3, a testing date because of A's sale of M stock to C. The sale results in a 70 percentage point increase in C's ownership of M stock, and M has an ownership change. Therefore, the M loss group has an ownership change on that day with respect to that loss carryover.

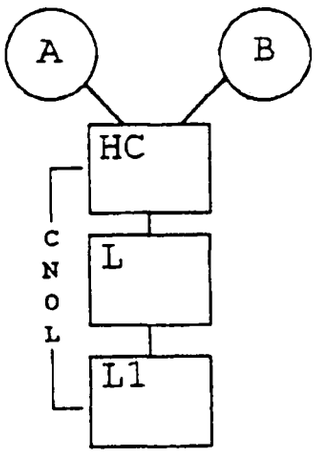
(3) *Special adjustments*—(i) *Common parent succeeded by a new common parent.* For purposes of determining if a loss group has an ownership change, if the common parent of a loss group is succeeded or acquired by a new common parent and the loss group remains in existence, the new common parent is treated as a continuation of the former common parent with appropriate adjustments to take into account shifts in ownership of the former common parent during the testing period (including shifts that occur incident to the common parent's becoming the former common parent).

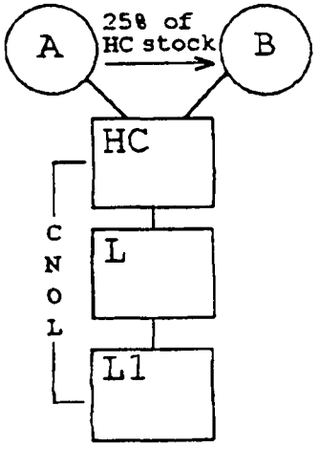
(ii) *Newly created loss subgroup parent.* For purposes of determining if a loss subgroup has an ownership change, if the member that is the loss subgroup parent has not been the loss subgroup parent for at least 3 years as of a testing date, appropriate adjustments must be made to take into account owner shifts of members of the loss subgroup so that the structure of the loss subgroup does not have the effect of avoiding an ownership change under section 382. (See paragraph (b)(3)(iii) *Example 3* of this section.)

(iii) *Examples.* The following examples illustrate the principles of this paragraph (b)(3).

Example 1. New common parent acquires old common parent. (a) A, who owns all the L stock, sells 30 percent of the L stock to B on August 26, Year 1. L owns all the L1 stock. The L group has a consolidated net operating loss arising in Year 1 that is carried over to Year 3. On July 16, Year 2, A and B transfer their L stock to a newly created holding company, HC, in exchange for 70 percent and 30 percent, respectively, of the HC stock. HC, L, and L1 thereafter file consolidated returns. Under the principles of § 1.1502-75(d), the L loss group is treated as remaining in existence, with HC taking the place of L as the new common parent of the loss group. The following is a graphic illustration of these facts:

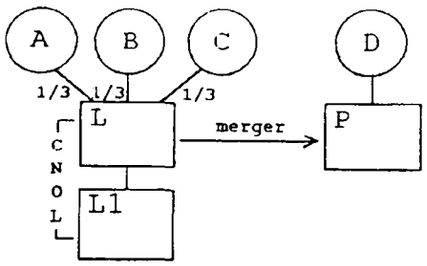


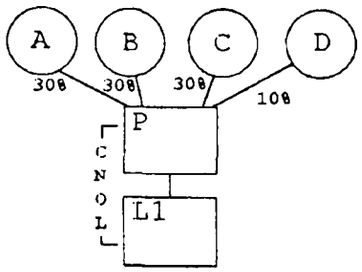




(b) On November 11, Year 3, A sells 25 percent of the HC stock to B. For purposes of determining if the L loss group has an ownership change under paragraph (b)(1)(i) of this section on November 11, Year 3, HC is treated as a continuation of L under paragraph (b)(3)(i) of this section because it acquired L and became the common parent without terminating the L loss group. Accordingly, HC's testing period commences on January 1, Year 1, the first day of the taxable year of the L loss group in which the consolidated net operating loss that is carried over to Year 3 arose (see § 1.382-2T(d)(3)(i)). Immediately after the close of November 11, Year 3, B's percentage ownership interest in the common parent of the loss group (HC) has increased by 55 percentage points over its lowest percentage ownership during the testing period (zero percent). Accordingly, HC and the L loss group have an ownership change on that day.

Example 2. New common parent in case in which common parent ceases to exist. (a) A, B, and C each own one-third of the L stock. L owns all the L1 stock. The L group has a consolidated net operating loss arising in Year 2 that is carried over to Year 3. On November 22, Year 3, L is merged into P, a corporation owned by D, and L1 thereafter files consolidated returns with P. A, B, and C, as a result of owning stock of L, own 90 percent of P's stock after the merger. D owns the remaining 10 percent of P's stock. The merger of L into P qualifies as a reverse acquisition of the L group under § 1.1502-75(d)(3)(i), and the L loss group is treated as remaining in existence, with P taking the place of L as the new common parent of the L group. The following is a graphic illustration of these facts:



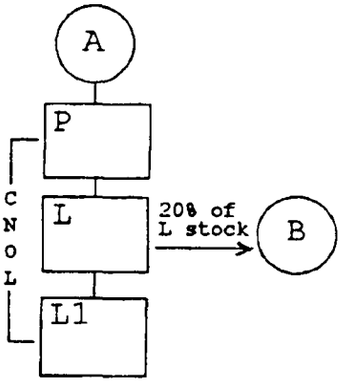


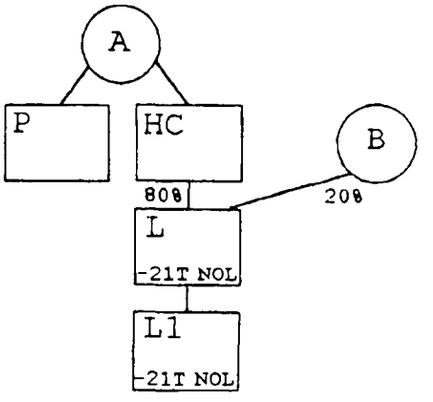
(b) For purposes of determining if the L loss group has an ownership change on November 22, Year 3, the day of the merger, P is treated as a continuation of L so that the testing period for P begins on January 1, Year 2, the first day of the taxable year of the L loss group in which the consolidated net operating loss that is carried over to Year 3 arose. Immediately after the close of November 22, Year 3, D is the only 5-percent shareholder that has increased his ownership interest in P during the testing period (from zero to 10 percentage points).

(c) The facts are the same as in paragraph (a) of this *Example 2*, except that A has held 23⅓ shares (23⅓ percent) of L's stock for five years, and A purchased an additional 10 shares of L stock from E two years before the merger. Immediately after the close of the day of the merger (a testing date), A's ownership interest in P, the common parent of the L loss group, has increased by 6⅔ percentage points over her lowest percentage ownership during the testing period (23⅓ percent to 30 percent).

(d) The facts are the same as in (a) of this *Example 2*, except that P has a net operating loss arising in Year 1 that is carried to the first consolidated return year ending after the day of the merger. Solely for purposes of determining whether the L loss group has an ownership change under paragraph (b)(1)(i) of this section, the testing period for P commences on January 1, Year 2. P does not determine the earliest day for its testing period by reference to its net operating loss carryover from Year 1, which §§ 1502-1(f)(3) and 1.1502-75(d)(3)(i) treat as arising in a SRLY. See § 1.1502-94T to determine the application of section 382 with respect to P's net operating loss carryover.

Example 3. Newly acquired loss subgroup parent. (a) P owns all the L stock and L owns all the L1 stock. The P group has a consolidated net operating loss arising in Year 1 that is carried over to Year 3. On January 19, Year 2, L issues a 20 percent stock interest to B. On February 5, Year 3, P contributes its L stock to a newly formed subsidiary, HC, in exchange for all the HC stock, and distributes the HC stock to its sole shareholder A. HC, L, and L1 thereafter file consolidated returns. A portion of the P group's Year 1 consolidated net operating loss is apportioned to L and L1 under § 1.1502-21T(b) and is carried over to the HC group's year ending after February 5, Year 3. HC, L, and L1 compose a loss subgroup within the meaning of § 1.1502-91T(d) with respect to the net operating loss carryovers from Year 1. The following is a graphic illustration of these facts:





(b) February 5, Year 3, is a testing date for HC as the loss subgroup parent with respect to the net operating loss carryovers of L and L1 from Year 1. See paragraph (b)(1)(ii)(B) of this section. For purposes of determining whether HC has an ownership change on the testing date, appropriate adjustments must be made with respect to the changes in the percentage ownership of the stock of HC because HC was not the loss subgroup parent for at least 3 years prior to the day on

which it became a member of the HC loss subgroup (a testing date). The appropriate adjustments include adjustments so that HC succeeds to the owner shifts of other members of the former group. Thus, HC succeeds to the owner shift of L that resulted from the sale of the 20 percent interest to B in determining whether the HC loss subgroup has an ownership change on February 5, Year 3, and on any subsequent testing date that includes January 19, Year 2.

(4) *End of separate tracking of certain losses.* If § 1.1502–96T(a) (relating to the end of separate tracking of attributes) applies to a loss subgroup, then, while one or more members that were included in the loss subgroup remain members of the consolidated group, there is an ownership change with respect to their attributes described in § 1.1502–96T(a)(2) only if the consolidated group is a loss group and has an ownership change under paragraph (b)(1)(i) of this section (or such a member has an ownership change under § 1.1502–96T(b) (relating to ownership changes of subsidiaries)). If, however, the loss subgroup has had an ownership change before § 1.1502–96T(a) applies, see § 1.1502–96T(c) for the continuing application of the subgroup's section 382 limitation with respect to its pre-change subgroup attributes.

(c) *Supplemental rules for determining ownership change*—(1) *Scope.* This paragraph (c) contains a supplemental rule for determining whether there is an ownership change of a loss group (or loss subgroup). It applies in addition to, and not instead of, the rules of paragraph (b) of this section. Thus, for example, if the common parent of the loss group has an ownership change under paragraph (b) of this section, the loss group has an ownership change even if, by applying this paragraph (c), the common parent would not have an ownership change.

(2) *Cause for applying supplemental rule.* This paragraph (c) applies to a loss group (or loss subgroup) if—

(i) Any 5-percent shareholder of the common parent (or loss subgroup parent) increases its percentage ownership interest in the stock of both—

(A) A subsidiary of the loss group (or loss subgroup) other than by a direct or indirect acquisition of stock of the common parent (or loss subgroup parent); and

(B) The common parent (or loss subgroup parent); and

(ii) Those increases occur within a 3 year period ending on any day of a consolidated return year or, if shorter, the period beginning on the first day following the most recent ownership change of the loss group (or loss subgroup).

(3) *Operating rules.* Solely for purposes of this paragraph (c)—

(i) A 5-percent shareholder of the common parent (or loss subgroup parent) is treated as increasing its percentage ownership interest in the common parent (or loss subgroup parent) or a subsidiary to the extent, if any, that any person acting pursuant to a plan or arrangement with the 5-percent shareholder increases its percentage ownership interest in the stock of that entity;

(ii) The rules in section 382(l)(3) and §§ 1.382–2T(h) and 1.382–4(d) (relating to constructive ownership) apply with respect to the stock of the subsidiary by treating such stock as stock of a loss corporation; and

(iii) In the case of a loss subgroup, a subsidiary includes any member of the loss subgroup other than the loss subgroup parent. (The loss subgroup parent is, however, a subsidiary of the loss group of which it is a member.)

(4) *Supplemental ownership change rules.* The determination whether the common parent (or loss subgroup parent) has an ownership change is made by applying paragraph (b)(1) of this section as modified by the following additional rules—

(i) *Additional testing dates for the common parent (or loss subgroup parent).* A testing date for the common parent (or loss subgroup parent) also includes—

(A) Each day on which there is an increase in the percentage ownership of stock of a subsidiary as described in paragraph (c)(2) of this section; and

(B) The first day of the first consolidated return year for which the group is a loss group (or the members compose a loss subgroup);

(ii) *Treatment of subsidiary stock as stock of the common parent (or loss subgroup parent).* The common parent (or loss subgroup parent) is treated as though it had issued to the person acquiring (or deemed to acquire) the subsidiary stock an amount of its own stock (by value) that equals the value of the subsidiary stock represented by the percentage increase in that person's ownership of the subsidiary (determined on a separate entity basis). A similar principle applies if the increase in percentage ownership interest is effected by a redemption or similar transaction; and

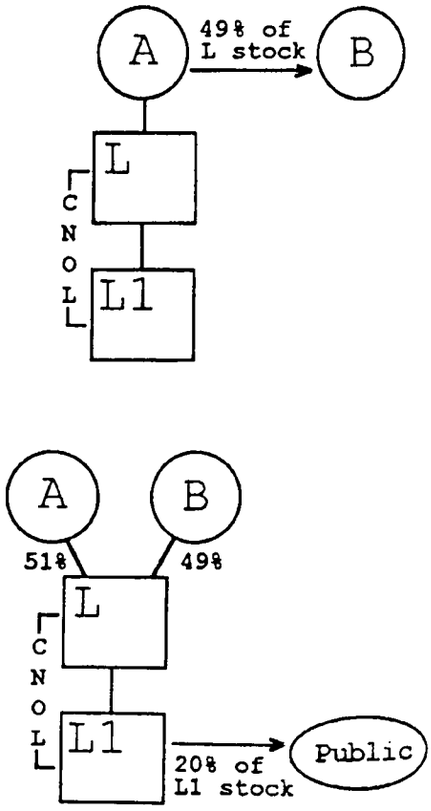
(iii) *5-percent shareholder of the common parent (or loss subgroup parent).* Any person described in paragraph (c)(3)(i) of this section who is acting pursuant to the plan or arrangement is treated as a 5-percent shareholder of the common parent (or loss subgroup parent).

(5) *Examples.* The following examples illustrate the principles of this paragraph (c).

Example 1. Stock of the common parent under supplemental rules. (a) A owns all the L stock. L is not a member of an affiliated group and has a net operating loss carryover arising in Year 1 that is carried over to Year 6. On September 20, Year 6, L transfers all of its assets and liabilities to a newly created subsidiary, S, in exchange for S stock. L and S thereafter file consolidated returns. On November 23, Year 6, B contributes cash to L in exchange for a 45 percent ownership interest in L and contributes cash to S for a 20 percent ownership interest in S.

(b) B is a 5-percent shareholder of L who increases his percentage ownership interest in L and S during the 3 year period ending on November 23, Year 6. Under paragraph (c)(4)(ii) of this section, the determination whether L (the common parent of a loss group) has an ownership change on November 23, Year 6 (or on any testing date in the testing period which includes November 23, Year 6), is made by applying paragraph (b)(1)(i) of this section and by treating the value of B's 20 percent ownership interest in S as if it were L stock issued to B.

Example 2. Plan or arrangement—public offering of subsidiary stock. (a) A owns all the stock of L and L owns all the stock of L1. The L group has a consolidated net operating loss arising in Year 1 that resulted from the operations of L1 and that is carried over to Year 2. As part of a plan, A sells 49 percent of the L stock to B on October 7, Year 2, and L1 issues new stock representing a 20 percent ownership interest in L1 to the public on November 6, Year 2. The following is a graphic illustration of these facts:



(b) A's sale of the L stock to B does not cause an ownership change of the L loss group on October 7, Year 2, under the rules of § 1.382–2T and paragraph (b)(1)(i) of this section.

(c) Because the issuance of L1 stock to the public occurs in connection with B's acquisition of L stock pursuant to a plan, paragraph (c)(4) of this section applies to determine whether the L loss group has an ownership change on November 6, Year 2 (or on any testing date for which the testing period includes November 6, Year 2).

(d) *Testing period following ownership change under this section.* If a loss group (or a loss subgroup) has had an ownership change under this section, the testing period for determining a subsequent ownership change with respect to pre-change consolidated attributes (or pre-change subgroup attributes) begins no earlier than the first day following the loss group's (or loss subgroup's) most recent change date.

(e) *Information statements*—(1) *Common parent of a loss group.* The common parent of a loss group must file the information statement required by § 1.382–2T(a)(2)(ii) for a consolidated return year because of any owner shift, equity structure shift, or the issuance or transfer of an option—

(i) With respect to the common parent and with respect to any subsidiary stock subject to paragraph (c) of this section; and

(ii) With respect to an ownership change described in § 1.1502–96T(b) (relating to ownership changes of subsidiaries).

(2) *Abbreviated statement with respect to loss subgroups.* The common parent of a consolidated group that has a loss subgroup during a consolidated return year must file the information statement required by § 1.382–2T(a)(2)(ii) because of any owner shift, equity structure shift, or issuance or transfer of an option with respect to the loss subgroup parent and with respect to any subsidiary stock subject to paragraph (c) of this section. Instead of filing a separate statement for each loss subgroup parent, the common parent (which is treated as a loss corporation) may file the single statement described in paragraph (e)(1) of this section. In addition to the information concerning stock ownership of the common parent, the single statement must identify each loss subgroup parent and state which loss subgroups, if any, have had ownership changes during the consolidated return year. The loss subgroup parent is, however, still required to maintain the records necessary to determine if the loss subgroup has an ownership change. This paragraph (e)(2) applies with respect to the attributes of a loss subgroup until, under § 1.1502–96T(a), the attributes are no longer treated as described in § 1.1502–91T(d) (relating to the definition of loss subgroup). After that time, the information statement described in paragraph (e)(1) of this section must be filed with respect to those attributes.

§ 1.1502–93T Consolidated section 382 limitation (or subgroup section 382 limitation) (temporary).

(a) *Determination of the consolidated section 382 limitation (or subgroup section 382 limitation)*—(1) *In general.* Following an ownership change, the consolidated section 382 limitation (or subgroup section 382 limitation) for any post-change year is an amount equal to the value of the loss group (or loss subgroup), as defined in paragraph (b) of this section, multiplied by the long-term tax-exempt rate that applies with respect to the ownership change, and adjusted as required by section 382 and the regulations thereunder. See, for example, section 382(b)(2) (relating to the carryforward of unused section 382 limitation), section 382(b)(3)(B) (relating to the section 382 limitation for the post-change year that includes the change date), section 382(m)(2) (relating to short taxable years), and section 382(h) (relating to recognized built-in gains and section 338 gains).

(2) *Coordination with apportionment rule.* For special rules relating to apportionment of a consolidated section 382 limitation (or a subgroup section 382 limitation) when one or more corporations cease to be members of a loss group (or a loss subgroup) and to aggregation of amounts so apportioned, see § 1.1502–95T(c).

(b) *Value of the loss group (or loss subgroup)*—(1) *Stock value immediately before ownership change.* Subject to any adjustment under paragraph (b)(2) of this section, the value of the loss group (or loss subgroup) is the value, immediately before the ownership change, of the stock of each member, other than stock that is owned directly or indirectly by another member. For this purpose—

(i) Ownership is determined under § 1.382–2T;

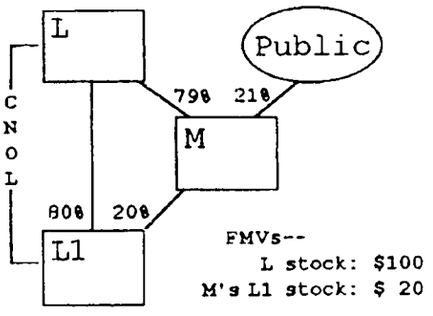
(ii) A member is considered to indirectly own stock of another member through a nonmember only if the member has a 5-percent or greater ownership interest in the nonmember; and

(iii) Stock includes stock described in section 1504(a)(4) and § 1.382–2T(f)(18)(ii) and (iii).

(2) *Adjustment to value.* The value of the loss group (or loss subgroup), as determined under paragraph (b)(1) of this section, is adjusted under any rule in section 382 or the regulations thereunder requiring an adjustment to such value for purposes of computing the amount of the section 382 limitation. See, for example, section 382(e)(2) (redemptions and corporate contractions), section 382(l)(1) (certain capital contributions) and section 382(l)(4) (ownership of substantial nonbusiness assets). The value of the loss group (or loss subgroup) determined under this paragraph (b) is also adjusted to the extent necessary to prevent any duplication of the value of the stock of a member. For example, the principles of § 1.382–8T (relating to controlled groups of corporations) apply in determining the value of a loss group (or loss subgroup) if, under § 1.1502–91T(g)(2), members are not included in the determination whether the group (or loss subgroup) has a net unrealized built-in loss.

(3) *Examples.* The following examples illustrate the principles of this paragraph (b).

Example 1. Basic case. (a) L, L1, and L2 compose a loss group. L has outstanding common stock, the value of which is $100. L1 has outstanding common stock and preferred stock that is described in section 1504(a)(4). L owns 90 percent of the L1 common stock, and A owns the remaining 10 percent of the L1 common stock plus all the preferred stock. The value of the L1 common stock is $40, and the value of the L1 preferred stock is $30. L2 has outstanding common stock, 50 percent of which is owned by L and 50 percent by L1. The L group has an ownership change. The following is a graphic illustration of these facts:



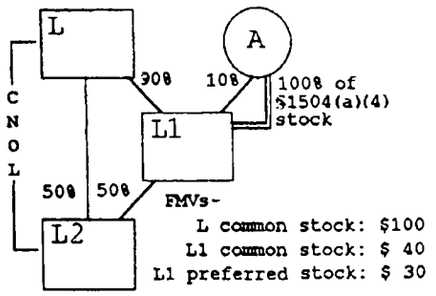
(b) Under paragraph (b)(1) of this section, the L group does not include the value of the stock of any member that is owned directly or indirectly by another member in computing its consolidated section 382 limitation. Accordingly, the value of the stock of the loss group is $134, the sum of the value of—

(1) The common stock of L ($100);

(2) the 10 percent of the L1 common stock ($4) owned by A; and

(3) The L1 preferred stock ($30) owned by A.

Example 2. Indirect ownership. (a) L and L1 compose a consolidated group. L's stock has a value of $100. L owns 80 shares (worth $80) and corporation M owns 20 shares (worth $20) of the L1 stock. L also owns 79 percent of the stock of corporation M. The L group has an ownership change. The following is a graphic illustration of these facts:



(b) Under paragraph (b)(1) of this section, because of L's more than 5 percent ownership interest in M, a nonmember, L is considered to indirectly own 15.8 shares of the L1 stock held by M (79% x 20 shares). The value of the L loss group is $104.20, the sum of the values of—

(1) The L stock ($100); and

(2) The L1 stock not owned directly or indirectly by L (21% x $20, or $4.20).

(c) *Recognized built-in gain of a loss group or loss subgroup.* If a loss group (or loss subgroup) has a net unrealized built-in gain, any recognized built-in gain of the loss group (or loss subgroup) is taken into account under section 382(h) in determining the consolidated section 382 limitation (or subgroup section 382 limitation).

(d) *Continuity of business*—(1) *In general.* A loss group (or a loss subgroup) is treated as a single entity for purposes of determining whether it satisfies the continuity of business enterprise requirement of section 382(c)(1).

(2) *Example.* The following example illustrates the principle of this paragraph (d).

Example. Continuity of business enterprise. L owns all the stock of two subsidiaries, L1 and L2. The L group has an ownership change. It has pre-change consolidated attributes attributable to L2. Each of the members has historically conducted a separate line of business. Each line of business is approximately equal in value. One year after the ownership change, L discontinues its separate business and the business of L2. The separate business of L1 is continued for the remainder of the 2 year period following the ownership change. The continuity of business enterprise requirement of section 382(c)(1) is met even though the separate businesses of L and L2 are discontinued.

(e) *Limitations of losses under other rules.* If a section 382 limitation for a post-change year exceeds the consolidated taxable income that may be offset by pre-change attributes for any reason, including the application of the limitation of § 1.1502–21T(c), the amount of the excess is carried forward under section 382(b)(2) (relating to the carryforward of unused section 382 limitation).

§ 1.1502–94T Coordination with section 382 and the regulations thereunder when a corporation becomes a member of a consolidated group (temporary).

(a) *Scope*—(1) *In general.* This section applies section 382 and the regulations thereunder to a corporation that is a new loss member of a consolidated group. A corporation is a new loss member if it—

(i) Carries over a net operating loss that arose (or is treated under § 1.1502–21T(c) as arising) in a SRLY with respect to the current group, and that is not described in § 1.1502–91T(d)(1); or

(ii) Has a net unrealized built-in loss (determined under paragraph (c) of this section on the day it becomes a member of the current group by treating that day as a change date) that is not taken into account under § 1.1502–91T(d)(2) in determining whether two or more corporations compose a loss subgroup.

(2) *Successor corporation as new loss member.* A new loss member also includes any successor to a corporation that has a net operating loss carryover arising in a SRLY and that is treated as remaining in existence under § 1.382–2(a)(1)(ii) following a transaction described in section 381(a).

(3) *Coordination in the case of a loss subgroup.* For rules regarding the determination of whether there is an ownership change of a loss subgroup with respect to a net operating loss or a net unrealized built-in loss described in § 1.1502–91T(d) (relating to the definition of loss subgroup) and the computation of a subgroup section 382 limitation following such an ownership change, see §§ 1.1502–92T and 1.1502–93T.

(4) *End of separate tracking of certain losses.* If § 1.1502–96T(a) (relating to the end of separate tracking of attributes) applies to a new loss member, then, while that member remains a member of the consolidated group, there is an ownership change with respect to its attributes described in § 1.1502–96T(a)(2) only if the consolidated group is a loss group and has an ownership change under § 1.1502–92T(b)(1)(i) (or that member has an ownership change under § 1.1502–96T(b) (relating to ownership changes of subsidiaries)). If, however, the new loss member has had an ownership change before § 1.1502–96T(a) applies, see § 1.1502–96T(c) for the continuing application of the section 382 limitation with respect to the member's pre-change losses.

(5) *Cross-reference.* See section 382(a) and § 1.1502–96T(c) for the continuing effect of an ownership change after a corporation becomes or ceases to be a member.

(b) *Application of section 382 to a new loss member*—(1) *In general.* Section 382 and the regulations thereunder apply to a new loss member to determine, on a separate entity basis, whether and to what extent a section 382 limitation applies to limit the amount of consolidated taxable income that may be offset by the new loss member's pre-change separate attributes. For example, if an ownership change with respect to the new loss member occurs under section 382 and the regulations thereunder, the amount of consolidated taxable income for any post-change year that may be offset by the new loss member's pre-change separate attributes shall not exceed the section 382 limitation as determined separately under section 382(b) with respect to that member for such year. If the post-change year includes the change date, section 382(b)(3)(A) is applied so that the section 382 limitation of the new loss member does not apply to the portion of the taxable income for such year that is allocable to the period in such year on or before the change date. See generally § 1.382–6 (relating to the allocation of income and loss).

(2) *Adjustment to value.* The value of the new loss member is adjusted to the extent necessary to prevent any duplication of the value of the stock of a member. For example, the principles of § 1.382–8T (relating to controlled groups of corporations) apply in determining the value of a new loss member.

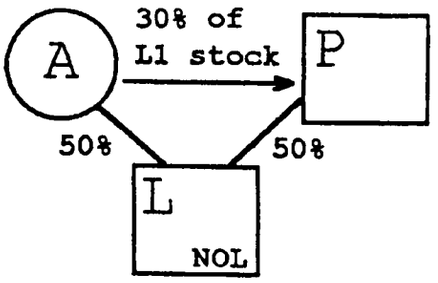
(3) *Pre-change separate attribute defined.* A pre-change separate attribute of a new loss member is—

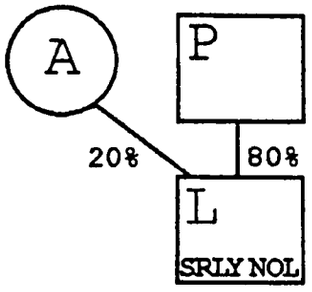
(i) Any net operating loss carryover of the new loss member described in paragraph (a)(1) of this section; and

(ii) Any recognized built-in loss of the new loss member.

(4) *Examples.* The following examples illustrate the principles of this paragraph (b).

Example 1. Basic case. (a) A and P each own 50 percent of the L stock. On December 19, Year 6, P purchases 30 percent of the L stock from A for cash. L has net operating losses arising in Year 1 and Year 2 that it carries over to Year 6 and Year 7. The following is a graphic illustration of these facts:

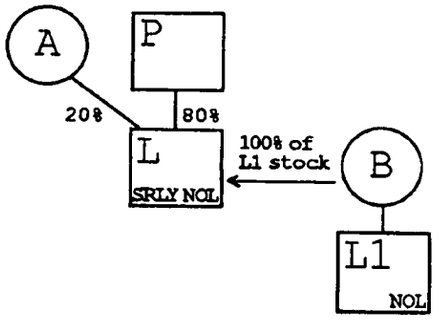


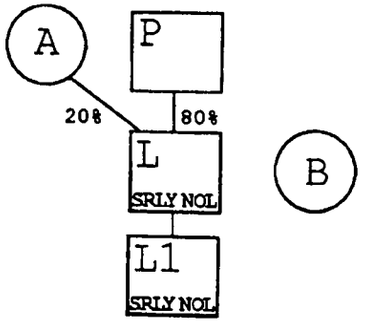


(b) L is a new loss member because it has net operating loss carryovers that arose in a SRLY with respect to the P group and L is not a member of a loss subgroup under § 1.1502–91T(d). Under section 382 and the regulations thereunder, L is a loss corporation on December 19, Year 6, that day is a testing date for L, and the testing period for L commences on December 20, Year 3.

(c) P's purchase of L stock does not cause an ownership change of L on December 19, Year 6, with respect to the net operating loss carryovers from Year 1 and Year 2 under section 382 and § 1.382–2T. The use of the loss carryovers, however, is subject to limitation under § 1.1502–21T(c).

Example 2. Multiple new loss members. (a) The facts are the same as in *Example 1*, and, on December 31, Year 6, L purchases all the stock of L1 from B for cash. L1 has a net operating loss of $40 arising in Year 3 that it carries over to Year 7. The following is a graphic illustration of these facts:





(b) L1 is a new loss member because it has a net operating loss carryover from Year 3 that arose in a SRLY with respect to the P group and L1 is not a member of a loss subgroup under § 1.1502–91T(d)(1).

(c) L's purchase of all the stock of L1 causes an ownership change of L1 on December 31, Year 6, under section 382 and § 1.382–2T. Accordingly, a section 382 limitation based on the value of the L1 stock immediately before the ownership change limits the amount of consolidated taxable income of the P group for any post-change year that may be offset by L1's loss from Year 3.

(d) L1's ownership change in connection with its becoming a member of the P group is an ownership change described in § 1.1502–96T(a). Thus, starting on January 1, Year 7, the P group no longer separately tracks owner shifts of the stock of L1 with respect to L1's loss from Year 3. Instead, the P group is a loss group because of such loss under § 1.1502–91T(c).

Example 3. Ownership changes of new loss members. (a) The facts are the same as in Example 2, and, on April 30, Year 7, C purchases all the stock of P for cash.

(b) L is a new loss member on April 30, Year 7, because its Year 1 and Year 2 losses arose in SRLYs with respect to the P group and it is not a member of a loss subgroup under § 1.1502–91T(d)(1). The testing period for L commences on May 1, Year 4. C's purchase of all the P stock causes an ownership change of L on April 30, Year 7, under section 382 and § 1.382–2T with respect to its Year 1 and Year 2 losses. Accordingly, a section 382 limitation based on the value of the L stock immediately before the ownership change limits the amount of consolidated taxable income of the P group for any post-change year that may be offset by L's Year 1 and Year 2 losses. The use of those carryovers is also subject to limitation under § 1.1502–21T(c).

(c) The P group is a loss group on April 30, Year 7, because it is entitled to use L1's loss from Year 3, and such loss is no longer treated as a loss of a new loss member starting the day after L1's ownership change on December 31, Year 6. See §§ 1.1502–96T(a) and 1.1502–91T(c)(2). C's purchase of all the P stock causes an ownership change of P, and therefore the P loss group, on April 30, Year 7, with respect to L1's Year 3 loss. Accordingly, a consolidated section 382 limitation based on the value of the P stock immediately before the ownership change limits the amount of consolidated taxable income of the P group for any post-change year that may be offset by L1's Year 3 loss.

(c) *Built-in gains and losses.* As the context may require, the principles of §§ 1.1502–91T(g) and (h) and 1.1502–93T(c) (relating to built-in gains and losses) apply to a new loss member on a separate entity basis. See § 1.1502–91T(g)(3).

(d) *Information statements.* The common parent of a consolidated group that has a new loss member subject to paragraph (b)(1) of this section during a consolidated return year must file the information statement required by § 1.382–2T(a)(2)(ii) because of any owner shift, equity structure shift, or issuance or transfer of an option with respect to the new loss member. Instead of filing a separate statement for each new loss member the common parent may file a single statement described in § 1.382–2T(a)(2)(ii) with respect to the stock ownership of the common parent (which is treated as a loss corporation). In addition to the information concerning stock ownership of the common parent, the single statement must identify each new loss member and state which new loss members, if any, have had ownership changes during the consolidated return year. The new loss member is, however, required to maintain the records necessary to determine if it has an ownership change. This paragraph (d) applies with respect to the attributes of a new loss member until an event occurs which ends separate tracking under § 1.1502–96T(a). After that time, the information statement described in § 1.1502–92T(e)(1) must be filed with respect to these attributes.

§ 1.1502–95T Rules on ceasing to be a member of a consolidated group (or loss subgroup) (temporary).

(a) *In general*—(1) *Consolidated group.* This section provides rules for applying section 382 on or after the day that a member ceases to be a member of a consolidated group (or loss subgroup). The rules concern how to determine whether an ownership change occurs with respect to losses of the member, and how a consolidated section 382 limitation (or subgroup section 382 limitation) is apportioned to the member. As the context requires, a reference in this section to a loss group, a member, or a corporation also includes a reference to a loss subgroup, and a reference to a consolidated section 382 limitation also includes a reference to a subgroup section 382 limitation.

(2) Election by common parent. Only the common parent (not the loss subgroup parent) may make the election under paragraph (c) of this section to apportion either a consolidated section 382 limitation or a subgroup section 382 limitation.

(3) *Coordination with §§ 1.1502–91T through 1.1502–93T.* For rules regarding the determination of whether there is an ownership change of a loss subgroup and the computation of a subgroup section 382 limitation following such an ownership change, see §§ 1.1502–91T through 1.1502–93T.

(b) *Separate application of section 382 when a member leaves a consolidated group*—(1) *In general.* Except as provided in §§ 1.1502–91T through

1.1502–93T (relating to rules applicable to loss groups and loss subgroups), section 382 and the regulations thereunder apply to a corporation on a separate entity basis after it ceases to be a member of a consolidated group (or loss subgroup). Solely for purposes of determining whether a corporation has an ownership change—

(i) Any portion of a consolidated net operating loss that is apportioned to the corporation under § 1.1502–21T(b) is treated as a net operating loss of the corporation beginning on the first day of the taxable year in which the loss arose;

(ii) The testing period may include the period during which (or before which) the corporation was a member of the group (or loss subgroup); and

(iii) Except to the extent provided in § 1.1502–20(g) (relating to reattributed losses), the day it ceases to be a member of a consolidated group is treated as a testing date of the corporation within the meaning of § 1.382–2(a)(4).

(2) *Effect of a prior ownership change of the group.* If a loss group has had an ownership change under § 1.1502–92T before a corporation ceases to be a member of a consolidated group (the former member)—

(i) Any pre-change consolidated attribute that is subject to a consolidated section 382 limitation continues to be treated as a pre-change loss with respect to the former member after the attribute is apportioned to the former member;

(ii) The former member's section 382 limitation with respect to such attribute is zero except to the extent the common parent apportions under paragraph (c) of this section all or a part of the consolidated section 382 limitation to the former member;

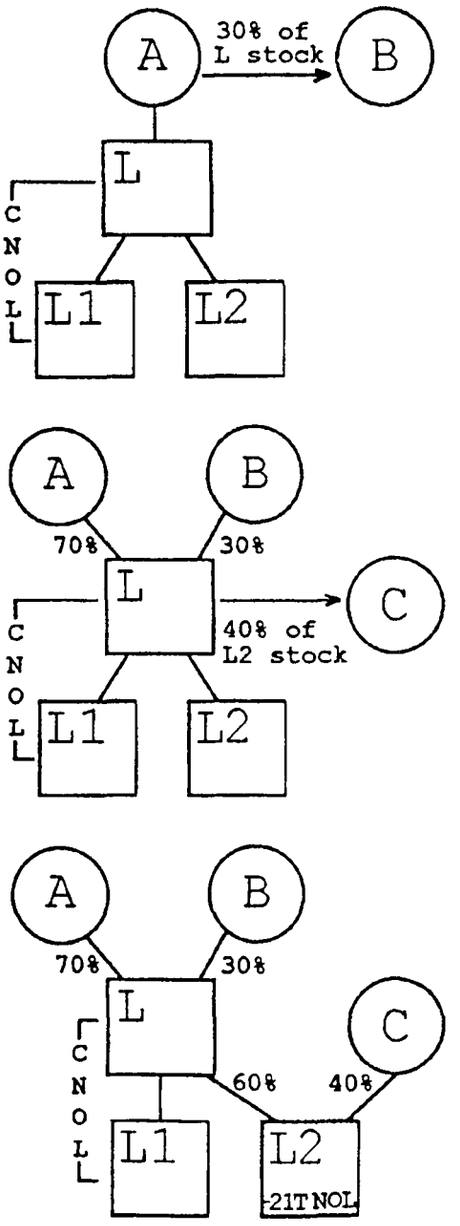
(iii) The testing period for determining a subsequent ownership change with respect to such attribute begins no earlier than the first day following the loss group's most recent change date; and

(iv) As generally provided under section 382, an ownership change of the former member that occurs on or after the day it ceases to be a member of a loss group may result in an additional, lesser limitation amount with respect to such loss.

(3) *Application in the case of a loss subgroup.* If two or more former members are included in the same loss subgroup immediately after they cease to be members of a consolidated group, the principles of paragraphs (b) and (c) of this section apply to the loss subgroup. Therefore, for example, an apportionment by the common parent under paragraph (c) of this section is made to the loss subgroup rather than separately to its members.

(4) *Examples.* The following examples illustrate the principles of this paragraph (b).

Example 1. Treatment of departing member as a separate corporation throughout the testing period. (a) A owns all the L stock. L owns all the stock of L1 and L2. The L group has a consolidated net operating loss arising in Year 1 that is carried over to Year 3. On January 12, Year 2, A sells 30 percent of the L stock to B. On February 7, Year 3, L sells 40 percent of the L2 stock to C, and L2 ceases to be a member of the group. A portion of the Year 1 consolidated net operating loss is apportioned to L2 under § 1.1502–21T(b) and is carried to L2's first separate return year, which ends December 31, Year 3. The following is a graphic illustration of these facts:



(b) Under paragraph (b)(1) of this section, L2 is a loss corporation on February 7, Year 3. Under paragraph (b)(1)(iii) of this section, February 7, Year 3, is a testing date. Under paragraph (b)(1)(ii) of this section, the testing period for L2 with respect to this testing date commences on January 1, Year 1, the first day of the taxable year in which the portion of the consolidated net operating loss apportioned to L2 arose. Therefore, in determining whether L2 has an ownership change on February 7, Year 3, B's purchase of 30 percent of the L stock and C's purchase of 40 percent of the L2 stock are each owner shifts. L2 has an ownership change under section 382(g) and § 1.382–2T because B and C have increased their ownership interests in L2 by 18 and 40 percentage points, respectively, during the testing period.

Example 2. Effect of prior ownership change of loss group. (a) L owns all the L1 stock and L1 owns all the L2 stock. The L loss group had an ownership change under § 1.1502–92T in Year 2 with respect to a consolidated net operating loss arising in Year 1 and carried over to Year 2 and Year 3. The consolidated section 382 limitation computed solely on the basis of the value of the stock of L is $100. On December 31, Year 2, L1 sells 25 percent of the stock of L2 to B. L2 is apportioned a portion of the Year 1 consolidated net operating loss which it carries over to its first separate return year ending after December 31, Year 2. L2's separate section 382 limitation with respect to this loss is zero unless L elects to apportion all or a part of the consolidated section 382 limitation to L2. (See paragraph (c) of this section for rules regarding the apportionment of a consolidated section 382 limitation.) L apportions $50 of the consolidated section 382 limitation to L2.

(b) On December 31, Year 3, L1 sells its remaining 75 percent stock interest in L2 to C, resulting in an ownership change of L2. L2's section 382 limitation computed on the change date with respect to the value of its stock is $30. Accordingly, L2's section 382 limitation for post-change years ending after December 31, Year 3, with respect to its pre-change losses, including the consolidated net operating losses apportioned to it from the L group, is $30, adjusted as required by section 382 and the regulations thereunder.

(c) *Apportionment of a consolidated section 382 limitation*—(1) *In general.* The common parent may elect to apportion all or any part of a consolidated section 382 limitation to a former member (or loss subgroup). See paragraph (e) of this section for the time and manner of making the election to apportion.

(2) *Amount of apportionment.* The common parent may apportion all or part of each element of the consolidated section 382 limitation determined under § 1.1502–93T. For this purpose, the consolidated section 382 limitation consists of two elements—

(i) The value element, which is the element of the limitation determined under section 382(b)(1) (relating to value multiplied by the long-term tax-exempt rate) without regard to such adjustments as those described in section 382(b)(2) (relating to the carryforward of unused section 382 limitation), section 382(b)(3)(B) (relating to the section 382 limitation for the post-

change year that includes the change date), section 382(h) (relating to built-in gains and section 338 gains), and section 382(m)(2) (relating to short taxable years); and

(ii) The adjustment element, which is so much (if any) of the limitation for the taxable year during which the former member ceases to be a member of the consolidated group that is attributable to a carryover of unused limitation under section 382(b)(2) or to recognized built-in gains under 382(h).

(3) *Effect of apportionment on the consolidated section 382 limitation.* The value element of the consolidated section 382 limitation for any post-change year ending after the day that a former member (or loss subgroup) ceases to be a member(s) is reduced to the extent that it is apportioned under this paragraph (c). The consolidated section 382 limitation for the post-change year in which the former member (or loss subgroup) ceases to be a member(s) is also reduced to the extent that the adjustment element for that year is apportioned under this paragraph (c).

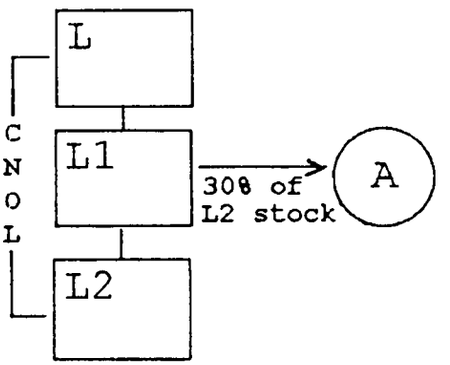
(4) *Effect on corporations to which the consolidated section 382 limitation is apportioned.* The amount of the value element that is apportioned to a former member (or loss subgroup) is treated as the amount determined under section 382(b)(1) for purposes of determining the amount of that corporation's (or loss subgroup's) section 382 limitation for any taxable year ending after the former member (or loss subgroup) ceases to be a member(s). Appropriate adjustments must be made to the limitation based on the value element so apportioned for a short taxable year, carryforward of unused limitation, or any other adjustment required under section 382. The adjustment element apportioned to a former member (or loss subgroup) is treated as an adjustment under section 382(b)(2) or section 382(h), as appropriate, for the first taxable year after the member (or members) ceases to be a member (or members).

(5) *Deemed apportionment when loss group terminates.* If a loss group terminates, to the extent the consolidated section 382 limitation is not apportioned under paragraph (c)(1) of this section, the consolidated section 382 limitation is deemed to be apportioned to the loss subgroup that includes the common parent, or, if there is no loss subgroup that includes the common parent immediately after the loss group terminates, to the common parent. A loss group terminates on the first day of the first taxable year that is a separate return year with respect to each member of the former loss group.

(6) *Appropriate adjustments when former member leaves during the year.* Appropriate adjustments are made to the consolidated section 382 limitation for the consolidated return year during which the former member (or loss subgroup) ceases to be a member(s) to reflect the inclusion of the former member in the loss group for a portion of that year.

(7) *Examples.* The following examples illustrate the principles of this paragraph (c).

Example 1. Consequence of apportionment. (a) L owns all the L1 stock and L1 owns all the L2 stock. The L group has a $200 consolidated net operating loss arising in Year 1 that is carried over to Year 2. At the close of December 31, Year 1, the group has an ownership change under § 1.1502–92T. The ownership change results in a consolidated section 382 limitation of $10 based on the value of the stock of the group. On August 29, Year 2, L1 sells 30 percent of the stock of L2 to A. L2 is apportioned $90 of the group's $200 consolidated net operating loss under § 1.1502–21T(b). L, the common parent, elects to apportion $6 of the consolidated section 382 limitation to L2. The following is a graphic illustration of these facts:



(b) For its separate return years ending after August 29, Year 2 (other than the taxable year ending December 31, Year 2), L2's section 382 limitation with respect to the $90 of the group's net operating loss apportioned to it is $6, adjusted, as appropriate, for any short taxable year, unused section 382 limitation, or other adjustment. For its consolidated return years ending after August 29, Year 2, (other than the year ending December 31, Year 2) the L group's consolidated section 382 limitation with respect to the remaining $110 of pre-change consolidated attribute is $4 ($10 minus the $6 value element apportioned to L2), adjusted, as appropriate, for any short taxable year, unused section 382 limitation, or other adjustment.

(c) For the L group's consolidated return year ending December 31, Year 2, the value element of its consolidated section 382 limitation is increased by $4 (rounded to the nearest dollar), to account for the period during which L2 was a member of the L group ($6, the consolidated section 382 limitation apportioned to L2, times 241/365, the ratio of the number of days during Year 2 that L2 is a member of the group to the number of days in the group's consolidated return year). See paragraph (c)(6) of this section. Therefore, the value element of the consolidated section 382 limitation for Year 2 of the L group is $8 (rounded to the nearest dollar).

(d) The section 382 limitation for L2's short taxable year ending December 31, Year 2, is $2 (rounded to the nearest dollar), which is the amount that bears the same relationship to $6, the value element of the consolidated section 382 limitation apportioned to L2, as the number of days during that short taxable year, 124 days, bears to 365. See § 1.382–4(c).

Example 2. Consequence of no apportionment. The facts are the same as in *Example 1*, except that L does not elect to apportion any portion of the consolidated section 382 limitation to L2. For its separate return years ending after August 29, Year 2, L2's section 382 limitation with respect to the $90 of the group's pre-change consolidated attribute apportioned to L2 is zero under paragraph (b)(2)(ii) of this section. Thus, the $90 consolidated net operating loss apportioned to L2 cannot offset L2's taxable income in any of its separate return years ending after August 29, Year 2. For its consolidated return years ending after August 29, Year 2, the L group's consolidated section 382 limitation with respect to the remaining $110 of pre-change consolidated attribute is $10, adjusted, as appropriate, for any short taxable year, unused section 382 limitation, or other adjustment.

Example 3. Apportionment of adjustment element. The facts are the same as in *Example 1*, except that L2 ceases to be a member of the L group on August 29, Year 3, and the L group has a $4 carryforward of an unused consolidated section 382 limitation (under section 382(b)(2)) to the 1993 consolidated return year. The carryover of unused limitation increases the consolidated section 382 limitation for the Year 3 consolidated return year from $10 to $14. L may elect to apportion all or any portion of the $10 value element and all or any portion of the $4 adjustment element to L2.

(d) *Rules pertaining to ceasing to be a member of a loss subgroup*—(1) *In general.* A corporation ceases to be a member of a loss subgroup—

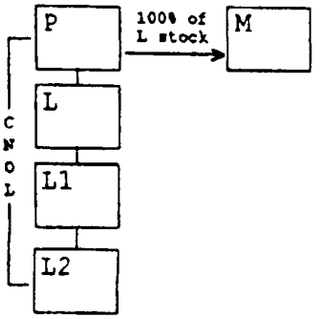
(i) On the first day of the first taxable year for which it files a separate return; or

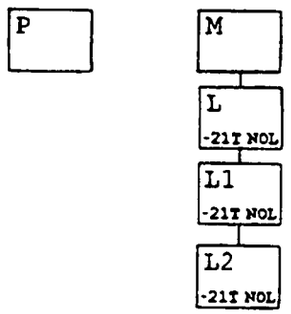
(ii) The first day that it ceases to bear a relationship described in section 1504(a)(1) to the loss subgroup parent (treating for this purpose the loss subgroup parent as the common parent described in section 1504(a)(1)(A)).

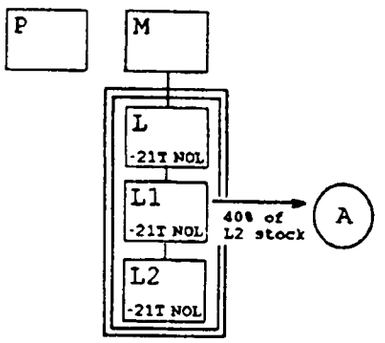
(2) *Examples.* The principles of this paragraph (d) are illustrated by the following examples.

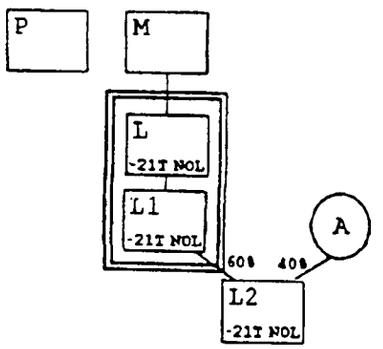
Example 1. Basic case. (a) P owns all the L stock, L owns all the L1 stock and L1 owns all the L2 stock. The P group has a consolidated net operating loss arising in Year 1 that is carried over to Year 2. On December 11, Year 2, P sells all the stock of L to corporation M. Each of L, L1, and L2 is apportioned a portion of the Year 1 consolidated net operating loss, and thereafter each joins with M in filing consolidated returns. Under § 1.1502-92T, the L loss subgroup has an ownership change on December 11, Year 2. The L loss

subgroup has a subgroup section 382 limitation of $100. The following is a graphic illustration of these facts:



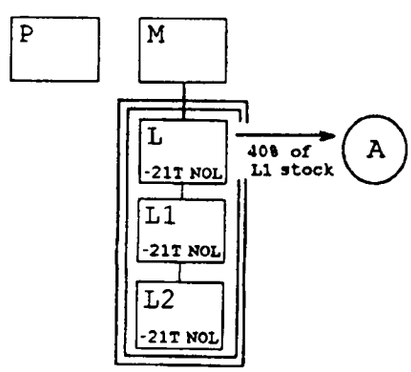


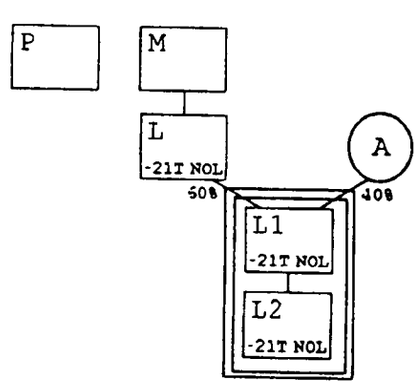




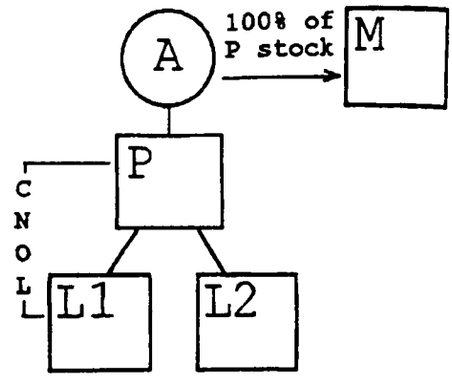
(b) On May 22, Year 3, L1 sells 40 percent of the L2 stock to A. L2 carries over a portion of the P group's net operating loss from Year 1 to its separate return year ending December 31, Year 3. Under paragraph (d)(1) of this section, L2 ceases to be a member of the L loss subgroup on May 22, Year 3, which is both (1) the first day of the first taxable year for which it files a separate return and (2) the day it ceases to bear a relationship described in section 1504(a)(1) to the loss subgroup parent, L. The net operating loss of L2 that is carried over from the P group is treated as a pre-change loss of L2 for its separate return years ending after May 22, Year 3. Under paragraphs (a)(2) and (b)(2) of this section, the separate section 382 limitation with respect to this loss is zero unless M elects to apportion all or a part of the subgroup section 382 limitation of the L loss subgroup to L2.

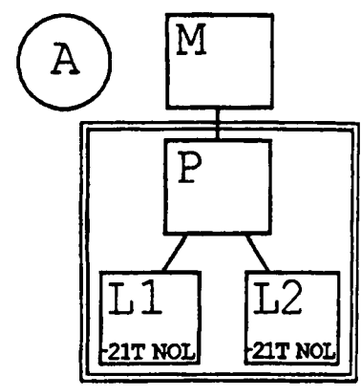
Example 2. Formation of a new loss subgroup. The facts are the same as in *Example 1*, except that A purchases 40 percent of the L1 stock from L rather than purchasing L2 stock from L1. L1 and L2 file a consolidated return for their first taxable year ending after May 22, Year 3, and each of L1 and L2 carries over a part of the net operating loss of the P group that arose in Year 1. Under paragraph (d)(1) of this section, L1 and L2 cease to be members of the L loss subgroup on May 22, Year 3. The net operating losses carried over from the P group are treated as pre-change subgroup attributes of the loss subgroup composed of L1 and L2. The subgroup section 382 limitation with respect to those losses is zero unless M elects to apportion all or part of the subgroup section 382 limitation of the L loss subgroup to the L1 loss subgroup. The following is a graphic illustration of these facts:

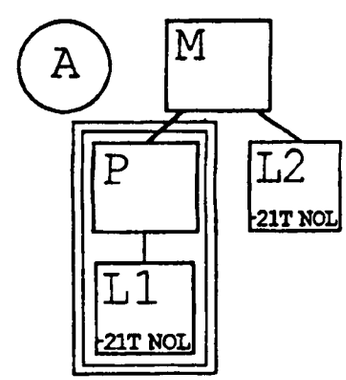




Example 3. Ceasing to bear a section 1504(a)(1) relationship to a loss subgroup parent. (a) A owns all the stock of P, and P owns all the stock of L1 and L2. The P group has a consolidated net operating loss arising in Year 1 that is carried over to Year 3 and Year 4. Corporation M acquires all the stock of P on November 11, Year 3, and P, L1, and L2 thereafter file consolidated returns with M. M's acquisition results in an ownership change of the P loss subgroup under § 1.1502-92T(b)(1)(ii). The following is a graphic illustration of these facts:







(b) P distributes the L2 stock to M on October 7, Year 4. L2 ceases to be a member of the P loss subgroup on October 7, Year 4, the first day that it ceases to bear the relationship described in section 1504(a)(1) to P, the P loss subgroup parent. See paragraph (d)(1)(ii) of this section. Thus, the section 382 limitation with respect to the pre-change subgroup attributes attributable to L2 is zero except to the extent M elects to apportion all or a part of the subgroup section 382 limitation of the P loss subgroup to L2.

Example 4. Relationship through a successor. The facts are the same as in *Example 3*, except that, instead of P's distributing the stock of L2, L2 merges into L1 on October 7, Year 4. L1 (as successor to L2 in the merger within the meaning of § 1.382-2T(f)(4)) continues to bear a relationship described in section 1504(a)(1) to P, the loss subgroup parent. Thus, L2 does not cease to be a member of the P loss subgroup as a result of the merger.

(e) *Filing the election to apportion—* (1) *Form of the election to apportion.* An election under paragraph (c) of this section must be made by the common parent. The election must be made in

the form of the following statement: "THIS IS AN ELECTION UNDER § 1.1502–95T OF THE INCOME TAX REGULATIONS TO APPORTION ALL OR PART OF THE [insert either CONSOLIDATED SECTION 382 LIMITATION or SUBGROUP SECTION 382 LIMITATION, as appropriate] TO [insert name and E.I.N. of the corporation (or the corporations that compose a new loss subgroup) to which allocation is made]. The declaration must also include the following information, as appropriate—

(i) The date of the ownership change that resulted in the consolidated section 382 limitation (or subgroup section 382 limitation);

(ii) The amount of the consolidated section 382 limitation (or subgroup section 382 limitation) for the taxable year during which the former member (or new loss subgroup) ceases to be a member of the consolidated group (determined without regard to any apportionment under this section;

(iii) The amount of the value element and adjustment element of the consolidated section 382 limitation (or subgroup section 382 limitation) that is apportioned to the former member (or new loss subgroup) pursuant to paragraph (c) of this section; and

(iv) The name and E.I.N. of the common parent making the apportionment.

(2) *Signing of the election.* The election statement must be signed by both the common parent and the former member (or, in the case of a loss subgroup, the common parent and the loss subgroup parent) by persons authorized to sign their respective income tax returns.

(3) *Filing of the election.* The election statement must be filed by the common parent of the group that is apportioning the consolidated section 382 limitation (or the subgroup section 382 limitation) with its income tax return for the taxable year in which the former member (or new loss subgroup) ceases to be a member. The common parent must also deliver a copy of the statement to the former member (or the members of the new loss subgroup) on or before the day the group files its income tax return for the consolidated return year that the former member (or new loss subgroup) ceases to be a member. A copy of the statement must be attached to the first return of the former member (or the first return in which the members of a new loss subgroup join) that is filed after the close of the consolidated return year of the group of which the former member (or the members of a new loss subgroup) ceases to be a member.

(4) *Revocation of election.* An election statement made under paragraph (c) of this section is revocable only with the consent of the Commissioner.

§ 1.1502–96T Miscellaneous rules (temporary).

(a) *End of separate tracking of losses*—(1) *Application.* This paragraph (a) applies to a member (or a loss subgroup) with a net operating loss carryover that arose (or is treated under § 1.1502–21T(c) as arising) in a SRLY (or a net unrealized built-in gain or loss determined at the time that the member (or loss subgroup) becomes a member of the consolidated group if there is—

(i) An ownership change of the member (or loss subgroup in connection with, or after, becoming a member of the group; or

(ii) A period of 5 consecutive years following the day that the member (or loss subgroup) becomes a member of a group during which the member (or loss subgroup) has not had an ownership change.

(2) *Effect of end of separate tracking.* If this paragraph (a) applies with respect to a member (or loss subgroup), then, starting on the day after the earlier of the change date (but not earlier than the day the member (or loss subgroup) becomes a member of the consolidated group) or the last day of the 5 consecutive year period described in paragraph (a)(1)(ii) of this section, the member's net operating loss carryover that arose (or is treated under § 1.1502–21T(c) as arising) in a SRLY, is treated as described in § 1.1502–91T(c)(1)(i). Also, the member's separately computed net unrealized built-in gain or loss is included in the determination whether the group has a net unrealized built-in gain or loss. The preceding sentences also apply for purposes of determining whether there is an ownership change with respect to such attributes following such change date (or earlier day) or 5 consecutive year period. Thus, for example, starting the day after the change date or the end of the 5 consecutive year period—

(i) The consolidated group which includes the new loss member or loss subgroup is no longer required to separately track owner shifts of the stock of the new loss member or loss subgroup parent to determine if an ownership change occurs with respect to the attributes of the new loss member or members included in the loss subgroup;

(ii) The group includes the member's attributes in determining whether it is a loss group under § 1.1502–91T(c);

(iii) There is an ownership change with respect to such attributes only if the group is a loss group and has an ownership change; and

(iv) If the group has an ownership change, such attributes are pre-change consolidated attributes subject to the loss group's consolidated section 382 limitation.

(3) *Continuing effect of end of separate tracking.* As the context may require, a current group determines which of its members are included in a loss subgroup on any testing date by taking into account the application of this section in the former group. See the example in § 1.1502–91T(f)(2).

(4) *Special rule for testing period.* For purposes of determining the beginning of the testing period for a loss group, the member's (or loss subgroup's) net operating loss carryovers (or net unrealized built-in gain or loss) described in paragraph (a)(2) of this section are considered to arise—

(i) in a case described in paragraph (a)(1)(i) of this section, in a taxable year that begins not earlier than the later of the day following the change date or the day that the member becomes a member of the group; and

(ii) in a case described in paragraph (a)(1)(ii) of this section, in a taxable year that begins 3 years before the end of the 5 consecutive year period.

(5) *Limits on effects of end of separate tracking.* The rule contained in this paragraph (a) applies solely for purposes of §§ 1.1502–91T through 1.1502–95T and this section (other than paragraph (b)(2)(ii)(B) of this section (relating to the definition of pre-change attributes of a subsidiary)) and § 1.1502–98T, and not for purposes of other provisions of the consolidated return regulations, including, for example, §§ 1.1502–15T and 1.1502–21T (relating to the consolidated net operating loss deduction). See also paragraph (c) of this section for the continuing effect of an ownership change with respect to pre-change attributes.

(b) *Ownership change of subsidiary*—(1) *Ownership change of a subsidiary because of options or plan or arrangement.* Notwithstanding § 1.1502–92T, a subsidiary may have

an ownership change for purposes of section 382 with respect to its attributes which a group or loss subgroup includes in making a determination under § 1.1502–91T(c)(1) (relating to the definition of loss group) or § 1.1502–91T(d) (relating to the definition of loss subgroup). The subsidiary has such an ownership change if it has an ownership change under the principles of § 1.1502–95T(b) and section 382 and the regulations thereunder (determined on a separate entity basis by treating the subsidiary as not being a member of a consolidated group) in the event of—

(i) The deemed exercise under § 1.382–4(d) of an option or options (other than an option with respect to stock of the common parent) held by a person (or persons acting pursuant to a plan or arrangement) to acquire more than 20 percent of the stock of the subsidiary; or

(ii) An increase by 1 or more 5-percent shareholders, acting pursuant to a plan or arrangement to avoid an ownership change of a subsidiary, in their percentage ownership interest in the subsidiary by more than 50 percentage points during the testing period of the subsidiary through the acquisition (or deemed acquisition pursuant to § 1.382–4(d)) of ownership interests in the subsidiary and in higher-tier members with respect to the subsidiary.

(2) *Effect of the ownership change—* (i) *In general.* If a subsidiary has an ownership change under paragraph (b)(1) of this section, the amount of consolidated taxable income for any post-change year that may be offset by the pre-change losses of the subsidiary shall not exceed the section 382 limitation for the subsidiary. For purposes of this limitation, the value of the subsidiary is determined solely by reference to the value of the subsidiary's stock.

(ii) *Pre-change losses.* The pre-change losses of a subsidiary are—

(A) Its allocable part of any consolidated net operating loss which is attributable to it under § 1.1502–21T(b) (determined on the last day of the consolidated return year that includes the change date) that is not carried back and absorbed in a taxable year prior to the year including the change date;

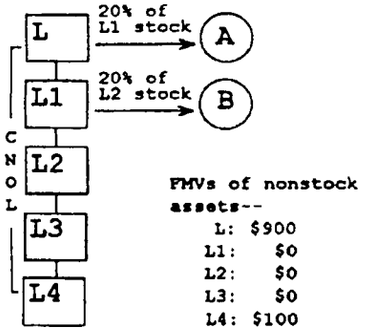
(B) Its net operating loss carryovers that arose (or are treated under § 1.1502–21T(c) as having arisen) in a SRLY; and

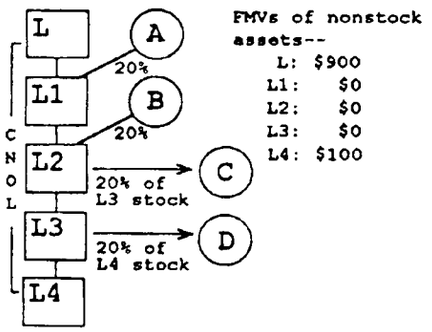
(C) Its recognized built-in loss with respect to its separately computed net unrealized built-in loss, if any, determined on the change date.

(3) *Coordination with §§ 1.1502–91T, 1.1502–92T, and 1.1502–94T.* If an increase in percentage ownership interest causes an ownership change with respect to an attribute under this paragraph (b) and under § 1.1502–92T on the same day, the ownership change is considered to occur only under § 1.1502–92T and not under this paragraph (b). See § 1.1502–94T for anti-duplication rules relating to value.

(4) *Example.* The following example illustrates paragraph (b)(1)(ii) of this section.

Plan to avoid an ownership change of a subsidiary. (a) L owns all the stock of L1, L1 owns all the stock of L2, L2 owns all the stock of L3, and L3 owns all the stock of L4. The L group has a consolidated net operating loss arising in Year 1 that is carried over to Year 2. L has assets other than its L1 stock with a value of $900. L1, L2, and L3 own no assets other than their L2, L3, and L4 stock. L4 has assets with a value of $100. During Year 2, A, B, C, and D, acting pursuant to a plan to avoid an ownership change of L4, acquire the following ownership interests in the members of the L loss group: (A) on September 11, Year 2, A acquires 20 percent of the L1 stock from L and B acquires 20 percent of the L2 stock from L1; and (B) on September 20, Year 2, C acquires 20 percent of the stock of L3 from L2 and D acquires 20 percent of the stock of L4 from L3. The following is a graphic illustration of these facts:





(b) The acquisitions by A, B, C, and D pursuant to the plan have increased their respective percentage ownership interests in L4 by approximately 10, 13, 16, and 20 percentage points, for a total of approximately 59 percentage points during the testing period. This more than 50 percentage point increase in the percentage ownership interest in L4 causes an ownership change of L4 under paragraph (b)(2) of this section.

(c) *Continuing effect of an ownership change.* A loss corporation (or loss subgroup) that is subject to a limitation under section 382 with respect to its pre-change losses continues to be subject to the limitation regardless of whether it becomes a member or ceases to be a member of a consolidated group. See § 1.382–5T(d) (relating to successive ownership changes and absorption of a section 382 limitation).

§ 1.1502–97T Special rules under section 382 for members under the jurisdiction of a court in a title 11 or similar case (temporary). [Reserved]

§ 1.1502–98T Coordination with section 383 (temporary).

The rules contained in §§ 1.1502–91T through 1.1502–96T also apply for purposes of section 383, with appropriate adjustments to reflect that section 383 applies to credits and net capital losses. Similarly, in the case of net capital losses, general business credits, and excess foreign taxes that are pre-change attributes, § 1.383–1 applies the principles of §§ 1.1502–91T through 1.1502–96T. For example, if a loss group has an ownership change under § 1.1502–92T and has a carryover of unused general business credits from a pre-change consolidated return year to a post-change consolidated return year, the amount of the group's regular tax liability for the post-change year that can be offset by the carryover cannot exceed the consolidated section 383 credit limitation for that post-change year, determined by applying the principles of §§ 1.383–1(c)(6) and 1.1502–93T (relating to the computation of the consolidated section 382 limitation).

§ 1.1502–99T Effective dates (temporary).

(a) *Effective date.* Sections 1.1502–91T through 1.1502–96T and 1.1502–98T apply to any testing date on or after January 1, 1997. Sections 1.1502–94T through 1.1502–96T also apply on any date on or after January 1, 1997, on which a corporation becomes a member of a group or on which a corporation ceases to be a member of a loss group (or a loss subgroup).

(b) *Testing period may include a period beginning before January 1, 1997.*

A testing period for purposes of §§ 1.1502–91T through 1.1502–96T and 1.1502–98T may include a period beginning before January 1, 1997. Thus, for example, in applying § 1.1502–92T(b)(1)(i) (relating to the determination of an ownership change of a loss group), the determination of the lowest percentage ownership interest of any 5-percent shareholder of the common parent during a testing period ending on a testing date occurring on or after January 1, 1997, takes into account the period beginning before January 1, 1997, except to the extent that the period is more than 3 years before the testing date or is otherwise before the beginning of the testing period. See § 1.1502–92T(b)(1).

(c) *Transition rules*—(1) *Methods permitted*—(i) *In general.* For the period ending before January 1, 1997, a consolidated group is permitted to use any method described in paragraph (c)(2) of this section which is consistently applied to determine if an ownership change occurred with respect to a consolidated net operating loss, a net operating loss carryover (including net operating loss carryovers arising in SRLYs), or a net unrealized built-in loss. If an ownership change occurred during that period, the group is also permitted to use any method described in paragraph (c)(2) of this section which is consistently applied to compute the amount of the section 382 limitation that applies to limit the use of taxable income in any post-change year ending before, on, or after January 1, 1997. The preceding sentence does not preclude the imposition of an additional, lesser limitation due to a subsequent ownership change nor, except as provided in paragraph (c)(1)(iii) of this section, does it permit the beginning of a new testing period for the loss group.

(ii) *Adjustments to offset excess limitation.* If an ownership change occurred during the period ending before January 1, 1997, and a method described in paragraph (c)(2) of this section was not used for a post-change year, the members (or group) must reduce the section 382 limitation for post-change years for which an income tax return is filed after January 1, 1997, to offset, as quickly as possible, the effects of any section 382 limitation that members took into account in excess of the amount that would have been allowable under §§ 1.1502–91T through 1.1502–96T and 1.1502–98T.

(iii) *Coordination with effective date.* Notwithstanding that a group may have used a method described in paragraph (c)(2)(ii) or (iii) of this section for the period before January 1, 1997, §§ 1.1502–91T through 1.1502–96T and 1.1502–98T apply to any testing date occurring on or after January 1, 1997, for purposes of determining whether there is an ownership change with respect to any losses and, if so, the collateral consequences. Any ownership change of a member other than the common parent pursuant to a method described in paragraph (c)(2)(ii) or (iii) of this section does not cause a new testing period of the loss group to begin for purposes of applying § 1.1502–92T on or after January 1, 1997.

(2) *Permitted methods.* The methods described in this paragraph (c)(2) are:

(i) A method that does not materially differ from the rules in §§ 1.1502–91T through 1.1502–96T and 1.1502–98T (other than those in § 1.1502–95T(c) (relating to the apportionment of a section 382 limitation) as they would apply to a corporation that ceases to be a member of the group before January 1, 1997). As the context requires, the method must treat references to rules in current regulations as references to rules in regulations generally effective for taxable years before January 1, 1997. Thus, for example, the taxpayer must treat a reference to § 1.382–4(d) (relating to options) as a reference to § 1.382–2T(h)(4) for any testing date to which § 1.382–2T(h)(4) applies. Similarly, a reference to § 1.1502–21T(c) may be a reference to § 1.1502–21A(c), as appropriate. Furthermore, the method must treat all corporations that were affiliated on January 1, 1987, and continuously thereafter as having met the 5 consecutive year requirement of § 1.1502–91T(d)(2)(i) on any day before January 1, 1992, on which the determination of net unrealized built-in gain or loss of a loss subgroup is made;

(ii) A reasonable application of the rules in section 382 and the regulations thereunder applied to each member on a separate entity basis, treating each member's allocable part of a consolidated net operating loss which is attributable to it under § 1.1502–21T(b) as a net operating loss of that member and applying rules similar to § 1.382–8T to avoid duplication of value in computing the section 382 limitation for the member (see § 1.382–8T(h) (relating to the effective date and transition rules regarding controlled groups)); or

(iii) A method approved by the Commissioner upon application by the common parent.

(d) *Amended returns.* A group may file an amended return in connection with an ownership change occurring before January 1, 1997, to modify the amount of a section 382 limitation with respect to a consolidated net operating loss, a net operating loss carryover (including net operating loss carryovers arising in SRLYs), or a recognized built-in loss (or gain) only if it files amended returns:

(1) For the earliest taxable year ending after December 31, 1986, in which it had an ownership change, if any, under § 1.1502–92T;

(2) For all subsequent taxable years for which returns have already been filed as of the date of the amended return;

(3) The modification with respect to all members for all taxable years ending in 1987 and thereafter complies with §§ 1.1502–91T through 1.1502–96T and 1.1502–98T; and

(4) The amended return(s) permitted by the applicable statute of limitations is/are filed before Tuesday, September 24, 1996.

(e) *Section 383.* This section also applies for the purposes of section 383, with appropriate adjustments to reflect that section 383 applies to credits and net capital losses.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 3. The authority citation for part 602 continues to read in part as follows:

Authority: 26 U.S.C. 7805.

Par. 4. In § 602.101, paragraph (c) is amended by adding an entry in numerical order to the table to read as follows:

§ 602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified or described	Current OMB control No.
* * * * *	
1.1502–95T.....	1545–1218
* * * * *	

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved May 31, 1996.

Leslie Samuels,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on June 26, 1996, 8:45 a.m., and published in the issue of the Federal Register for June 27, 1996, 61 F.R. 33335)

Subtitle B.—Estate and Gift Taxes
Chapter 11.—Estate Tax
Subchapter A.—Estates of Citizens or Residents
Part III.—Gross Estate

Section 2031.—Definition of Gross Estate

26 CFR 20.2031–5: Valuation of cash on hand or on deposit.

Rev. Rul. 67–396 is modified to provide that, if certain conditions are satisfied, the delivery of a check to a noncharitable donee will be deemed to be complete for federal gift and estate tax purposes when the check is deposited, cashed against available funds of the donee, or presented for payment in the calendar year for which favorable gift tax treatment is sought. See Rev. Rul. 96–56, page 161.

Part IV.—Taxable Estate

Section 2056A.—Qualified Domestic Trust

26 CFR 20.2056A–2: Requirements for qualified domestic trusts.

T.D. 8686

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 20 and 602

Requirements to Ensure Collection of Section 2056A Estate Tax

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that provide guidance relating to the additional requirements necessary to ensure the collection of the estate tax imposed under section 2056A(b) with respect to taxable events involving qualified domestic trusts (QDOTs) described in section 2056A(a).
DATES: These regulations are effective November 29, 1996.

For dates of applicability, see § 20.2056A–2(d).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1443. Responses to this collection of information are required in order for an estate to be eligible for the estate tax marital deduction in cases where the surviving spouse is not a United States citizen.

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

The estimated annual burden per respondent varies from 30 minutes to 3 hours, depending on individual circumstances, with an estimated average of 1.39 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer T:FP, Washington, DC 20224, and to the **Office of Management and Budget**, Attention: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to this collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

A notice of proposed rulemaking was published in the Federal Register on January 5, 1993 (58 FR 305), reflecting amendments to the Internal Revenue Code by the Technical and Miscellaneous Revenue Act of 1988 (Public Law 100–647), the Revenue Reconciliation Act of 1989 (Public Law 101–239), and the Revenue Reconciliation Act of 1990 (Public Law 101–508). The amendments generally relate to sections 2056 and 2523, and affect the availability of the estate and gift tax marital deduction when the surviving spouse or the donee spouse is not a United States citizen. Part of the NPRM was published in the Federal Register as final regulations, in TD 8612, on August 22, 1995 (60 FR 43531 [1995–2 C.B. 192]). That part of the NPRM that addressed the regulatory requirements to ensure the collection of the estate tax imposed by section 2056A(b)(1)(A) and (B) was published in the Federal Register on August 22, 1995, in the form of temporary and proposed regulations, (60 FR 43554 and 60 FR 43575, respectively) in order to afford the public a further opportunity to comment on these security arrangements.

On January 16, 1996, the IRS held a hearing on the temporary and proposed regulations. These final regulations reflect the comments received in response to the temporary and proposed regulations.

Explanation of Provisions

The following is a summary of the significant comments received and the reasons for accepting or rejecting those comments in the final regulations.

Under the temporary regulations, a qualified domestic trust (QDOT) that has assets in excess of $2 million, may alternate among the three security arrangements provided in the regulations (U.S. bank trustee, bond or letter of credit), provided that at all times, at least one of the three arrangements is in effect. A QDOT with assets of $2 million or less need not satisfy these requirements, if, in general, the trust holdings of foreign situs real property are limited to 35 percent of the fair market value of the trust corpus.

Comments were received that trusts in actual compliance with these regulatory requirements, but which do not explicitly include the required language, will not qualify as a QDOT. In addition, comments suggested that the imposition of numerous governing instrument requirements will increase the difficulty of drafting a QDOT and result in a trust document that will have to include detailed provisions, many of which are not likely to be applicable. A suggestion was made that if the governing instrument requirement is retained in the regulations, then the required security provisions should be permitted to be incorporated by reference in a trust document. This suggestion was adopted. However, in order to assist taxpayers who may wish to specify the required provisions in the governing instrument, the IRS has published guidance in the Internal Revenue Bulletin (see § 602.101(d)(2) of this chapter) providing sample language that may be used in a QDOT instrument to satisfy the additional security requirements contained in the final regulations.

In response to comments, the language of the regulations has been modified to clarify that the QDOT may alternate among the three arrangements

provided in the regulations as long as, at any given time, one of the three arrangements is required to be operative.

Comments suggested that the temporary regulations may be viewed as requiring that a QDOT that initially employs the bank trustee security alternative must, irrespective of whether the QDOT has switched to another security option, continue to have at least one U.S. Bank acting as a trustee. In response to this comment, the final regulations clarify that, if the QDOT changes to a different security arrangement, a U.S. bank need not continue to act as trustee.

Under the temporary regulations, in determining whether the value of the assets passing to a QDOT are in excess of, or less than, $2 million, indebtedness with respect to the assets is not taken into account to reduce value. Similarly, under the temporary regulations, the amount of the bond or letter of credit that is furnished to the IRS must be equal to 65 percent of the fair market value of the trust assets determined "without regard to any indebtedness thereon." Comments suggested that indebtedness should be taken into account in determining whether the $2 million dollar threshold has been exceeded and the amount of the bond or letter of credit required. This change has not been made. The IRS and Treasury believe that the retention of the rule that indebtedness on the property is not taken into account to reduce value most effectively ensures collection of the estate tax imposed under section 2056A(b). For the limited purpose under this section (i.e., to determine whether the $2 million threshold is exceeded and the amount of the bond or letter of credit to be furnished to the IRS) the complexity that would be involved in drafting rules to determine which debts qualify to be taken into account and which do not is not warranted.

Under the temporary regulations, with regard to the bond and letter of credit security options, if the fair market value of the trust assets, is "finally determined" to be in excess of the value of the trust assets as originally reported, the trustee has a reasonable period of time (not exceeding sixty days from the date of the final determination) to adjust the amount of the bond or letter of credit. The temporary regulations also use the term "finally determined" in addressing substantial undervaluations of property passing to a QDOT and the grace period provided to meet the security requirements when a QDOT is determined to contain assets in excess of $2 million. Comments were received suggesting that the regulations provide a definition of "finally determined".

Accordingly, the final regulations provide that the value of the assets will be finally determined on the earliest to occur of—

1. The entry of a decision, judgment, decree, or other order by any court of competent jurisdiction that has become final;

2. The execution of a closing agreement made under section 7121;

3. Any final disposition by the IRS of a claim for refund;

4. The issuance of an estate tax closing letter (if no claim for refund is filed); or

5. The expiration of the statute of limitations for assessment with respect to the decedent's estate tax liability.

In response to comments, the regulation addressing the required duration of the bond or letter of credit has been clarified to provide that the security arrangement must remain in effect until the trust ceases to function as a QDOT.

Comments have been received regarding the amount of the bond or letter of credit that must be furnished to the IRS. One commentator stated that, since the purpose of the bond or letter of credit requirement is to provide a source of funds for the payment of the section 2056A(b) estate tax, the amount of the required bond or letter of credit should be based on either the maximum federal estate tax rate, or the amount of estate tax deferred, rather than 65% of the value of the QDOT, as provided in the regulations. This suggestion has not been adopted. Generally, the regulation requires a bond of 65 percent of the initial fair market value of the trust assets to ensure that the potential estate tax liability is adequately secured if the trust property appreciates in value.

The temporary regulations providing that notice of failure to renew a bond or letter of credit must be "received by the IRS at least 60 days prior to the end of the term of the bond or letter of credit" has been changed to reference the date the notice is "mailed to" the IRS. Further, under the final regulations, the notice must also be mailed to the U.S. Trustee of the QDOT.

Under the regulations, in the case of a QDOT of less than $2 million, if on the last day of a taxable year of the QDOT, the value of foreign real property owned by the QDOT exceeds 35 percent of the QDOT assets because of distributions of principal during that year, or because of fluctuations in the value of the foreign currency in the jurisdiction where the real property is located, a grace period of one year is provided to allow the trustee to comply with the 35 percent limit. Comments suggested that changes in the relative value of the trust assets would also cause the trust to fail to satisfy the 35 percent limit, and failure to comply due to such changes that are beyond the control of the trustee should also be eligible for the grace period. Accordingly, under the final regulations, the trustee will also be accorded the grace period to satisfy the 35 percent limit if, as a result of changes in the relative values of the trust assets, more than 35 percent of the value of the trust consists of foreign real estate.

Under the temporary regulations, for purposes of determining whether the $2 million threshold has been exceeded, and for purposes of determining the amount of the bond or letter of credit, the executor of the decedent's estate may exclude up to $600,000 in value attributable to real property wherever situated (and related furnishings) owned directly by the QDOT that is used by the surviving spouse as the spouse's principal residence. Comments were received that the regulations should be expanded to allow the exclusion of all residential real property that is actually used by the surviving spouse. Thus, a vacation home or second home would qualify for the exclusion. It was also suggested that all personally used residential real property, regardless of value, should be eligible for the exclusion. The final regulations do not change the monetary limit of $600,000 for the exclusion. The $600,000 limit for the exclusion facilitates the reduction of the costs associated with providing security while adequately ensuring the collection of the section 2056A(b) tax. This is especially the case in situations where the residential real property is situated outside the United States so that a significant collection risk is presented. However, under the final regulations the exclusion has been redesignated as a "personal residence" exclusion. The exclusion is now available for the principal residence of the surviving spouse and one additional residence, to the extent the combined value excluded does not exceed $600,000. The second residence will be eligible for the exclusion only if the residence is used by the surviving

spouse as a personal residence and not subject to any rental arrangement with any person.

Under the temporary regulations, the residence exclusion election is made by attaching a written statement to the estate tax return on which the QDOT election is made. Commentators suggested that the final regulations allow the election to be made at any time during the term of the QDOT, and not necessarily at the time of filing of the decedent's estate tax return. For example, if the bank trustee alternative is selected by the trustee of the QDOT, but at some future date the trustee desires to change to the bond or letter of credit security arrangement, the trustee should be given the opportunity to make a delayed election of the exclusion. In response to these comments, the final regulations provide that the election may be made at any time during the term of the QDOT. In addition, the final regulation provides for the cancellation of a prior election.

Under the temporary regulations, the U.S. Trustee of a QDOT is required to file an annual statement with the IRS containing specified items of information (including a list of all assets held by the QDOT together with the fair market value of each asset determined as of the last day of the taxable year) if the residence exclusion applies during the taxable year. Comments were received suggesting that the cost of compliance with this annual reporting requirement will limit the utility of the residence exclusion. In response to these comments, annual reporting is no longer required solely because the personal residence exclusion was elected. However, the regulations retain the annual reporting requirement where the residence previously subject to the exclusion is sold, or where the residence ceases to be used as a personal residence during the taxable or calendar year.

Under the temporary regulations, if a residence that is subject to the exclusion is sold during the term of the QDOT, the exclusion will continue to apply if, within 12 months of the date of sale, the amount of the adjusted sales price (as defined in section 1034(d)(1)) is used to purchase a new residence for the spouse. In response to comments, this provision has been amended to provide that if a residence ceases to be used as the personal residence of the spouse, or if the residence is sold during the term of the QDOT, the exclusion may be applied to another residence that is held in either the same QDOT or in another QDOT, if the other residence is used as a personal residence of the spouse. The amount of exclusion that may be applied to the new personal residence under these circumstances can be up to $600,000 (less that amount previously allocated to a residence that continues to qualify for the exclusion) even if the entire $600,000 exclusion was not previously used for the initial personal residence(s).

Also, under the temporary regulations, on the sale of a residence, if less than the entire adjusted sales price is reinvested in a new residence, then the amount of the exclusion initially claimed by the QDOT is reduced proportionately. For example, if a residence is sold for an adjusted sales price of $1,000,000 and a new residence is acquired for $800,000, then, the original exclusion would be reduced by $120,000 to $480,000: $200,000 (adjusted sales price not reinvested)/ $1,000,000 (adjusted sales price) x $600,000. Comments were received suggesting that this rule be changed to provide that the amount of the exclusion as adjusted not be reduced below the amount actually reinvested (up to $600,000). This suggestion was adopted in the final regulations, reflecting that two residences can now qualify for the $600,000 exclusion.

Special Analyses

It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the notice of proposed rulemaking preceding the regulations was issued prior to March 29, 1996, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 20 and 602 are amended as follows:

PART 20—ESTATE TAX; ESTATES OF DECEDENTS DYING AFTER AUGUST 16, 1954

Paragraph 1. The authority citation for part 20 continues to read in part as follows:

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

Par. 2. In § 20.2056A–0, the table of contents is amended by revising the entry for § 20.2056A–2(d) to read as follows:

§ 20.2056A–0 Table of contents.

* * * * *

§ 20.2056A–2 Requirements for qualified domestic trust.

* * * * *

(d) Additional requirements to ensure collection of the section 2056A estate tax.

(1) Security and other arrangements for payment of estate tax imposed under section 2056A(b)(1).

(2) Individual trustees.

(3) Annual reporting requirements.

(4) Request for alternate arrangement or waiver.

(5) Adjustment of dollar threshold and exclusion.

(6) Effective date and special rules.

* * * * *

Par. 3. In § 20.2056A–2, paragraph (d) is added to read as follows:

§ 20.2056A–2 Requirements for qualified domestic trust.

* * * * *

(d) *Additional requirements to ensure collection of the section 2056A estate tax*—(1) *Security and other arrangements for payment of estate tax imposed under section 2056A(b)(1)*—(i) *QDOTs with assets in excess of $2 million.* If the fair market value of the assets passing, treated, or deemed to have passed to the QDOT (or in the form of a QDOT), determined without reduction for any indebtedness with respect to the assets, as finally determined for federal estate tax purposes, exceeds $2 million as of the date of the decedent's death or, if applicable, the alternate valuation date (adjusted as provided in paragraph (d)(1)(iii) of this section), the trust instrument must meet the requirements of either paragraph (d)(1)(i)(A), (B), or (C) of this section at all times during the term of the QDOT. The QDOT may alternate between any of the arrangements provided in paragraphs (d)(1)(i)-(A), (B), and (C) of this section provided that, at any given time, one of the arrangements must be operative. See paragraph (d)(1)(iii) of this section for the definition of finally determined. The QDOT may provide that the trustee has the discretion to use any one of the security arrangements or may provide

that the trustee is limited to using only one or two of the arrangements specified in the trust instrument. A trust instrument that specifically states that the trust must be administered in compliance with paragraph (d)(1)(i)(A), (B), or (C) of this section is treated as meeting the requirements of paragraphs (d)(1)(i)(A), (B), or (C) for purposes of paragraphs (d)(1)(i) and, if applicable, (d)(1)(ii) of this section.

(A) *Bank Trustee.* Except as otherwise provided in paragraph (d)(6)(ii) or (iii) of this section, the trust instrument must provide that whenever the Bank Trustee security alternative is used for the QDOT, at least one U.S. Trustee must be a bank as defined in section 581. Alternatively, except as otherwise provided in paragraph (d)(6)(ii) or (iii) of this section, at least one trustee must be a United States branch of a foreign bank, provided that, in such cases, during the entire term of the QDOT a U.S. Trustee must act as a trustee with the foreign bank trustee.

(B) *Bond.* Except as otherwise provided in paragraph (d)(6)(ii) or (iii) of this section, the trust instrument must provide that whenever the bond security arrangement alternative is used for the QDOT, the U.S. Trustee must furnish a bond in favor of the Internal Revenue Service in an amount equal to 65 percent of the fair market value of the trust assets (determined without regard to any indebtedness with respect to the assets) as of the date of the decedent's death (or alternate valuation date, if applicable), as finally determined for federal estate tax purposes (and as further adjusted as provided in paragraph (d)(1)(iv) of this section). If, after examination of the estate tax return, the fair market value of the trust assets, as originally reported on the estate tax return, is adjusted (pursuant to a judicial proceeding or otherwise) resulting in a final determination of the value of the assets as reported on the return, the U.S. Trustee has a reasonable period of time (not exceeding sixty days after the conclusion of the proceeding or other action resulting in a final determination of the value of the assets) to adjust the amount of the bond accordingly. But see, paragraph (d)(1)(i)(D) of this section for a special rule in the case of a substantial undervaluation of QDOT assets. Unless an alternate arrangement under paragraph (d)(1)(i)(A), (B), or (C) of this section, or an arrangement prescribed under paragraph (d)(4) of this section, is provided, or the trust is otherwise no longer subject to the requirements of section 2056A pursuant to section 2056A(b)(12), the bond must remain in effect until the trust ceases to function as a QDOT and any tax liability finally determined to be due under section 2056A(b) is paid, or is finally determined to be zero.

(*1*) *Requirements for the bond.* The bond must be with a satisfactory surety, as prescribed under section 7101 and § 301.7101–1 of this chapter (Regulations on Procedure and Administration), and is subject to Internal Revenue Service review as may be prescribed by the Commissioner. The bond may not be cancelled. The bond must be for a term of at least one year and must be automatically renewable at the end of that term, on an annual basis thereafter, unless notice of failure to renew is mailed to the U.S. Trustee and the Internal Revenue Service at least 60 days prior to the end of the term, including periods of automatic extensions. Any notice of failure to renew required to be sent to the Internal Revenue Service must be sent to the Estate and Gift Tax Group in the District Office of the Internal Revenue Service that has examination jurisdiction over the decedent's estate (Internal Revenue Service, District Director, [*specify location*] District Office, Estate and Gift Tax Examination Group, [specify Street Address, City, State, Zip Code]) (or in the case of noncitizen decedents and United States citizens who die domiciled outside the United States, Estate Tax Group, Assistant Commissioner (International), 950 L'Enfant Plaza, CP:IN:D:C:EX:HQ:1114, Washington, DC 20024). The Internal Revenue Service will not draw on the bond if, within 30 days of receipt of the notice of failure to renew, the U.S. Trustee notifies the Internal Revenue Service (at the same address to which notice of failure to renew is to be sent) that an alternate arrangement under paragraph (d)(1)(i)(A), (B), or (C) or (d)(4) of this section, has been secured and that the arrangement will take effect immediately prior to or upon expiration of the bond.

(*2*) *Form of bond.* The bond must be in the following form (or in a form that is the same as the following form in all material respects), or in such alternative form as the Commissioner may prescribe by guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter):

Bond in Favor of the Internal Revenue Service To Secure Payment of Section 2056A Estate Tax Imposed Under Section 2056A(b) of the Internal Revenue Code.

KNOW ALL PERSONS BY THESE PRESENTS, That the undersigned, _____, the SURETY, and _____, the PRINCIPAL, are irrevocably held and firmly bound to pay the Internal Revenue Service upon written demand that amount of any tax up to *$[amount determined under paragraph (d)(1)(i)(B) of this section]*, imposed under section 2056A(b)(1) of the Internal Revenue Code (including penalties and interest on said tax) determined by the Internal Revenue Service to be payable with respect to the principal as trustee for: *[Identify trust and governing instrument, name and address of trustee]*, a qualified domestic trust as defined in section 2056A(a) of the Internal Revenue Code, for the payment of which the said Principal and said Surety, bind themselves, their heirs, executors, administrators, successors and assigns, jointly and severally, firmly by these presents.

WHEREAS, The Internal Revenue Service may demand payment under this bond at any time if the Internal Revenue Service in its sole discretion determines that a taxable event with respect to the trust has occurred; the trust no longer qualifies as a qualified domestic trust as described in section 2056A(a) of the Internal Revenue Code and the regulations promulgated thereunder, or a distribution subject to the tax imposed under section 2056A(b)(1) has been made. Demand by the Internal Revenue Service for payment may be made whether or not the tax and tax return (Form 706–QDT) with respect to the taxable event is due at the time of such demand, or an assessment has been made by the Internal Revenue Service with respect to the tax.

NOW THEREFORE, The condition of this obligation is such that it must not be cancelled and, if payment of all tax liability finally determined to be imposed under section 2056A(b) is made, then this obligation is null and void; otherwise, this obligation is to remain in full force and effect for one year from its effective date and is to be automatically renewable on an annual basis unless, at least 60 days prior to the expiration date, including periods of automatic renewals, the surety mails to the U.S. Trustee and the Internal Revenue Service by Registered or Certified Mail, return receipt requested, notice of the failure to renew. Receipt of this

notice of failure to renew by the Internal Revenue Service may be considered a taxable event. The Internal Revenue Service will not draw upon the bond if, within 30 days of receipt of the notice of failure to renew, the trustee notifies the Internal Revenue Service that an alternate security arrangement has been secured and that the arrangement will take effect immediately prior to or upon expiration of the bond. The surety remains liable for all taxable events occurring prior to the date of expiration. All notices required to be sent to the Internal Revenue Service under this instrument should be sent to District Director, *[specify location]* District Office, Estate and Gift Tax Examination Group, Street Address, City, State, Zip Code. (In the case of nonresident noncitizen decedents and United States citizens who die domiciled outside the United States, all notices should be sent to Estate Tax Group, Assistant Commissioner (International), 950 L'Enfant Plaza, CP:IN:D:C:EX:HQ:1114, Washington, DC 20024).

This bond shall be effective as of _____. Principal _____
Date _____ Surety _____
Date _____

(*3*) *Additional governing instrument requirements.* The trust instrument must provide that in the event the Internal Revenue Service draws on the bond, in accordance with its terms, neither the U.S. Trustee nor any other person will seek a return of any part of the remittance until after April 15th of the calendar year following the year in which the bond is drawn upon. After that date, any such remittance will be treated as a deposit and returned (without interest) upon request of the U.S. Trustee, unless it is determined that assessment or collection of the tax imposed by section 2056A(b)(1) is in jeopardy, within the meaning of section 6861. If an assessment under section 6861 is made, the remittance will first be credited to any tax liability reported on the Form 706–QDT, then to any unpaid balance of a section 2056A(b)(1)(A) tax liability (plus interest and penalties) for any prior taxable years, and any balance will then be returned to the U.S. Trustee.

(*4*) *Procedure.* The bond is to be filed with the decedent's federal estate tax return, Form 706 or 706NA (unless an extension for filing the bond is granted under § 301.9100 of this chapter). The U.S. Trustee must provide a written statement with the bond that provides a list of the assets that will be used to fund the QDOT and the respective values of the assets. The written statement must also indicate whether any exclusions under paragraph (d)(1)(iv) of this section are claimed.

(C) *Letter of credit.* Except as otherwise provided in paragraph (d)(6)(ii) or (iii) of this section, the trust instrument must provide that whenever the letter of credit security arrangement is used for the QDOT, the U.S. Trustee must furnish an irrevocable letter of credit issued by a bank as defined in section 581, a United States branch of a foreign bank, or a foreign bank with a confirmation by a bank as defined in section 581. The letter of credit must be for an amount equal to 65 percent of the fair market value of the trust assets (determined without regard to any indebtedness with respect to the assets) as of the date of the decedent's death (or alternate valuation date, if applicable), as finally determined for federal estate tax purposes (and as further adjusted as provided in paragraph (d)(1)(iv) of this section). If, after examination of the estate tax return, the fair market value of the trust assets, as originally reported on the estate tax return, is adjusted (pursuant to a judicial proceeding or otherwise) resulting in a final determination of the value of the assets as reported on the return, the U.S. Trustee has a reasonable period of time (not exceeding 60 days after the conclusion of the proceeding or other action resulting in a final determination of the value of the assets) to adjust the amount of the letter of credit accordingly. But see, paragraph (d)(1)(i)(D) of this section for a special rule in the case of a substantial undervaluation of QDOT assets. Unless an alternate arrangement under paragraph (d)(1)(i)(A), (B), or (C) of this section, or an arrangement prescribed under paragraph (d)(4) of this section, is provided, or the trust is otherwise no longer subject to the requirements of section 2056A pursuant to section 2056A(b)(12), the letter of credit must remain in effect until the trust ceases to function as a QDOT and any tax liability finally determined to be due under section 2056A(b) is paid or is finally determined to be zero.

(*1*) *Requirements for the letter of credit.* The letter of credit must be irrevocable and provide for sight payment. The letter of credit must have a term of at least one year and must be automatically renewable at the end of the term, at least on an annual basis, unless notice of failure to renew is mailed to the U.S. Trustee and the Internal Revenue Service at least sixty days prior to the end of the term, including periods of automatic renewals. If the letter of credit is issued by the U.S. branch of a foreign bank and the U.S. branch is closing, the branch (or foreign bank) must notify the U.S. Trustee and the Internal Revenue Service of the closure and the notice of closure must be mailed at least 60 days prior to the date of closure. Any notice of failure to renew or closure of a U.S. branch of a foreign bank required to be sent to the Internal Revenue Service must be sent to the Estate and Gift Tax Group in the District Office of the Internal Revenue Service that has examination jurisdiction over the decedent's estate (Internal Revenue Service, District Director, *[specify location]* District Office, Estate and Gift Tax Examination Group, [Street Address, City State, Zip Code]) (or in the case of noncitizen decedents and United States citizens who die domiciled outside the United States, Estate Tax, Assistant Commissioner (International), 950 L'Enfant Plaza, CP:IN:D:C:EX:HQ:1114, Washington, DC 20024). The Internal Revenue Service will not draw on the letter of credit if, within 30 days of receipt of the notice of failure to renew or closure of the U.S. branch of a foreign bank, the U.S. Trustee notifies the Internal Revenue Service (at the same address to which notice is to be sent) that an alternate arrangement under paragraph (d)(1)(i)(A), (B), or (C), or (d)(4) of this section, has been secured and that the arrangement will take effect immediately prior to or upon expiration of the letter of credit or closure of the U.S. branch of the foreign bank.

(*2*) *Form of letter of credit.* The letter of credit must be made in the following form (or in a form that is the same as the following form in all material respects), or an alternative form that the Commissioner prescribes by guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter):

[Issue Date]

To: Internal Revenue Service
Attention: District Director, *[specify location]* District Office
Estate and Gift Tax Examination Group
[Street Address, City, State, ZIP Code]

[Or in the case of nonresident noncitizen decedents and United States citizens who die domiciled outside the United States,

To: Estate Tax Group,
Assistant Commissioner
(International)
950 L'Enfant Plaza
CP:IN:D:C:EX:HQ:1114
Washington, DC 20024].

Dear Sirs:

We hereby establish our irrevocable Letter of Credit No. ____ in your favor for drawings up to U.S. $ [*Applicant should provide bank with amount which Applicant determined under paragraph (d)(1)(i)(C)*] effective immediately. This Letter of Credit is issued, presentable and payable at our office at _____ _____ and expires at 3:00 p.m. [EDT, EST, CDT, CST, MDT, MST, PDT, PST] on _____ at said office.

For information and reference only, we are informed that this Letter of Credit relates to [*Applicant should provide bank with the identity of qualified domestic trust and governing instrument*], and the name, address, and identifying number of the trustee is [*Applicant should provide bank with the trustee name, address and the QDOT's TIN number, if any*].

Drawings on this Letter of Credit are available upon presentation of the following documents:

1. Your draft drawn at sight on us bearing our Letter of Credit No. _____; and

2. Your signed statement as follows: The amount of the accompanying draft is payable under [*identify bank*] irrevocable Letter of Credit No. _____ pursuant to section 2056A of the Internal Revenue Code and the regulations promulgated thereunder, because the Internal Revenue Service in its sole discretion has determined that a "taxable event" with respect to the trust has occurred; e.g., the trust no longer qualifies as a qualified domestic trust as described in section 2056A of the Internal Revenue Code and regulations promulgated thereunder, or a distribution subject to the tax imposed under section 2056A(b)(1) of the Internal Revenue Code has been made.

Except as expressly stated herein, this undertaking is not subject to any agreement, requirement or qualification. The obligation of [*Name of Issuing Bank*] under this Letter of Credit is the individual obligation of [*Name of Issuing Bank*] and is in no way contingent upon reimbursement with respect thereto.

It is a condition of this Letter of Credit that it is deemed to be automatically extended without amendment for a period of one year from the expiration date hereof, or any future expiration date, unless at least 60 days prior to any expiration date, we mail to you and to the U.S. Trustee notice by Registered Mail or Certified Mail, return receipt requested, or by courier to your and the trustee's address indicated above, that we elect not to consider this Letter of Credit renewed for any such additional period. Upon receipt of this notice, you may draw hereunder on or before the then current expiration date, by presentation of your draft and statement as stipulated above.

[In the case of a letter of credit issued by a U.S. branch of a foreign bank the following language must be added]. It is a further condition of this Letter of Credit that if the U.S. branch of *[name of foreign bank]* is to be closed, that at least sixty days prior to closing, we mail to you and the U.S. Trustee notice by Registered Mail or Certified Mail, return receipt requested, or by courier to your and the U.S. Trustee's address indicated above, that this branch will be closing. This notice will specify the actual date of closing. Upon receipt of the notice, you may draw hereunder on or before the date of closure, by presentation of your draft and statement as stipulated above.

Except where otherwise stated herein, this Letter of Credit is subject to the Uniform Customs and Practice for Documentary Credits, 1993 Revision, ICC Publication No. 500. If we notify you of our election not to consider this Letter of Credit renewed and the expiration date occurs during an interruption of business described in Article 17 of said Publication 500, unless you had consented to cancellation prior to the expiration date, the bank hereby specifically agrees to effect payment if this Letter of Credit is drawn against within 30 days after the resumption of business.

Except as stated herein, this Letter of Credit cannot be modified or revoked without your consent.

Authorized Signature _____
Date _____

(*3*) *Form of confirmation.* If the requirements of this paragraph (d)(1)(i)(C) are satisfied by the issuance of a letter of credit by a foreign bank with confirmation by a bank as defined in section 581, the confirmation must be made in the following form (or in a form that is the same as the following form in all material respects), or an alternative form as the Commissioner prescribes by guidance published in the Internal Revenue Bulletin (see § 602.101(d)(2) of this chapter):

[Issue Date]

To: Internal Revenue Service
Attention: District Director,
[specify location]
District Office
Estate and Gift Tax
Examination Group
[State Address, City,
State, ZIP Code]

[or in the case of nonresident noncitizen decedents and United States citizens who die domiciled outside the United States,

To: Estate Tax Group,
Assistant Commissioner
(International)
950 L'Enfant Plaza
CP:IN:D:C:EX:HQ:1114
Washington, DC 20024].

Dear Sirs:

We hereby confirm the enclosed irrevocable Letter of Credit No. _____, and amendments thereto, if any, in your favor by _____ [Issuing Bank] for drawings up to U.S. $_____ [same amount as in initial Letter of Credit] effective immediately. This confirmation is issued, presentable and payable at our office at _____ and expires at 3:00 p.m. [EDT, EST, CDT, CST, MDT, MST, PDT, PST] on _____ at said office.

For information and reference only, we are informed that this Confirmation relates to [Applicant should provide bank with the identity of qualified domestic trust and governing instrument], and the name, address, and identifying number of the trustee is [Applicant should provide bank with the trustee name, address and the QDOT's TIN number, if any].

We hereby undertake to honor your sight draft(s) drawn as specified in the Letter of Credit.

Except as expressly stated herein, this undertaking is not subject to any agreement, condition or qualification. The obligation of [*Name of Confirming Bank*] under this Confirmation is the individual obligation of [*Name of Confirming Bank*] and is in no way contingent upon reimbursement with respect thereto.

It is a condition of this Confirmation that it is deemed to be automatically extended without amendment for a period of one year from the expiry date

hereof, or any future expiration date, unless at least sixty days prior to the expiration date, we send to you and to the U.S. Trustee notice by Registered Mail or Certified Mail, return receipt requested, or by courier to your and the trustee's addresses, respectively, indicated above, that we elect not to consider this Confirmation renewed for any additional period. Upon receipt of this notice by you, you may draw hereunder on or before the then current expiration date, by presentation of your draft and statement as stipulated above.

Except where otherwise stated herein, this Confirmation is subject to the Uniform Customs and Practice for Documentary Credits, 1993 Revision, ICC Publication No. 500. If we notify you of our election not to consider this Confirmation renewed and the expiration date occurs during an interruption of business described in Article 17 of said Publication 500, unless you had consented to cancellation prior to the expiration date, the bank hereby specifically agrees to effect payment if this Confirmation is drawn against within 30 days after the resumption of business.

Except as stated herein, this Confirmation cannot be modified or revoked without your consent.

Authorized Signature _____
Date _____

(*4*) *Additional governing instrument requirements.* The trust instrument must provide that if the Internal Revenue Service draws on the letter of credit (or confirmation) in accordance with its terms, neither the U.S. Trustee nor any other person will seek a return of any part of the remittance until April 15th of the calendar year following the year in which the letter of credit (or confirmation) is drawn upon. After that date, any such remittance will be treated as a deposit and returned (without interest) upon request of the U.S. Trustee after the date specified above, unless it is determined that assessment or collection of the tax imposed by section 2056A(b)(1) is in jeopardy, within the meaning of section 6861. If an assessment under section 6861 is made, the remittance will first be credited to any tax liability reported on the Form 706–QDT, then to any unpaid balance of a section 2056A(b)(1)(A) tax liability (plus interest and penalties) for any prior taxable years, and any balance will then be returned to the U.S. Trustee.

(*5*) *Procedure.* The letter of credit (and confirmation, if applicable) is to be filed with the decedent's federal estate tax return, Form 706 or 706NA (unless an extension for filing the letter of credit is granted under § 301.9100 of this chapter). The U.S. Trustee must provide a written statement with the letter of credit that provides a list of the assets that will be used to fund the QDOT and the respective values of the assets. The written statement must also indicate whether any exclusions under paragraph (d)(1)(iv) of this section are claimed.

(D) *Disallowance of marital deduction for substantial undervaluation of QDOT property in certain situations.* (*1*) If either—

(*i*) The bond or letter of credit security arrangement under paragraph (d)(1)(i)(B) or (C) of this section is chosen by the U.S. Trustee; or

(*ii*) The QDOT property as originally reported on the decedent's estate tax return is valued at $2 million or less but, as finally determined for federal estate tax purposes, the QDOT property is determined to be in excess of $2 million, then the marital deduction will be disallowed in its entirety for failure to comply with the requirements of section 2056A if the value of the QDOT property reported on the estate tax return is 50 percent or less of the amount finally determined to be the correct value of the property for federal estate tax purposes.

(*2*) The preceding sentence does not apply if—

(*i*) There was reasonable cause for the undervaluation; and

(*ii*) The fiduciary of the estate acted in good faith with respect to the undervaluation. For this purpose, § 1.6664–4(b) of this chapter applies, to the extent applicable, with respect to the facts and circumstances to be taken into account in making this determination.

(ii) *QDOTs with assets of $2 million or less.* If the fair market value of the assets passing, treated, or deemed to have passed to the QDOT (or in the form of a QDOT), determined without reduction for any indebtedness with respect to the assets, as finally determined for federal estate tax purposes, is $2 million or less as of the date of the decedent's death or, if applicable, the alternate valuation date (adjusted as provided in paragraph (d)(1)(iv) of this section), the trust instrument must provide that either no more than 35 percent of the fair market value of the trust assets, determined annually on the last day of the taxable year of the trust (or on the last day of the calendar year if the QDOT does not have a taxable year), will consist of real property located outside of the United States, or the trust will meet the requirements prescribed by paragraph (d)(1)(i)(A), (B), or (C) of this section. See paragraph (d)(1)(ii)(D) of this section for special rules in the case of principal distributions from a QDOT, fluctuations in the value of foreign real property held by a QDOT due to changes in value of foreign currency, and fluctuations in the fair market value of assets held by the QDOT. See paragraph (d)(1)(iv) of this section for a special rule for personal residences. If the fair market value, as originally reported on the decedent's estate tax return, of the assets passing or deemed to have passed to the QDOT (determined without reduction for any indebtedness with respect to the assets) is $2 million or less, but the fair market value of the assets as finally determined for federal estate tax purposes is more than $2 million, the U.S. Trustee has a reasonable period of time (not exceeding sixty days after the conclusion of the proceeding or other action resulting in a final determination of the value of the assets) to meet the requirements prescribed by paragraph (d)(1)(i)(A), (B), or (C) of this section. However, see paragraph (d)(1)(i)(D) of this section in the case of a substantial undervaluation of QDOT assets. See § 20.2056A–2(d)(1)(iii) for the definition of finally determined.

(A) *Multiple QDOTs.* For purposes of this paragraph (d)(1)(ii), if more than one QDOT is established for the benefit of the surviving spouse, the fair market value of all the QDOTs are aggregated in determining whether the $2 million threshold under this paragraph (d)(1)(ii) is exceeded.

(B) *Look-through rule.* For purposes of determining whether no more than 35 percent of the fair market value of the QDOT assets consists of foreign real property, if the QDOT owns more than 20% of the voting stock or value in a corporation with 15 or fewer shareholders, or more than 20% of the capital interest of a partnership with 15 or fewer partners, then all assets owned by the corporation or partnership are deemed to be owned directly by the QDOT to the extent of the QDOT's pro rata share of the assets of that corporation or partnership. For a partnership, the QDOT partner's pro rata share is based on the greater of its interest in the capital or profits of the partnership. For

purposes of this paragraph, all stock in the corporation, or interests in the partnership, as the case may be, owned by or held for the benefit of the surviving spouse, or any members of the surviving spouse's family (within the meaning of section 267(c)(4)), are treated as owned by the QDOT solely for purposes of determining the number of partners or shareholders in the entity and the QDOT's percentage voting interest or value in the corporation or capital interest in the partnership, but not for the purpose of determining the QDOT's pro rata share of the assets of the entity.

(C) *Interests in other entities.* Interests owned by the QDOT in other entities (such as an interest in a trust) are accorded treatment consistent with that described in paragraph (d)(1)(ii)(B) of this section.

(D) *Special rule for foreign real property.* For purposes of this paragraph (d)(1)(ii), if, on the last day of any taxable year during the term of the QDOT (or the last day of the calendar year if the QDOT does not have a taxable year), the value of foreign real property owned by the QDOT exceeds 35 percent of the fair market value of the trust assets due to: distributions of QDOT principal during that year; fluctuations in the value of the foreign currency in the jurisdiction where the real estate is located; or fluctuations in the fair market value of any assets held in the QDOT, then the QDOT will not be treated as failing to meet the requirements of this paragraph (d)(1). Accordingly, the QDOT will not cease to be a QDOT within the meaning of § 20.2056A–5(b)(3) if, by the end of the taxable year (or the last day of the calendar year if the QDOT does not have a taxable year) of the QDOT immediately following the year in which the 35 percent limit was exceeded, the value of the foreign real property held by the QDOT does not exceed 35 percent of the fair market value of the trust assets or, alternatively, the QDOT meets the requirements of either paragraph (d)(1)(i)(A), (B), or (C) of this section on or before the close of that succeeding year.

(iii) *Definition of finally determined.* For purposes of § 20.2056A–2(d)(1)(i) and (ii), the fair market value of assets will be treated as finally determined on the earliest to occur of—

(A) The entry of a decision, judgment, decree, or other order by any court of competent jurisdiction that has become final;

(B) The execution of a closing agreement made under section 7121;

(C) Any final disposition by the Internal Revenue Service of a claim for refund;

(D) The issuance of an estate tax closing letter (Form L–154 or equivalent) if no claim for refund is filed; or

(E) The expiration of the period of assessment.

(iv) *Special rules for personal residence and related personal effects*—(A) *Two million dollar threshold.* For purposes of determining whether the $2 million threshold under paragraphs (d)(1)(i) and (ii) of this section has been exceeded, the executor of the estate may elect to exclude up to $600,000 in value attributable to real property (and related furnishings) owned directly by the QDOT that is used by, or held for the use of the surviving spouse as a personal residence and that passes, or is treated as passing, to the QDOT under section 2056(d). The election may be made regardless of whether the real property is situated within or without the United States. The election is made by attaching to the estate tax return on which the QDOT election is made a written statement claiming the exclusion. The statement must clearly identify the property or properties (i.e. address and location) for which the election is being made.

(B) *Security requirement.* For purposes of determining the amount of the bond or letter of credit required when paragraph (d)(1)(i)(B) or (C) of this section applies, the executor of the estate may elect to exclude, during the term of the QDOT, up to $600,000 in value attributable to real property (and related furnishings) owned directly by the QDOT that is used by, or held for the use of the surviving spouse as a personal residence and that passes, or is treated as passing, to the QDOT under section 2056(d). The election may be made regardless of whether the real property is situated within or without the United States. The election is made by attaching to the estate tax return on which the QDOT election is made a written statement claiming the exclusion. If an election is not made on the decedent's estate tax return, the election may be made, prospectively, at any time, during the term of the QDOT, by attaching to the Form 706–QDT a written statement claiming the exclusion. A statement may also be attached to the Form 706–QDT that cancels a prior election of the personal residence exclusion that was made under this paragraph, either on the decedent's estate tax return or on a Form 706–QDT.

(C) *Foreign real property limitation.* The special rules of this paragraph (d)(1)(iv) do not apply for purposes of determining whether more than 35 percent of the QDOT assets consist of foreign real property under paragraph (d)(1)(ii) of this section.

(D) *Personal residence.* For purposes of this paragraph (d)(1)(iv), a *personal residence* is either the principal residence of the surviving spouse within the meaning of section 1034 or one other residence of the surviving spouse. In order to be used by or held for the use of the spouse as a personal residence, the residence must be available at all times for use by the surviving spouse. The residence may not be rented to another party, even when not occupied by the spouse. A personal residence may include appurtenant structures used by the surviving spouse for residential purposes and adjacent land not in excess of that which is reasonably appropriate for residential purposes (taking into account the residence's size and location).

(E) *Related furnishings.* The term *related furnishings* means furniture and commonly included items such as appliances, fixtures, decorative items and china, that are not beyond the value associated with normal household and decorative use. Rare artwork, valuable antiques, and automobiles of any kind or class are not within the meaning of this term.

(F) *Required statement.* If one or both of the exclusions provided in paragraph (d)(1)(iv)(A) or (B) of this section are elected by the executor of the estate and the personal residence is later sold or ceases to be used, or held for use as a personal residence, the U.S. Trustee must file the statement that is required under paragraph (d)(3) of this section at the time and in the manner provided in paragraphs (d)(3)(ii) and (iii) of this section.

(G) *Cessation of use.* Except as provided in this paragraph (d)(1)(iv)(G), if the residence ceases to be used by, or held for the use of, the spouse as a personal residence of the spouse, or if the residence is sold during the term of the QDOT, the exclusions provided in paragraphs (d)(1)(iv)(A) and (B) of this section cease to apply. However, if the residence is sold, the exclusion continues to apply if, within 12 months of the date of sale, the amount of the adjusted sales price (as defined in section

1034(b)(1)) is reinvested to purchase a new personal residence for the spouse. If less than the amount of the adjusted sales price is reinvested, the amount of the exclusion equals the amount reinvested in the new residence plus any amount previously allocated to a residence that continues to qualify for the exclusion, up to a total of $600,000. If the QDOT ceases to qualify for all or any portion of the initially claimed exclusions, paragraph (d)(1)(i) of this section, if applicable (determined as if the portion of the exclusions disallowed had not been initially claimed by the QDOT), must be complied with no later than 120 days after the effective date of the cessation. In addition, if a residence ceases to be used by, or held for the use of the spouse as a personal residence of the spouse or if the personal residence is sold during the term of the QDOT, the personal residence exclusion may be allocated to another residence that is held in either the same QDOT or in another QDOT that is established for the surviving spouse, if the other residence qualifies as being used by, or held for the use of the spouse as a personal residence. The trustee may allocate up to $600,000 to the new personal residence (less the amount previously allocated to a residence that continues to qualify for the exclusion) even if the entire $600,000 exclusion was not previously utilized with respect to the original personal residence(s).

(v) *Anti-abuse rule.* Regardless of whether the QDOT designates a bank as the U.S. Trustee under paragraph (d)(1)(i)(A) of this section (or otherwise complies with paragraph (d)(1)(i)(A) of this section by naming a foreign bank with a United States branch as a trustee to serve with the U.S. Trustee), complies with paragraph (d)(1)(i)(B) or (C) of this section, or is subject to and complies with the foreign real property requirements of paragraph (d)(1)(ii) of this section, the trust immediately ceases to qualify as a QDOT if the trust utilizes any device or arrangement that has, as a principal purpose, the avoidance of liability for the estate tax imposed under section 2056A(b)(1), or the prevention of the collection of the tax. For example, the trust may become subject to this paragraph (d)(1)(v) if the U.S. Trustee that is selected is a domestic corporation established with insubstantial capitalization by the surviving spouse or members of the spouse's family.

(2) *Individual trustees.* If the U.S. Trustee is an individual United States citizen, the individual must have a tax home (as defined in section 911(d)(3)) in the United States.

(3) *Annual reporting requirements—* (i) *In general.* The U.S. Trustee must file a written statement described in paragraph (d)(3)(iii) of this section, if the QDOT satisfies any one of the following criteria for the applicable reporting years—

(A) The QDOT directly owns any foreign real property on the last day of its taxable year (or the last day of the calendar year if it has no taxable year), and the QDOT does not satisfy the requirements of paragraph (d)(1)(i)(A), (B), or (C) or (d)(4) of this section by employing a bank as trustee or providing security; or

(B) The personal residence previously subject to the exclusion under paragraph (d)(1)(iv) of this section is sold, or that personal residence ceases to be used, or held for use, as a personal residence, during the taxable year (or during the calendar year if the QDOT does not have a taxable year); or

(C) After the application of the look-through rule contained in paragraph (d)(1)(ii)(B) of this section, the QDOT is treated as owning any foreign real property on the last day of the taxable year (or the last day of the calendar year if the QDOT has no taxable year), and the QDOT does not satisfy the requirements of paragraph (d)(1)(A), (B), (C) or (d)(4) of this section by employing a bank as trustee or providing security.

(ii) *Time and manner of filing.* The written statement, containing the information described in paragraph (d)(3)(iii) of this section, is to be filed for the taxable year of the QDOT (calendar year if the QDOT does not have a taxable year) for which any of the events or conditions requiring the filing of a statement under paragraph (d)(3)(i) of this section have occurred or have been satisfied. The written statement is to be submitted to the Internal Revenue Service by filing a Form 706–QDT, with the statement attached, no later than April 15th of the calendar year following the calendar year in which or with which the taxable year of the QDOT ends (or by April 15th of the following year if the QDOT has no taxable year), unless an extension of time is obtained under § 20.2056A–11(a). The Form 706–QDT, with attached statement, must be filed regardless of whether the Form 706–QDT is otherwise required to be filed under the provisions of this chapter. Failure to file timely the statement may subject the QDOT to the rules of paragraph (d)(1)(v) of this section.

(iii) *Contents of statement.* The written statement must contain the following information—

(A) The name, address, and taxpayer identification number, if any, of the U.S. Trustee and the QDOT; and

(B) A list summarizing the assets held by the QDOT, together with the fair market value of each listed QDOT asset, determined as of the last day of the taxable year (December 31 if the QDOT does not have a taxable year) for which the written statement is filed. If the look-through rule contained in paragraph (d)(1)(ii)(B) of this section applies, then the partnership, corporation, trust or other entity must be identified and the QDOT's pro rata share of the foreign real property and other assets owned by that entity must be listed on the statement as if directly owned by the QDOT; and

(C) If a personal residence previously subject to the exclusion under paragraph (d)(1)(iv) of this section is sold during the taxable year (or during the calendar year if the QDOT does not have a taxable year), the statement must provide the date of sale, the adjusted sales price (as defined in section 1034(b)(1)), the extent to which the amount of the adjusted sales price has been or will be used to purchase a new personal residence and, if not timely reinvested, the steps that will or have been taken to comply with paragraph (d)(1)(i) of this section, if applicable; and

(D) If the personal residence ceases to be used, or held for use, as a personal residence by the surviving spouse during the taxable year (or during the calendar year if the QDOT does not have a taxable year), the written statement must describe the steps that will or have been taken to comply with paragraph (d)(1)(i) of this section, if applicable.

(4) *Request for alternate arrangement or waiver.* If the Commissioner provides guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter) pursuant to which a testator, executor, or the U.S. Trustee may adopt an alternate plan or arrangement to assure collection of the section 2056A estate tax, and if the alternate plan or arrangement is adopted in accordance with the published guidance, then the QDOT will be treated, subject to paragraph (d)(1)(v) of this section, as meeting the requirements of paragraph (d)(1)

of this section. Until this guidance is published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter), taxpayers may submit a request for a private letter ruling for the approval of an alternate plan or arrangement proposed to be adopted to assure collection of the section 2056A estate tax in lieu of the requirements prescribed in this paragraph (d)(4).

(5) *Adjustment of dollar threshold and exclusion.* The Commissioner may increase or decrease the dollar amounts referred to in paragraph (d)(1)(i), (ii) or (iv) of this section in accordance with guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter).

(6) *Effective date and special rules.* (i) This paragraph (d) is effective for estates of decedents dying after February 19, 1996.

(ii) *Special rule in the case of incompetency.* A revocable trust or a trust created under the terms of a will is deemed to meet the governing instrument requirements of this paragraph (d) notwithstanding that the requirements are not contained in the governing instrument (or otherwise incorporated by reference) if the trust instrument (or will) was executed on or before November 20, 1995, and—

(A) The testator or settlor dies after February 19, 1996;

(B) The testator or settlor is, on November 20, 1995, and at all times thereafter, under a legal disability to amend the will or trust instrument;

(C) The will or trust instrument does not provide the executor or the U.S. Trustee with a power to amend the instrument in order to meet the requirements of section 2056A; and

(D) The U.S. Trustee provides a written statement with the federal estate tax return (Form 706 or 706NA) that the trust is being administered (or will be administered) so as to be in actual compliance with the requirements of this paragraph (d) and will continue to be administered so as to be in actual compliance with this paragraph (d) for the duration of the trust. This statement must be binding on all successor trustees.

(iii) *Special rule in the case of certain irrevocable trusts.* An irrevocable trust is deemed to meet the governing instrument requirements of this paragraph (d) notwithstanding that the requirements are not contained in the governing instrument (or otherwise incorporated by reference) if the trust was executed on or before November 20, 1995, and:

(A) The settlor dies after February 19, 1996;

(B) The trust instrument does not provide the U.S. Trustee with a power to amend the trust instrument in order to meet the requirements of section 2056A; and

(C) The U.S. Trustee provides a written statement with the decedent's federal estate tax return (Form 706 or 706NA) that the trust is being administered in actual compliance with the requirements of this paragraph (d) and will continue to be administered so as to be in actual compliance with this paragraph (d) for the duration of the trust. This statement must be binding on all successor trustees.

§ 20.2056A–2T [Removed]

Par. 3a. Section 20.2056A–2T is removed.

PART 602—0MB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 4. The authority citation for part 602 continues to read as follows:
Authority: 26 U.S.C. 7805.

Par. 5. In § 602.101, paragraph (c) is amended by:

1. Removing the following entry from the table:

§ 602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
20.2056A–2T(d)	1545–1443
* * * * *	

2. Adding the following entry in numerical order to the table to read as follows:

§ 602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
20.2056A–2.	1545–1443
* * * * *	

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved September 19, 1996.

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

(Filed by the Office of the Federal Register on November 27, 1996, 8:45 a.m., and published in the issue of the Federal Register for November 29, 1996, 61 F.R. 60551)

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26 CFR 20.2056A–2(d)(1): Security and other arrangements for payment of estate tax imposed under section 2056A(b)(1).

Sample paragraphs are provided that may be used to satisfy the governing instrument requirements contained in §§ 20.2056A–2(d)(1)(i) and (d)(1)(ii) of the Estate Tax Regulations for a qualified domestic trust (QDOT) as described in § 2056A of the Internal Revenue Code. See Rev. Proc. 96–54, page 386.

Chapter 12.—Gift Tax
Subchapter B.—Transfers

Section 2511.—Transfers in General

26 CFR 25.2511–2: Cessation of donor's dominion and control.
(Also § 2031; 20.2031–5.)

If certain conditions are satisfied, the delivery of a check to a noncharitable donee will be deemed to be complete for federal gift and estate tax purposes when the check is deposited, cashed against available funds of the donee, or presented for payment in the calendar year for which favorable gift tax treatment is sought. Rev. Rul. 67–396 modified.

Rev. Rul. 96–56

In view of the Fourth Circuit's decision in *Metzger v. Commissioner*, 38 F.3d 118 (4th Cir. 1994) the Internal Revenue Service has reconsidered the rationale for the holding in Situation 1 of Rev. Rul. 67–396, 1967–2 C.B. 351. In *Situation 1*, the donor transferred a gift check on December 25 to a noncharitable donee, but the donee held the check until January 2 of the following year when it was cashed by the drawee bank. Rev. Rul. 67–396 concludes that the gift was not complete for federal gift tax purposes until the check was paid by the drawee bank on January 2, because prior to the check's payment, certification, acceptance by the drawee, or negotiation, the donor had not relinquished dominion and control over the funds. Prior to the occurrence of one of these events, the donor could have stopped payment and revoked the gift.

Metzger holds that if a check is delivered to a noncharitable donee, for federal gift tax purposes, completion of

the gift relates back to the date the check was deposited by the donee, provided the check is paid by the drawee bank while the donor is alive and: (1) the donor intended to make a gift; (2) delivery of the check was unconditional; and (3) the donee presented the check for payment in the year for which completed gift treatment is sought and within a reasonable time of issuance. The Service will follow the *Metzger* decision.

HOLDING

Rev. Rul. 67–396 is modified to provide that the delivery of a check to a noncharitable donee will be deemed to be a completed gift for federal gift and estate tax purposes on the earlier of (i) the date on which the donor has so parted with dominion and control under local law as to leave in the donor no power to change its disposition, or (ii) the date on which the donee deposits the check (or cashes the check against available funds of the donee) or presents the check for payment, if it is established that: (1) the check was paid by the drawee bank when first presented to the drawee bank for payment; (2) the donor was alive when the check was paid by the drawee bank; (3) the donor intended to make a gift; (4) delivery of the check by the donor was unconditional; and (5) the check was deposited, cashed, or presented in the calendar year for which completed gift treatment is sought and within a reasonable time of issuance. The result in *Situation 1* of Rev. Rul. 67–396 remains the same for two reasons: the check was not delivered unconditionally (the donor requested that the donee not deposit or cash the check for a few days) and the check was not presented for payment in the same calendar year for which completed gift treatment was sought.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 67–396 is modified.

Subtitle C.—Employment Taxes
Chapter 21.—Federal Insurance Contributions Act
SubChapter C.—General Provisions

Section 3121.—Definitions

26 CFR 31.3121(a)–1: Wages.

Is back pay that is received in satisfaction of a claim for denial of a promotion due to disparate treatment employment discrimination under Title VII of the Civil Rights Act of 1964, as amended in 1991, treated as "wages" for purposes of § 3121 (FICA)? See Rev. Rul. 96–65, page 6.

Chapter 22.—Railroad Retirement Tax Act
Subchapter C.—Tax on Employers

Section 3221.—Rate of Tax

Determination of Quarterly Rate of Excise Tax for Railroad Retirement Supplemental Annuity Program

In accordance with directions in Section 3221(c) of the Railroad Retirement Tax Act (26 U.S.C. 3221(c)), the Railroad Retirement Board has determined that the excise tax imposed by such Section 3221(c) on every employer, with respect to having individuals in his employ, for each work-hour for which compensation is paid by such employer for services rendered to him during the quarter beginning July 1, 1996, shall be at the rate of 34 cents.

In accordance with directions in Section 15(a) of the Railroad Retirement Act of 1974, the Railroad Retirement Board has determined that for the quarter beginning July 1, 1996, 33.4 percent of the taxes collected under Sections 3211(b) and 3221(c) of the Railroad Retirement Tax Act shall be credited to the Railroad Retirement Account and 66.6 percent of the taxes collected under such Sections 3211(b) and 3221(c) plus 100 percent of the taxes collected under Section 3221(d) of the Railroad Retirement Tax Act shall be credited to the Railroad Retirement Supplemental Account.

Dated May 29, 1996.

Beatrice Ezerski,
Secretary to the Board.

(Filed by the Office of the Federal Register on June 5, 1996, 8:45 a.m., and published in the issue of the Federal Register for June 6, 1996, 61 F.R. 28911)

Determination of Quarterly Rate of Excise Tax for Railroad Retirement Supplemental Annuity Program

In accordance with directions in Section 3221(c) of the Railroad Retirement Tax Act (26 U.S.C., Section 3221(c)), the Railroad Retirement Board has determined that the excise tax imposed by such Section 3221(c) on every employer, with respect to having individuals in his employ, for each work-hour for which compensation is paid by such employer for services rendered to him during the quarter beginning October 1, 1996, shall be at the rate of 34 cents.

In accordance with directions in Section 15(a) of the Railroad Retirement Act of 1974, the Railroad Retirement Board has determined that for the quarter beginning October 1, 1996, 33.8 percent of the taxes collected under Sections 3211(b) and 3221(c) of the Railroad Retirement Tax Act shall be credited to the Railroad Retirement Account and 66.2 percent of the taxes collected under such Sections 3211(b) and 3221(c) plus 100 percent of the taxes collected under Section 3221(d) of the Railroad Retirement Tax Act shall be credited to the Railroad Retirement Supplemental Account.

Dated: August 27, 1996.

Beatrice Ezerski,
Secretary to the Board

(Filed by the Office of the Federal Register on September 4, 1996, 8:45 a.m., and published in the issue of the Federal Register for September 5, 1996, 61 F.R. 46871)

In accordance with directions in Section 3221(c) of the Railroad Retirement Tax Act (26 U.S.C. 3221(c)), the Railroad Retirement Board has determined that the excise tax imposed by such Section 3221(c) on every employer, with respect to having individuals in his employ, for each work-hour for which compensation is paid by such employer for services rendered to him during the quarter beginning January 1, 1997, shall be at the rate of 35 cents.

In accordance with directions in Section 15(a) of the Railroad Retirement Act of 1974, the Railroad Retirement Board has determined that for the quarter beginning January 1, 1997, 33.4 percent of the taxes collected under Sections 3211(b) and 3221(c) of the Railroad Retirement Tax Act shall be credited to the Railroad Retirement Account and 66.6 percent of the taxes collected under such Sections 3211(b) and 3221(c) plus 100 percent of the taxes collected under Section 3221(d) of the Railroad Retirement Tax Act shall be credited to the Railroad Retirement Supplemental Account.

Dated: December 4, 1996.

Beatrice Ezerski,
Secretary to the Board

(Filed by the Office of the Federal Register on December 11, 1996, 8:45 a.m., and published in the issue of the Federal Register for December 12, 1996, 61 F.R. 65422)

Subchapter D.—General Provisions

Section 3231.—Definitions

26 CFR 31.3231(e)–1: Compensation

Is back pay that is received in satisfaction of a claim for denial of a promotion due to disparate treatment employment discrimination under Title VII of the Civil Rights Act of 1964, as amended in 1991, treated as "compensation" for purposes of § 3231 (RRTA)? See Rev. Rul. 96–65, page 6.

Chapter 23.—Federal Unemployment Tax Act

Section 3306.—Definitions

26 CFR 31.3306(b)–1: Wages.

Is back pay that is received in satisfaction of a claim for denial of a promotion due to disparate treatment employment discrimination under Title VII of the Civil Rights Act of 1964, as amended in 1991, treated as "wages" for purposes of § 3306 (FUTA)? See Rev. Rul. 96–65, page 6.

Chapter 24.—Collection of Income Tax at Source on Wages

Subchapter A.—Withholding From Wages

Section 3401.—Definitions

26 CFR 31.3401(a)–1: Wages.

Is back pay that is received in satisfaction of a claim for denial of a promotion due to disparate treatment employment discrimination under Title VII of the Civil Rights Act of 1964, as amended in 1991, treated as "wages" for purposes of § 3401 (federal income tax withholding)?

Subtitle D.—Miscellaneous Excise Taxes

Chapter 31.—Retail Excise Taxes

Subchapter A.—Luxury Passenger Automobiles

Section 4001.—Passenger Vehicles

The Service is providing inflation adjustments to the price above which a passenger vehicle becomes subject to an excise tax for transactions occurring in calendar year 1997. See Rev. Proc. 96–59, page 391.

Section 4003.—Special Rules

The Service is providing inflation adjustments to the price above which a passenger vehicle becomes subject to an excise tax for transactions occurring in calendar year 1997. (Price includes the price of installation of parts or accessories on a passenger vehicle within six months of the date after the vehicle was first placed in service.) See Rev. Proc. 96–59, page 391.

Chapter 34.—Policies Issued by Foreign Insurers

Section 4371.—Imposition of Tax

Ct.D. 2060

SUPREME COURT OF THE UNITED STATES

No. 95–591

UNITED STATES, PETITIONER v. INTERNATIONAL BUSINESS MACHINES CORPORATION

[517 U.S.—]

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

June 10, 1996

Syllabus

Pursuant to § 4371 of the Internal Revenue Code, respondent International Business Machines Corporation (IBM) paid a tax on insurance premiums remitted to foreign insurers to cover shipments of goods to its foreign subsidiaries. When its refund claims were denied, IBM filed suit in the Court of Federal Claims, contending that § 4371's application to policies insuring export shipments violated the Export Clause, which states that "[n]o Tax or Duty shall be laid on Articles exported from any State." The court agreed, rejecting the Government's argument that *Thames & Mersey Marine Ins. Co.* v. *United States*, 237 U. S. 19—in which this Court held that a federal stamp tax on policies insuring marine risks could not, under the Export Clause, be constitutionally applied to policies covering export shipments—had been superseded by subsequent decisions interpreting the Import-Export Clause, which states in relevant part, "No State shall . . . lay any Imposts or Duties on Imports or Exports." The Court of Appeals affirmed.

Held: The Export Clause prohibits assessment of nondiscriminatory federal taxes on goods in export transit.

(a) While this Court has strictly enforced the Export Clause's prohibition against federal taxation of goods in export transit and certain closely related services and activities, see, *e.g., Thames & Mersey, supra,* it has not exempted pre-export goods and services from ordinary tax burdens or exempted from federal taxation various services and activities only tangentially related to the export process, see, *e.g., Cornell* v. *Coyne*, 192 U.S. 418. Conceding that the tax assessed here violates the Export Clause under *Thames & Mersey*, the Government asks that the case be overruled because its underlying theory has been rejected in the context of the Commerce and Import-Export Clauses and those Clauses have historically been interpreted in harmony with the Export Clause.

(b) When this Court expressly disavowed its early view that the dormant Commerce Clause required a strict ban on state taxation of interstate commerce, *Complete Auto Transit, Inc.* v. *Brady*, 430 U.S. 274, 288–289, it resolved a long struggle over the meaning of the nontextual negative command of that Clause. The Export Clause, on the other hand, expressly prohibits Congress from laying any tax or duty on exports. These textual disparities strongly suggest that shifts in the Court's view of the dormant Commerce Clause's scope cannot govern Export Clause interpretation. Cf. *Richfield Oil Corp.* v. *State Bd. of Equalization*, 329 U. S. 69, 75–76.

(c) While one may question *Thames & Mersey*'s finding that a tax on policies insuring exports is functionally the same as a tax on exportation itself, the Government apparently has chosen not to do so here. Under the principles that animate the policy of *stare decisis*, the Court declines to overrule *Thames & Mersey*'s long-standing precedent, which has caused no uncertainty in commercial export transactions, on a theory not argued by the parties.

(d) This Court's recent Import-Export Clause cases do not require that *Thames & Mersey* be overruled. Meaningful textual differences that should not be overlooked exist between the Export Clause and the Import-Export Clause. In finding the assessments in *Michelin Tire Corp.* v. *Wages*, 423 U.S. 276, and *Department of Revenue of Wash.* v. *Association of Wash. Stevedoring Cos.*, 435 U. S. 734, valid, the Court recognized that the Import-Export Clause's absolute ban on "Imposts or Duties" is not a ban on every tax. Because impost and duty are thus narrower terms than tax, a particular state assessment might be beyond the Import-Export Clause's reach, while an identical federal assessment might be subject to the Export Clause. The word "Tax" has a common, and usually expansive, meaning that should not be ignored. The Clauses were also intended to serve different goals. The Government's policy argument—that the Framers intended the Export Clause to narrowly alleviate the fear of northern repression through taxation of southern exports by prohibiting only discriminatory taxes—cannot be squared with the Clause's broad language. The better reading is that the Framers sought to alleviate their concerns by completely denying to Congress the power to tax exports at all. See *Fairbank* v. *United States*, 181 U. S. 283.

(e) Even assuming that *Michelin* and *Washington Stevedoring* govern the Export Clause inquiry here, those holdings do not interpret the Import-Export Clause to permit assessment of nondiscriminatory taxes on imports and exports in transit.

59 F. 3d 1234, affirmed.

THOMAS, J., delivered the opinion of the Court, in which REHNQUIST, C. J., and O'CONNOR, SCALIA, SOUTER, and BREYER, JJ., joined. KENNEDY, J., filed a dissenting opinion, in which GINSBURG, J., joined. STEVENS, J., took no part in the consideration or decision of the case.

JUSTICE THOMAS delivered the opinion of the Court.

We resolve in this case whether the Export Clause of the Constitution permits the imposition of a generally applicable, nondiscriminatory federal tax on goods in export transit. We hold that it does not.

I

Section 4371 of the Internal Revenue Code imposes a tax on insurance premiums paid to foreign insurers that are not

subject to the federal income tax.[1] 26 U. S. C. § 4371 (1982 ed.). International Business Machines Corporation (IBM) ships products that it manufactures in the United States to numerous foreign subsidiaries and insures those shipments against loss. When the foreign subsidiary makes the shipping arrangements, the subsidiary often places the insurance with a foreign carrier. When it does, both IBM and the subsidiary are listed as beneficiaries in the policy.

IBM filed federal excise tax returns for the years 1975 through 1984, but reported no liability under § 4371. The IRS audited IBM and determined that the premiums paid to foreign insurers were taxable under § 4371 and that IBM—as a named beneficiary of the insurance policies—was liable for the tax. The IRS assessed a tax against IBM for each of those years.

IBM paid the assessments and filed refund claims, which the IRS denied. IBM then commenced suit in the Court of Federal Claims, contending that application of § 4371 to policies insuring its export shipments violated the Export Clause. The focus of the suit was this Court's decision in *Thames & Mersey Marine Ins. Co.* v. *United States*, 237 U.S. 19 (1915), in which we held that a federal stamp tax on policies insuring marine risks could not, under the Export Clause, be constitutionally applied to policies covering export shipments. The United States argued that the analysis of *Thames & Mersey* is no longer valid, having been superseded by subsequent decisions interpreting the Import-Export Clause—specifically, *Michelin Tire Corp.* v. *Wages*, 423 U. S. 276 (1976), and *Department of Revenue of Wash.* v. *Association of Wash. Stevedoring Cos.*, 435 U. S. 734 (1978). The Court of Federal Claims noted that this Court has never overruled *Thames & Mersey* and ruled that application of § 4371 to policies insuring goods in export transit violates the Export Clause. 31 Fed. Cl. 500 (1994). The Court of Appeals for the Federal Circuit affirmed. 59 F. 3d 1234 (1995). We agreed to hear this case to decide whether we should overrule *Thames & Mersey*. 516 U.S. — (1995).

II

The Export Clause states simply and directly: "No Tax or Duty shall be laid on Articles exported from any State." U.S. Const., Art. I, § 9, cl. 5. We have had few occasions to interpret the language of the Export Clause, but our cases have broadly exempted from federal taxation not only export goods, but also services and activities closely related to the export process. At the same time, we have attempted to limit the term "Articles exported" to permit federal taxation of pre-export goods and services.

Our early cases upheld federal assessments on the manufacture of particular products ultimately intended for export by finding that pre-export products are not "Articles exported." See *Pace* v. *Burgess*, 92 U. S. 372 (1876); *Turpin* v. *Burgess*, 117 U. S. 504 (1886); *Cornell* v. *Coyne*, 192 U. S. 418 (1904). *Pace* and *Turpin* both involved a federal excise tax on tobacco products. In *Pace*, though tobacco intended for export was exempted from the tax, the exemption itself was subject to a per-package stamp charge of 25 cents. When a tobacco manufacturer challenged the stamp charge, we upheld the charge on the basis that the stamps were designed to prevent fraud in the export exemption from the excise tax and did not, therefore, represent a tax on exports. 92 U.S., at 375. When Congress later repealed the 25-cent charge for the exemption stamp in a statute that referred to the stamp as an "export tax," another manufacturer sued to recover the money it had paid for the exemption stamps. See *Turpin, supra*. Without disturbing the prior ruling in *Pace* that the stamp charge was not a tax on exports, 117 U.S., at 505, we explained that the prohibition of the Export Clause "has reference to the imposition of duties on goods by reason or because of their exportation or intended exportation, or whilst they are being exported," *id.*, at 507. We said that the plaintiffs would have had no Export Clause claim even if there had been no exemption from the excise because the goods were not in the course of exportation and might never be exported. *Ibid. Turpin* broadly suggested that the Export Clause prohibits both taxes levied on goods in the course of exportation and taxes directed specifically at exports.

In *Cornell*, the Court addressed whether the Export Clause prohibited application of a federal excise tax on filled cheese manufactured under contract for export. Looking to the analysis set out in *Turpin*, we rejected the contention that the Export Clause bars application of a nondiscriminatory tax imposed before the product entered the course of exportation. "The true construction of the constitutional provision is that no burden by way of tax or duty can be cast upon the exportation of articles, and does not mean that articles exported are relieved from the prior ordinary burdens of taxation which rest upon all property similarly situated." *Cornell, supra*, at 427. *Pace, Turpin*, and *Cornell* made clear that nondiscriminatory pre-exportation assessments do not violate the Export Clause, even if the goods are eventually exported.

At the same time we were defining a domain within which nondiscriminatory taxes could permissibly be imposed on goods intended for export, we were also making clear that the Export Clause strictly prohibits any tax or duty, discriminatory or not, that falls on exports during the course of exportation. See *Fairbank* v. *United States*, 181 U. S. 283 (1901); *United States* v. *Hvoslef*, 237 U. S. 1 (1915); *Thames & Mersey Marine Ins. Co.* v. *United States, supra*. In *Fairbank*, for example, we addressed a federal stamp tax on bills of lading for export shipments imposed by the War Revenue Act of 1898. The Court found that the tax was facially discriminatory, *Fairbank, supra*, at 290, and, though not directly imposed on the goods being exported, the tax was nevertheless "in effect a duty on the article transported," 181 U. S., at 294. Consequently, the tax fell directly into the category of forbidden taxes on exports defined in *Turpin*. In striking down the tax, we said:

> "The requirement of the Constitution is that exports should be free from any governmental burden. The language is 'no tax or duty.' Whether such provision is or is not wise is a question of policy with which the courts have nothing to do. We know historically that it was one of the compromises which entered into and made possible the adoption of the Constitution. It is a restriction on the power of Congress . . . ." 181 U. S., at 290.

Hvoslef and *Thames & Mersey* differed from *Fairbank* in that the taxes imposed in those cases—on ship charters and marine insurance, respectively—did not facially discriminate against exports. The Court nonetheless prohibited the application of those generally applicable, nondiscriminatory taxes to the transactions at issue because

[1] The tax does not apply if a policy issued by a foreign insurer is "signed or countersigned by an officer or agent of the insurer in a State, or in the District of Columbia, within which such insurer is authorized to do business." 26 U. S. C. § 4373(1) (1982 ed.).

each tax was, in effect, a tax on exports. The type of charter contract at issue in *Hvoslef* was "in contemplation of law a mere contract of affreightment," 237 U.S., at 16, and we found that the tax, as applied to charters for exportation, "was in substance a tax on the exportation; and a tax on the exportation is a tax on the exports," *id.*, at 17. Likewise, in *Thames & Mersey*, we found that "proper insurance during the voyage is one of the necessities of exportation" and that "the taxation of policies insuring cargoes during their transit to foreign ports is as much a burden on exporting as if it were laid on the charter parties, the bills of lading, or the goods themselves." 237 U. S., at 27.

Shortly after *Hvoslef* and *Thames & Mersey*, the Court rejected an attempt to shield from taxation the net income of a company engaged in the export business. *William E. Peck & Co.* v. *Lowe*, 247 U. S. 165 (1918). In accordance with the analysis set out in *Turpin*, we found both that the tax was nondiscriminatory and that "[i]t is not laid on articles in course of exportation or on anything which inherently or by the usages of commerce is embraced in exportation or any of its processes." 247 U. S., at 174.

Only a few years later the Court struck down the application of a tax on the export sale of certain baseball equipment. See *A. G. Spalding & Bros.* v. *Edwards*, 262 U. S. 66 (1923). Although the tax was clearly nondiscriminatory, we explained that the goods being taxed had entered the course of exportation when they were delivered to the export carrier. *Id.*, at 70. Because the taxable event, the transfer of title, occurred at the same moment the goods entered the course of exportation, we held that the tax could not constitutionally be applied to the export sale. *Id.*, at 69–70.

The Court has strictly enforced the Export Clause's prohibition against federal taxation of goods in export transit, and we have extended that protection to certain services and activities closely related to the export process. We have not, however, exempted pre-export goods and services from ordinary tax burdens; nor have we exempted from federal taxation various services and activities only tangentially related to the export process.

III

The Government concedes, as it did below, that this case is largely indistinguishable from *Thames & Mersey* and that, if *Thames & Mersey* is still good law, the tax assessed against IBM under § 4371 violates the Export Clause. See Tr. of Oral Arg. 5; 59 F. 3d, at 1237. The parties apparently agree that there is no legally significant distinction between the insurance policies at issue in this case and those at issue in *Thames & Mersey*, and, accordingly, the Government asks that we overrule *Thames & Mersey*.

The Government asserts that the Export Clause permits the imposition of generally applicable, nondiscriminatory taxes, even on goods in export transit. The Government urges that we have historically interpreted the Commerce, Import-Export, and Export Clauses in harmony and that we have rejected the theory underlying *Thames & Mersey* in the context of the Commerce and Import-Export Clauses. Accordingly, the Government contends that our Export Clause jurisprudence, symbolized by *Thames & Mersey*, has become an anachronism in need of modernization. The Government asks us to reinterpret the Export Clause to permit the imposition of generally applicable, nondiscriminatory taxes as we have under the Commerce Clause and, it argues, under the Import-Export Clause.

A

The Government contends that our dormant Commerce Clause jurisprudence has shifted dramatically and that our traditional understanding of the Export Clause, which is based partly on an outmoded view of the Commerce Clause, can no longer be justified. It is true that some of our early Export Clause cases relied on an interpretation of the Commerce Clause that we have since rejected. In *Fairbank*, 181 U. S., at 298–300, for example, we analogized to *Robbins* v. *Shelby County Taxing Dist.*, 120 U. S. 489, 497 (1887), in which we held that "[i]nterstate commerce cannot be taxed at all [by the States], even though the same amount of tax should be laid on domestic commerce, or that which is carried on solely within the state." Referring to the categorical ban on taxation of interstate commerce declared in *Robbins*, we likened the scope of the Commerce Clause's ban on state taxation of interstate commerce to the Export Clause's ban on federal taxation of exports. *Fairbank, supra*, at 300; see also *Hvoslef*, 237 U. S., at 15 ("The court [in *Fairbank*] found an analogy in the construction which had been given to the commerce clause in protecting interstate commerce from state legislation imposing direct burdens"). After *Thames & Mersey*, the Commerce Clause construction espoused in *Robbins* fell out of favor, see *Western Live Stock* v. *Bureau of Revenue*, 303 U. S. 250, 254 (1938) ("It was not the purpose of the commerce clause to relieve those engaged in interstate commerce from their just share of state tax burden even though it increases the cost of doing the business"), and we expressly disavowed that view in *Complete Auto Transit, Inc.* v. *Brady*, 430 U. S. 274, 288—289 (1977).

Our rejection in *Complete Auto* of much of our early dormant Commerce Clause jurisprudence did not, however, signal a similar rejection of our Export Clause cases. Our decades-long struggle over the meaning of the nontextual negative command of the dormant Commerce Clause does not lead to the conclusion that our interpretation of the textual command of the Export Clause is equally fluid. At one time, the Court may have thought that the dormant Commerce Clause required a strict ban on state taxation of interstate commerce, but the text did not require that view.[2] The text of the Export Clause, on the other hand, expressly prohibits Congress from laying any tax or duty on exports. These textual disparities strongly suggest that shifts in the Court's view of the scope of the dormant Commerce Clause should not, and indeed cannot, govern our interpretation of the Export Clause. Cf. *Richfield Oil Corp.* v. *State Bd. of Equalization*, 329 U. S. 69, 75–76 (1946) (distinguishing accommodations made under the Commerce Clause from the express textual prohibition of the Import-Export Clause).

B

The Government's primary assertion is that modifications in our Import-Export Clause jurisprudence require parallel modifications in the Export Clause

[2] The Commerce Clause is an express grant of power to Congress to "regulate Commerce . . . among the several States." U. S. Const., Art. I, § 8, cl. 3. It does not expressly prohibit the States from doing anything, though we have long recognized negative implications of the Clause that prevent certain state taxation even when Congress has failed to legislate. See *Fulton Corp.* v. *Faulkner*, 516 U. S. __, __ (1996) (slip op., at 4–5); *Quill Corp.* v. *North Dakota*, 504 U. S. 298, 309 (1992).

context. More specifically, the Government argues that our decisions in *Michelin Tire Corp.* v. *Wages*, 423 U. S. 276 (1976), and *Department of Revenue of Wash.* v. *Association of Wash. Stevedoring Cos.*, 435 U. S. 734 (1978), establish that States may impose generally applicable, nondiscriminatory taxes even if those taxes fall on imports or exports. The Export Clause, the Government contends, is no more restrictive.

The Import-Export Clause, which is textually similar to the Export Clause, says in relevant part, "No State shall . . . lay any Imposts or Duties on Imports or Exports." U. S. Const., Art. I, § 10, cl. 2. Though minor textual differences exist and the Clauses are directed at different sovereigns, historically both have been treated as broad bans on taxation of exports, and in several cases the Court has interpreted the provisions of the two Clauses in tandem. For instance, in the Court's first decision interpreting the Import-Export Clause, Chief Justice Marshall said:

> "The States are forbidden to lay a duty on exports, and the United States are forbidden to lay a tax or duty on articles exported from any State. There is some diversity in language, but none is perceivable in the act which is prohibited." *Brown* v. *Maryland*, 12 Wheat. 419, 445 (1827).

See also *Kosydar* v. *National Cash Register Co.*, 417 U. S. 62, 67, n. 5 (1974); *Hvoslef, supra*, at 13–14; *Cornell*, 192 U. S., at 427–428; *Turpin*, 117 U. S., at 506–507. The Government argues that our longstanding parallel interpretations of the two Clauses require judgment in its favor. We disagree.

In *Michelin*, we addressed whether a State could impose a nondiscriminatory ad valorem property tax on imported goods that were no longer in import transit. Michelin, which imported tires from Canada and France and stored them in a warehouse, argued that Georgia could not constitutionally assess ad valorem property taxes against its imported tires. We explained that "[t]he Framers of the Constitution . . . sought to alleviate three main concerns": (i) ensuring that the Federal Government speaks with one voice when regulating foreign commerce; (ii) preserving import revenues as a major source of federal revenue; and (iii) preventing disharmony likely to be caused if seaboard States taxed goods coming through their ports. *Michelin, supra*, at 285–286. The Court found that nondiscriminatory ad valorem taxes violate none of these policies. A century earlier, however, the Court had ruled that, under the "original package doctrine," a State could not impose such a tax until the goods had lost their character as imports and had been incorporated into the mass of property in the State. *Low* v. *Austin*, 13 Wall. 29, 34 (1872). The *Michelin* Court overruled *Low* and held that the nondiscriminatory property tax levied on Michelin's inventory of imported tires did not violate the Import-Export Clause because it was not an impost or duty on imports. 423 U. S., at 301. See also *Limbach* v. *Hooven & Allison Co.*, 466 U. S. 353 (1984) (reaffirming that *Michelin* expressly overruled the original package doctrine altogether and not merely *Low* on its facts).

Two years later, in *Washington Stevedoring*, we upheld against an Import-Export Clause challenge a nondiscriminatory state tax assessed against the compensation received by stevedoring companies for services performed within the State. The Court found that Washington's stevedoring tax did not violate the policies underlying the Import-Export Clause. Unlike the property tax at issue in *Michelin*, the activity taxed by Washington occurred while imports and exports were in transit. That fact was not dispositive, however, because the tax did not fall on the goods themselves:

> "The levy reaches only the business of loading and unloading ships or, in other words, the business of transporting cargo within the State of Washington. Despite the existence of the first distinction, the presence of the second leads to the conclusion that the Washington tax is not a prohibited 'Impost or Duty' when it violates none of the policies [that animate the Import-Export Clause]." *Washington Stevedoring, supra*, at 755.

Relying on *Canton R. Co.* v. *Rogan*, 340 U. S. 511 (1951), which upheld a tax on the gross receipts of a railroad that operated a marine terminal and transported imports and exports, we ruled in *Washington Stevedoring* that taxation of transportation services, whether by railroad on the docks or by stevedores loading and unloading ships, did not relate to the value of the goods and could not be considered imposts or duties on the goods themselves. 435 U.S., at 757.

1

A tax on policies insuring exports is not, precisely speaking, the same as a tax on exports, but *Thames & Mersey* held that they were functionally the same under the Export Clause. We noted in *Washington Stevedoring* that one may question the finding in *Thames & Mersey* that the tax was essentially a tax upon the exportation itself. 435 U. S., at 756, n. 21. We expressed concern that "[t]he basis for distinguishing *Thames & Mersey* is less clear" than for *Fairbank* or *Richfield Oil*, because the marine insurance policies in *Thames & Mersey* arguably "had a value apart from the value of the goods." 435 U. S., at 756, n. 21. Nevertheless, the Government apparently has chosen not to challenge that aspect of *Thames & Mersey* in this case. Tr. of Oral Arg. 5, 8–9, 40. When questioned on that implicit concession at oral argument, the Government admitted that it "chose not to" argue that § 4371 does not impose a tax on the goods themselves. *Id.*, at 9. It would be inappropriate for us to reexamine in this case, without the benefit of the parties' briefing, whether the policies on which § 4371 is assessed are so closely connected to the goods that the tax is, in essence, a tax on exports.[3] See, *e.g.*, *id.*, at 27–28 ("[T]he record doesn't reveal the sort of statistical information Justice Breyer was suggesting might be relevant" to determine "whether this is sufficiently indirect that it's not a tax on exports, . . . because the Government has conceded throughout

[3] The Court has never held that the Export Clause prohibits only direct taxation of goods in export transit. In *Brown* v. *Maryland*, 12 Wheat. 419 (1827), Chief Justice Marshall expressed in dicta his skepticism that a federal occupational tax on exporters could pass scrutiny under the Export Clause. *Id.*, at 445 ("[W]ould government be permitted to shield itself from the just censure to which this attempt to evade the prohibitions of the constitution would expose it, by saying that this was a tax on the person, not on the article, and that the legislature had a right to tax occupations?"). In *Fairbank*, *Hvoslef*, and *Thames & Mersey*, we struck down taxes that were not assessed directly on goods in export transit, but which the Court found to be so closely related as to be effectively a tax on the goods themselves. We have never repudiated that principle, but neither have we ever carefully defined how we decide whether a particular federal tax is sufficiently related to the goods or their value to violate the Export Clause. To the extent the issue was raised in the petition for certiorari, the Government failed to address the issue in its brief on the merits and therefore has abandoned it. See *Posters 'N' Things, Ltd.* v. *United States*, 511 U. S. 513 (1994) (slip op., at 15); *Russell* v. *United States*, 369 U. S. 749, 754, n. 7 (1962).

that they are not disputing that this tax, if discriminatory, is in violation of the Constitution").

Stare decisis is a "principle of policy," *Helvering* v. *Hallock*, 309 U. S. 106, 119 (1940), and not "an inexorable command," *Payne* v. *Tennessee*, 501 U. S. 808, 828 (1991). Applying that policy, we frequently have declined to overrule cases in appropriate circumstances because *stare decisis* "promotes the evenhanded, predictable, and consistent development of legal principles, fosters reliance on judicial decisions, and contributes to the actual and perceived integrity of the judicial process." *Id.*, at 827. "[E]ven in constitutional cases, the doctrine carries such persuasive force that we have always required a departure from precedent to be supported by some 'special justification.'" *Id.*, at 842 (SOUTER, J., concurring) (quoting *Arizona* v. *Rumsey*, 467 U. S. 203, 212 (1984)).

Though from time to time we have overruled governing decisions that are "unworkable or are badly reasoned," *Payne, supra*, at 827; see *Smith* v. *Allwright*, 321 U. S. 649, 665 (1944), we have rarely done so on grounds not advanced by the parties. *Thames & Mersey* has been controlling precedent for over 80 years, and the Government does not, indeed could not, argue that the rule established there is "unworkable." Despite the dissent's speculative protestations to the contrary, *post*, at 9–11, there is simply no evidence that *Thames & Mersey* has caused or will cause uncertainty in commercial export transactions. The principles that animate our policy of *stare decisis* caution against overruling a long-standing precedent on a theory not argued by the parties, and we decline to do so in this case.[4]

2

What the Government does argue is that our Import-Export Clause cases require us to overrule *Thames & Mersey*[5]. We have good reason to hesitate before adopting the analysis of our recent Import-Export Clause cases into our Export Clause jurisprudence. Though we have frequently interpreted the Clauses together, see *supra*, at 9–10, our more recent Import-Export Clause cases, on which the Government relies, caution that meaningful textual differences exist and should not be overlooked. The Export Clause prohibits Congress from laying any "Tax or Duty" on exports, while the Import-Export Clause prevents the States from laying any "Imposts or Duties" on imports or exports. In both *Michelin* and *Washington Stevedoring*, we left open the possibility that a particular state assessment might not properly be called an impost or duty, and thus would be beyond the reach of the Import-Export Clause, while an identical federal assessment might properly be called a tax and would be subject to the Export Clause. Though we found in *Michelin* that a nondiscriminatory state property tax does not transgress the policy dictates of the Import-Export Clause, we also recognized that the Import-Export Clause is "not written in terms of a broad prohibition of every 'tax,' " and that impost and duty are narrower terms than tax. 423 U. S., at 290–293. In *Washington Stevedoring*, we likewise rejected the assertion that the Import-Export Clause absolutely prohibits all taxation of imports and exports. 435 U. S., at 759. We said that "the term 'Impost or Duty' is not self-defining and does not necessarily encompass all taxes" and that the respondents' argument to the contrary ignored "the central holding of *Michelin* that the absolute ban is only of 'Imposts or Duties' and not of all taxes." *Ibid.*

The distinction between imposts or duties and taxes is especially pertinent in light of the peculiar definitional analysis we chose in *Michelin*. Finding substantial ambiguity in the phrase "Imposts or Duties," we "decline[d] to presume it was intended to embrace taxation that does not create the evils the Clause was specifically intended to eliminate." *Michelin, supra*, at 293–294. We entirely bypassed the etymological inquiry into the proper meaning of the terms "impost" and "duty," and instead created a regime in which those terms are conclusions to be drawn from an examination into whether a particular assessment "was the type of exaction that was regarded as objectionable by the Framers of the Constitution." 423 U. S., at 286. We are not prepared to say that the word "Tax" is "sufficiently ambiguous," *id.*, at 293, that we may ignore its common, and usually expansive,[6] meaning in favor of an Export Clause decisional rule in which a tax is not a "Tax" unless it discriminates against exports. Consequently, *Michelin* and *Washington Stevedoring*, which held that the assessments in question were not "Imposts or Duties" at all, do not logically validate the assessment at issue in this case, which, by all accounts, remains a "Tax."

It is not intuitively obvious that *Michelin*'s three-pronged analysis of the Framers' concerns is really just another way of stating a nondiscrimination principle. But even if it were, the Government cannot reasonably rely on *Michelin* to govern the Export Clause because *Michelin* drew its analysis around the phrase "Imposts or Duties" and expressly excluded the broader term "Tax" that appears in the Export Clause. *Michelin* marked a more permissive approach to state taxation under the Import-Export Clause only by distinguishing the presumptively stricter language of the Export Clause. We agree with the Government that *Michelin* informs our decision in this case, but not in a way that supports the Government's position. It is simply no longer true that the Court perceives no substantive difference between the two Clauses.

We are similarly hesitant to adopt the Import-Export Clause's policy-based analysis without some indication that the Export Clause was intended to alleviate the same "evils" to which the Import-Export Clause was directed. Unlike the Import-Export Clause, which was intended to protect federal supremacy in international commerce, to preserve federal revenue from import duties and imposts, and to prevent coastal States with ports from taking unfair advantage of inland States, see *Michelin, supra*, at 285–286, the Export Clause serves none of those goals. Indeed, textually, the Export Clause does quite the opposite. It specifically prohibits Congress from regulating international commerce through export taxes, disallows any at-

[4] The dissent suggests that "the Court assumes the statute to be invalid rather than deciding it to be so." *Post*, at 2. We make no such assumptions. Rather, we begin with a longstanding decision that, by all accounts, controls this case. Even the Government agrees that Congress enacted a law whose application in this case directly contravenes our holding in *Thames & Mersey*. We sit not to condemn § 4371, but rather to determine whether it is to be saved by overruling binding precedent.

[5] The dissent suggests that we make a "serious mistake" in deciding whether a nondiscriminatory tax on goods violates the Export Clause, *post*, at 19. We do not agree that it is a mistake to address the arguments actually advanced by the parties.

[6] Though *Michelin* discusses "taxes" in terms of "every exaction," 423 U. S., at 290, it also suggests that at the time of the Founding "probably only capitation, land, and general property exactions were known by the term 'tax' rather than the term 'duty,' " *id.*, at 291. In any event, the *Michelin* Court understood that the terms used in the Export Clause were broader than those used in the Import-Export Clause.

tempt to raise federal revenue from exports, and has no direct effect on the way the States treat imports and exports.

As a purely historical matter, the Export Clause was originally proposed by delegates to the Federal Convention from the Southern States, who feared that the Northern States would control Congress and would use taxes and duties on exports to raise a disproportionate share of federal revenues from the South. See 2 M. Farrand, The Records of the Federal Convention of 1787, pp. 95, 305–308, 359–363 (rev. ed. 1966). The Government argues that this "narrow historical purpose" justifies a narrow interpretation of the text and that application of § 4371 to policies insuring exports does not conflict with the policies embodied in the Clause. Brief for United States 32–34. While the original impetus may have had a narrow focus, the remedial provision that ultimately became the Export Clause does not, and there is substantial evidence from the Debates that proponents of the Clause fully intended the breadth of scope that is evident in the language. See, *e. g.*, 2 Farrand, Records of the Federal Convention, at 220 (Mr. King: "In two great points the hands of the Legislature were absolutely tied. The importation of slaves could not be prohibited—exports could not be taxed"); *id.*, at 305 ("Mr. Mason urged the necessity of connecting with the power of levying taxes . . . that no tax should be laid on exports"); *id.*, at 360 (Mr. Elseworth [sic]: "There are solid reasons agst. Congs taxing exports"); *ibid.* ("Mr. Butler was strenuously opposed to a power over exports"); *id.*, at 361 (Mr. Sherman: "It is best to prohibit the National legislature in all cases"); *id.*, at 362 ("Mr. Gerry was strenuously opposed to the power over exports").

The Government argued for a different narrow interpretation of the Export Clause in *Fairbank*. See 181 U. S., at 292–293. Arguing that the Debates expressed a primary interest in diffusing sectional conflicts, the Government urged the *Fairbank* Court to interpret the Export Clause to permit taxation of "the act of exportation or the document evidencing the receipt of goods for export, for these exist with substantial uniformity throughout the country." *Id.*, at 292. We rejected that argument:

> "If mere discrimination between the States was all that was contemplated, it would seem to follow that an *ad valorem* tax upon all exports would not be obnoxious to this constitutional prohibition. But surely under this limitation Congress can impose an export tax neither on one article of export, nor on all articles of export." *Ibid.*

As in *Fairbank*, we think the text of the constitutional provision provides a better decisional guide than that offered by the Government. The Government's policy argument—that the Framers intended the Export Clause to narrowly alleviate the fear of northern repression through taxation of southern exports by prohibiting only discriminatory taxes—cannot be squared with the broad language of the Clause. The better reading, that adopted by our earlier cases, is that the Framers sought to alleviate their concerns by completely denying to Congress the power to tax exports at all.

3

Even assuming that *Michelin* and *Washington Stevedoring* govern our Export Clause inquiry in this case, the Government's argument falls short of its goal. Our holdings in *Michelin* and *Washington Stevedoring* do not reach the facts of this case and, more importantly, do not interpret the Import-Export Clause to permit assessment of nondiscriminatory taxes on imports and exports in transit. *Michelin* involved a tax on goods, but the goods were no longer in transit. The tax in *Washington Stevedoring* burdened imports and exports while they were still in transit, but it did not fall directly on the goods themselves. This case, as it comes to us, is a hybrid in which the tax both burdens exports during transit and—as the Government concedes and our earlier cases held—is essentially a tax on the goods themselves. The Government argues that *Michelin* and *Washington Stevedoring* by analogy permit Congress to impose generally applicable, nondiscriminatory taxes that fall directly on exports in transit. Brief for United States 32 (*Michelin* and *Washington Stevedoring* "demonstrate that, when a generally applicable, nondiscriminatory tax is at issue, the mere fact that the tax applies also to goods that are in the export or import process does not provide a constitutional immunity from taxation"). If this contention is to succeed, the Government at the very least must show that our Import-Export Clause jurisprudence now permits a State to impose a nondiscriminatory tax directly on goods in import or export transit. We think the Government has failed to make that showing.

The Court has never upheld a state tax assessed directly on goods in import or export transit. In *Michelin*, we suggested that the Import-Export Clause would invalidate application of a nondiscriminatory property tax to goods still in import or export transit. 423 U. S., at 290 (compliance with the Import-Export Clause may be secured "by prohibiting the assessment of even nondiscriminatory property taxes on [import or export] goods which are merely in transit through the State when the tax is assessed"). See also *Virginia Indonesia Co.* v. *Harris County Appraisal Dist.*, 910 S. W. 2d 905, 915 (Tex. 1995) (invalidating application of a nondiscriminatory ad valorem property tax to goods in export transit).

We also declined to endorse the Government's theory in *Washington Stevedoring*. After reciting that the Court in *Canton R. Co.* had distinguished *Thames & Mersey*, *Fairbank*, and *Richfield Oil*, we pointed out that in those cases "the State [or Federal Government] had taxed either the goods or activity so connected with the goods that the levy amounted to a tax on the goods themselves." *Washington Stevedoring*, 435 U. S., at 756, n. 21. We expressly declined to "reach the question of the applicability of the *Michelin* approach when a State directly taxes imports or exports in transit," *id.*, at 757, n. 23, because, although the goods in that case were in transit, the tax fell on "a service distinct from the goods and their value," *id.*, at 757. Thus, contrary to the Government's contention, this Court's Import-Export Clause cases have not upheld the validity of generally applicable, nondiscriminatory taxes that fall on imports or exports in transit. We think those cases leave us free to follow the express textual command of the Export Clause to prohibit the application of any tax "laid on Articles exported from any State."

* * * * *

We conclude that the Export Clause does not permit assessment of nondiscriminatory federal taxes on goods in export transit. Reexamination of the question whether a particular assessment on an activity or service is so closely connected to the goods as to amount to a tax on the goods themselves must await another day. We decline to overrule *Thames & Mersey*. The judgment of the Court of Appeals for the Federal Circuit is affirmed.

It is so ordered.

Subtitle F.—Procedure and Administration
Chapter 61.—Information and Returns
Subchapter A.—Returns and Records
Part II.—Tax Returns or Statements
Subpart A.—General Requirement

Section 6011.—General Requirement of Return, Statement, or List

26 CFR 31.6011(a)–4: Returns of income tax withheld.

Standard and alternate procedures to be used in preparing employment tax forms where a predecessor-successor employer relationship exists. Rev. Proc. 84–77 modified and superseded. See Rev. Proc. 96–60, page 399.

26 CFR 301.6011–2T: Required use of magnetic media (Temporary).

Automatic extensions of time to furnish Forms W–2 to employees and file Forms W–2 with the Social Security Administration are provided for "Qualified Employers." See Rev. Proc. 96–57, page 389.

26 CFR 301.6011–2T: Required use of magnetic media (temporary).

T.D. 8683

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 1 and 301

Magnetic Media Filing Requirements for Information Returns

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains regulations relating to the requirements for filing information returns on magnetic media or in other machine-readable form under section 6011(e) of the Internal Revenue Code (Code). These regulations affect persons filing information returns. These regulations prescribe new magnetic media filing requirements for employers filing wage and tax statements for employees in Puerto Rico, U.S. Virgin Islands, Guam, and American Samoa. In addition, these regulations provide taxpayers with the guidance to comply with the changes made to the Code and to the administrative practices with respect to filing on magnetic media or in other machine-readable form. The text of these temporary regulations also serves as the text of the proposed regulations set forth in REG–209803–95, page 497.

EFFECTIVE DATE: These regulations are effective on January 1, 1997.

SUPPLEMENTARY INFORMATION: For persons residing in the following locations, contact the following offices of the Social Security Administration (not a toll-free call), if the inquiry relates to magnetic media filing and magnetic media specifications for Form W–2, Form 499R–2/W–2PR, Form W–2VI, Form W–2GU, and Form W–2AS:

Alabama (404) 331–2587 (Atlanta),
Alaska (206) 615–2125 (Seattle),
American Samoa (415) 744–4559 (San Francisco),
Arizona (415) 744–4559 (San Francisco),
Arkansas (501) 324–5466 (Little Rock),
California (415) 744–4559 (San Francisco),
Colorado (303) 844–2364 (Denver),
Connecticut (617) 565–2895 (Boston),
Delaware (215) 597–4632 (Philadelphia),
District of Columbia (215) 597–4632 (Philadelphia),
Florida (404) 331–2587 (Atlanta),
Georgia (404) 331–2587 (Atlanta),
Guam (415) 744–4559 (San Francisco),
Hawaii (415) 744–4559 (San Francisco),
Idaho (206) 615–2125 (Seattle),
Illinois (312) 353–6717 (Chicago),
Indiana (312) 353–6717 (Chicago),
Iowa (816) 426–2095 (Kansas City),
Kansas (816) 426–2095 (Kansas City),
Kentucky (404) 331–2587 (Atlanta),
Louisiana (504) 389–0426 (Baton Rouge),
Maine (617) 565–2895 (Boston),
Maryland (215) 597–4632 (Philadelphia),
Massachusetts (617) 565–2895 (Boston),
Michigan (312) 353–6717 (Chicago),
Minnesota (312) 353–6717 (Chicago),
Mississippi (404) 331–2587 (Atlanta),
Missouri (816) 426–2095 (Kansas City),
Montana (303) 844–2364 (Denver),
Nebraska (816) 426–2095 (Kansas City),
Nevada (415) 744–4559 (San Francisco),
New Hampshire (617) 565–2895 (Boston),
New Jersey (212) 264–0258 (New York),
New Mexico (505) 262–6048 (Albuquerque),
New York (212) 264–0258 (New York),
North Carolina (404) 331–2587 (Atlanta),
North Dakota (303) 844–2364 (Denver),
Ohio (312) 353–6717 (Chicago),
Oklahoma (405) 951–3007 (Oklahoma City),
Oregon (206) 615–2125 (Seattle),
Pennsylvania (215) 597–4632 (Philadelphia),
Puerto Rico (809) 766–5574 (San Juan),
Rhode Island (617) 565–2895 (Boston),
South Carolina (404) 331–2587 (Atlanta),
South Dakota (303) 844–2364 (Denver),
Tennessee (404) 331–2587 (Atlanta),
Texas-Central/South (210) 229–6433 (San Antonio),
Texas-Dallas County (214) 767–6777 (Dallas),
Texas-North (817) 334–3123 (Forth Worth),
Texas-Southeast (713) 653–4722 (Houston),
Texas-West (505) 262–6048 (Albuquerque),
Utah (303) 844–2364 (Denver),
Vermont (617) 565–2895 (Boston),
Virgin Islands (809) 766–5574 (San Juan),
Virginia (215) 597–4632 (Philadelphia),
Washington (206) 615–2125 (Seattle),
West Virginia (215) 597–4632 (Philadelphia),
Wisconsin (312) 353–6717 (Chicago), and
Wyoming (303) 844–2364 (Denver).

Magnetic Media Reporting, Internal Revenue Service, Martinsburg Computing Center, P.O. Box 1359, Martinsburg, West Virginia 25401–1359; telephone (304) 263–8700 (not a toll-free call), if the inquiry relates to either the waiver procedure for all forms described in these regulations or to the magnetic media specifications for Forms 1042–S, 1098, 1099 series, 5498, 8027, or W–2G.

Background

This document contains amendments to the Procedure and Administration Regulations (26 CFR Part 301) relating to the requirement under section 6011(e) to file information returns on magnetic

media or in other machine-readable form. Section 6011(e) authorizes the Secretary to prescribe regulations providing the standards for determining which returns must be filed on magnetic media or in other machine-readable form. Section 6011(e) of the Internal Revenue Code (Code) was added to the Code by section 319 of the Tax Equity and Fiscal Responsibility Act of 1982, Public Law 97–248, 96 Stat. 610; and was amended by section 109 of the Interest and Dividend Tax Compliance Act of 1983, Public Law 98–67, 97 Stat. 383; and section 7713 of the Revenue Reconciliation Act of 1989 (1989 Act), Public Law 101–239, 103 Stat. 2394.

This document also contains conforming amendments to the Income Tax Regulations (26 CFR Part 1) relating to returns of information of brokers and barter exchanges required under section 6045.

Explanation of Provisions

In order to reduce its administrative burden and increase accurate processing of information, the Social Security Administration (the SSA) requested that regulations be issued to require Forms 499R–2/W–2PR (Withholding Statement), Forms W–2VI (U.S. Virgin Islands Wage and Tax Statement), Forms W–2GU (Guam Wage and Tax Statement), and Forms W–2AS (American Samoa Wage and Tax Statement) to be filed on magnetic media. In Notice 95–64 (1995–2 C.B. 342), the IRS informed taxpayers of its intention to issue regulations requiring these forms to be filed on magnetic media with the SSA and invited public comment on the matter. The Notice stated that the requirement would be effective for wage and tax statements required to be filed after December 31, 1996. No comments were received in response to the Notice. These regulations expand the wage and tax statements required to be filed on magnetic media with the SSA to include Form 499R–2/W–2PR, Form W–2VI, Form W–2GU, and Form W–2AS.

In addition, these regulations reflect the current provisions of section 6011(e). As amended by the 1989 Act, section 6011(e)(2)(A) provides that the Secretary shall not require any person to file returns on magnetic media unless the person is required to file at least 250 returns during the calendar year (250-threshold). Consistent with the provisions of section 6011(e)(2)(A), these regulations provide that no person is required to file on magnetic media unless the person is required to file 250 or more returns during the calendar year. Further, these regulations clarify that each type of information return is considered a separate return, and the 250-threshold applies separately to each type of form required to be filed.

In addition, these regulations reflect the current administrative practices with respect to filing information returns on magnetic media or in other machine-readable form. The IRS and the SSA now permit filing on tape cartridge but no longer permit filing on cassette. Further, the IRS currently permits electronic filing as an alternative method of filing, and the SSA is considering permitting electronic filing in the future. Thus, under these regulations, magnetic media generally include magnetic tape, tape cartridge, diskette, and other media (such as electronic filing) specifically permitted under the applicable regulations, procedures, or publications.

Further, these regulations reflect the current procedures for obtaining consent and authorization from the IRS before filing on magnetic media. These regulations refer to Form 4419 (Application for Filing Information Returns Magnetically/Electronically), which must be filed by a transmitter with the IRS before filing Forms 1042–S, 1098, 1099 series, 5498, 8027, and W–2G on magnetic media or electronically. These regulations also remove any reference to obtaining consent from the SSA because it no longer requires consent or authorization before filing on magnetic media.

Under the existing regulations, a taxpayer may request a hardship waiver from the magnetic media filing requirements. The principal factor for demonstrating hardship is the amount, if any, by which the cost of filing on magnetic media exceeds the cost of filing on paper. The existing regulations provide that, if an employer is required to make a final return on Form 941, or a variation thereof, and expedited filing of Form W–2 is required, the unavailability of the specifications for magnetic media filing will be treated as creating a hardship, and a waiver of the magnetic media filing requirements for the expedited Forms W–2 may be granted. This document extends this waiver provision to expedited filing of Forms 499R–2/W–2PR, Forms W–2VI, Forms W–2GU, and Forms W–2AS.

Special Analyses

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

It is hereby certified that the regulations in this document will not have a significant economic impact on a substantial number of small entities. This certification is based on a determination that these regulations impose no additional reporting or recordkeeping requirement and only prescribe the method of filing information returns that are already required to be filed. Further, these regulations are consistent with the requirements imposed by statute. Section 6011(e)(2)(A) provides that, in prescribing regulations providing standards for determining which returns must be filed on magnetic media or in other machine-readable form, the Secretary shall not require any person to file returns on magnetic media unless the person is required to file at least 250 returns during the calendar year. Consistent with the statutory provision, these regulations do not require information returns to be filed on magnetic media unless 250 or more returns are required to be filed. Further, the economic impact caused by filing on magnetic media should be minimal. If a taxpayer's operations are computerized, reporting in accordance with the regulations should be less costly than filing on paper. If the taxpayer's operations are not computerized, the incremental cost of magnetic media reporting should be minimal in most cases because of the availability of computer service bureaus. In addition, the existing regulations provide that the IRS may waive the magnetic media filing requirements upon a showing of hardship. It is anticipated that the waiver authority will be exercised so as not to unduly burden taxpayers lacking both the necessary data processing facilities and access at a reasonable cost to computer service bureaus. Accordingly, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required.

Pursuant to section 7805(f) of the Internal Revenue Code, these regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 301 are amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.6045–1 is amended by adding a sentence at the end of paragraph (q) to read as follows:

§ 1.6045–1 Returns of information of brokers and barter exchanges.

* * * * *

(q) * * * With regard to paragraph (l) of this section, see section 6011(e) of the Internal Revenue Code for information returns required to be filed after December 31, 1989, and before January 1, 1997; and see § 1.6045–1T(l) for information returns required to be filed after December 31, 1996.

Par. 3. Section 1.6045–1T is added to read as follows:

§ 1.6045–1T Returns of information of brokers and barter exchanges (temporary).

(a) through (k) [Reserved] For further guidance, see § 1.6045–1(a) through (k).

(l) *Use of magnetic media.* For information returns filed after December 31, 1996, see § 301.6011–2T of this chapter for rules relating to filing information returns on magnetic media and for rules relating to waivers granted for undue hardship. For information returns filed prior to January 1, 1997, see § 1.6045–1(l).

Par. 4. Section 1.6045–2 is amended by adding a sentence at the end of paragraph (i) to read as follows:

§ 1.6045–2 Furnishing statement required with respect to certain substitute payments.

* * * * *

(i) * * * With regard to paragraph (g)(2) of this section, see section 6011(e) of the Internal Revenue Code for information returns required to be filed after December 31, 1989, and before January 1, 1997; and see § 1.6045–2T(g)(2) for information returns required to be filed after December 31, 1996.

Par. 5. Section 1.6045–2T is added to read as follows:

§ 1.6045–2T Furnishing statement required with respect to certain substitute payments (temporary).

(a) through (g)(1) [Reserved] For further guidance, see § 1.6045–2(a) through (g)(1).

(g)(2) *Use of magnetic media.* For information returns filed after December 31, 1996, see § 301.6011–2T of this chapter for rules relating to filing information returns on magnetic media and for rules relating to waivers granted for undue hardship. For information returns filed prior to January 1, 1997, see § 1.6045–2(g)(2).

PART 301—PROCEDURE AND ADMINISTRATION

Par. 4. The authority citation for part 301 continues to read in part as follows:

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

Par. 5. Section 301.6011–2T is added to read as follows:

§ 301.6011–2T Required use of magnetic media (temporary).

This section applies to information returns required to be filed after December 31, 1996. For information returns required to be filed after December 31, 1989, and before January 1, 1997, see section 6011(e) of the Internal Revenue Code and § 301.6011–2.

(a) *Meaning of terms.* The following definitions apply for purposes of this section:

(1) *Magnetic media.* The term *magnetic media* means any magnetic media permitted under applicable regulations, revenue procedures, or, in the case of returns filed with the Social Security Administration, Social Security Administration publications. These generally include magnetic tape, tape cartridge, and diskette, as well as other media (such as electronic filing) specifically permitted under the applicable regulations, procedures, or publications.

(2) and (3) [Reserved] For further guidance, see § 301.6011– 2(a)(2) and (3).

(b) *Returns required on magnetic media.* (1) If the use of Form 1042–S, 1098, 1099 series, 5498, 8027, W–2G, or other form treated as a form specified in this paragraph (b)(1) is required by the applicable regulations or revenue procedures for the purpose of making an information return, the information required by the form must be submitted on magnetic media, except as otherwise provided in paragraph (c) of this section. Returns on magnetic media must be made in accordance with applicable revenue procedures or publications. See § 601.601(d)(2)(ii)(*b*) of this chapter. Pursuant to these procedures, the consent of the Commissioner of Internal Revenue (or other authorized officer or employee of the Internal Revenue Service) to a magnetic medium must be obtained by submitting Form 4419 (Application for Filing Information Returns Magnetically/Electronically) prior to submitting a return described in this paragraph (b)(1) on the magnetic medium.

(2) If the use of Form W–2 (Wage and Tax Statement), Form 499R–2/W–2PR (Withholding Statement), Form W–2VI (U.S. Virgin Islands Wage and Tax Statement), Form W–2GU (Guam Wage and Tax Statement), Form W–2AS (American Samoa Wage and Tax Statement), or other form treated as a form specified in this paragraph (b)(2) is required for the purpose of making an information return, the information required by the form must be submitted on magnetic media, except as otherwise provided in paragraph (c) of this section. Returns described in this paragraph (b)(2) must be made in accordance with applicable Social Security Administration procedures or publications (which may be obtained from the local office of the Social Security Administration).

(3) [Reserved] For further guidance, see § 301.6011–2(b)(3).

(c) *Exceptions*—(1) *Low-volume filers/250-threshold*—(i) *In general.* No person is required to file information returns on magnetic media unless the person is required to file 250 or more returns during the calendar year. Persons filing fewer than 250 returns during the calendar year may make the returns on the prescribed paper form, or, alternatively, such persons may make returns on magnetic media in accordance with paragraph (b) of this section.

(ii) [Reserved] For further guidance, see § 301.6011– 2(c)(1)(ii).

(iii) *No aggregation.* Each type of information return described in paragraphs (b)(1) and (2) of this section is considered a separate return for purposes of this paragraph (c)(1). Therefore, the 250-threshold applies separately to each type of form required to be filed.

(iv) *Examples.* The provisions of paragraph (c)(1)(iii) of this section are illustrated by the following examples:

Example 1. For the calendar year ending December 31, 1996, Company X is required to file

200 returns on Form 1099-INT and 350 returns on Form 1099-MISC. Company X is not required to file Forms 1099-INT on magnetic media but is required to file Forms 1099-MISC on magnetic media.

Example 2. During the calendar year ending December 31, 1996, Company Y has 275 employees in Puerto Rico and 50 employees in American Samoa. Company Y is required to file Forms 499R-2/W-2PR on magnetic media but is not required to file Forms W-2AS on magnetic media.

Example 3. For the calendar year ending December 31, 1996, Company Z files 300 original returns on Form 1099-DIV and later files 70 corrected returns on Form 1099-DIV. Company Z is required to file the original returns on magnetic media. However, Company Z is not required to file the corrected returns on magnetic media because the corrected returns fall under the 250-threshold. See § 301.6721-1(a)(2)(ii).

(2) *Waiver.* (i) The Commissioner may waive the requirements of this section if hardship is shown in a request for waiver filed in accordance with this paragraph (c)(2)(i). The principal factor in determining hardship will be the amount, if any, by which the cost of filing the information returns in accordance with this section exceeds the cost of filing the returns on other media. Notwithstanding the foregoing, if an employer is required to make a final return on Form 941, or a variation thereof, and expedited filing of Forms W-2, Forms 499R-2/W-2PR, Forms W-2VI, Forms W-2GU, or Form W-2AS is required, the unavailability of the specifications for magnetic media filing will be treated as creating a hardship. See § 31.6071(a)-1(a)(3)(ii). A request for waiver must be made in accordance with applicable revenue procedures or publications. See § 601.601-(d)(2)(ii)(*b*) of this chapter. Pursuant to these procedures, a request for waiver should be filed at least 45 days before the due date of the information return in order for the Service to have adequate time to respond to the request for waiver. The waiver will specify the type of information return and the period to which it applies and will be subject to such terms and conditions regarding the method of reporting as may be prescribed by the Commissioner.

(ii) The Commissioner may prescribe rules that supplement the provisions of paragraph (c)(2)(i) of this section.

(c)(3) and (4) [Reserved]. For further guidance, see § 301.6011-2(c)(3) and (4).

(d) and (e) [Reserved] For further guidance, see § 301.6011-2(d) and (e).

(f) *Failure to file.* If a person fails to file an information return on magnetic media when required to do so by this section, the person is deemed to have failed to file the return. In addition, if a person making returns on a paper form under paragraph (c) of this section fails to file a return on machine-readable paper form when required to do so by this section, the person is deemed to have failed to file the return. See sections 6652, 6693, and 6721 for penalties for failure to file certain returns. See also section 6724 and the regulations under section 6721 for the specific rules and limitations regarding the penalty imposed under section 6721 for failure to file on magnetic media.

(g) *Effective date.* (1) [Reserved] For further guidance, see § 301.6011-2(g)(1).

(2) Paragraphs (a)(1), (b)(1) and (2), (c)(1)(i), (iii), and (iv), (c)(2), and (f) of this section are effective for information returns required to be filed after December 31, 1996. For information returns required to be filed after December 31, 1989, and before January 1, 1997, see section 6011(e) of the Internal Revenue Code and § 301.6011-2.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved September 10, 1996.

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

(Filed by the Office of the Federal Register on October 9, 1996, 8:45 a.m., and published in the issue of the Federal Register for October 10, 1996, 61 F.R. 53058)

Subpart B.—Income Tax Returns

Section 6012.—Persons Required to Make Returns of Income

26 CFR 1.6012-1: Individuals required to make returns of income.

The Service is providing adjusted tax tables for individuals and trusts and estates for taxable years beginning in 1997 to reflect changes in the cost of living. See Rev. Proc. 96-59, page 392.

26 CFR 1.6012-5: Composite return in lieu of specified form.

What are the requirements for participation in the 1997 Electronic Filing Program for the Form 1040 series? See Rev. Proc. 96-61, page 401.

What are the requirements for participation in the 1997 On-Line Filing Program for the Form 1040 series? See Rev. Proc. 96-62, page 412.

Section 6013.—Joint Returns of Income Tax by Husband and Wife

26 CFR 1.6013-1: Joint returns.

The Service is providing adjusted tax tables for individuals for taxable years beginning in 1997 to reflect changes in the cost of living. See Rev. Proc. 96-59, page 392.

Part III.—Information Returns
Subpart A.—Information Concerning Persons Subject to Special Provisions

Section 6033.—Returns by Exempt Organizations

The Service is providing inflation adjustments for taxable years beginning in 1997 to the amount of dues certain exempt organizations can charge and still be excepted from the reporting requirements for exempt organizations with nondeductible lobbying expenditures. See Rev. Proc. 96-59, page 392.

Section 6039F.—Notice of Large Gifts Received From Foreign Persons

The Service is providing an inflation adjustment for taxable years beginning in 1997 to the amount of gifts in a taxable year from foreign person(s) that triggers a reporting requirement for a United States person. See Rev. Proc. 96-59, page 392.

Subpart B.—Information Concerning Transactions With Other Persons

Section 6041.—Information at Source

26 CFR 1.6041-1: Return of information as to payments of $600 or more.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 96-42, page 306.

26 CFR 7.6041-1: Return of information as to payments of winnings from bingo, keno, and slot machines (Temporary).

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 96-42, page 306.

Section 6041A.—Returns Regarding Payments of Remuneration for Services and Direct Sales

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 96-42, page 306.

Section 6042.—Returns Regarding Payments of Dividends and Corporate Earnings and Profits

26 CFR 1.6042-2: Returns of information as to dividends paid in calendar years after 1962.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 96-42, page 306.

26 CFR 1.6042–4: Statements to recipients of dividend payments.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 96–42, page 306.

Section 6043.—Returns Regarding Liquidation, Dissolution, Termination, or Contraction

26 CFR 1.6043–2 Return of information respecting distributions in liquidation.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 96–42, page 306.

Section 6044.—Returns Regarding Payments of Patronage Dividends

26 CFR 1.6044–2: Returns of information as to payments of patronage dividends with respect to patronage occurring in taxable years beginning after 1962.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 96–42, page 306.

26 CFR 1.6044–5: Statements to recipients of patronage dividends.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 96–42, page 306.

Are payors, required to report payments on Form 1099, permitted to use certain logos and identifying slogans on substitute Forms 1099? See Notice 96–62, page 228.

Section 6045.—Returns of Brokers

26 CFR 1.6045–1: Returns of information of brokers and barter exchanges.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 96–42, page 306.

26 CFR 1.6045–2: Furnishing statement required with respect to certain substitute payments.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 96–42, page 306.

26 CFR 1.6045–4: Information reporting on real estate transactions with dates of closing on or after January 1, 1991.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 96–42, page 306.

Section 6047.—Information Relating to Certain Trusts and Annuity Plans

26 CFR 1.6047–1: Information to be furnished with regard to employee retirement plan covering an owner-employee.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 96–42, page 306.

Section 6049.—Returns Regarding Payments of Interest

26 CFR 1.6049–4: Return of information as to interest paid and original issue discount includible in gross income after December 31, 1982.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 96–42, page 306.

26 CFR 1.6049–6: Statements to recipients of interest payments and holders of obligations as to which there is attributed original issue discount after December 31, 1982.

Are payors, required to report payments on Form 1099, permitted to use certain logos and identifying slogans on substitute Forms 1099? See Notice 96–62, page 228.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 96–42, page 306.

26 CFR 1.6049–7: Returns of information with respect to REMIC regular interests and collateralized debt obligations.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 96–42, page 306.

Section 6050A.—Reporting Requirements of Certain Fishing Boat Operators

26 CFR 1.6050A–1: Reporting requirements of certain fishing boat operators.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 96–42, page 306.

Section 6050B.—Returns Relating to Unemployment Compensation

26 CFR 1.6050B–1: Information returns by person making unemployment compensation payments.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 96–42, page 306.

Section 6050D.—Returns Relating to Energy Grants and Financing

26 CFR 1.6050D–1: Information returns relating to energy grants and financing.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 96–42, page 306.

Section 6050E.—State and Local Income Tax Refunds

26 CFR 1.6050E–1: Reporting of state and local income tax refunds.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 96–42, page 306.

Section 6050H.—Returns Relating to Mortgage Interest Received in Trade or Business From Individuals

26 CFR 1.6050H–1: Information reporting of mortgage interest received in a trade or business from an individual.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 96–42, page 306.

26 CFR 1.6050H–2: Time, form, and manner of reporting interest received on qualified mortgage.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 96–42, page 306.

Section 6050J.—Returns Relating to Foreclosures and Abandonments of Security

26 CFR 1.6050J–1T: Questions and answers concerning information returns relating to foreclosures and abandonments of security (Temporary).

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 96–42, page 306.

Section 6050N.—Returns Regarding the Payments of Royalties

26 CFR 1.6050N–1: Statements to recipients of royalties.

Are payors, required to report payments on Form 1099, permitted to use certain logos and identifying slogans on substitute Forms 1099? See Notice 96–62, page 228.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 96–42, page 306.

Section 6050P.—Returns Relating to the Cancellation of Indebtedness by Certain Financial Entities

26 CFR 1.6050P–1T: Information reporting for discharges of indebtedness by certain financial entities (temporary).

26 CFR 1.6050P–1: Information reporting for discharges of indebtedness by certain financial entities.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 96–42, page 306.

Subpart C.—Information Regarding Wages Paid Employees

Section 6051.—Receipts for Employees

26 CFR 31.6051–1: Statements for employees.

Automatic extensions of time to furnish Forms W–2 to employees and file Forms W–2 with the Social Security Administration are provided for "Qualified Employers." See Rev. Proc. 96–57, page 389.

Standard and alternate procedures to be used in preparing employment tax forms where a predecessor-successor employer relationship exists. Rev. Proc. 84–77 modified and superseded. See Rev. Proc. 96–60, page 399.

Part IV.—Signing and Verifying of Returns and Other Documents

Section 6061.—Signing of Returns and Other Documents

26 CFR 1.6061–1: Signing of returns and other documents by individuals.

What are the requirements for participation in the 1997 Electronic Filing Program for the Form 1040 series? See Rev. Proc. 96–61, page 401.

Part V.—Time for Filing Returns and Other Documents

Section 6071.—Time for Filing Returns and Other Documents

26 CFR 31.6071(a)–1: Time for filing returns and other documents.

Automatic extensions of time to furnish Forms W-2 to employees and file Forms W-2 with the Social Security Administration are provided for "Qualified Employers." See Rev. Proc. 96-57, page 389.

Standard and alternate procedures to be used in preparing employment tax forms where a predecessor-successor employer relationship exists. Rev. Proc. 84–77 modified and superseded. See Rev. Proc. 96–60, page 399.

Part VI.—Extension of Time for Filing Returns

Section 6081.—Extension of Time for Filing Returns

26 CFR 31.6081(a)–1: Extensions of time for filing returns and other documents.

Automatic extensions of time to furnish Forms W-2 to employees and file Forms W-2 with the Social Security Administration are provided for "Qualified Employers." See Rev. Proc. 96-57, page 389.

Chapter 64.—Collection
Subchapter A.—General Provisions

Section 6302.—Mode or Time of Collection

26 CFR 40.6302(c)–1: Use of Government depositaries.

T.D. 8685

DEPARTMENT OF THE TREASURY
Internal Revenue Service

26 CFR Parts 40, 48, 49, 301, 601 and 602

Deposits of Excise Taxes

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to deposits of excise taxes. These regulations reflect changes to the law made by the Uruguay Round Agreements Act and affect persons required to make deposits of excise taxes. This document also removes obsolete excise tax regulations.

EFFECTIVE DATE: November 12, 1996

SUPPLEMENTARY INFORMATION:

Background

The Uruguay Round Agreements Act of 1994 amended sections 6302(e) and (f) (relating to deposits of excise taxes). As amended, effective January 1, 1995, these provisions require an additional deposit in September of each year of all excise taxes except those imposed by section 4261 or 4271 (relating to air transportation). The taxes imposed by sections 4261 and 4271 are scheduled to expire on December 31, 1996. If those taxes are reinstated, they will be subject to the new deposit provisions beginning on January 1, 1997.

Temporary regulations (T.D. 8616 [1995–2 C.B. 263]) were published in the **Federal Register** on August 29, 1995 (60 FR 44758), along with a notice of proposed rulemaking (PS–8–95 [1995–2 C.B. 506]) cross-referencing the temporary regulations (60 FR 44788). No written comments were received and no public hearing was held. The proposed regulations are adopted as revised by this Treasury decision and the corresponding temporary regulations are removed.

Explanation of Revisions

The temporary regulations provide rules implementing the changes made by the Act in a separate regulations section (§ 40.6302(c)–5T). Instead of finalizing that section, this document incorporates the amendments made by the temporary regulations into the text of §§ 40.6302(c)–1 through 40.6302(c)–4.

To reflect changes in technology, the 14-day rule under § 40.6302(c)–4 is amended to apply to deposits made by electronic funds transfer.

In addition, the rules set forth in §§ 601.104(a)(5) and 601.403(c)(2), relating to persons required to collect and pay over tax, have been combined, revised, and moved to part 49 as § 49.4291–1.

Removal of Obsolete Regulations; Amendments to Table of OMB Control Numbers

This document removes obsolete excise tax regulations under part 601 and obsolete cross-references under part 301. Also removed are obsolete regulations relating to matters now under the jurisdiction of the Bureau of Alcohol, Tobacco, and Firearms (ATF). Generally, regulations pertaining to ATF procedural rules are in 27 CFR parts 70 and 71.

In addition, this document updates various entries in the Table of OMB Numbers contained in part 602.

Special Analyses

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

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 40, 48, 49, 301, 601, and 602 are amended as follows:

PART 40—EXCISE TAX PROCEDURAL REGULATIONS

Paragraph 1. The authority citation for part 40 continues to read in part as follows:

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

Par. 1a. Section 40.6011(a)–1 is amended as follows:

1. Paragraph (c) is amended by adding a sentence to the end of the paragraph.

2. Paragraph (d) is removed.

The addition reads as follows:

§ 40.6011(a)–1 Returns.

* * * * *

(c) * * * For provisions relating to obligations of a person required to col-

lect and pay over facilities and services excise taxes, see § 49.4291–1 of this chapter.

Par. 2. Section 40.6011(a)–2(b)(2) is amended by removing the reference "§ 40.6302(c)–1(e)(2)" and adding "§ 40.6302(c)–1(f)(2)" in its place.

Par. 3. Section 40.6302(c)–1 is amended as follows:

1. Paragraph (a) is amended by removing the parenthetical "(relating to taxes imposed on gasoline by section 4081)" from the last sentence and adding "(relating to section 4081 taxes)" in its place.

2. Paragraph (b)(1)(i) is amended by removing the reference "paragraph (e)" and adding "paragraph (f)" in its place.

3. Paragraph (b)(1)(ii) is removed and paragraph (b)(1)(iii) is redesignated as paragraph (b)(1)(ii).

4. Paragraph (b)(5)(ii) is removed and paragraph (b)(5)(iii) is redesignated as paragraph (b)(5)(ii).

5. Newly designated paragraph (b)(5)(ii) is amended by removing the reference "paragraph (e)(3)" and adding "paragraph (f)(3)" in its place.

6. Paragraph (b)(6)(ii) is amended by removing the language "paragraph (b)(6)(iii) of this section (relating to deposits of gasoline tax for September)" and adding "paragraph (e) of this section (relating to deposits of 9-day rule taxes for September)" in its place.

7. Paragraph (b)(6)(iii) is removed.

8. Paragraphs (c)(2)(i)(A) and (c)(2)(iii)(B) are amended by removing the parenthetical "(16.67 percent)".

9. Paragraph (c)(2)(iv) is removed.

10. Paragraph (c)(3)(iii) is removed and paragraph (c)(3)(iv) is redesignated as paragraph (c)(3)(iii).

11. Paragraph (g) is removed.

12. Paragraphs (e) and (f) are redesignated as paragraphs (f) and (g), respectively, and a new paragraph (e) is added.

13. Newly designated paragraph (f)(3)(ii) is amended by removing the reference "paragraph (e)(3)" and adding "paragraph (f)(3)" in its place.

The addition reads as follows:

§ 40.6302(c)–1 Use of Government depositaries.

* * * * *

(e) *Special rules for September*—(1) *Deposits required.* In the case of deposits of 9-day rule taxes for the second semimonthly period in September, separate deposits are required for the period September 16th-26th and the period September 27th-30th.

(2) *Amount of deposit.* The deposits of 9-day rule taxes for the period September 16th-26th and the period September 27th-30th must be not less than the amount of net tax liability for 9-day rule taxes incurred during the respective periods. The net tax liability incurred during these periods may be computed by—

(i) Determining the amount of net tax liability reasonably expected to be incurred during the second semimonthly period in September;

(ii) Treating 11/15 of that amount as the net tax liability incurred during the period September 16th-26th; and

(iii) Treating the remainder of the amount determined under paragraph (e)(2)(i) of this section (adjusted to reflect net tax liability actually incurred through the end of September) as the net tax liability incurred during the period September 27th-30th.

(3) *Time to deposit*—(i) *In general.* The deposit of 9-day rule taxes required for the period beginning September 16th must be made by September 29. The deposit required for the period ending September 30th must be made at the time prescribed in paragraph (b)(6)(i) of this section for making deposits for the second semimonthly period in September.

(ii) *Due date on Saturday or Sunday.* A deposit that would otherwise be due on September 29 must be made by September 28 if September 29 is a Saturday and by September 30 if September 29 is a Sunday.

(4) *Safe harbor rule based on look-back quarter liability.* The safe harbor rule in paragraph (c)(2)(i) of this section does not apply to 9-day rule taxes for the third calendar quarter unless—

(i) The deposit of 9-day rule taxes for the period September 16th-26th is not less than 11/90 of the net tax liability reported for 9-day rule taxes for the look-back quarter; and

(ii) The total deposit of 9-day rule taxes for the second semimonthly period in September is not less than 1/6 of the net tax liability reported for 9-day rule taxes for the look-back quarter.

(5) *Safe harbor rule based on current liability.* The safe harbor rule of paragraph (c)(3)(i) of this section does not apply to 9-day rule taxes for the third calendar quarter unless—

(i) The deposit of 9-day rule taxes for the period September 16th-26th is not less than 69.67 percent of the net tax liability for 9-day rule taxes for the second semimonthly period in September; and

(ii) The total deposit of 9-day rule taxes for the second semimonthly period in September is not less than 95 percent of the net tax liability for 9-day rule taxes for that semimonthly period.

(6) *Persons not required to use electronic funds transfer.* In the case of a person that is not required to deposit excise taxes by electronic funds transfer (a non-EFT depositor), the rules of this paragraph (e) apply with the following modifications:

(i) The periods for which separate deposits must be made are September 16th-25th and September 26th-30th.

(ii) The deposit required for the period beginning September 16th must be made by September 28. A deposit that would otherwise be due on September 28 must be made by September 27 if September 28 is a Saturday and by September 29 if September 28 is a Sunday.

(iii) The generally applicable fractions and percentage are modified to reflect the different deposit periods in accordance with the following table:

Generally applicable fractions and percentage	Modifications for non-EFT depositors
11/15	10/15
11/90	10/90
69.67 percent	63.33 percent

(7) *Effective date.* This paragraph (e) is effective August 1, 1995, for all 9-day rule taxes except those imposed by section 4261 or 4271. For taxes imposed by section 4261 or 4271, this paragraph (e) applies beginning January 1, 1997.

* * * * *

Par. 4. Section 40.6302(c)–2 is amended as follows:

1. Paragraphs (b)(2)(i)(A) and (b)(2)(ii)(B) are amended by removing the parenthetical "(16.67 percent)".

2. Paragraph (c) is revised.

The revision reads as follows:

§ 40.6302(c)–2 Special rules for use of Government depositaries under section 4681.

* * * * *

(c) *Special rules for September*—(1) *Deposits required.* In the case of deposits of 30-day rule taxes for the first semimonthly period in September, separate deposits are required for the period September 1st-11th and the period September 12th-15th.

(2) *Amount of deposit.* The deposits of 30-day rule taxes for the period September 1st-11th and the period September 12th-15th must be not less than the amount of net tax liability for 30-day rule taxes incurred during the respective periods. The net tax liability incurred during these periods may be computed by—

(i) Determining the amount of net tax liability incurred during the first semimonthly period in September (or, if semimonthly liability is computed by dividing monthly liability by two, the amount reasonably expected to be incurred);

(ii) Treating 11/15 of that amount as the net tax liability incurred during the period September 1st-11th; and

(iii) Treating the remainder of the amount determined under paragraph (c)(2)(i) of this section (adjusted, if that amount is based on reasonable expectations, to reflect net tax liability actually incurred through the end of September) as the net tax liability incurred during the period September 12th-15th.

(3) *Time to deposit*—(i) *In general.* The deposit required for the period beginning September 1st and the deposit for the second semimonthly period in August must be made by September 29. The deposit required for the period ending September 15th must be made at the time prescribed in paragraph (b)(1)(i) of this section for making deposits for the first semimonthly period in September.

(ii) *Due date on Saturday or Sunday.* A deposit that would otherwise be due on September 29 must be made by September 28 if September 29 is a Saturday and by September 30 if September 29 is a Sunday.

(4) *Safe harbor rule based on look-back quarter liability.* The safe harbor rule of paragraph (b)(2)(i) of this section does not apply for the third calendar quarter unless—

(i) The deposit of 30-day rule taxes for the period September 1st-11th is not less than 11/90 of the net tax liability reported for 30-day rule taxes for the look-back quarter; and

(ii) The total deposit of 30-day rule taxes for the first semimonthly period in September is not less than 1/6 of the net tax liability reported for 30-day rule taxes for the look-back quarter.

(5) *Safe harbor rule based on current liability.* The safe harbor rule of paragraph (b)(3) of this section does not apply for the third calendar quarter unless—

(i) The deposit of 30-day rule taxes for the period September 1st-11th is not less than 69.67 percent of the net tax liability for 30-day rule taxes for the first semimonthly period in September; and

(ii) The total deposit of 30-day rule taxes for the first semimonthly period in September is not less than 95 percent of the net tax liability for 30-day rule taxes for that semimonthly period.

(6) *Persons not required to use electronic funds transfer.* In the case of a person that is not required to deposit excise taxes by electronic funds transfer (a non-EFT depositor), the rules of this paragraph (c) apply with the following modifications:

(i) The periods for which separate deposits must be made are September 1st-10th and September 11th-15th.

(ii) The deposit required for the period beginning September 1st and the deposit required for the second semimonthly period in August must be made by September 28. A deposit that would otherwise be due on September 28 must be made by September 27 if September 28 is a Saturday and by September 29 if September 28 is a Sunday.

(iii) The generally applicable fractions and percentage are modified to reflect the different deposit periods in accordance with the following table:

Generally applicable fractions and percentage	Modifications for non-EFT depositors
11/15	10/15
11/90	10/90
69.67 percent	63.33 percent

(7) *Effective date.* This paragraph (c) is effective August 1, 1995.

Par. 5. Section 40.6302(c)–3 is amended as follows:

1. In paragraph (b)(1)(ii), first sentence, the language "deposits to" is removed and "deposits of" is added in its place.

2. In paragraph (b)(3), first sentence, the language "durina" is removed and "during a" is added in its place.

3. Paragraphs (f) and (g) are redesignated as paragraphs (g) and (h), respectively, and a new paragraph (f) is added.

4. In newly designated paragraph (h), first sentence, the language "This section" is removed and "Except as otherwise provided, this section" is added in its place.

The addition reads as follows:

§ 40.6302(c)–3 Special rules for use of Government depositaries under chapter 33.

* * * * *

(f) *Special rules for September*—(1) *Deposits required.* In the case of alternative method taxes charged (that is, included in amounts billed or tickets sold) during the first semimonthly period in September, separate deposits are required for the taxes charged during the period September 1st-11th and the period September 12th-15th.

(2) *Time to deposit*—(i) *In general.* The deposit required for alternative method taxes charged during the period beginning September 1st must be made by September 29. The deposit required for alternative method taxes charged during the period ending September 15th must be made at the time prescribed in paragraph (c) of this section for making deposits for the first semimonthly period in October.

(ii) *Due date on Saturday or Sunday.* A deposit that would otherwise be due on September 29 must be made by September 28 if September 29 is a Saturday and by September 30 if September 29 is a Sunday.

(3) *Amount of deposit.* The deposits of alternative method taxes required for the period September 1st-11th and the period September 12th-15th must be not less than the amount of alternative method taxes charged during the respective periods. The amount of alternative method taxes charged during these periods may be computed by—

(i) Determining the net amount of alternative method taxes reflected in the separate account for the first semimonthly period in September (or one-half of the net amount of alternative method taxes reasonably expected to be reflected in the separate account for the month of September);

(ii) Treating 11/15 of that amount as the amount of taxes charged during the period September 1st-11th; and

(iii) Treating the remainder of the amount determined under paragraph (f)(3)(i) of this section (adjusted, if that amount is based on reasonable expectations, to reflect actual taxes charged through the end of September) as the amount charged during the period September 12th-15th.

(4) *Safe harbor rule based on look-back quarter liability.* The safe harbor

rule of § 40.6302(c)–1(c)(2)(i) does not apply for the fourth calendar quarter unless—

(i) The deposit for alternative method taxes charged during the period September 1st-11th is not less than 11/90 of the net tax liability reported for alternative method taxes for the look-back quarter; and

(ii) The total deposit for alternative method taxes charged during the first semimonthly period in September is not less than 1/6 of the net tax liability reported for alternative method taxes for the look-back quarter.

(5) *Safe harbor rule based on current liability.* The safe harbor rule of § 40.6302(c)–1(c)(3)(i) does not apply for the fourth calendar quarter unless—

(i) The deposit for alternative method taxes charged during the period September 1st-11th is not less than 69.67 percent of the alternative method taxes charged during the first semimonthly period in September; and

(ii) The total deposit for alternative method taxes charged during the first semimonthly period in September is not less than 95 percent of the alternative method taxes charged during that semimonthly period.

(6) *Persons not required to use electronic funds transfer.* In the case of a person that is not required to deposit excise taxes by electronic funds transfer (a non-EFT depositor), the rules of this paragraph (f) apply with the following modifications:

(i) The taxes for which separate deposits must be made are the taxes charged during the periods September 1st-10th and September 11th-15th.

(ii) The deposit required for taxes charged during the period beginning September 1st must be made by September 28. A deposit that would otherwise be due on September 28 must be made by September 27 if September 28 is a Saturday and by September 29 if September 28 is a Sunday.

(iii) The generally applicable fractions and percentage are modified to reflect the different deposit periods in accordance with the following table:

Generally applicable fractions and percentage	Modifications for non-EFT depositors
11/15	10/15
11/90	10/90
69.67 percent	63.33 percent

(7) *Effective date.* This paragraph (f) is effective August 1, 1995, for all taxes except those imposed by section 4261 or 4271. For taxes imposed by section 4261 or 4271, this paragraph (f) applies beginning January 1, 1997.

* * * * *

Par. 6. Section 40.6302(c)–4 is amended as follows:

1. Paragraph (a) is amended by revising the first sentence and removing the second sentence.

2. Paragraph (b)(1) is amended by removing the language "transfer between accounts with the same Government depositary" in the first sentence and adding "electronic funds transfer" in its place.

3. Paragraph (d) is redesignated as paragraph (e) and a new paragraph (d) is added.

4. Newly designated paragraph (e) is amended by removing the language "Highway Act" and adding "Highway Revenue Act" in its place.

The revision and addition read as follows:

§ 40.6302(c)–4 Special rule for use of Government depositaries under section 4081.

(a) *Overview.* This section sets forth a special rule for deposits of taxes imposed by section 4081. * * *

* * * * *

(d) *Special rules for September.* Deposits of 14-day rule taxes for the second semimonthly period in September must be made in the manner prescribed by § 40.6302(c)–1(e) applied with the following modifications:

(1) Each reference to 9-day rule taxes is treated, instead, as a reference to 14-day rule taxes.

(2) The deposit required for the period ending September 30th must be made at the time prescribed in paragraph (b) of this section (rather than at the time prescribed in § 40.6302(c)–1(b)(6)(i)).

* * * * *

§ 40.6302(c)–5T [Removed]

Par. 7. Section 40.6302(c)–5T is removed.

§ 40.9999–1 [Amended]

Par. 8. Section 40.9999–1 is amended as follows:

1. *Example 1*(iii) is amended by removing the parenthetical "(§ 40.6302(c)–1(e)(2))" and adding "(§ 40.6302(c)–1(f)(2))" in its place.

2. *Example 3* is amended by:

a. Removing the language "diesel fuel" and adding "aviation fuel" in its place in the following locations:

i. *Example 3*, heading.

ii. *Example 3*(i)(1), each time it appears in the first sentence.

iii. *Example 3*(i)(1), second and third sentences.

iv. *Example 3*(i)(4), second sentence.

v. *Example 3*(ii), fourth and seventh sentences.

vi. *Example 3*(iii), third sentence.

vii. *Example 3*(iv), second sentence.

b. In *Example 3*(iii), second sentence, removing the parenthetical "(§ 40.6302(c)–1(e)(3))" and adding "(§ 40.6302(c)–1(f)(3))" in its place.

PART 48—MANUFACTURERS AND RETAILERS EXCISE TAXES

Par. 9. The authority citation for part 48 continues to read in part as follows:

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

§ 48.4082–2 [Amended]

Par. 9a. In § 48.4082–2, paragraph (a) is amended by removing the reference "section 6714" and adding "section 6715" in its place.

§ 48.4083–1 [Amended]

Par. 10. Section 48.4083–1 is amended as follows:

1. In paragraph (b)(1) introductory text, first sentence, the reference "section 6714(a)" is removed and "section 6715(a)" is added in its place.

2. In paragraph (d)(1), second sentence, the reference "section 6714" is removed and "section 6715" is added in its place.

§ 48.6427–7 [Removed]

Par. 11. Section 48.6427–7 is removed.

§ 48.6714–1 [Redesignated as 48.6715–1]

Par. 12. Section 48.6714–1 is redesignated as § 48.6715–1.

Par. 13. In newly designated § 48.6715–1, the first and second sentences of paragraph (a) introductory text are amended by removing the reference "section 6714(a)" and adding "section 6715(a)" in its place.

PART 49—FACILITIES AND SERVICES EXCISE TAXES

Par. 14. The authority citation for part 49 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 14a. Subpart F, consisting of § 49.4291–1, is added to read as follows:

Subpart F—Collection of Tax By Persons Receiving Payment

§ 49.4291–1 Persons receiving payment must collect tax.

Except as otherwise provided in section 4263(a), every person receiving any payment for facilities or services on which a tax is imposed upon the payor thereof under chapter 33 shall collect the amount of the tax from the person making that payment. Under section 7501, all taxes collected in this manner are held by the collecting agent in trust for the United States. If the person from whom the tax is required to be collected refuses to pay it or if for any reason it is impossible for the collecting agent to collect the tax from that person, the collecting agent is required to report to the district director the name and address of that person, the nature of the facility provided or service rendered, the amount paid therefor, and the date on which paid. Upon receipt of this information the district director will proceed against the person to whom the facilities were provided or the services rendered to assert the amount of tax due, affording that person the same district conference, protest, and appellate rights as are available to other excise taxpayers. In addition, when a field or office audit of a collecting agent's records, or of a taxpayer's records, discloses that the collecting agent failed during prior reporting periods to collect taxes due, the district director may assert those taxes directly against the person to whom the facilities were provided or the services rendered, whether or not the collecting agent had attempted collection or the person liable for the tax had refused payment thereof.

PART 301—PROCEDURE AND ADMINISTRATION

Par. 15. The authority citation for part 301 continues to read in part as follows:

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

§ 301.6156–1 [Removed]

Par. 15a. Section 301.6156–1 is removed.

§ 301.6206–1 [Removed]

Par. 16. Section 301.6206–1 is removed.

§§ 301.6415–1 through 301.6421–1 and 301.6423–1 [Removed]

Par. 17. Sections 301.6415–1 through 301.6421–1 and 301.6423–1 are removed.

§ 301.6675–1 [Removed]

Par. 18. Section 301.6675–1 is removed.

Par. 19. The undesignated center heading following § 301.6905–1 is revised to read as follows:

Licensing

Par. 20. The undesignated center heading preceding § 301.7001–1 is removed.

Par. 21. The undesignated center heading preceding § 301.7011–1 is removed.

§ 301.7011–1 [Removed]

Par. 22. Section 301.7011–1 is removed.

§ 301.7232–1 [Removed]

Par. 23. Section 301.7232–1 is removed.

§ 301.7328–1 [Removed]

Par. 24. Section 301.7328–1 is removed.

PART 601—STATEMENT OF PROCEDURAL RULES

Par. 25. The authority citation for part 601 continues to read as follows:

Authority: 5 U.S.C. 301 and 552.

§ 601.101 [Amended]

Par. 25a. Section 601.101 is amended as follows:

1. Paragraph (b) is amended by removing the seventh sentence and the last sentence.

2. Paragraph (c) is removed.

Par. 26. Section 601.102 is amended as follows:

1. Paragraphs (b)(2)(i) and (b)(2)(ii) are revised.

2. Paragraphs (b)(2)(iii), (b)(2)(iv), and (c) are removed.

The revisions read as follows:

§ 601.102 Classification of taxes collected by the Internal Revenue Service.

* * * * *

(b) * * *

(2) * * *

(i) Employment taxes.

(ii) Miscellaneous excise taxes collected by return.

* * * * *

§ 601.104 [Amended]

Par. 27. Section 601.104 is amended as follows:

1. Paragraphs (a)(4) and (a)(5) are removed.

2. Paragraph (c)(4) is amended by removing the eighth and ninth sentences.

§ 601.201 [Amended]

Par. 28. In § 601.201, paragraph (a)(2) is amended by removing the last sentence.

§ 601.202 [Amended]

Par. 29. In § 601.202, paragraph (c)(1) is amended by removing the parenthetical "(other than the manufacturers excise tax on firearms arising from application of sections 4181 and 4182 of the Internal Revenue Code of 1954)".

§ 601.203 [Amended]

Par. 30. In § 601.203, paragraph (a)(1) is amended by removing the last sentence.

Subpart C [Removed and Reserved]

Par. 31. Subpart C of part 601 is removed and reserved.

Par. 32. The heading for subpart D of part 601 is revised to read as follows:

Subpart D—Provisions Special to Certain Employment Taxes §§ 601.402 through 601.405 [Removed]

Par. 33. Sections 601.402 through 601.405 are removed.

Subpart J [Removed]

Par. 34. Subpart J of part 601 is removed.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 35. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 35a. In § 602.101, paragraph (c) is amended by:

1. Removing the following entries from the table:

§ 602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control No.
* * * *	*
48.0–3	1545–0685
* * * *	*
48.4102–1	1545–0023
	1545–0725
* * * *	*
48.4221–8	1545–0023
48.4221–9	1545–0023
* * * *	*
48.6427–7	1545–0143
	1545–0162
* * * *	*
48.6675–1	1545–0723
* * * *	*
301.7011–1	1545–0123
* * * *	*
601.104	1545–0023
	1545–0233
* * * *	*
601.201	1545–0819
* * * *	*
601.402	1545–0014
601.403	1545–0023
* * * *	*

2. Adding entries in numerical order to the table to read as follows:

§ 602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control No.
* * * *	*
601.104	1545–0233
* * * *	*
601.201	1545–0019
	1545–0819
* * * *	*
601.401	1545–0257
601.504	1545–0150
* * * *	*

Approved June 26, 1996.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

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

(Filed by the Office of the Federal Register on November 8, 1996, 8:45 a.m., and published in the issue of the Federal Register for November 12, 1996, 61 F.R. 58004)

Subchapter C.—Lien for Taxes

Section 6323.—Validity and Priority Against Certain Persons

Ct.D. 2059

SUPREME COURT OF THE UNITED STATES

No. 95–323

UNITED STATES, PETITIONER v. THOMAS R. NOLAND, TRUSTEE FOR DEBTOR FIRST TRUCK LINES, INC. 517 U.S.—

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

May 13, 1996

Syllabus

The Internal Revenue Service filed claims in the Bankruptcy Court for taxes, interest, and penalties that accrued after debtor First Truck Lines, Inc., sought relief under Chapter 11 of the Bankruptcy Code but before the case was converted to a Chapter 7 bankruptcy. The court found that all of the IRS's claims were entitled to first priority as administrative expenses under 11 U. S. C. §§ 503(b)(1)(C) and 507(a)(1), but held that the penalty claim was subject to "equitable subordination" under § 510(c), which the court interpreted as giving it authority not only to deal with inequitable Government conduct, but also to adjust a statutory priority of a category of claims. The court's decision to subordinate the penalty claim to the claims of the general unsecured creditors was affirmed by the District Court and the Sixth Circuit, which concluded that postpetition, nonpecuniary loss tax penalty claims are susceptible to subordination by their very nature.

Held: A bankruptcy court may not equitably subordinate claims on a categorical basis in derogation of Congress's priorities scheme. The language of § 510(c), principles of statutory construction, and legislative history clearly indicate Congress's intent in its 1978 revision of the Code to use the existing judge-made doctrine of equitable subordination as the starting point for deciding when subordination is appropriate. By adopting "principles of equitable subordination," § 510(c) allows a bankruptcy court to reorder a tax penalty when justified by particular facts. It is also clear that Congress meant to give courts some leeway to develop the doctrine. However, a reading of the statute that would give courts leeway broad enough to allow subordination at odds with the congressional ordering of priorities by category is improbable in the extreme. The statute would then empower a court to modify the priority provision's operation at the same level at which Congress operated when it made its characteristically general judgment to establish the hierarchy of claims in the first place, thus delegating legislative revision, not authorizing equitable exception. Nonetheless, just such a legislative type of decision underlies the reordering of priorities here. The Sixth Circuit's decision runs directly counter to Congress's policy judgment that a postpetition tax penalty should receive the priority of an administrative expense. Since the Sixth Circuit's rationale was inappropriately categorical in nature, this Court need not decide whether a bankruptcy court must always find creditor misconduct before a claim may be equitably subordinated.

48 F. 3d 210, reversed and remanded.

SOUTER, J., delivered the opinion for a unanimous Court.

JUSTICE SOUTER delivered the opinion of the Court.

The issue in this case is the scope of a bankruptcy court's power of equitable subordination under 11 U.S.C. § 510(c). Here, in the absence of any finding of inequitable conduct on the part of the Government, the Bankruptcy Court subordinated the Government's claim for a postpetition, noncompensatory tax penalty, which would normally receive first priority in bankruptcy as an "administrative expense," §§ 503(b)(1)(C), 507(a)(1). We hold that the bankruptcy court may not equitably subordinate claims on a categorical basis in derogation of Congress's scheme of priorities.

In April 1986, First Truck Lines, Inc., voluntarily filed for relief under Chapter 11 of the Bankruptcy Code, and in the subsequent operation of its business as a debtor-in-possession incurred, but failed to discharge, tax liabilities to the Internal Revenue Service. First Truck moved to convert the case to a Chapter 7 liquidation in June 1988, and in August 1988 the Bankruptcy Court granted that motion and appointed respondent Thomas R. Noland as trustee. The liquidation of the estate's assets raised insufficient funds to pay all of the creditors.

After the conversion, the IRS filed claims for taxes, interest, and penalties that accrued after the Chapter 11 filing but before the Chapter 7 conversion, and although the parties agreed that the claims for taxes and interest were entitled to priority as administrative expenses, §§ 503(b), 507(a)(1), and 726(a)(1),[1] they disagreed about the priority to be given tax penalties. The Bankruptcy Court determined that the penalties (like the taxes and interest) were administrative expenses under

[1] Section 507(a)(1) provides, in relevant part: "(a) The following expenses and claims have priority in the following order: (1) First, administrative expenses allowed under section 503(b) of this title . . . ." Under § 503(b)(1), administrative expenses include "any tax . . . incurred by the estate" (with certain exceptions not relevant here), as well as "any fine [or] penalty . . . relating to [such] a tax . . . ." Section 726(a)(1) adopts the order of payment specified in § 507 for Chapter 7 proceedings.

§ 503(b) but held them to be subject to equitable subordination under § 510(c).[2] In so doing, the Court read that section to provide authority not only to deal with inequitable conduct on the Government's part, but also to adjust a statutory priority of a category of claims. The Bankruptcy Court accordingly weighed the relative equities that seemed to flow from what it described as "the Code's preference for compensating actual loss claims," and subordinated the tax penalty claim to those of the general unsecured creditors. *In re First Truck Lines, Inc.*, 141 B. R. 621, 629 (SD Ohio 1992). The District Court affirmed. *Internal Revenue Service* v. *Noland, 190 B. R. 827 (SD Ohio 1993).*

After reviewing the legislative history of the 1978 revision to the Bankruptcy Code and several recent appeals cases on equitable subordination of tax penalties, the Sixth Circuit affirmed, as well. *In re First Truck Lines, Inc.*, 48 F. 3d 210 (1995). The Sixth Circuit stated that it did

> "not see the fairness or the justice in permitting the Commissioner's claim for tax penalties, which are not being assessed because of pecuniary losses to the Internal Revenue Service, to enjoy an equal or higher priority with claims based on the extension of value to the debtor, whether secured or not. Further, assessing tax penalties against the estate of a debtor no longer in existence serves no punitive purpose. Because of the nature of postpetition, nonpecuniary loss tax penalty claims in a Chapter 7 case, we believe such claims are susceptible to subordination. To hold otherwise would be to allow creditors who have supported the business during its attempt to reorganize to be penalized once that effort has failed and there is not enough to go around." *Id.*, at 218.

See also *Burden* v. *United States*, 917 F. 2d 115, 120 (CA3 1990); *Schultz Broadway Inn* v. *United States*, 912 F. 2d 230, 234 (CA8 1990); *In re Virtual Network Services Corp.*, 902 F. 2d 1246, 1250 (CA7 1990). We granted certiorari to determine the appropriate scope of the power under the Bankruptcy Code to subordinate a tax penalty, 516 U. S. ___ (1995), and we now reverse.

[2] Section 510(c) provides that "the court may ... under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim ... ."

The judge-made doctrine of equitable subordination predates Congress's revision of the Code in 1978. Relying in part on our earlier cases, see, *e.g.*, *Comstock* v. Group of Institutional Investors, 335 U. S. 211 (1948); *Pepper* v. *Litton*, 308 U. S. 295 (1939); *Taylor* v. *Standard Gas & Elec. Co.*, 306 U. S. 307 (1939), the Fifth Circuit, in its influential opinion in *In re Mobile Steel Co.*, 563 F. 2d 692, 700 (CA5 1977), observed that the application of the doctrine was generally triggered by a showing that the creditor had engaged in "some type of inequitable conduct." *Mobile Steel* discussed two further conditions relating to the application of the doctrine: that the misconduct have "resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant," and that the subordination "not be inconsistent with the provisions of the Bankruptcy Act." *Ibid.* This last requirement has been read as a "reminder to the bankruptcy court that although it is a court of equity, it is not free to adjust the legally valid claim of an innocent party who asserts the claim in good faith merely because the court perceives that the result is inequitable." DeNatale & Abram, The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors, 40 Bus. Law. 417, 428 (1985). The district courts and courts of appeals have generally followed the *Mobile Steel* formulation, *In re Baker & Getty Financial Services, Inc.*, 974 F. 2d 712, 717 (CA6 1992).

Although Congress included no explicit criteria for equitable subordination when it enacted § 510(c)(1), the reference in § 510(c) to "principles of equitable subordination," clearly indicates congressional intent at least to start with existing doctrine. This conclusion is confirmed both by principles of statutory construction, see *Midlantic Nat. Bank* v. *New Jersey Dept. of Environmental Protection*, 474 U. S. 494, 501 (1986) ("The normal rule of statutory construction is that if Congress intends for legislation to change the interpretation of a judicially created concept, it makes that intent specific. The Court has followed this rule with particular care in construing the scope of bankruptcy codifications") (citation omitted), and by statements in the legislative history that Congress "intended that the term 'principles of equitable subordination' follow existing case law and leave to the courts development of this principle," 124 Cong. Rec. 32398 (1978) (Rep. Edwards); see also *id.*, at 33998 (Sen. DeConcini). In keeping with pre-1978 doctrine, many Courts of Appeals have continued to require inequitable conduct before allowing the equitable subordination of most claims, see, *e.g.*, *In re Fabricators, Inc.*, 926 F. 2d 1458, 1464 (CA5 1991); *In re Bellanca Aircraft Corp.*, 850 F. 2d 1275, 1282–1283 (CA8 1988), although several have done away with the requirement when the claim in question was a tax penalty. See, *e.g.*, *Burden, supra*, at 120; *Schultz, supra*, at 234; *In re Virtual Network, supra*, at 1250.

Section 510(c) may of course be applied to subordinate a tax penalty, since the Code's requirement that a Chapter 7 trustee must distribute assets "in the order specified in ... section 507," (which gives a first priority to administrative expense tax penalties) is subject to the qualification, "[e]xcept as provided in section 510 of this title ... ." 11 U.S.C. § 726(a). Thus, "principles of equitable subordination" may allow a bankruptcy court to reorder a tax penalty in a given case. It is almost as clear that Congress meant to give courts some leeway to develop the doctrine, 124 Cong. Rec. 33998 (1978), rather than to freeze the pre-1978 law in place. The question is whether that leeway is broad enough to allow subordination at odds with the congressional ordering of priorities by category.

The answer turns on Congress's probable intent to preserve the distinction between the relative levels of generality at which trial courts and legislatures respectively function in the normal course. Hence, the adoption in § 510(c) of "principles of equitable subordination" permits a court to make exceptions to a general rule when justified by particular facts, cf. *Hecht Co.* v. *Bowles*, 321 U. S. 321, 329 (1944) ("The essence of equity jurisdiction has been the power of the Chancellor to do equity and to mould each decree to the necessities of the particular case"). But if the provision also authorized a court to conclude on a general, categorical level that tax penalties should not be treated as administrative expenses to be paid first, it would empower a court to modify the operation of the priority statute at the same level at which Congress operated when it made its characteristically general judgment to establish the hierarchy of claims in the first place. That is, the distinction between characteristic legislative and trial court functions would simply be swept away, and

the statute would delegate legislative revision, not authorize equitable exception. We find such a reading improbable in the extreme. "Decisions about the treatment of categories of claims in bankruptcy proceedings . . . are not dictated or illuminated by principles of equity and do not fall within the judicial power of equitable subordination . . . ." *Burden*, 917 F. 2d, at 122 (Alito, J., concurring in part and dissenting in part).

Just such a legislative type of decision, however, underlies the Bankruptcy Court's reordering of priorities in question here, as approved by the District Court and the Court of Appeals. Despite language in its opinion about requiring a balancing of the equities in individual cases, the Court of Appeals actually concluded that "postpetition, nonpecuniary loss tax penalty claims" are "susceptible to subordination" by their very "nature." 48 F. 3d, at 218. And although the court said that not every tax penalty would be equitably subordinated, *ibid.*, that would be the inevitable result of consistent applications of the rule employed here, which depends not on individual equities but on the supposedly general unfairness of satisfying "postpetition, nonpecuniary loss tax penalty claims" before the claims of a general creditor.

The Court of Appeals's decision thus runs directly counter to Congress's policy judgment that a postpetition tax penalty should receive the priority of an administrative expense, 11 U.S.C. §§ 503(b)(1)(C), 507(a)(1), and 726(a)(1). This is true regardless of Noland's argument that the Bankruptcy Court made a distinction between compensatory and noncompensatory tax penalties, for this was itself a categorical distinction at a legislative level of generality. Indeed, Congress recognized and employed that distinction elsewhere in the priority provisions: Congress specifically assigned 8th priority to certain compensatory tax penalties, see § 507(a)(8)(G), and 12th priority to prepetition, noncompensatory penalties, see § 726(a)(1), and (4).[3]

[3] Noland argues that "although the penalties at issue arose postpetition," this claim should be viewed as a prepetition penalty because a "reorganized debtor is in many respects similar to a prepetition debtor ... [and] the conversion of [this] case to chapter 7 was tantamount to the filing of a new petition." Brief for Respondent 16, n. 7. But we agree with the Sixth Circuit, see *In re First Truck Lines, Inc.*, 48 F. 3d 210, 214 (1995), that the penalties at issue here are postpetition administrative expenses pursuant to 11 U. S. C. §§ 348(d), 503(b)(1). Although § 348(d) provides that a "claim against the estate or the debtor that arises after the order for relief but before conversion in a case that is converted under section 1112, 1208, or 1307 of this title, other than a claim specified in section 503(b) of this title, shall be treated for all purposes as if such claim had arisen immediately before the date of the filing of the petition," the claim for priority here is "specified in section 503(b)" and Congress has already determined that it is not to be treated like prepetition penalties. Noland may or may not have a valid policy argument, but it is up to Congress, not this Court, to revise the determination if it so chooses.

The Sixth Circuit, to be sure, invoked a more modest authority than legislative revision when it relied on statements by the congressional leaders of the 1978 Code revisions, see 48 F. 3d, at 215, 217–218, and it is true that Representative Edwards and Senator DeConcini stated that "under existing law, a claim is generally subordinated only if [the] holder of such claim is guilty of inequitable conduct, or the claim itself is of a status susceptible to subordination, such as a penalty or a claim for damages arising from the purchase or sale of a security of the debtor." 124 Cong. Rec. 32398 (1978) (Rep. Edwards); see also *id.*, at 33998 (Sen. DeConcini). But their remarks were not statements of existing law and the Sixth Circuit's reliance on the unexplained reference to subordinated penalties ran counter to this Court's previous endorsement of priority treatment for postpetition tax penalties. See *Nicholas* v. *United States*, 384 U. S. 678, 692–695 (1966). More fundamentally, statements in legislative history cannot be read to convert statutory leeway for judicial development of a rule on particularized exceptions into delegated authority to revise statutory categorization, untethered to any obligation to preserve the coherence of substantive congressional judgments.

Given our conclusion that the Sixth Circuit's rationale was inappropriately categorical in nature, we need not decide today whether a bankruptcy court must always find creditor misconduct before a claim may be equitably subordinated. We do hold that (in the absence of a need to reconcile conflicting congressional choices) the circumstances that prompt a court to order equitable subordination must not occur at the level of policy choice at which Congress itself operated in drafting the Bankruptcy Code. Cf. *In re Ahlswede*, 516 F. 2d 784, 787 (CA9) ("[T]he [equity] chancellor never did, and does not now, exercise unrestricted power to contradict statutory or common law when he feels a fairer result may be obtained by application of a different rule"), cert. denied *sub nom. Stebbins* v. *Crocker Citizens Nat. Bank*, 423 U.S. 913 (1975); *In re Columbia Ribbon Co.*, 117 F. 2d 999, 1002 (CA3 1941) (court cannot "set up a subclassification of claims ... and fix an order of priority for the sub-classes according to its theory of equity").

In this instance, Congress could have, but did not, deny noncompensatory, postpetition tax penalties the first priority given to other administrative expenses, and bankruptcy courts may not take it upon themselves to make that categorical determination under the guise of equitable subordination. 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.

Chapter 66.—Limitations
Subchapter B.—Limitations on Credit or Refund

Section 6512.—Limitations in Case of Petition to Tax Court

Ct.D. 2058

SUPREME COURT OF THE UNITED STATES

No. 94-1785

COMMISSIONER OF INTERNAL REVENUE, PETITIONER v. ROBERT F. LUNDY
516 U.S.—

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

January 17, 1996

Syllabus

Respondent Lundy and his wife withheld from their 1987 wages substantially more in federal income taxes than they actually owed for that year, but they did not file their 1987 tax return when it was due, nor did they file a return or claim a refund of the overpaid taxes in the succeeding 2½ years. On September 26, 1990, the Commissioner of Internal Revenue mailed Lundy a notice of deficiency for 1987. Some three months later, the Lundys filed their joint 1987 tax return, which claimed a refund of their overpaid taxes, and Lundy filed a timely petition in the Tax Court seeking a redetermination of the claimed deficiency and a refund. The Tax Court held that where, as here, a taxpayer has not filed a tax return by the time a notice of deficiency is mailed, and the notice is mailed more than two years after the date on which the taxes are paid, a 2-year

"look-back" period applies under 26 U. S. C. § 6512(b)(3)(B), and the court lacks jurisdiction to award a refund. The Fourth Circuit reversed, finding that the applicable look-back period in these circumstances is three years and that the Tax Court had jurisdiction to award a refund.

Held: The Tax Court lacks jurisdiction to award a refund of taxes paid more than two years prior to the date on which the Commissioner mailed the taxpayer a notice of deficiency, if, on the date that the notice was mailed, the taxpayer had not yet filed a return. In these circumstances, the applicable look-back period under § 6512(b)(3)(B) is two years.

(a) Section 6512(b)(3)(B) forbids the Tax Court to award a refund unless it first determines that the taxes were paid "within the [look-back] period which would be applicable under section 6511(b)(2) . . . if on the date of the mailing of the notice of deficiency a claim [for refund] had been filed." Section § 6511(b)(2)(A) in turn instructs the court to apply a 3-year look-back period if a refund claim is filed, as required by § 6511(a), "within 3 years from the time the return was filed," while § 6511(b)(2)(B) specifies a 2-year look-back period if the refund claim is not filed within that 3-year period. The Tax Court properly applied the 2-year look-back period to Lundy's case because, as of September 26, 1990 (the date the notice of deficiency was mailed), Lundy had not filed a tax return, and, consequently, a claim filed on that date would not be filed within the 3-year period described in § 6511(a). Lundy's taxes were withheld from his wages, so they are deemed paid on the date his 1987 tax return was due (April 15, 1988), which is more than two years prior to the date the notice of deficiency was mailed. Lundy is therefore seeking a refund of taxes paid outside the applicable look-back period, and the Tax Court lacks jurisdiction to award a refund.

(b) Lundy suggests two alternative interpretations of § 6512(b)(3)(B), neither of which is persuasive. Lundy first adopts the Fourth Circuit's view, which is that the applicable look-back period is determined by reference to the date that the taxpayer *actually filed* a claim for refund, and argues that he is entitled to a 3-year look-back period because his late-filed 1987 tax return contained a refund claim that was filed within three years from the filing of the return itself. This interpretation is contrary to the requirements of the statute and leads to a result that Congress could not have intended, as it in some circumstances subjects a timely filer of a return to a shorter limitations period in Tax Court than a delinquent filer. Lundy's second argument, that the "claim" contemplated by § 6512(b)(3)(B) can only be a claim filed on a tax return, such that a uniform 3-year look-back period applies under that section, is similarly contrary to the language of the statute.

(c) This Court is bound by § 6512(b)(3)(B)'s language as it is written, and even if the Court were persuaded by Lundy's policy-based arguments for applying a 3-year look-back period, the Court is not free to rewrite the statute simply because its effects might be susceptible of improvement.

45 F. 3d 856, reversed.

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

JUSTICE O'CONNOR delivered the opinion of the Court.

In this case, we consider the "look-back" period for obtaining a refund of overpaid taxes in the United States Tax Court under 26 U.S.C. § 6512(b)(3)(B), and decide whether the Tax Court can award a refund of taxes paid more than two years prior to the date on which the Commissioner of Internal Revenue mailed the taxpayer a notice of deficiency, when, on the date the notice of deficiency was mailed, the taxpayer had not yet filed a return. We hold that in these circumstances the 2-year look-back period set forth in § 6512(b)(3)(B) applies, and the Tax Court lacks jurisdiction to award a refund.

I

During 1987, respondent Robert F. Lundy and his wife had $10,131 in federal income taxes withheld from their wages. This amount was substantially more than the $6,594 the Lundys actually owed in taxes for that year, but the Lundys did not file their 1987 tax return when it was due, nor did they file a return or claim a refund of the overpaid taxes in the succeeding two and a half years. On September 26, 1990, the Commissioner of Internal Revenue mailed Lundy a notice of deficiency, informing him that he owed $7,672 in additional taxes and interest for 1987 and that he was liable for substantial penalties for delinquent filing and negligent underpayment of taxes, see 26 U. S. C. §§ 6651(a)(1) and 6653(1).

Lundy and his wife mailed their joint tax return for 1987 to the Internal Revenue Service (IRS) on December 22, 1990. This return indicated that the Lundys had overpaid their income taxes for 1987 by $3,537 and claimed a refund in that amount. Two days after the return was mailed, Lundy filed a timely petition in the Tax Court seeking a redetermination of the claimed deficiency and a refund of the couple's overpaid taxes. The Commissioner filed an answer generally denying the allegations in Lundy's petition. Thereafter, the parties negotiated towards a settlement of the claimed deficiency and refund claim. On March 17, 1992, the Commissioner filed an amended answer acknowledging that Lundy had filed a tax return and that Lundy claimed to have overpaid his 1987 taxes by $3,537.

The Commissioner contended in this amended pleading that the Tax Court lacked jurisdiction to award Lundy a refund. The Commissioner argued that if a taxpayer does not file a tax return before the IRS mails the taxpayer a notice of deficiency, the Tax Court can only award the taxpayer a refund of taxes paid within two years prior to the date the notice of deficiency was mailed. See 26 U.S.C. § 6512(b)(3)(B). Under the Commissioner's interpretation of § 6512(b)(3)(B), the Tax Court lacked jurisdiction to award Lundy a refund because Lundy's withheld taxes were deemed paid on the date that his 1987 tax return was due (April 15, 1988), see § 6513(b)(1), which is more than two years before the date the notice was mailed (September 26, 1990).

The Tax Court agreed with the position taken by the Commissioner and denied Lundy's refund claim. Citing an unbroken line of Tax Court cases adopting a similar interpretation of § 6512(b)(3)(B), *e.g. Allen* v. *Commissioner*, 99 T. C. 475, 479–480 (1992); *Galuska* v. *Commissioner*, 98 T. C. 661, 665 (1992); *Berry* v. *Commissioner*, 97 T. C. 339, 344–345 (1991); *White* v. *Commissioner*, 72 T. C. 1126, 1131–1133 (1979) (renumbered statute); *Hosking* v. *Commissioner*, 62 T. C. 635, 642–643 (1974) (renumbered statute), the Tax Court held that if a taxpayer has not filed a tax return by the time the notice of deficiency is mailed, and the notice is mailed more than two years after the date on which the taxes are paid, the look-back period under § 6512(b)(3)(B) is two years and the Tax Court lacks jurisdiction to award a refund. 65 TCM 3011, 3014–3015, RIA TC memo ¶93, 278 (1993).

The Court of Appeals for the Fourth Circuit reversed, finding that the applicable look-back period in these circumstances is three years and that the Tax Court had jurisdiction to award Lundy a refund. 45 F. 3d 856, 861 (1995). Every other Court of Appeals to have addressed the question has affirmed the Tax Court's interpretation of § 6512(b)(3)(B), see *Davison* v. *Commissioner*, 9 F. 3d 1538 (CA2 1993) (unpublished disposition); *Allen* v. *Commissioner*, 23 F. 3d 406 (CA6 1994) (unpublished disposition); *Galuska* v. *Commissioner*, 5 F. 3d 195, 196 (CA7 1993); *Richards* v. *Commissioner*, 37 F. 3d 587, 589 (CA10 1994); see also *Rossman* v. *Commissioner*, 46 F. 3d 1144 (CA9 1995) (unpublished disposition) (affirming on other grounds). We granted certiorari to resolve the conflict, 515 U. S. ____ (1995), and now reverse.

II

A taxpayer seeking a refund of overpaid taxes ordinarily must file a timely claim for a refund with the Internal Revenue Service (IRS) under 26 U. S. C. § 6511.[1] That section contains two separate provisions for determining the timeliness of a refund claim. It first establishes a *filing deadline:* The taxpayer must file a claim for a refund "within 3 years from the time the return was filed or 2 years from the time the tax was paid, whichever of such periods expires the later, or if no return was filed by the taxpayer, within 2 years from the time the tax was paid." § 6511(b)(1) (incorporating by reference § 6511(a)). It also defines two *"look-back" periods:* If the claim is filed "within 3 years from the time the return was filed," *ibid.*, then the taxpayer is entitled to a refund of "the portion of the tax paid within the 3 years immediately preceding the filing of the claim." § 6511(b)(2)(A) (incorporating by reference § 6511(a)). If the claim is not filed within that 3-year period, then the taxpayer is entitled to a refund of only that "portion of the tax paid during the 2 years immediately preceding the filing of the claim." § 6511(b)(2)(B) (incorporating by reference § 6511(a)).

Unlike the provisions governing refund suits in United States District Court or the United States Court of Federal Claims, which make timely filing of a refund claim a jurisdictional prerequisite to bringing suit, see 26 U.S.C. § 7422(a); *Martin* v. *United States*, 833 F. 2d 655, 658–659 (CA7 1987), the restrictions governing the Tax Court's authority to award a refund of overpaid taxes incorporate only the look-back period and not the filing deadline from § 6511. See 26 U.S.C. § 6512(b)(3).[2] Consequently, a taxpayer who seeks a refund in the Tax Court, like respondent, does not need to actually file a claim for refund with the IRS; the taxpayer need only show that the tax to be refunded was paid during the applicable look-back period.

In this case, the applicable look-back period is set forth in § 6512(b)(3)(B), which provides that the Tax Court cannot award a refund of any overpaid taxes unless it first determines that the taxes were paid:

> "within the period which would be applicable under section 6511(b)(2) ... if on the date of the mailing of the notice of deficiency a claim had been filed (whether or not filed) stating the grounds upon which the Tax Court finds that there is an overpayment."

The analysis dictated by § 6512(b)(3)(B) is not elegant, but it is straightforward. Though some courts have adverted to the filing of a "deemed claim," see *Galuska*, 5 F. 3d, at 196; *Richards*, 37 F. 3d, at 589, all that matters for the proper application of § 6512(b)(3)(B) is that the "claim" contemplated in that section be treated as the only mechanism for determining whether a taxpayer can recover a refund. Section 6512(b)(3)(B) defines the look-back period that applies in Tax Court by incorporating the look-back provisions from § 6511(b)(2), and directs the Tax Court to determine the applicable period by inquiring into the timeliness of a hypothetical claim for refund filed "on the date of the mailing of the notice of deficiency."

To this end, § 6512(b)(3)(B) directs the Tax Court's attention to § 6511(b)(2), which in turn instructs the court to apply either a 3-year or a 2-year look-back period. See §§ 6511(b)(2)(A) and (B) (incorporating by reference § 6511(a)); see *supra*, at 5. To decide which of these look-back periods to apply, the Tax Court must consult the filing provisions of § 6511(a) and ask whether the claim described by § 6512(b)(3)(B)—a claim filed "on the date of the mailing of the notice of deficiency"—would be filed "within 3 years from the time the return was filed." See § 6511(b)(2)(A) (incorporating by reference § 6511(a)). If a claim filed on the date of the mailing of the notice of deficiency would be filed within that 3-year period, then the look-back period is also three years and the Tax Court has jurisdiction to award a refund of any taxes paid within three years prior to the date of the mailing of the notice of deficiency. §§ 6511(b)(2)(A) and 6512(b)(3)(B). If the claim

[1] In relevant part, 26 U. S. C. § 6511 provides:

"(a) Period of limitation on filing claim

Claim for credit or refund of an overpayment of any tax imposed by this title in respect of which tax the taxpayer is required to file a return shall be filed by the taxpayer within 3 years from the time the return was filed or 2 years from the time the tax was paid, whichever of such periods expires the later, or if no return was filed by the taxpayer, within 2 years from the time the tax was paid. Claim for credit or refund of an overpayment of any tax imposed by this title which is required to be paid by means of a stamp shall be filed by the taxpayer within 3 years from the time the tax was paid.

"(b) Limitation on allowance of credits and refunds

"(1) Filing of claim within prescribed period

No credit or refund shall be allowed or made after the expiration of the period of limitation prescribed in subsection (a) for the filing of a claim for credit or refund, unless a claim for credit or refund is filed by the taxpayer within such period.

"(2) Limit on amount of credit or refund

"(A) Limit where claim filed within 3-year period

If the claim was filed by the taxpayer during the 3-year period prescribed in subsection (a), the amount of the credit or refund shall not exceed the portion of the tax paid within the period, immediately preceding the filing of the claim, equal to 3 years plus the period of any extension of time for filing the return. If the tax was required to be paid by means of a stamp, the amount of the credit or refund shall not exceed the portion of the tax paid within the 3 years immediately preceding the filing of the claim.

"(B) Limit where claim not filed within 3-year period

If the claim was not filed within such 3-year period, the amount of the credit or refund shall not exceed the portion of the tax paid during the 2 years immediately preceding the filing of the claim.

"(C) Limit if no claim filed

If no claim was filed, the credit or refund shall not exceed the amount which would be allowable under subparagraph (A) or (B), as the case may be, if claim was filed on the date the credit or refund is allowed."

[2] In relevant part, 26 U. S. C. § 6512(b) provides:

"(1) Jurisdiction to determine

Except as provided by paragraph (3) and by section 7463, if the Tax Court finds that there is no deficiency and further finds that the taxpayer has made an overpayment of income tax for the same taxable year ... in respect of which the Secretary determined the deficiency, or finds that there is a deficiency but that the taxpayer has made an overpayment of such tax, the Tax Court shall have jurisdiction to determine the amount of such overpayment, and such amount shall, when the decision of the Tax Court has become final, be credited or refunded to the taxpayer.

. . . . .

"(3) Limit on amount of credit or refund

No such credit or refund shall be allowed or made of any portion of the tax unless the Tax Court determines as part of its decision that such portion was paid—

"(A) after the mailing of the notice of deficiency,

"(B) within the period which would be applicable under section 6511(b)(2), (c), or (d), if on the date of the mailing of the notice of deficiency a claim had been filed (whether or not filed) stating the grounds upon which the Tax Court finds that there is an overpayment, or

"(C) within the period which would be applicable under section 6511(b)(2), (c), or (d), in respect of any claim for refund filed within the applicable period specified in section 6511 and before the date of the mailing of the notice of deficiency"

"(i) which had not been disallowed before that date,

"(ii) which had been disallowed before that date and in respect of which a timely suit for refund could have been commenced as of that date, or

"(iii) in respect of which a suit for refund had been commenced before that date and within the period specified in section 6532."

would not be filed within that 3-year period, then the period for awarding a refund is only two years. §§ 6511(b)(2)(B) and 6512(b)(3)(B).

In this case, we must determine which of these two look-back periods to apply when the taxpayer fails to file a tax return when it is due, and the Commissioner mails the taxpayer a notice of deficiency before the taxpayer gets around to filing a late return. The Fourth Circuit held that a taxpayer in this situation is entitled to a 3-year look-back period if the taxpayer actually files a timely claim at some point in the litigation, see *infra*, at 10–11, and respondent offers additional reasons for applying a 3-year look-back period, see *infra*, at 13–17. We think the proper application of § 6512(b)(3)(B) instead requires that a 2-year look-back period be applied.

We reach this conclusion by following the instructions set out in § 6512(b)(3)(B). The operative question is whether a claim filed "on the date of the mailing of the notice of deficiency" would be filed "within 3 years from the time the return was filed." See *supra*, at 7; § 6512(b)(3)(B) (incorporating §§ 6511(b)(2) and 6511(a)). In the case of a taxpayer who does not file a return before the notice of deficiency is mailed, the claim described in § 6512(b)(3)(B) could not be filed "within 3 years from the time the return was filed." No return having been filed, there is no date from which to measure the 3-year filing period described in § 6511(a). Consequently, the claim contemplated in § 6512(b)(3)(B) would not be filed within the 3-year window described in § 6511(a), and the 3-year look-back period set out in § 6511(b)(2)(A) would not apply. The applicable look-back period is instead the default 2-year period described in § 6511(b)(2)(B), which is measured from the date of the mailing of the notice of deficiency, see § 6512(b)(3)(B). The taxpayer is entitled to a refund of any taxes paid within two years prior to the date of the mailing of the notice of deficiency.

Special rules might apply in some cases, see *e.g.*, § 6511(c) (extension of time by agreement); § 6511(d) (special limitations periods for designated items), but in the case where the taxpayer has filed a timely tax return and the IRS is claiming a deficiency in taxes from that return, the interplay of §§ 6512(b)(3)(B) and 6511(b)(2) generally ensures that the taxpayer can obtain a refund of any taxes against which the IRS is asserting a deficiency. In most cases, the notice of deficiency must be mailed within three years from the date the tax return is filed. See 26 U. S. C. §§ 6501(a) and 6503(a)(1); *Badaracco* v. *Commissioner*, 464 U. S. 386, 389, 392 (1984). Therefore, if the taxpayer has already filed a return (albeit perhaps a faulty one), any claim filed "on the date of the mailing of the notice of deficiency" would necessarily be filed within three years from the date the return is filed. In these circumstances, the applicable look-back period under § 6512(b)(3)(B) would be the 3-year period defined in § 6511(b)(2)(A), and the Tax Court would have jurisdiction to award a refund.

Therefore, in the case of a taxpayer who files a timely tax return, § 6512(b)(3)(B) usually operates to toll the filing period that might otherwise deprive the taxpayer of the opportunity to seek a refund. If a taxpayer contesting the accuracy of a previously filed tax return in Tax Court discovers for the first time during the course of litigation that he is entitled to a refund, the taxpayer can obtain a refund from the Tax Court without first filing a timely claim for refund with the IRS. It does not matter, as it would in district court, see § 7422 (incorporating §§ 6511), that the taxpayer has discovered the entitlement to a refund well after the period for filing a timely refund claim with the IRS has passed, because § 6512(b)(3)(B) applies "whether or not [a claim is] filed," and the look-back period is measured from the date of the mailing of the notice of deficiency. *Ibid.* Nor does it matter, as it might in a refund suit, see 26 CFR § 301.6402–2(b)(1) (1995), whether the taxpayer has previously apprised the IRS of the precise basis for the refund claim, because 26 U. S. C. § 6512(b)(3)(B) posits the filing of a hypothetical claim "stating the grounds upon which the Tax Court finds that there is an overpayment," § 6512(b)(3)(B).

Section 6512(b)(3)(B) treats delinquent filers of income tax returns less charitably. Whereas timely filers are virtually assured the opportunity to seek a refund in the event they are drawn into Tax Court litigation, a delinquent filer's entitlement to a refund in Tax Court depends on the date of the mailing of the notice of deficiency. Section 6512(b)(3)(B) tolls the limitations period, in that it directs the Tax Court to measure the look-back period from the date on which the notice of deficiency is mailed and not the date on which the taxpayer actually files a claim for refund. But in the case of delinquent filers, § 6512(b)(3)(B) establishes only a 2-year look-back period, so the delinquent filer is not assured the opportunity to seek a refund in Tax Court: If the notice of deficiency is mailed more than two years after the taxes were paid, the Tax Court lacks jurisdiction to award the taxpayer a refund.

The Tax Court properly applied this 2-year look-back period to Lundy's case. As of September 26, 1990 (the date the notice was mailed), Lundy had not filed a tax return. Consequently, a claim filed on that date would not be filed within the 3-year period described in § 6511(a), and the 2-year period from § 6511(b)(2)(B) applies. Lundy's taxes were withheld from his wages, so they are deemed paid on the date his 1987 tax return was due (April 15, 1988), see 26 U. S. C. § 6513(b)(1), which is more than two years prior to the date the notice of deficiency was mailed (September 26, 1990). Lundy is therefore seeking a refund of taxes paid outside the applicable look-back period, and the Tax Court lacks jurisdiction to award such a refund.

III

In deciding Lundy's case, the Fourth Circuit adopted a different approach to interpreting § 6512(b)(3)(B) and applied a 3-year look-back period. Respondent supports the Fourth Circuit's rationale, but also offers an argument for applying a uniform 3-year look-back period under § 6512(b)(3)(B). We find neither position persuasive. p1The Fourth Circuit held that:

> "[T]he Tax Court, when applying the limitation provision of § 6511(b)(2) in light of § 6512(b)(3)(B), should substitute the date of the mailing of the notice of deficiency for the date on which the taxpayer filed the claim for refund, but only for the purpose of determining the benchmark date for measuring the limitation period and not for the purpose of determining whether the two-year or three-year limitation period applies." 45 F. 3d, at 861.

In other words, the Fourth Circuit held that the look-back period is *measured* from the date of the mailing of the notice of deficiency (*i.e.*, the taxpayer is entitled to a refund of any taxes paid within either two or three years prior to that date), but that that date is irrelevant

in calculating the *length* of the look-back period itself. The look-back period, the Fourth Circuit held, must be defined in terms of the date that the taxpayer *actually filed* a claim for refund. *Ibid.* ("[T]he three-year limitation period applies because Lundy filed his claim for refund ... within three years of filing his tax return"). Thus, under the Fourth Circuit's view, Lundy was entitled to a 3-year look-back period because Lundy's late-filed 1987 tax return contained a claim for refund, and that claim was filed within three years from the filing of the return. *Ibid.* (taxpayer entitled to same look-back period that would apply in district court).

Contrary to the Fourth Circuit's interpretation, the fact that Lundy actually filed a claim for a refund after the date on which the Commissioner mailed the notice of deficiency has no bearing in determining whether the Tax Court has jurisdiction to award Lundy a refund. See *supra*, at 6. Once a taxpayer files a petition with the Tax Court, the Tax Court has exclusive jurisdiction to determine the existence of a deficiency or to award a refund, see 26 U. S. C. § 6512(a), and the Tax Court's jurisdiction to award a refund is limited to those circumstances delineated in § 6512(b)(3). Section 6512(b)(3)(C) is the only provision that measures the look-back period based on a refund claim that is actually filed by the taxpayer, and that provision is inapplicable here because it only applies to refund claims filed "before the date of the mailing of the notice of deficiency." § 6512(b)(3)(C). Under § 6512(b)(3)-(B), which is the provision that does apply, the Tax Court is instructed to consider only the timeliness of a claim filed "on the date of the mailing of the notice of deficiency," not the timeliness of any claim that the taxpayer might actually file.

The Fourth Circuit's rule also leads to a result that Congress could not have intended, in that it subjects the timely, not the delinquent, filer to a shorter limitations period in Tax Court. Under the Fourth Circuit's rule, the availability of a refund turns entirely on whether the taxpayer has in fact filed a claim for refund with the IRS, because it is the date of *actual filing* that determines the applicable look-back period under § 6511(b)(2) (and, by incorporation, § 6512(b)(3)(B)). See 45 F. 3d, at 861; see *supra*, at 11. This rule might "eliminate[] the inequities resulting" from adhering to the 2-year look-back period, 45 F. 3d, at 863, but it creates an even greater inequity in the case of a taxpayer who dutifully files a tax return when it is due, but does not initially claim a refund. We think our interpretation of the statute achieves an appropriate and reasonable result in this case: The taxpayer who files a timely income tax return could obtain a refund in the Tax Court under § 6512(b)(3)(B), without regard to whether the taxpayer has actually filed a timely claim for refund. See *supra*, at 8–9.

If it is the actual filing of a refund claim that determines the length of the look-back period, as the Fourth Circuit held, the filer of a timely income tax return might be out of luck. If the taxpayer does not file a claim for refund with his tax return, and the notice of deficiency arrives shortly before the 3-year period for filing a timely claim expires, see 26 U. S. C. §§ 6511(a) and (b)(1), the taxpayer might not discover his entitlement to a refund until well after the commencement of litigation in the Tax Court. But having filed a timely return, the taxpayer would be precluded by the passage of time from filing an actual claim for refund "within 3 years from the time the return was filed," as § 6511(b)(2)(A) requires. § 6511(b)(2)-(A) (incorporating by reference § 6511(a)). The taxpayer would therefore be entitled only to a refund of taxes paid within two years prior to the mailing of the notice of deficiency. See § 6511(b)(2)(B); 45 F. 3d, at 861–862 (taxpayer entitled to same look-back period as would apply in district court, and look-back period is determined based on date of actual filing). It is unlikely that Congress intended for a taxpayer in Tax Court to be worse off for having filed a timely return, but that result would be compelled under the Fourth Circuit's approach.

Lundy offers an alternative reading of the statute that avoids this unreasonable result, but Lundy's approach is similarly defective. The main thrust of Lundy's argument is that the "claim" contemplated in § 6512(b)(3)(B) could be filed "within 3 years from the time the return was filed," such that the applicable look-back period under § 6512(b)(3)(B) would be three years, if the claim were itself filed on a tax return. Lundy in fact argues that Congress must have intended the claim described in § 6512(b)(3)(B) to be a claim filed on a return, because there is no other way to file a claim for refund with the IRS. Brief for Respondent 28, 30 (citing 26 CFR § 301.6402–3(a)(1) (1995). Lundy therefore argues that § 6512(b)(3)(B) incorporates a uniform 3-year look-back period for Tax Court cases: If the taxpayer files a timely return, the notice of deficiency (and the "claim" under § 6512(b)(3)-(B)) will necessarily be filed within three years of the return and the look-back period is three years; if the taxpayer does not file a return, then the claim contemplated in § 6512(b)(3)(B) is deemed to be a claim filed with, and thus within three years of, a return and the look-back period is again three years. Like the Fourth Circuit's approach, Lundy's reading of the statute has the convenient effect of ensuring that taxpayers in Lundy's position can almost always obtain a refund if they file in Tax Court, but we are bound by the terms Congress chose to use when it drafted the statute, and we do not think that the term "claim" as it is used in § 6512(b)(3)(B) is susceptible of the interpretation Lundy has given it. The Internal Revenue Code does not define the term "claim for refund" as it is used in § 6512(b)(3)(B), cf. 26 U.S.C. § 6696(e)(2) ("For purposes of section 6694 and 6695 ... [t]he term 'claim for refund' means a claim for refund of, or credit against, any tax imposed by subtitle A"), but it is apparent from the language of § 6512(b)(3)(B) and the statute as a whole that a claim for refund can be filed separately from a return. Section 6512(b)(3)(B) provides that the Tax Court has jurisdiction to award a refund to the extent the taxpayer would be entitled to a refund "if on the date of the mailing of the notice of deficiency *a claim* had been filed." (Emphasis added.) It does not state, as Lundy would have it, that a taxpayer is entitled to a refund if on that date "a claim and a return had been filed."

Perhaps the most compelling evidence that Congress did not intend the term "claim" in § 6512 to mean a "claim filed on a return" is the parallel use of the term "claim" in § 6511(a). Section 6511(a) indicates that a claim for refund is timely if it is "filed by the taxpayer within 3 years from the time the return was filed," and it plainly contemplates that a claim can be filed even "if no return was filed." 26 U.S.C. § 6511(a). If a claim could *only* be filed with a return, as Lundy contends, these provisions of the statute would be senseless, cf. 26 U. S. C. § 6696 (separately defining "claim for refund" and "return"), and we have been given no reason to believe that Congress meant

the term "claim" to mean one thing in § 6511 but to mean something else altogether in the very next section of the statute. The interrelationship and close proximity of these provisions of the statute "presents a classic case for application of the 'normal rule of statutory construction that identical words used in different parts of the same act are intended to have the same meaning.'" *Sullivan* v. *Stroop*, 496 U. S. 478, 484 (1990) (quoting *Sorenson* v. *Secretary of Treasury*, 475 U. S. 851, 860 (1986) (internal quotation marks omitted).

The regulation Lundy cites in support of his interpretation, 26 CFR § 301.6402–3(a)(1) (1995), is consistent with our interpretation of the statute. That regulation states only that a claim must "[i]n general" be filed on a return, *ibid.*, inviting the obvious conclusion that there are some circumstances in which a claim and a return can be filed separately. We have previously recognized that even a claim that does not comply with federal regulations might suffice to toll the limitations periods under the Tax Code, see, *e.g.*, *United States* v. *Kales*, 314 U. S. 186, 194 (1941) ("notice fairly advising the Commissioner of the nature of the taxpayer's claim" tolls the limitations period, even if "it does not comply with formal requirements of the statute and regulations"), and we must assume that if Congress had intended to require that the "claim" described in § 6512(b)(3)(B) be a "claim filed on a return," it would have said so explicitly.

IV

Lundy offers two policy-based arguments for applying a 3-year look-back period under § 6512(b)(3)(B). He argues that the application of a 2-year period is contrary to Congress' broad intent in drafting § 6512(b)(3)(B), which was to preserve, not defeat, a taxpayer's claim to a refund in Tax Court, and he claims that our interpretation creates an incongruity between the limitations period that applies in Tax Court litigation and the period that would apply in a refund suit filed in district court or the Court of Federal Claims. Even if we were inclined to depart from the plain language of the statute, we would find neither of these arguments persuasive.

Lundy correctly argues that Congress intended § 6512(b)(3)(B) to permit taxpayers to seek a refund in Tax Court in circumstances in which they might otherwise be barred from filing an administrative claim for refund with the IRS. This is in fact the way § 6512(b)(3)(B) operates in a large number of cases. See *supra*, at 8–9. But that does not mean that Congress intended that § 6512(b)(3)(B) would always preserve taxpayers' ability to seek a refund. Indeed, it is apparent from the face of the statute that Congress also intended § 6512(b)(3)(B) to act sometimes as a bar to recovery. To this end, the section incorporates *both* the 2-year and the 3-year look-back periods from § 6511(b)(2), and we must assume (contrary to Lundy's reading, which provides a uniform 3-year period, see *supra*, at 13–14) that Congress intended for both those look-back periods to have some effect. Cf. *Badaracco*, 464 U. S., at 405 (Stevens, J., dissenting) ("Whatever the correct standard for construing a statute of limitations ... surely the presumption ought to be that some limitations period is applicable"). (Emphasis deleted.)

Lundy also suggests that our interpretation of the statute creates a disparity between the limitations period that applies in Tax Court and the periods that apply in refund suits filed in district court or the Court of Federal Claims. In this regard, Lundy argues that the claim for refund he filed with his tax return on December 28 would have been timely for purposes of district court litigation because it was filed "within three years from the time the return was filed," § 6511(b)(1) (incorporating by reference § 6511(a)); see also Rev. Rul. 76–511, 1976–2 Cum. Bull. 428, and within the 3-year look-back period that would apply under § 6511(b)(2)(A). Petitioner disagrees that there is any disparity, arguing that Lundy's interpretation of the statute is wrong and that Lundy's claim for refund would not have been considered timely in district court. See Brief for Petitioner 12, 29–30 and n. 11 (citing *Miller* v. *United States*, 38 F. 3d 473, 475 (1994)).

We assume without deciding that Lundy is correct, and that a different limitations period would apply in district court, but nonetheless find in this disparity no excuse to change the limitations scheme that Congress has crafted. The rules governing litigation in Tax Court differ in many ways from the rules governing litigation in the district court and the Court of Federal Claims. Some of these differences might make the Tax Court a more favorable forum, while others may not. Compare 26 U. S. C. § 6213(a) (taxpayer can seek relief in Tax Court without first paying an assessment of taxes) with *Flora* v. *United States*, 362 U.S. 145, 177 (1960) (28 U.S.C. § 1346(a)(1) requires full payment of the tax assessment before taxpayer can file a refund suit in district court); and compare 26 U.S.C. § 6512(b)(3)(B) (Tax Court must assume that the taxpayer has filed a claim "stating the grounds upon which the Tax Court" intends to award a refund) with 26 CFR § 301.6402–2(b)(1) (1995) (claim for refund in district court must state grounds for refund with specificity). To the extent our interpretation of § 6512(b)(3)(B) reveals a further distinction between the rules that apply in these fora, it is a distinction compelled by the statutory language, and it is a distinction Congress could rationally make. As our discussion of § 6512(b)(3)(B) demonstrates, see *supra*, at 8–9, all a taxpayer need do to preserve the ability to seek a refund in the Tax Court is comply with the law and file a timely return.

We are bound by the language of the statute as it is written, and even if the rule Lundy advocates might "accor[d] with good policy," we are not at liberty "to rewrite [the] statute because [we] might deem its effects susceptible of improvement." *Badaracco*, 464 U. S., at 398. Applying § 6512(b)(3)(B) as Congress drafted it, we find that the applicable look-back period in this case is two years, measured from the date of the mailing of the notice of deficiency. Accordingly, we find that the Tax Court lacked jurisdiction to award Lundy a refund of his overwithheld taxes. The judgment is reversed.

It is so ordered.

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.

Uniform tables for computing interest using the daily compounding rules. See Rev. Proc. 95–17, 1995–1, C.B. *556.*

Subchapter B.—Interest on Overpayments

Section 6611.—Interest on Overpayments

26 CFR 301.6611–1: Interest on overpayments.

Uniform tables for computing interest using the daily compounding rules. See Rev. Proc. 95–17, 1995–1, C.B. *556.*

Subchapter C.—Determination of Interest Rate, Compounding of Interest

Section 6621.— Determination of Rate of Interest

26 CFR 301.6621–1: Interest rate.

Uniform tables for computing interest using the daily compounding rules. See Rev. Proc. 95–17, 1995–1, C.B. *556.*

26 CFR 301.6621–1: Interest rate.

Interest rates; underpayments and overpayments. The rate of interest determined under section 6621 of the Code for the calendar quarter beginning October 1, 1996, will be 8 percent for overpayments, 9 percent for underpayments, and 11 percent for large corporate underpayments. The rate of interest paid on the portion of a corporation overpayment exceeding $10,000 is 6.5 percent.

Rev. Rul. 96–44

Section 6621 of the Internal Revenue Code establishes different rates for interest on tax overpayments and interest on tax underpayments. Under § 6621(a)(1), the overpayment rate is the sum of the federal short-term rate plus 2 percentage points, except the rate for the portion of a corporate overpayment of tax exceeding $10,000 for a taxable period is the sum of the federal short-term rate plus 0.5 of a percentage point for interest computations made after December 31, 1994. Under § 6621(a)-(2), the underpayment rate is the sum of the federal short-term rate plus 3 percentage points.

Section 6621(c) provides that for purposes of interest payable under § 6601 on any large corporate underpayment, the underpayment rate under § 6621(a)(2) is determined by substituting "5 percentage points" for "3 percentage points." See § 6621(c) and § 301.6621–3 of the Regulations on Procedure and Administration for the definition of a large corporate underpayment and for the rules for determining the applicable rate. Section 6621(c) and § 301.6621–3 are generally effective for periods after December 31, 1990.

Section 6621(b)(1) provides that the Secretary will determine the federal short-term rate for the first month in each calendar quarter.

Section 6621(b)(2)(A) provides that the federal short-term rate determined under § 6621(b)(1) for any month applies during the first calendar quarter beginning after such month.

Section 6621(b)(3) provides that the federal short-term rate for any month is the federal short-term rate determined during such month by the Secretary in accordance with § 1274(d), rounded to the nearest full percent (or, if a multiple of 1/2 of 1 percent, the rate is increased to the next highest full percent).

Notice 88–59, 1988–1 C.B. 546, announced that in determining the quarterly interest rates to be used for overpayments and underpayments of tax under § 6621, the Internal Revenue Service will use the federal short-term rate based on daily compounding because that rate is most consistent with § 6621 which, pursuant to § 6622, is subject to daily compounding.

Rounded to the nearest full percent, the federal short-term rate based on daily compounding determined during the month of July 1996 is 6 percent. Accordingly, an overpayment rate of 8 percent and an underpayment rate of 9 percent are established for the calendar quarter beginning October 1, 1996. The overpayment rate for the portion of corporate overpayments exceeding $10,000 for the calendar quarter beginning October 1, 1996, is 6.5 percent. The underpayment rate for large corporate underpayments for the calendar quarter beginning October 1, 1996, is 11 percent. These rates apply to amounts bearing interest during that calendar quarter.

Interest factors for daily compound interest for annual rates of 6.5 percent, 8 percent, 9 percent, and 11 percent are published in Tables 66, 69, 71, and 75 of Rev. Proc. 95–17, 1995–1 C.B. 556, 620, 623, 625, and 629.

Annual interest rates to be compounded daily pursuant to § 6622 that apply for prior periods are set forth in the accompanying tables.

TABLE OF INTEREST RATES

PERIODS BEFORE JUL. 1, 1975–PERIODS ENDING DEC. 31, 1986

OVERPAYMENTS AND UNDERPAYMENTS

PERIOD	RATE	DAILY RATE TABLE IN 1995–1 C.B.
Before Jul. 1, 1975	6%	Table 2, pg. 557
Jul. 1, 1975—Jan. 31, 1976	9%	Table 4, pg. 559
Feb. 1, 1976—Jan. 31, 1978	7%	Table 3, pg. 558
Feb. 1, 1978—Jan. 31, 1980	6%	Table 2, pg. 557
Feb. 1, 1980—Jan. 31, 1982	12%	Table 5, pg. 560
Feb. 1, 1982—Dec. 31, 1982	20%	Table 6, pg. 560
Jan. 1, 1983—Jun. 30, 1983	16%	Table 37, pg. 591
Jul. 1, 1983—Dec. 31, 1983	11%	Table 27, pg. 581
Jan. 1, 1984—Jun. 30, 1984	11%	Table 75, pg. 629
Jul. 1, 1984—Dec. 31, 1984	11%	Table 75, pg. 629
Jan. 1, 1985—Jun. 30, 1985	13%	Table 31, pg. 585
Jul. 1, 1985—Dec. 31, 1985	11%	Table 27, pg. 581
Jan. 1, 1986—Jun. 30, 1986	10%	Table 25 pg. 579
Jul. 1, 1986—Dec. 31, 1986	9%	Table 23, pg. 577

TABLE OF INTEREST RATES

FROM JAN. 1, 1987–PRESENT

	OVERPAYMENTS			UNDERPAYMENTS		
	RATE TABLE PG 1995–1 C.B.			RATE TABLE PG 1995–1 C.B.		
Jan. 1, 1987—Mar. 31, 1987	8%	21	575	9%	23	577
Apr. 1, 1987—Jun. 30, 1987	8%	21	575	9%	23	577
Jul. 1, 1987—Sep. 30, 1987	8%	21	575	9%	23	577
Oct. 1, 1987—Dec. 31, 1987	9%	23	577	10%	25	579
Jan. 1, 1988—Mar. 31, 1988	10%	73	627	11%	75	629
Apr. 1, 1988—Jun. 30, 1988	9%	71	625	10%	73	627
Jul. 1, 1988—Sep. 30, 1988	9%	71	625	10%	73	627
Oct. 1, 1988—Dec. 31, 1988	10%	73	627	11%	75	629
Jan. 1, 1989—Mar. 31, 1989	10%	25	579	11%	27	581
Apr. 1, 1989—Jun. 30, 1989	11%	27	581	12%	29	583
Jul. 1, 1989—Sep. 30, 1989	11%	27	581	12%	29	583
Oct. 1, 1989—Dec. 31, 1989	10%	25	579	11%	27	581
Jan. 1, 1990—Mar. 31, 1990	10%	25	579	11%	27	581
Apr. 1, 1990—Jun. 30, 1990	10%	25	579	11%	27	581
Jul. 1, 1990—Sep. 30, 1990	10%	25	579	11%	27	581
Oct. 1, 1990—Dec. 31, 1990	10%	25	579	11%	27	581
Jan. 1, 1991—Mar. 31, 1991	10%	25	579	11%	27	581
Apr. 1, 1991—Jun. 30, 1991	9%	23	577	10%	25	579
Jul. 1, 1991—Sep. 30, 1991	9%	23	577	10%	25	579
Oct. 1, 1991—Dec. 31, 1991	9%	23	577	10%	25	579
Jan. 1, 1992—Mar. 31, 1992	8%	69	623	9%	71	625
Apr. 1, 1992—Jun. 30, 1992	7%	67	621	8%	69	623
Jul. 1, 1992—Sep. 30, 1992	7%	67	621	8%	69	623
Oct. 1, 1992—Dec. 31, 1992	6%	65	619	7%	67	621
Jan. 1, 1993—Mar. 31, 1993	6%	17	571	7%	19	573
Apr. 1, 1993—Jun. 30, 1993	6%	17	571	7%	19	573
Jul. 1, 1993—Sep. 30, 1993	6%	17	571	7%	19	573
Oct. 1, 1993—Dec. 31, 1993	6%	17	571	7%	19	573
Jan. 1, 1994—Mar. 31, 1994	6%	17	571	7%	19	573
Apr. 1, 1994—Jun. 30, 1994	6%	17	571	7%	19	573
Jul. 1, 1994—Sep. 30, 1994	7%	19	573	8%	21	575
Oct. 1, 1994—Dec. 31, 1994	8%	21	575	9%	23	577
Jan. 1, 1995—Mar. 31, 1995	8%	21	575	9%	23	577
Apr. 1, 1995—Jun. 30, 1995	9%	23	577	10%	25	579
Jul. 1, 1995—Sep. 30, 1995	8%	21	575	9%	23	577
Oct. 1, 1995—Dec. 31, 1995	8%	21	575	9%	23	577
Jan. 1, 1996—Mar. 31, 1996	8%	69	623	9%	71	625
Apr. 1, 1996—Jun. 30, 1996	7%	67	621	8%	69	623
Jul. 1, 1996—Sep. 30, 1996	8%	69	623	9%	71	625
Oct. 1, 1996—Dec. 31, 1996	8%	69	623	9%	71	625

TABLE OF INTEREST RATES FOR LARGE CORPORATE UNDERPAYMENTS

FROM JANUARY 1, 1991–PRESENT

		RATE TABLE PG 1995–1 C.B.	
Jan. 1, 1991—Mar. 31, 1991	13%	31	585
Apr. 1, 1991—Jun. 30, 1991	12%	29	583
Jul. 1, 1991—Sep. 30, 1991	12%	29	583
Oct. 1, 1991—Dec. 31, 1991	12%	29	583

TABLE OF INTEREST RATES FOR LARGE CORPORATE UNDERPAYMENTS—Continued

FROM JANUARY 1, 1991–PRESENT

		RATE TABLE PG 1995–1 C.B.	
Jan. 1, 1992—Mar. 31, 1992	11%	75	629
Apr. 1, 1992—Jun. 30, 1992	10%	73	627
Jul. 1, 1992—Sep. 30, 1992	10%	73	627
Oct. 1, 1992—Dec. 31, 1992	9%	71	625
Jan. 1, 1993—Mar. 31, 1993	9%	23	577
Apr. 1, 1993—Jun. 30, 1993	9%	23	577
Jul. 1, 1993—Sep. 30, 1993	9%	23	577
Oct. 1, 1993—Dec. 31, 1993	9%	23	577
Jan. 1, 1994—Mar. 31, 1994	9%	23	577
Apr. 1, 1994—Jun. 30, 1994	9%	23	577
Jul. 1, 1994—Sep. 30, 1994	10%	25	579
Oct. 1, 1994—Dec. 31, 1994	11%	27	581
Jan. 1, 1995—Mar. 31, 1995	11%	27	581
Apr. 1, 1995—Jun. 30, 1995	12%	29	583
Jul. 1, 1995—Sep. 30, 1995	11%	27	581
Oct. 1, 1995—Dec. 31, 1995	11%	27	581
Jan. 1, 1996—Mar. 31, 1996	11%	75	629
Apr. 1, 1996—Jun. 30, 1996	10%	73	627
Jul. 1, 1996—Sep. 30, 1996	11%	75	629
Oct. 1, 1996—Dec. 31, 1996	11%	75	629

TABLE OF INTEREST RATES FOR CORPORATE OVERPAYMENTS EXCEEDING $10,000

FROM JANUARY 1, 1995-PRESENT

		RATE TABLE PG 1995–1 C.B.	
Jan. 1, 1995—Mar. 31, 1995	6.5%	18	572
Apr. 1, 1995—Jun. 30, 1995	7.5%	20	574
Jul. 1, 1995—Sep. 30, 1995	6.5%	18	572
Oct. 1, 1995—Dec. 31, 1995	6.5%	18	572
Jan. 1, 1996—Mar. 31, 1996	6.5%	66	620
Apr. 1, 1996—Jun. 30, 1996	5.5%	64	618
Jul. 1, 1996—Sep. 30, 1996	6.5%	66	620
Oct. 1, 1996—Dec. 31, 1996	6.5%	66	620

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26 CFR 301.6621–1: Interest rate

Interest rates; underpayments and overpayments. The rate of interest determined under section 6621 of the Code for the calendar quarter beginning October 1, 1996, will be 8 percent for overpayments, 9 percent for underpayments, and 11 percent for large corporate underpayments. The rate of interest paid on the portion of a corporate overpayment exceeding $10,000 is 6.5 percent.

Rev. Rul. 96–61

Section 6621 of the Internal Revenue Code establishes different rates for interest on tax overpayments and interest on tax underpayments. Under § 6621(a)(1), the overpayment rate is the sum of the federal short-term rate plus 2 percentage points, except the rate for the portion of a corporate overpayment of tax exceeding $10,000 for a taxable period is the sum of the federal short-term rate plus 0.5 of a percentage point for interest computations made after December 31, 1994. Under § 6621(a)(2), the underpayment rate is the sum of the federal short-term rate plus 3 percentage points.

Section 6621(c) provides that for purposes of interest payable under § 6601 on any large corporate underpayment, the underpayment rate under § 6621(a)(2) is determined by substituting "5 percentage points" for "3 percentage points." See § 6621(c) and § 301.6621–3 of the Regulations on Procedure and Administration for the definition of a large corporate underpayment and for the rules for determining the applicable rate. Section 6621(c) and § 301.6621–3 are generally effective for periods after December 31, 1990.

Section 6621(b)(1) provides that the Secretary will determine the federal short-term rate for the first month in each calendar quarter.

Section 6621(b)(2)(A) provides that the federal short-term rate determined

under § 6621(b)(1) for any month applies during the first calendar quarter beginning after such month.

Section 6621(b)(2)(B) provides that in determining the addition to tax under § 6654 for failure to pay estimated tax for any taxable year, the federal short-term rate that applies during the third month following such taxable year also applies during the first 15 days of the fourth month following such taxable year.

Section 6621(b)(3) provides that the federal short-term rate for any month is the federal short-term rate determined during such month by the Secretary in accordance with § 1274(d), rounded to the nearest full percent (or, if a multiple of 1/2 of 1 percent, the rate is increased to the next highest full percent).

Notice 88–59, 1988–1 C.B. 546, announced that, in determining the quarterly interest rates to be used for overpayments and underpayments of tax under § 6621, the Internal Revenue Service will use the federal short-term rate based on daily compounding because that rate is most consistent with § 6621 which, pursuant to § 6622, is subject to daily compounding.

Rounded to the nearest full percent, the federal short-term rate based on daily compounding determined during the month of October 1996 is 6 percent. Accordingly, an overpayment rate of 8 percent and an underpayment rate of 9 percent are established for the calendar quarter beginning January 1, 1997. The overpayment rate for the portion of corporate overpayments exceeding $10,000 for the calendar quarter beginning January 1, 1997, is 6.5 percent. The underpayment rate for large corporate underpayments for the calendar quarter beginning January 1, 1997, is 11 percent. These rates apply to amounts bearing interest during that calendar quarter.

The 9 percent rate also applies to estimated tax underpayments for the first calendar quarter in 1997 and for the first 15 days in April 1997.

Interest factors for daily compound interest for annual rates of 6.5 percent, 8 percent, 9 percent, and 11 percent are published in Tables 18, 21, 23, and 27, of Rev. Proc. 95–17, 1995–1 C.B. 556, 572, 575, 577, and 581.

Annual interest rates to be compounded daily pursuant to § 6622 that apply for prior periods are set forth in the tables accompanying this revenue ruling.

TABLE OF INTEREST RATES

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OVERPAYMENTS AND UNDERPAYMENTS

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Jan. 1, 1988—Mar. 31, 1988	10%	73	627	11%	75	629
Apr. 1, 1988—Jun. 30, 1988	9%	71	625	10%	73	627
Jul. 1, 1988—Sep. 30, 1988	9%	71	625	10%	73	627
Oct. 1, 1988—Dec. 31, 1988	10%	73	627	11%	75	629
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Apr. 1, 1989—Jun. 30, 1989	11%	27	581	12%	29	583
Jul. 1, 1989—Sep. 30, 1989	11%	27	581	12%	29	583
Oct. 1, 1989—Dec. 31, 1989	10%	25	579	11%	27	581

TABLE OF INTEREST RATES—Continued

FROM JAN. 1, 1987—PRESENT

	OVERPAYMENTS			UNDERPAYMENTS		
	RATE	TABLE	PG 1995-1 C.B.	RATE	TABLE	PG 1995-1 C.B.
Jan. 1, 1990—Mar. 31, 1990	10%	25	579	11%	27	581
Apr. 1, 1990—Jun. 30, 1990	10%	25	579	11%	27	581
Jul. 1, 1990—Sep. 30, 1990	10%	25	579	11%	27	581
Oct. 1, 1990—Dec. 31, 1990	10%	25	579	11%	27	581
Jan. 1, 1991—Mar. 31, 1991	10%	25	579	11%	27	581
Apr. 1, 1991—Jun. 30, 1991	9%	23	577	10%	25	579
Jul. 1, 1991—Sep. 30, 1991	9%	23	577	10%	25	579
Oct. 1, 1991—Dec. 31, 1991	9%	23	577	10%	25	579
Jan. 1, 1992—Mar. 31, 1992	8%	69	623	9%	71	625
Apr. 1, 1992—Jun. 30, 1992	7%	67	621	8%	69	623
Jul. 1, 1992—Sep. 30, 1992	7%	67	621	8%	69	623
Oct. 1, 1992—Dec. 31, 1992	6%	65	619	7%	67	621
Jan. 1, 1993—Mar. 31, 1993	6%	17	571	7%	19	573
Apr. 1, 1993—Jun. 30, 1993	6%	17	571	7%	19	573
Jul. 1, 1993—Sep. 30, 1993	6%	17	571	7%	19	573
Oct. 1, 1993—Dec. 31, 1993	6%	17	571	7%	19	573
Jan. 1, 1994—Mar. 31, 1994	6%	17	571	7%	19	573
Apr. 1, 1994—Jun. 30, 1994	6%	17	571	7%	19	573
Jul. 1, 1994—Sep. 30, 1994	7%	19	573	8%	21	575
Oct. 1, 1994—Dec. 31, 1994	8%	21	575	9%	23	577
Jan. 1, 1995—Mar. 31, 1995	8%	21	575	9%	23	577
Apr. 1, 1995—Jun. 30, 1995	9%	23	577	10%	25	579
Jul. 1, 1995—Sep. 30, 1995	8%	21	575	9%	23	577
Oct. 1, 1995—Dec. 31, 1995	8%	21	575	9%	23	577
Jan. 1, 1996—Mar. 31, 1996	8%	69	623	9%	71	625
Apr. 1, 1996—Jun. 30, 1996	7%	67	621	8%	69	623
Jul. 1, 1996—Sep. 30, 1996	8%	69	623	9%	71	625
Oct. 1, 1996—Dec. 31, 1996	8%	69	623	9%	71	625
Jan. 1, 1997—Mar. 31, 1997	8%	21	575	9%	23	577

TABLE OF INTEREST RATES FOR
LARGE CORPORATE UNDERPAYMENTS

FROM JANUARY 1, 1991—PRESENT

		RATE TABLE 1995-1 C.B.	PG
Jan. 1, 1991—Mar. 31, 1991	13%	31	585
Apr. 1, 1991—Jun. 30, 1991	12%	29	583
Jul. 1, 1991—Sep. 30, 1991	12%	29	583
Oct. 1, 1991—Dec. 31, 1991	12%	29	583
Jan. 1, 1992—Mar. 31, 1992	11%	75	629
Apr. 1, 1992—Jun. 30, 1992	10%	73	627
Jul. 1, 1992—Sep. 30, 1992	10%	73	627
Oct. 1, 1992—Dec. 31, 1992	9%	71	625
Jan. 1, 1993—Mar. 31, 1993	9%	23	577
Apr. 1, 1993—Jun. 30, 1993	9%	23	577
Jul. 1, 1993—Sep. 30, 1993	9%	23	577
Oct. 1, 1993—Dec. 31, 1993	9%	23	577
Jan. 1, 1994—Mar. 31, 1994	9%	23	577
Apr. 1, 1994—Jun. 30, 1994	9%	23	577
Jul. 1, 1994—Sep. 30, 1994	10%	25	579
Oct. 1, 1994—Dec. 31, 1994	11%	27	581
Jan. 1, 1995—Mar. 31, 1995	11%	27	581

TABLE OF INTEREST RATES FOR
LARGE CORPORATE UNDERPAYMENTS—Continued

FROM JANUARY 1, 1991—PRESENT

		RATE TABLE 1995-1 C.B.	PG
Apr. 1, 1995—Jun. 30, 1995	12%	29	583
Jul. 1, 1995—Sep. 30, 1995	11%	27	581
Oct. 1, 1995—Dec. 31, 1995	11%	27	581
Jan. 1, 1996—Mar. 31, 1996	11%	75	629
Apr. 1, 1996—Jun. 30, 1996	10%	73	627
Jul. 1, 1996—Sep. 30, 1996	11%	75	629
Oct. 1, 1996—Dec. 31, 1996	11%	75	629
Jan. 1, 1997—Mar. 31, 1997	11%	27	581

TABLE OF INTEREST RATES FOR CORPORATE
OVERPAYMENTS EXCEEDING $10,000

FROM JANUARY 1, 1995—PRESENT

		RATE TABLE 1995-1 C.B.	PG
Jan. 1, 1995—Mar. 31, 1995	6.5%	18	572
Apr. 1, 1995—Jun. 30, 1995	7.5%	20	574
Jul. 1, 1995—Sep. 30, 1995	6.5%	18	572
Oct. 1, 1995—Dec. 31, 1995	6.5%	18	572
Jan. 1, 1996—Mar. 31, 1996	6.5%	66	620
Apr. 1, 1996—Jun. 30, 1996	5.5%	64	618
Jul. 1, 1996—Sep. 30, 1996	6.5%	66	620
Oct. 1, 1996—Dec. 31, 1996	6.5%	66	620
Jan, 1, 1997—Mar. 31, 1997	6.5%	18	572

Section 6622.—Interest Compounded Daily

26 CFR 301.6622-1: Interest compounded daily.

Uniform tables for computing interest using the daily compounding rules. See Rev. Proc. 95-17, 1995-1, C.B. 556.

Chapter 74.—Closing Agreements and Compromises

Section 7121.—Closing Agreements

If an issuer of state or local bonds has used the proceeds of those bonds to pay more than fair market value for nonpurpose investments deposited into an advance refunding escrow, what are the procedures that an issuer may follow to request a closing agreement pursuant to which the purchase of those investments alone will not be sufficient to cause §§ 103(b)(2) and 148 of the Internal Revenue Code to apply to those bonds? See Rev. Proc. 96-41, page 301.

Chapter 76.—Judicial Proceedings
Subchapter B.—Proceedings by Taxpayers and Third Parties

Section 7430.—Awarding of Costs and Certain Fees

The Service is providing an inflation adjustment for calendar year 1997 to the hourly limit on attorney fees that may be awarded in a judgment or settlement of an administrative or judicial proceeding concerning the determination, collection, or refund of tax, interest, or penalty. See Rev. Proc. 96-59, page 392.

Chapter 77.—Miscellaneous Provisions

Section 7503.—Time for Performance of Acts Where Last Day Falls on Saturday, Sunday, or Legal Holiday

26 CFR 301.7503-1: Time for performance of acts where last day falls on Saturday, Sunday, or legal holiday.

T.D. 8681

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 301

Time for Performance of Acts Where Last Day Falls on Saturday, Sunday, or Legal Holiday

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the time for performance of acts by taxpayers and by the Commissioner, a district director, or the director of a regional service center, when the last day for performance falls on a Saturday, Sunday, or legal holiday. In particular, these regulations replace the list of legal holidays with a citation

to the District of Columbia law that is the source of the list.

EFFECTIVE DATE: These regulations are effective Wednesday, August 14, 1996.

SUPPLEMENTARY INFORMATION:

Background

On September 25, 1995, the IRS published in the **Federal Register** (60 FR 49356) a notice of proposed rulemaking (IA–36–91 [1995–2 C.B. 470]) relating to the time for performance of acts when the last day for performance falls on a Saturday, Sunday, or legal holiday. When the last day for performance of an act by a taxpayer or an employee or administrator of the IRS falls on a Saturday, Sunday, or legal holiday, section 7503 of the Internal Revenue Code (Code) extends the time for performing the act. Under the extension, the act must be performed by the next day that is not a Saturday, Sunday, or legal holiday. The current regulations explain and supplement section 7503. This document contains final regulations that simplify and update the current regulations. In particular, the final regulations replace the list of holidays, which are determined by reference to the law in the District of Columbia, with a citation to that law.

The IRS received oral and written comments on the notice of proposed rulemaking. No public hearing was held or requested. After consideration of the comments, which are addressed below, the proposed regulations under section 7503 are adopted as published in the notice.

Explanation of Provisions and Summary of Comments

In response to the notice of proposed rulemaking for the regulations under section 7503, three categories of comments were received. First, there was some concern that replacing the list of legal holidays with a citation to the law in the District of Columbia would mean the list of holidays would no longer be accessible. It was suggested that the IRS annually publish the holidays by announcement or some other method. The final regulations do not retain the list of holidays because such a list requires regulatory revision whenever a change in the law occurs with respect to the holidays. However, a tax calendar that lists the legal holidays is annually made available through IRS Publication 509. This free publication can be obtained by calling the toll free telephone number 1–800–TAX–FORM (1–800–829–3676), or by contacting an IRS Forms Distribution Center.

Second, it was requested that the IRS address the impact of a federal government shutdown on the time for performance of acts when the last day for performance is a day when the government is closed. Section 7503 of the Code is limited to extending the time for performance of acts when the last day for performance falls on a Saturday, Sunday, or legal holiday. Therefore, the regulations for section 7503 are not appropriate for clarifying the effect of a federal government shutdown on the time allowed for performance of an act.

Third and last, it was requested that the regulations outline the kinds of acts to which the extension of time provided under section 7503 applies. The final regulations do not include this information. The purpose of the current regulatory project is to replace the list of holidays and revise other outdated material in the regulations. Outlining the kinds of acts to which section 7503 applies is not within the scope of the current project.

Special Analyses

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

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 301 is amended as follows:

PART 301—PROCEDURE AND ADMINISTRATION

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

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

Par. 2. Section 301.7503–1 is amended as follows:

1. In the fourth sentence of paragraph (a), the language "Thursday, November 22, 1956 (Thanksgiving Day), the suit will be timely if filed on Friday, November 23, 1956, in the Court of Claims" is removed and the language "Thursday, November 23, 1995 (Thanksgiving Day), the suit will be timely if filed on Friday, November 24, 1995, in the Court of Federal Claims" is added in its place.

2. Paragraph (b) is revised as set forth below.

3. Paragraph (c) is removed.

The revision reads as follows:

§ 301.7503–1 Time for performance of acts where last day falls on Saturday, Sunday, or legal holiday.

* * * * *

(b) *Legal holidays.* For the purpose of section 7503, the term *legal holiday* includes the legal holidays in the District of Columbia as found in D.C. Code Ann. 28–2701. In the case of any return, statement, or other document required to be filed, or any other act required under the authority of the internal revenue laws to be performed, at an office of the Internal Revenue Service, or any other office or agency of the United States, located outside the District of Columbia but within an internal revenue district, the term *legal holiday* includes, in addition to the legal holidays in the District of Columbia, any statewide legal holiday of the state where the act is required to be performed. If the act is performed in accordance with law at an office of the Internal Revenue Service or any other office or agency of the United States located in a territory or possession of the United States, the term *legal holiday* includes, in addition to the legal holidays in the District of Columbia, any legal holiday that is recognized throughout the territory or possession in which the office is located.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved June 20, 1996.

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

(Filed by the Office of the Federal Register on August 13, 1996, 8:45 a.m., and published in the issue of the Federal Register for August 14, 1996, 61 F.R. 42178)

Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1996. See Rev. Rul. 96–34, page 75.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1996. See Rev. Rul. 96–37, page 77.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1996. See Rev. Rul. 96–43, page 78.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1996. See Rev. Rul. 96–49, page 79.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1996. See Rev. Rul. 96–52, page 81.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1996. See Rev. Rul. 96–57, page 82.

Chapter 80.—General Rules

Subchapter A.—Application of Internal Revenue Laws

Section 7805.—Rules and Regulations

26 CFR 301.7805–1: Rules and regulations.

Are amounts received in satisfaction of a claim for denial of a promotion due to disparate treatment employment discrimination under Title VII of the Civil Rights Act of 1964, as amended in 1991, excludable from gross income under § 104(a)(2)? The holding will not apply adversely to damages received under any provision of law providing tort or tort type remedies for employment discrimination on the basis of race, color, religion, gender, national origin, or other similar classifications, if the damages are received (1) on or before June 14, 1995, the date that *Schleier* was decided by the Supreme Court, or (2) pursuant to a written binding agreement, court decree, or mediation award in effect on (or issued on or before) June 14, 1995. See Rev. Rul. 96–65, page 6.

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26 CFR 301.9100–1T: Extensions of time to make elections (temporary).

T.D. 8680

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 301 and 602

Extensions of Time to Make Elections

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations concerning extensions of time for making certain elections under the Internal Revenue Code (Code). The regulations provide the standards that the Commissioner will use to grant taxpayers extensions of time for making these elections. The text of these temporary regulations also serves as the text of the proposed regulations set forth in IA–29–96 on page 483.

DATES: These regulations are effective June 27, 1996.

For dates of applicability, see § 301.9100–1T(h) of these regulations.

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 collection of information contained in these regulations has been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget under control number 1545–1488. Responses to this collection of information are required to obtain an extension of time for making an election.

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

For further information concerning this collection of information, where to submit comments on the collection of information and the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble to IA–29–96 on page 483.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains temporary regulations amending the Regulations on Procedure and Administration (26 CFR part 301) concerning extensions of time for making certain elections. The regulations provide the standards that the Commissioner will use to grant taxpayers extensions of time for making these elections. These standards provide relief to taxpayers who reasonably and in good faith fail to make a timely election when granting relief will not prejudice the interests of the government. The regulations provide a means by which taxpayers can be in the same position they would have been in had they made their elections in a timely fashion.

Explanation of Provisions

These temporary regulations provide the standards the Commissioner will use to determine whether to grant an extension of time to make an election when the deadline for making the election is prescribed by regulation, revenue ruling, revenue procedure, notice, or announcement published in the Federal Register or the Internal Revenue Bulletin (regulatory election). Under section 6081(a), these regulations also provide an automatic extension of time to make an election when the deadline for making the election is prescribed by statute (statutory election) and the deadline for making the election is the due date of the return or the due date of the return including extensions. These regulations adopt and revise the standards for relief provided in Rev. Proc. 92–85, 1992–2 C.B. 490.

Automatic Extensions

Rev. Proc. 92–85 provides an automatic 12-month extension for certain regulatory elections listed in Appendix A of that revenue procedure. The temporary regulations continue the automatic 12-month extension and update the list of eligible regulatory elections.

Rev. Proc. 92–85 also provides an automatic 6-month extension for statutory elections when the deadline for making the election is prescribed as the due date of the return or the due date of the return including extensions. The temporary regulations expand the automatic 6-month extension to include regulatory elections.

Other Extensions

Rev. Proc. 92–85 provides relief for certain regulatory elections that do not qualify for relief under the automatic extensions. Rev. Proc. 92–85 requires a taxpayer to demonstrate that (1) it acted reasonably and in good faith and (2) granting relief will not prejudice the

interests of the government. The temporary regulations continue to provide extensions for such regulatory elections upon a showing of reasonable action and good faith and no prejudice to the interests of the government.

The temporary regulations adopt the standards for reasonable action and good faith in Rev. Proc. 92–85. The regulations provide that a taxpayer is deemed to have acted reasonably and in good faith if: (1) the taxpayer applies for relief before the failure to make the regulatory election is discovered by the IRS; (2) the taxpayer inadvertently failed to make the election because of intervening events beyond its control; (3) the taxpayer failed to make the election because after exercising reasonable diligence the taxpayer was unaware of the necessity for the election; (4) the taxpayer reasonably relied on written advice of the IRS; or (5) the taxpayer relied on a qualified tax professional, including a professional employed by the taxpayer, and the professional failed to make or advise the taxpayer to make the election. However, a taxpayer is deemed to have not acted reasonably and in good faith if: (1) the taxpayer is requesting relief for an election to alter a return position for which an accuracy-related penalty could have been imposed under section 6662; (2) the taxpayer was fully informed of the required election and related tax consequences and chose not to file the election; or (3) the taxpayer uses hindsight in requesting relief.

The temporary regulations adopt the standards for prejudice to the interests of the government in Rev. Proc. 92–85. The regulations provide that the interests of the government are deemed to be prejudiced if granting relief would result in a taxpayer having a lower tax liability than the taxpayer would have had if the regulatory election had been timely made. In addition, the interests of the government are ordinarily deemed to be prejudiced if the tax year in which the election should have been made or any affected tax years are closed by the statute of limitations.

Accounting Method and Period Elections

Rev. Proc. 92–85 provides limited relief (ordinarily not to exceed 90 days from the deadline for filing Form 3115, Application for Change in Accounting Method) for requests to change an accounting method subject to the procedure described in § 1.446–1(e)(3)(i) (requiring the advance written consent of the Commissioner). The temporary regulations continue this limited relief. Rev. Proc. 92–85 provides an automatic 12-month extension for the election to use the last-in, first-out (LIFO) inventory method under section 472 and also provides relief for the section 472 election beyond the automatic 12-month extension. Rev. Proc. 92–85 is otherwise inapplicable to accounting method regulatory elections, except for three specific elections listed in Appendix B of that revenue procedure.

The temporary regulations provide relief for all accounting method regulatory elections. For example, relief will now be available for elections under sections 197 (amortization of goodwill and certain other intangibles) and 468A (special rules for nuclear decommissioning costs).

The temporary regulations provide additional rules regarding what constitutes prejudice to the interests of the government for accounting method regulatory elections. The temporary regulations provide that the interests of the government are deemed to be prejudiced except in unusual and compelling circumstances if: (1) the election requires an adjustment under section 481(a); (2) the taxpayer is under examination, requests relief to change from an impermissible method of accounting, and granting relief will provide the taxpayer a more favorable method of accounting or more favorable terms and conditions than the taxpayer would receive if the change is made as part of the examination; or (3) the election provides a more favorable method of accounting or more favorable terms and conditions if the election is made by a certain date or taxable year.

Rev. Proc. 92–85 provides an automatic 12-month extension for elections to use other than the required taxable year under section 444. Rev. Proc. 92–85 also provides limited relief (ordinarily not to exceed 90 days from the deadline for filing Form 1128, Application to Adopt, Change, or Retain a Tax Year) for accounting period regulatory elections subject to Rev. Proc. 87–32, 1987–2 C.B. 396. Rev. Proc. 92–85 is otherwise inapplicable to accounting period regulatory elections. The temporary regulations extend the limited relief for elections subject to Rev. Proc. 87–32 to all other accounting period regulatory elections except for the section 444 election, and provide relief for the section 444 election beyond the automatic 12-month extension.

Effect on other documents

Rev. Proc. 92–85, 1992–2 C.B. 490, as modified and clarified by Rev. Proc. 93–28, 1993–2 C.B. 344, is obsolete as of June 27, 1996.

Rev. Proc. 92–20, 1992–1 C.B. 685, is modified as of June 27, 1996, to the extent that the provisions of this regulation apply to applications for relief with respect to requests to change an accounting method subject to the procedures of Rev. Proc. 92–20.

Rev. Proc. 87–32, 1987–2 C.B. 396, is modified as of June 27, 1996, to the extent that the provisions of this regulation apply to applications for relief with respect to requests to change an accounting period subject to the procedures of Rev. Proc. 87–32.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy 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:

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 is amended by adding entries in numerical order to read as follows:

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

Section 301.9100–1T also issued under 26 U.S.C. 6081;
Section 301.9100–2T also issued under 26 U.S.C. 6081;
Section 301.9100–3T also issued under 26 U.S.C. 6081; * * *

Par. 2. Sections 301.9100–1T through 301.9100–3T are added to read as follows:

§ 301.9100–1T Extensions of time to make elections (temporary).

(a) - (c) [Reserved].

(d) *Introduction.* The regulations under this section and §§ 301.9100–2T through 301.9100–3T provide the standards the Commissioner will use to determine whether to grant an extension of time to make a regulatory election. The regulations under this section and §§ 301.9100–2T through 301.9100–3T also provide an automatic extension of time to make certain statutory elections. An extension of time is available for elections that a taxpayer is otherwise eligible to make and the granting of an extension of time is not a determination that the taxpayer is otherwise eligible to make the election. Section 301.9100–2T provides automatic extensions of time for making regulatory and statutory elections when the deadline for making the election is the due date of the return or the due date of the return including extensions. Section 301.9100–3T provides extensions of time for making regulatory elections that do not meet the requirements of § 301.9100–2T.

(e) *Terms.* The following terms have the meanings provided below:

Election includes an application for relief in respect of tax; a request to adopt, change, or retain an accounting method or accounting period; but does not include an application for an extension of time for filing a return under section 6081.

Regulatory election means an election whose deadline is prescribed by a regulation published in the Federal Register, or a revenue ruling, revenue procedure, notice, or announcement published in the Internal Revenue Bulletin.

Statutory election means an election whose deadline is prescribed by statute.

Taxpayer means any person within the meaning of section 7701(a)(1).

(f) *General standards for relief.* The Commissioner in the Commissioner's discretion may grant a reasonable extension of time to make a regulatory election, or a statutory election (but no more than 6 months except in the case of a taxpayer who is abroad), under all subtitles of the Internal Revenue Code except subtitles E, G, H, and I, provided the taxpayer demonstrates to the satisfaction of the Commissioner that—

(1) The taxpayer acted reasonably and in good faith; and

(2) Granting relief will not prejudice the interests of the government.

(g) *Exceptions.* Notwithstanding the provisions of paragraph (f) of this section, an extension of time will not be granted—

(1) For elections under section 4980A(f)(5);

(2) For elections required to be made prior to November 20, 1970, in the case of an election—

(i) Required to be made in or with the taxpayer's original income tax return;

(ii) Required to be exercised by filing a claim for credit or refund, unless the election is required to be exercised on or before a date that precedes the date of expiration of the period of limitations provided in section 6511;

(iii) Required to be filed in a petition to the Tax Court;

(iv) To change a previous election;

(v) To change an accounting method as described in §§ 1.77–1 of this chapter and 1.446–1 of this chapter;

(vi) To change an accounting period as described in § 1.442–1 of this chapter; or

(vii) To change the method of treating bad debts as described in § 1.166–1 of this chapter; or

(3) For elections that are expressly excepted from relief or where alternative relief is provided by a statute, a regulation published in the Federal Register, or a revenue ruling, revenue procedure, notice, or announcement published in the Internal Revenue Bulletin.

(h) *Effective dates.* In general, this section and §§ 301.9100–2T through 301.9100–3T are effective for all requests for relief being considered by the IRS on June 27, 1996, and for all requests for relief submitted on or after June 27, 1996. However, the automatic 12-month extension and the automatic 6-month extension provided in § 301.9100–2T are effective for elections whose due dates are on or after June 27, 1996.

§ 301.9100–2T Automatic extensions (temporary).

(a) *Automatic 12-month extension—* (1) *In general.* An automatic extension of 12 months from the original deadline for making a regulatory election is granted to make elections described in paragraph (a)(2) of this section provided the taxpayer takes corrective action as defined in paragraph (c) of this section within that 12-month extension period.

(2) *Elections eligible for automatic 12-month extension.* The following regulatory elections are eligible for the automatic 12-month extension described in paragraph (a)(1) of this section—

(i) The election to use other than the required taxable year under section 444;

(ii) The election to use the last-in, first-out (LIFO) inventory method under section 472;

(iii) The 15-month rule for filing an exemption application for a section 501(c)(9), 501(c)(17), or 501(c)(20) organization under section 505;

(iv) The 15-month rule for filing an exemption application for a section 501(c)(3) organization under section 508;

(v) The election to be treated as a homeowners association under section 528;

(vi) The election to adjust basis on partnership transfers and distributions under section 754;

(vii) The estate tax election to specially value qualified real property (where the IRS has not yet begun an examination of the filed return) under section 2032A(d)(1);

(viii) The chapter 14 gift tax election to treat a qualified payment right as other than a qualified payment under section 2701(c)(3)(C)(i); and

(ix) The chapter 14 gift tax election to treat any distribution right as a qualified payment under section 2701(c)(3)(C)(ii).

(b) *Automatic 6-month extension.* An automatic extension of 6 months from the due date of a return excluding extensions is granted to make regulatory or statutory elections whose deadlines are prescribed as the due date of the return or the due date of the return including extensions in the case of a taxpayer that timely filed its return for the year the election should have been made, provided the taxpayer takes corrective action as defined in paragraph (c) of this section within that 6-month extension period. This extension does not apply, however, to regulatory or statutory elections that must be made by the due date of the return excluding extensions.

(c) *Corrective action.* For purposes of this section, *corrective action* means filing an original or an amended return for the year the regulatory or statutory election should have been made and attaching the appropriate form or statement for making the election. For those

elections not required to be filed with a return, corrective action means taking the steps required to file the election in accordance with the statute, the regulation published in the Federal Register, or the revenue ruling, revenue procedure, notice, or announcement published in the Internal Revenue Bulletin. Taxpayers who make an election under an automatic extension (and all taxpayers whose tax liability would be affected by the election) must report their income in a manner that is consistent with the election and comply with all other requirements for making the election for the year the election should have been made and for all affected years; otherwise, the Service may invalidate the election.

(d) *Procedural requirements.* Any return, statement of election, or other form of filing that must be made to obtain an automatic extension must provide the following statement at the top of the document: "FILED PURSUANT TO § 301.9100–2T". Any filing made to obtain an automatic extension must be sent to the same address that the filing to make the election would have been sent had the filing been timely made. No request for a letter ruling is required to obtain an automatic extension. Accordingly, user fees do not apply to taxpayers taking corrective action to obtain an automatic extension.

(e) The following example illustrates the rules of this section:

Example. Taxpayer A fails to make a certain election when filing A's 1996 income tax return on March 17, 1997, the due date of the return. This election does not affect the tax liability of any other taxpayer. The applicable regulation requires that the election be made by attaching the appropriate form to a timely filed return including extensions. In accordance with paragraphs (b) and (c) of this section, A may make the regulatory election by filing an amended return with the appropriate form by September 15, 1997 (6 months from the March 17, 1997, due date).

§ 301.9100–3T Other extensions (temporary).

(a) *In general.* Requests for extensions of time for regulatory elections that do not meet the requirements of § 301.9100–2T must be made under the rules of this section. Requests for relief subject to this section will be granted when the taxpayer provides the evidence (including affidavits described in paragraph (e) of this section) to establish that the taxpayer acted reasonably and in good faith, and granting relief will not prejudice the interests of the government.

(b) *Reasonable action and good faith*—(1) *In general.* Except as provided in paragraphs (b)(3)(i) through (iii) of this section, a taxpayer is deemed to have acted reasonably and in good faith if the taxpayer—

(i) Requests relief under this section before the failure to make the regulatory election is discovered by the IRS;

(ii) Inadvertently failed to make the election because of intervening events beyond the taxpayer's control;

(iii) Failed to make the election because, after exercising reasonable diligence (taking into account the taxpayer's experience and the complexity of the return or issue), the taxpayer was unaware of the necessity for the election;

(iv) Reasonably relied on the written advice of the IRS; or

(v) Reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make, or advise the taxpayer to make, the election.

(2) *Reasonable reliance on a qualified tax professional.* For purposes of this paragraph (b), a taxpayer will not be considered to have reasonably relied on a qualified tax professional if the taxpayer knew or should have known that the professional was not—

(i) Competent to render advice on the regulatory election; or

(ii) Aware of all relevant facts.

(3) *Taxpayer deemed to have not acted reasonably or in good faith.* For purposes of this paragraph (b), a taxpayer is deemed to have not acted reasonably and in good faith if the taxpayer—

(i) Seeks to alter a return position for which an accuracy-related penalty has been or could be imposed under section 6662 at the time the taxpayer requests relief (taking into account any qualified amended return filed within the meaning of § 1.6664–2(c)(3)) of this chapter and the new position requires or permits a regulatory election for which relief is requested;

(ii) Was fully informed of the required election and related tax consequences, but chose not to file the election; or

(iii) Uses hindsight in requesting relief. If specific facts have changed since the original deadline for making the election that make the election advantageous to a taxpayer, the IRS will not ordinarily grant relief. In such a case, the IRS will grant relief only when the taxpayer provides strong proof that the taxpayer's decision to seek relief did not involve hindsight.

(c) *Prejudice to the interests of the government*—(1) *In general*—(i) *Lower tax liability.* The interests of the government are prejudiced if granting relief would result in a taxpayer having a lower tax liability in the aggregate for all years to which the regulatory election applies than the taxpayer would have had if the election had been timely made (taking into account the time value of money). Similarly, if the tax consequences of more than one taxpayer are affected by the election, the government's interests are prejudiced if extending the time for making the election may result in the affected taxpayers, in the aggregate, having a lower tax liability than if the election had been timely made.

(ii) *Closed years.* The interests of the government are ordinarily prejudiced if the tax year in which the regulatory election should have been made or any tax years that would have been affected by the election had it been timely made are closed by the period of limitations on assessment under section 6501(a) before the taxpayer's receipt of a ruling granting relief under this section. The IRS may condition a grant of relief on the taxpayer providing the IRS with a statement from an independent auditor (other than an auditor providing an affidavit pursuant to paragraph (e)(3) of this section) certifying that the requirements of paragraph (c)(1)(i) of this section are satisfied.

(2) *Special rules for accounting method regulatory elections.* The interests of the government are deemed to be prejudiced except in unusual and compelling circumstances if the accounting method regulatory election is—

(i) Subject to the procedure described in § 1.446–1(e)(3)(i) of this chapter (requiring the advance written consent of the Commissioner), and the request for relief under this section is filed more than 90 days after the deadline for filing the Form 3115, Application for Change in Accounting Method;

(ii) Not an election described in paragraph (c)(2)(i) of this section and requires an adjustment under section 481(a) (or would require an adjustment under section 481(a) if the taxpayer changed to the method of accounting for which relief is requested in a taxable year subsequent to the taxable year the election should have been made);

(iii) Not an election described in paragraph (c)(2)(i) of this section, the taxpayer is under examination and requests relief under this section to change from an impermissible method of accounting, and granting relief will provide the taxpayer a more favorable method of accounting or more favorable terms and conditions than the taxpayer would receive if the change from the impermissible method is made as part of the examination; or

(iv) Not an election described in paragraph (c)(2)(i) of this section and the election provides a more favorable method of accounting or more favorable terms and conditions if the election is made by a certain date or taxable year.

(3) *Special rules for accounting period regulatory elections.* The interests of the government are deemed to be prejudiced except in unusual and compelling circumstances if an election is an accounting period regulatory election (other than the election to use other than the required taxable year under section 444) and the request for relief is filed more than 90 days after the deadline for filing the Form 1128, Application to Adopt, Change, or Retain a Tax Year (or other required statement).

(d) *Effect of amended returns*—(1) *Second examination under section 7605(b).* Taxpayers requesting and receiving an extension of time under this section waive any objections to a second examination under section 7605(b) for the issue(s) that is the subject of the relief request and any correlative adjustments.

(2) *Suspension of the period of limitations under section 6501(a).* A request for relief under this section does not suspend the period of limitations on assessment under section 6501(a). Thus, for relief to be granted, the IRS may require the taxpayer to consent under section 6501(c)(4) to an extension of the period of limitations on assessment for the tax year in which the regulatory election should have been made and any tax years that would have been affected by the election had it been timely made.

(e) *Procedural requirements*—(1) *In general.* Requests for relief under this section must provide evidence that satisfies the requirements in paragraphs (b) and (c) of this section, and must provide additional information as required by this paragraph (e).

(2) *Affidavit and declaration from taxpayer.* The taxpayer, or the individual who acts on behalf of the taxpayer with respect to tax matters, must submit a detailed affidavit describing the events that led to the failure to make a valid regulatory election and to the discovery of the failure. When the taxpayer relied on a qualified tax professional for advice, the taxpayer's affidavit must describe the engagement and responsibilities of the professional as well as the extent to which the taxpayer relied on the professional. The affidavit must be accompanied by a dated declaration, signed by the taxpayer, which states: "Under penalties of perjury, I declare that, to the best of my knowledge and belief, the facts presented herein are true, correct, and complete." The individual who signs for an entity must have personal knowledge of the facts and circumstances at issue.

(3) *Affidavits and declarations from other parties.* The taxpayer must submit detailed affidavits from the individuals having knowledge or information about the events that led to the failure to make a valid regulatory election and to the discovery of the failure. These individuals must include the taxpayer's income tax return preparer, any individual (including an employee of the taxpayer) who made a substantial contribution to the preparation of the return, and any accountant or attorney, knowledgeable in tax matters, who advised the taxpayer with regard to the election. An affidavit must describe the engagement and responsibilities of the individual as well as the advice that the individual provided to the taxpayer. Each affidavit must include the name, current address, and taxpayer identification number of the individual, and be accompanied by a dated declaration, signed by the individual, which states: "Under penalties of perjury, I declare that, to the best of my knowledge and belief, the facts presented herein are true, correct, and complete."

(4) *Other Information.* The request for relief filed under this section must also contain the following information—

(i) The taxpayer must state whether the taxpayer's return(s) for the tax year in which the regulatory election should have been made or any tax years that would have been affected by the election had it been timely made is being examined by a district director, or is being considered by an appeals office or a federal court. The taxpayer must notify the IRS office considering the request for relief if the IRS starts an examination of any such return while the taxpayer's request for relief is pending;

(ii) The taxpayer must state when the applicable return, form, or statement used to make the election was required to be filed and when it was actually filed;

(iii) The taxpayer must submit a copy of any documents that refer to the election;

(iv) When requested, the taxpayer must submit a copy of the taxpayer's income tax return for any taxable year for which the taxpayer requests an extension and any return affected by the election; and

(v) When applicable, the taxpayer must submit a copy of the income tax returns of other taxpayers affected by the election.

(5) *Filing instructions.* A request for relief under this section is a request for a letter ruling. Requests for relief should be submitted in accordance with the applicable procedures for requests for a letter ruling and must be accompanied by the applicable user fee.

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

Example 1. Taxpayer discovers own error. Taxpayer A prepares A's 1996 income tax return. A is unaware that a particular regulatory election is available to report a transaction in a particular manner. A files the 1996 return without making the election and reporting the transaction in a different manner. In 1998, A hires a qualified tax professional to prepare A's 1998 return. The professional discovers that A did not make the election. A promptly files for relief in accordance with this section. Assuming paragraphs (b)(3)(i) through (iii) of this section do not apply, A is deemed to have acted reasonably and in good faith.

Example 2. Reliance on qualified tax professional. Taxpayer B hires a qualified tax professional to advise B on preparing B's 1996 income tax return and provides the professional with all the information requested. The professional fails to advise B that a regulatory election is necessary in order for B to report income on B's 1996 return in a particular manner. Nevertheless, B reports this income in a manner that is consistent with having made the election. In 1999, during the examination of the 1996 return by the IRS, the examining agent discovers that the election has not been filed. B promptly files for relief in accordance with this section, including attaching an affidavit from B's professional stating that the professional failed to advise B that the election was necessary. Assuming paragraphs (b)(3)(i) through (iii) of this section do not apply, B is deemed to have acted reasonably and in good faith.

Example 3. Accuracy-related penalty. Taxpayer C reports income on its 1996 income tax return in a manner that contravenes a statutory provision. C was aware of the statutory provision that prohibited the manner in which C reported this income, but did not provide adequate disclosure of the return position within the meaning of § 1.6662-3(c) of this chapter. In 1999, during the examination of the 1996 return, the IRS raises an issue regarding the reporting of this income on C's return. C requests relief under this section to elect

an alternative method of reporting the income. Under paragraph (b)(3)(i) of this section, C is deemed to have not acted reasonably and in good faith because C seeks to alter a return position for which an accuracy-related penalty could be imposed under section 6662.

Example 4. Election not requiring adjustment under section 481(a). Taxpayer D prepares D's 1996 income tax return. D is unaware that a particular accounting method regulatory election is available. D files the 1996 return using another method of accounting. In 1998, D hires a qualified tax professional to prepare D's 1998 return. The professional discovers that D did not make the election. D promptly files for relief in accordance with this section. Assume the applicable regulation provides that the election does not require an adjustment under section 481(a) and the election is not subject to the procedure described in § 1.446–1(e)(3)(i) of this chapter. Further assume that if D were granted an extension of time to make the election, D would pay no less tax than if the election had been timely made. Under paragraph (c) of this section, the interests of the government are not deemed to be prejudiced.

Example 5. Election requiring adjustment under section 481(a). The facts are the same as in *Example 4* of this paragraph (f) except that the applicable regulation provides that the election requires an adjustment under section 481(a). Under paragraph (c)(2)(ii) of this section, the interests of the government are deemed to be prejudiced except in unusual or compelling circumstances.

Example 6. Under examination. A regulation permits an automatic change from an impermissible method of accounting on a cut-off basis. Any change to this method made as part of an examination is made with a section 481(a) adjustment. Taxpayer E reports income on E's 1996 income tax return using the impermissible method of accounting. In 1999, during the examination of the 1996 return by the IRS, the examining agent questions the propriety of E's method of accounting. E requests relief under this section to make the change pursuant to the regulation for 1996. E will receive less favorable terms and conditions if the change in method of accounting is made with a section 481(a) adjustment by the examining agent than if the change is made on a cut-off basis pursuant to the regulation. Under paragraph (c)(2)(iii) of this section, the interests of the government are deemed to be prejudiced except in unusual and compelling circumstances.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

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

Authority: 26 U.S.C. 7805

Par. 4. Section 602.101(c) is amended by adding the following entries in numerical order to the table:

§ 602.101 OMB Control numbers

* * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
§ 301.9100–2T	1545–1488
§ 301.9100–3T	1545–1488
* * * * *	

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Donald C. Lubick,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on June 26, 1996, 8:45 a.m., and published in the issue of the Federal Register for June 27, 1996, 61 F.R. 33365)

Subchapter C.—Provisions Affecting More Than One Subtitle

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

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1996. See Rev. Rul. 96–34, page 75.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1996. See Rev. Rul. 96–37, page 77.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1996. See Rev. Rul. 96–43, page 78.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1996. See Rev. Rul. 96–49, page 79.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1996. See Rev. Rul. 96–52, page 81.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1996. See Rev. Rul. 96–57, page 82.

CPI adjustment for below-market loans for 1997. The amount that section 7872(g) of the Code permits a taxpayer to lend to a qualified continuing care facility without incurring imputed interest is published and adjusted for inflation for years 1987–1997. Rev. Rul. 96–5 supplemented and superseded.

Rev. Rul. 96–64

This revenue ruling publishes the amount that § 7872(g) of the Internal Revenue Code permits a taxpayer to lend to a qualifying continuing care facility without incurring imputed interest. The amount is adjusted for inflation for the years after 1986.

Section 7872 of the Code generally treats loans bearing a below-market interest rate as if they bore interest at the market rate.

Section 7872(g)(1) of the Code provides that, in general, § 7872 does not apply for any calendar year to any below-market loan made by a lender to a qualified continuing care facility pursuant to a continuing care contract if the lender (or the lender's spouse) attains age 65 before the close of the year.

Section 7872(g)(2) of the Code provides that, in the case of loans made after October 11, 1985, and before 1987, § 7872(g)(1) applies only to the extent that the aggregate outstanding amount of any loan to which § 7872(g) applies (determined without regard to § 7872(g)(2)), when added to the aggregate outstanding amount of all other previous loans between the lender (or the lender's spouse) and any qualified continuing care facility to which § 7872(g)(1) applies, does not exceed $90,000.

Section 7872(g)(5) of the Code provides that, for loans made during any calendar year after 1986 to which § 7872(g)(1) applies, the $90,000 limit specified in § 7872(g)(2) is increased by an inflation adjustment. The inflation adjustment for any calendar year is the percentage (if any) by which the Consumer Price Index (CPI) for the preceding calendar year exceeds the CPI for calendar year 1985. Section 7872(g)(5) states that the CPI for any calendar year is the average of the CPI as of the close of the 12-month period ending on September 30 of that calendar year.

Rev. Rul. 96–5, 1996–3 I.R.B. 29, publishes the amount specified in § 7872(g)(2) of the Code, increased by the inflation adjustment, for the years 1987–96.

Table 1 sets forth the amount specified in § 7872(g)(2) of the Code. The amount is increased by the inflation adjustment for the years 1987–97.

REV. RUL. 96–64 TABLE 1
Limit under 7872(g)(2)

Year	*Amount*
Before 1987	$ 90,000
1987	$ 92,200
1988	$ 94,800
1989	$ 98,800
1990	$103,500
1991	$108,600
1992	$114,100
1993	$117,500
1994	$121,100
1995	$124,300
1996	$127,800
1997	$131,300

Note: These inflation adjustments were computed using the All-Urban, Consumer Price Index 1982–1984 base, published by the Bureau of Labor Statistics.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 96–5, 1996–3 I.R.B. 29, is supplemented and superseded.

Part II. Treaties and Tax Legislation

CONTENTS

Subpart A.—Tax Conventions

Shipping and Aircraft Agreements

Fiji **202**

Jordan **202**

Luxembourg **203**

Russia **205**

Part II. Treaties and Tax Legislation

Subpart A.—Tax Conventions

FIJI

REPUBLIC OF FIJI
MINISTRY OF
FOREIGN AFFAIRS
SUVA
AUGUST 12, 1996

The Ministry of Foreign Affairs of the Government of the Republic of Fiji presents its compliments to the Embassy of the United States of America and has the honour to refer to the latter's Note No. 64 of June 19, 1996, the text of which reads as follows:

"The Embassy of the United States of America presents its compliments to the Ministry of Foreign Affairs of the Government of the Republic of Fiji and has the honour to propose that the two governments conclude an agreement to exempt from income tax on a reciprocal basis, income derived by residents of the other country from the international operation of ships and aircraft. The terms of the agreement are as follows:

The Government of the United States of America, in accordance with section 872(B) and 883(A) of the Internal Revenue Code, agrees to exempt from tax gross income derived from the international operation of ships or aircraft by individuals who are residents of Fiji (other than United States citizens) and corporations which are incorporated in Fiji.

The Government of the Republic of Fiji agrees to exempt from tax gross income derived from the international operation of ships or aircraft by individuals who are residents of the United States of America (other than Fiji citizens) and corporations which are incorporated in the United States of America.

In the case of a Fiji corporation, the exemption shall apply only if the corporation meets one of the following conditions:

(I) The corporation's stock is primarily and regularly traded on an established securities market in Fiji, another country which grants an equivalent exemption to U.S. corporations, or the United States,

or

(II) More than 50 percent of the value of the corporation's stock is owned directly or indirectly by individuals who are residents of Fiji or of another foreign country which grants an equivalent exemption to U.S. corporations or by a corporation organized in a country which grants an equivalent exemption to U.S. corporations and whose stock is primarily and regularly traded on an established securities market in that country, another country which grants an equivalent exemption to U.S. corporations, or the United States.

For the purpose of exemption from the U.S. tax, Subparagraph (II) will be considered to be satisfied if the corporation is a "controlled foreign corporation" under the Internal Revenue Code.

In the case of a U.S. corporation, the exemption shall apply only if the corporation meets the ownership requirements under Fiji law.

In this agreement:

(A) The terms "contracting state", and "other contracting state" mean the Sovereign Democratic Republic of Fiji or the United States of America, the governments of which have concluded this agreement.

(B) Gross income includes all income derived from international operation of ships or aircraft, including:

(I) Income from the rental on a full (time or voyage) basis of ships or aircraft used in international transport;

(II) Income from the rental on a bareboat basis of ships or aircraft used in international transport;

(III) Income from the rental of containers and related equipment used in international transport that is incidental to income from the international operation of ships and aircraft; and

(IV) Gains from the sale or other alienation of ships or aircraft used in international transport derived by a person primarily engaged in the international operation of ships or aircraft.

In the application of this agreement by a contracting state, any term not defined in this agreement shall, unless the context otherwise requires, have the meaning which it has under the laws of that state relating to the taxes to which this agreement applies.

The Embassy proposes that if the foregoing is acceptable to the Government of the Republic of Fiji, this note and the Ministry's note in reply shall constitute an agreement. This agreement shall enter into force on the date of the Ministry's note in reply and shall have effect in respect of income derived on or after January 1, 1996, and during all prior years for which the relevant statute of limitations remains open on that date.

This agreement shall continue into force until the Government of either contracting state gives written notice of termination of the agreement to the Government of the other contracting state through the diplomatic channel.

The Embassy of the United States of America avails itself of this opportunity to renew to the Ministry of Foreign Affairs of the Government of the Republic of Fiji the assurances of its highest consideration."

The Ministry has the further honour to confirm that the Government of the Republic of Fiji accepts that the Embassy's above-quoted Note and this Note in reply from the Ministry shall constitute an agreement between the two governments to exempt from income tax on a reciprocal basis, income derived by residents of the other country from the international operation of ships and aircraft.

The Ministry of Foreign Affairs of the Government of the Republic of Fiji avails itself of this opportunity to renew to the Embassy of the United States of America the assurances of its highest consideration.

JORDAN

EMBASSY OF
THE UNITED STATES OF AMERICA
AMMAN, JORDAN
APRIL 7, 1988

Note No. 078

The Embassy of the United States of America presents its compliments to the Ministry of Foreign Affairs of Jordan and has the honor to propose that the two governments conclude an agreement to exempt from income tax, on a reciprocal basis, income derived by residents of the other country from the international operation of ships and aircraft. The terms of the agreement are as follows:

• The Government of the United States of America, in accordance with Sections 872(b) and 883 of the Internal

Revenue Code, agrees to exempt from tax gross income derived from the international operation of ships or aircraft by individuals who are residents of Jordan (other than U.S. citizens) and corporations organized in Jordan. This exemption is granted on the basis of equivalent exemptions granted by Jordan to citizens of the United States (who are not residents of Jordan) and to corporations organized in the United States (which are not subject to tax by Jordan on the basis of residence).

• In the case of a corporation, the exemption shall apply only if the corporation meets either of the following conditions:

(1) More than 50 percent of the value of the corporation's stock is owned, directly or indirectly, by individuals who are residents of Jordan or of another country which grants a reciprocal exemption to U.S. citizens and corporations; or

(2) The corporation's stock is primarily and regularly traded on an established securities market in Jordan, or is wholly owned by a corporation whose stock is so traded and which is also organized in Jordan.

For purposes of subparagraph 1, the Government of Jordan and its wholly owned public corporations will be treated as an individual resident of Jordan. For purposes of the exemption from U.S. tax, subparagraph (1) will be considered to be satisfied if the corporation is a "controlled foreign corporation" under the Internal Revenue Code.

• Gross income includes all income derived from the international operation of ships or aircraft on a full (time or voyage) basis and income from the rental of containers and related equipment which is incidental to the international operation of ships or aircraft. It also includes income from the rental on a bareboat basis of ships and aircraft used for international transport.

• The Embassy of the United States of America considers that this Note, together with the Ministry's reply Note confirming that the Government of Jordan agrees to these terms, constitutes an agreement amending the agreement of April 17, 1973 and June 20, 1974.[1] This agreement shall enter into force on the date of the Ministry's reply Note and shall have effect with respect to taxable years beginning on or after January 1, 1987.

[1]TIAS 8002; 26 UTS 16.

• Either government may terminate this agreement by giving written notice of termination through diplomatic channels.

• The Embassy of the United States of America takes this opportunity to renew to the Ministry of Foreign Affairs of Jordan the assurances of its highest consideration.

HASHEMITE KINGDOM OF
JORDAN
MINISTRY OF
FOREIGN AFFAIRS
APRIL 7, 1988

No. 490

The Ministry of Foreign Affairs of the Hashemite Kingdom of Jordan present their compliments to the Embassy of the United States of America and have the honour to acknowledge receipt of their Note No. 078 dated April 7, 1988 which reads as follows:

[For text of the U.S. note, see above.]

The Ministry have the further honour to inform the distinguished Embassy that the foregoing proposal is acceptable to the Government of the Hashemite Kingdom of Jordan who therefore agree that the Embassy's note together with this reply shall constitute an agreement between the two governments which shall amend the agreement of April 17, 1973 and June 20, 1974 and shall enter into force on the date of this reply.

The Ministry of Foreign Affairs of the Hashemite Kingdom of Jordan avail themselves of this opportunity to renew to the Embassy of the United States of America the assurances of their highest consideration.

LUXEMBOURG

EMBASSY OF THE UNITED
STATES OF AMERICA
LUXEMBOURG
APRIL 11, 1989

The Embassy of the United States of America presents its compliments to the Ministry of Foreign Affairs of the Grand Duchy of Luxembourg and has the honor to propose that the two Governments conclude an agreement to exempt from income and capital tax, on a reciprocal basis, income derived and capital owned by residents of the other country in respect of the international operations of ships and aircraft. The terms of the agreement are as follows:

The Government of the United States of America, in accordance with sections 872(b) and 883(a) of the Internal Revenue Code, agrees to exempt from tax, gross income derived from the international operation of ships or aircraft by individuals who are residents of Luxembourg (other than U.S. citizens) and corporations organized in Luxembourg. This exemption is granted on the basis of equivalent exemptions granted by the Grand Duchy of Luxembourg to individual residents of the United States and to corporations organized in the United States (which are not subject to tax by Luxembourg on the basis of residence).

In the case of a Luxembourg corporation, the exemption shall apply only if the corporation meets either of the following conditions:

(i) The corporation's stock is primarily and regularly traded on an established securities market in Luxembourg, another country which grants an equivalent exemption to U.S. corporations, or the United States; or

(ii) More than 50 percent of the value of the corporation's stock is owned, directly or indirectly, by individuals who are residents of Luxembourg or of another country which grants an equivalent exemption to U.S. corporations or by a corporation organized in a country which grants a reciprocal exemption to U.S. corporations and whose stock is primarily and regularly traded on an established securities market in that country, another country which grants an equivalent exemption to U.S. corporations, or the United States.

For purposes of subparagraph (ii), the Government of the Grand Duchy of Luxembourg will be treated as an individual resident of Luxembourg. For purposes of the exemption from U.S. tax, subparagraph (ii) will be considered to be satisfied if the corporation is a "controlled foreign corporation" under the Internal Revenue Code.

Gross income includes all income derived from the international operation of ships or aircraft, including income from the rental of ships or aircraft on a full (time or voyage) basis and income from the rental of containers and related equipment which is incidental to the international operation of ships or aircraft. It also includes income from the rental on a bareboat basis of ships and aircraft used for international transport.

The Grand Duchy of Luxembourg agrees to exempt from income taxes on individuals and corporations and from communal tax on commercial profits

income derived from the international operation of ships or aircraft by U.S. residents and corporations organized in the United States (other than corporations which are subject to tax by Luxembourg on the basis of residence).

The Grand Duchy of Luxembourg agrees to exempt from wealth tax and communal tax on invested capital, capital represented by ships or aircraft operated in international traffic and by movable property pertaining to the operation of such ships or aircraft.

In the case of a U.S. corporation, the exemption shall apply only if the corporation meets either of the following conditions:

(i) the corporation's stock is primarily and regularly traded on an established securities market in the United States, another country which grants a reciprocal exemption to Luxembourg corporations, or the United States; or

(ii) more than 50 percent of the value of the corporation's stock is owned, directly or indirectly, by individuals who are residents of the United States or of another country which grants a reciprocal exemption to Luxembourg corporations or by a corporation organized in a country which grants a reciprocal exemption to Luxembourg corporations and whose stock is primarily and regularly traded on an established securities exchange in that country, another country which grants a reciprocal exemption to Luxembourg corporations or the United States.

Income includes all income derived from the international operation of ships or aircraft, including income from the rental of ships or aircraft on a full (time or voyage) basis and income from the rental of containers and related equipment which is incidental to the international operation of ships or aircraft. It also includes income from the rental on a bareboat basis of ships and aircraft used for international transport.

This agreement will not affect the provisions of Article V of the Convention of December 18, 1962, between the United States of America and the Grand Duchy of Luxembourg with respect to taxes on income and property which will remain in effect.

This agreement shall enter into force upon the confirmation by the Embassy of the United States of America of the notification by the Government of the Grand Duchy of Luxembourg indicating that all necessary internal procedures have been completed and the exemption from taxes as provided for in paragraphs 1 and 2 shall have effect with respect to taxable years beginning on or after January 1, 1987.

Either government may terminate this agreement by giving written notice of termination through diplomatic channels.

The Embassy of the United States of America takes this opportunity to renew to the Ministry of Foreign Affairs the assurances of its highest consideration.

GRAND DUCHY OF LUXEMBOURG
MINISTRY OF FOREIGN AFFAIRS
LUXEMBOURG
JUNE 22, 1989

The Ministry of Foreign Affairs of the Grand Duchy of Luxembourg presents its compliments to the Embassy of the United States of America and has the honor to acknowledge receipt of its note of 11 April 1989, proposing the terms of an agreement for a reciprocal exemption from income and capital tax of income derived and capital owned in respect of the international operation of ships and aircraft. The terms of the agreement are as follow:

1. The Government of the United States of America, in accordance with section 872(b) and 883(a) of the Internal Revenue Code, agrees to exempt from tax, gross income derived from the international operation of ships or aircraft by individuals who are residents of Luxembourg (other than U.S. citizens) and corporations organized in Luxembourg, This exemption is granted on the basis of equivalent exemptions granted by the Grand Duchy of Luxembourg to individual residents of the United States and to corporations organized in the United States (which are not subject to tax by Luxembourg on the basis of residence).

In the case of a Luxembourg corporation, the exemption shall apply only if the corporation meets either of the following conditions:

(i) The corporation's stock is primarily and regularly traded on an established securities market in Luxembourg, another country which grants an equivalent exemption to U.S. corporations, or the United States; or

(ii) More than 50 percent of the value of the corporation's stock is owned, directly or indirectly, by individuals who are residents of Luxembourg or of another country which grants an equivalent exemption to U.S. corporations or by a corporation organized in a country which grants a reciprocal exemption to U.S. corporations and whose stock is primarily and regularly traded on an established securities market in that country, another country which grants an equivalent exemption to U.S. corporations, or the United States.

For purposes of subparagraph (ii), the Government of the Grand Duchy of Luxembourg will be treated as an individual resident of Luxembourg. For purposes of the exemption from U.S. tax, subparagraph (ii) will be considered to be satisfied if the corporation is a "controlled foreign corporation" under the Internal Revenue Code.

Gross income includes all income derived from the international operation of ships or aircraft, including income from the rental of ships or aircraft on a full (time or voyage) basis and income from the rental of containers and related equipment which is incidental to the international operation of ships or aircraft. It also includes income from the rental on a bareboat basis of ships and aircraft used for international transport.

2. The Grand Duchy of Luxembourg agrees to exempt from income taxes on individuals and corporations and from communal tax on commercial profits income derived from the international operations of ships or aircraft by U.S. residents and corporations organized in the United States (other than corporations which are subject to tax by Luxembourg on the basis of residence).

The Grand Duchy of Luxembourg agrees to exempt from wealth tax and communal tax on invested capital, capital represented by ships or aircraft operated in international traffic and by movable property pertaining to the operation of such ships or aircraft.

In the case of a U.S. corporation, the exemption shall apply only if the corporation meets either of the following conditions:

(i) The corporation's stock is primarily and regularly traded on an established securities market in the United States, another country which grants a reciprocal exemption to Luxembourg corporations, or Luxembourg; or

(ii) More than 50 percent of the value of the corporation's stock is owned, directly or indirectly, by individuals who are residents of the United States or of another country which grants a reciprocal exemption to Luxembourg corporations or by a corporation organized in a

country which grants a reciprocal exemption to Luxembourg corporations and whose stock is primarily and regularly traded on an established securities exchange in that country, another country which grants a reciprocal exemption to Luxembourg corporations or Luxembourg.

Income includes all income derived from the international operation of ships or aircraft, including income from the rental of ships or aircraft on a full (time or voyage) basis and income from the rental of containers and related equipment which is incidental to the international operation of ships or aircraft. It also includes income from the rental on a bareboat basis of ships and aircraft used for international transport.

3. This agreement will not affect the provisions of Article V of the Convention of December 18, 1962, between the United States of America and the Grand Duchy of Luxembourg with respect to taxes on income and property which will remain in effect.

4. This agreement shall enter into force upon the confirmation by the Embassy of the United States of America of the notification by the Government of the Grand Duchy of Luxembourg indicating that all necessary internal procedures have been completed and the exemption from taxes as provided for in paragraphs 1 and 2 shall have effect with respect to taxable years beginning on or after January 1, 1987.

5. Either Government may terminate this agreement by giving written notice of termination through diplomatic channels.

The Ministry of Foreign Affairs of the Grand Duchy of Luxembourg takes this opportunity to renew to the Embassy of the United States of America the assurances of his highest consideration.

RUSSIA

EMBASSY OF
THE UNITED STATES OF AMERICA
MOSCOW
JULY 18, 1994

The Embassy of the United States of America presents its compliments to the Ministry of Foreign Affairs of the Russian Federation. The Government of the United States of America, in accordance with Sections 872(b) and 883(a) of the Internal Revenue Code, agrees to exempt from tax gross income derived from the international operations of ships or aircraft by individual residents of the Russian Federation (other than U.S. citizens) and corporations which are incorporated in the Russian Federation. This exemption is granted on the basis of equivalent exemptions granted by the Russian Federation to individual residents of the United States and to corporations organized in the United States.

In the case of a Russian corporation, the exemptions shall apply only if the corporation meets the ownership or public trading requirements of U.S. law.

Gross income includes all income derived from the international operation of ships or aircraft, including:

I. Income from the rental on a full (time or voyage) basis of ships or aircraft used in international transport;

II. Income from the rental on a bareboat basis of ships or aircraft used in international transport if such income is incidental to income from the international operation of ships or aircraft;

III. Income from the rental of containers and related equipment used in international transport if such income is incidental to income from the international operation of ships or aircraft;

IV. Gains from the sale or other alienation of ships or aircraft used in international transport by a person primarily engaged in the international operation of ships or aircraft.

When the Government of the Russian Federation agrees to these terms, this will constitute an agreement between the two governments. This agreement shall enter into force on the date of the Government of the Russian Federation's reply note and shall have effect with respect to taxable years beginning on or after January 1, 1991, and terminate from the date of entry into force of the Agreement between the Russian Federation and the United States of America to Avoid Double Taxation and Prevention of Tax Evasion with Respect to Taxes on Income and Capital dated June 17, 1992.

The Embassy of the United States of America avails itself of the opportunity to extend to the Ministry of Foreign Affairs of the Russian Federation renewed assurances of its highest consideration.

RUSSIAN FEDERATION
MINISTRY OF
FOREIGN AFFAIRS
MOSCOW
JULY 21, 1994

The Ministry of Foreign Affairs of the Russian Federation presents its compliments to the Embassy of the United States of America and has the honor to confirm receipt of the Embassy note no. MFA/112/94 dated July 18, 1994, which reads as follows:

The Russian translation of the abovementioned note agrees in all substantive respects with the original English text, with the following exceptions:

P. 1, para. 1
English: . . . presents its compliments to the Ministry of Foreign Affairs of the Russian Federation. The Government of the United States of America. . .
Russian: . . . presents its compliments to the Ministry of Foreign Affairs of the Russian Federation *and has the honor to advise that* the Government of the United States of America . . .

Ibid
English: the Internal Revenue Code
Russian: the Tax Code

P. 2, para. IV
English: . . . by a *person primarily* engaged in the international transport . . .
Russian: . . . by a *juridical* person _____ engaged in the international transport . . .
[Translator's note: in the numeration of paragraphs on pp. 1–2, the English text uses Roman numerals, whereas the Russian text employs ordinary numbers]

We have the honor to inform you that the foregoing is acceptable to the Government of the Russian Federation, and it therefore agrees that the U.S. Embassy note and this reply thereto shall constitute an Agreement between the Government of the Russian Federation and the Government of the United States of America, which shall enter into force on the date of this reply.

The Ministry of Foreign Affairs of the Russian Federation avails itself of the opportunity to extend to the Embassy of the United States of America the assurances of its high consideration.

Part III. Administrative, Procedural, and Miscellaneous

CONTENTS

Delegation Order 155 (Rev. 4) **208**
Notice 96–36 **208**
Notice 96–37 **208**
Notice 96–38 **209**
Notice 96–39 **209**
Notice 96–40 **210**
Notice 96–41 **211**
Notice 96–42 **211**
Notice 96–43 **211**
Notice 96–44 **212**
Notice 96–45 **212**
Notice 96–46 **212**
Notice 96–47 **213**
Notice 96–48 **214**
Notice 96–49 **215**
Notice 96–50 **216**
Notice 96–51 **216**
Notice 96–52 **218**
Notice 96–53 **219**
Notice 96–54 **222**
Notice 96–55 **222**
Notice 96–56 **223**
Notice 96–57 **225**
Notice 96–58 **226**
Notice 96–59 **226**
Notice 96–60 **227**
Notice 96–61 **227**
Notice 96–62 **228**
Notice 96–63 **228**
Notice 96–64 **229**
Notice 96–65 **232**
Notice 96–66 **235**
Notice 96–67 **235**
Notice 96–68 **236**
Revenue Procedure 96–36 **237**
Revenue Procedure 96–37 **299**
Revenue Procedure 96–38 **300**
Revenue Procedure 96–39 **300**
Revenue Procedure 96–40 **301**
Revenue Procedure 96–41 **301**
Revenue Procedure 96–42 **306**
Revenue Procedure 96–43 **330**
Revenue Procedure 96–44 **330**
Revenue Procedure 96–45 **336**
Revenue Procedure 96–46 **338**
Revenue Procedure 96–47 **338**
Revenue Procedure 96–48 **339**
Revenue Procedure 96–49 **369**
Revenue Procedure 96–50 **370**
Revenue Procedure 96–51 **370**
Revenue Procedure 96–52 **372**
Revenue Procedure 96–53 **375**
Revenue Procedure 96–54 **386**
Revenue Procedure 96–55 **387**
Revenue Procedure 96–56 **389**
Revenue Procedure 96–57 **389**
Revenue Procedure 96–58 **390**
Revenue Procedure 96–59 **392**
Revenue Procedure 96–60 **399**
Revenue Procedure 96–61 **401**
Revenue Procedure 96–62 **412**
Revenue Procedure 96–63 **420**
Revenue Procedure 96–64 **427**
Social Security Contribution and Benefit Base **434**

Part III. Administrative, Procedural, and Miscellaneous

Delegation Order No. 155 (Rev. 4)

Delegation of Authority

AGENCY: Internal Revenue Service

ACTION: Delegation of Authority

SUMMARY: This delegation order is revised to give authority to sign recommendation letters for nonsuit settlements to the Regional Counsel and District Counsel in the field and to the Deputy Associate Chief Counsel and Assistant Chief Counsel in the National Office. In addition, it has been expanded in scope to cover nonrefund matters. The text of the delegation order appears below.

EFFECTIVE DATE: August 15, 1996.

Recommendation Letters to the Department of Justice Concerning Settlement Offers Covering Persons or Periods Not in Suit Authority: For matters under their respective jurisdictions, to sign recommendation letters to the Department of Justice concerning Settlement Offers related to pending refund cases or any other cases or matters referred to the Department of Justice for prosecution or defense with respect to persons or periods not in suit.

Delegated to:

Chief Counsel
Associate Chief Counsel
Deputy Associate Chief Counsel

Authority: For matters under their respective jurisdictions, to sign recommendation letters concerning Settlement Offers *related* to pending refund cases or any other cases or matters referred to the Department of Justice for prosecution or defense with respect to: (a) periods not in suit ending prior to the date of the resulting settlement agreement; (b) tax consequences for periods not in suit ending after the date of the settlement agreement that necessarily result from the settlement of the periods in suit; (c) issues conceded in full by the taxpayer for periods not in suit ending after the date of the settlement agreement; (d) persons not in suit for the periods described in (a); and (e) persons not in suit for the items described in (b) and (c).

Delegated to:

Regional Counsel
District Counsel
Assistant Chief Counsel

In exercising both of the above authorities, the advice of the Chief of Appeals and/or District Director with jurisdiction over the nonsuit persons or periods should be obtained and considered.

Redelegation: The authority delegated herein may not be redelegated.

Sources of Authority: 26 CFR 301.7122–1, 26 CFR 301.7701–9. To the extent that authority previously exercised consistent with this order may require ratification, it is hereby approved and ratified. This order supersedes Delegation Order No. 155 (Rev. 3), effective October 1, 1991.

Dated: August 15, 1996.

Michael P. Dolan,
Deputy Commissioner.

(Filed by the Ofice of the Federal Register on September 5, 1996, 8:45 a.m., and published in the issue of the Federal Register for September 6, 1996, 61 F.R. 47235)

Weighted Average Interest Rate Update

Notice 96–36

Notice 88–73 provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 and as further amended by the Uruguay Round Agreements Act, Pub. L. 103–465 (GATT).

The average yield on the 30-year Treasury Constant Maturities for May 1996 is 6.93 percent.

The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	90% to 108% Permissible Range	90% to 110% Permissible Range
June	1996	6.92	6.23 to 7.48	6.23 to 7.61

Instructions for Filing Claims for Refund of Insurance Premium Excise Tax Based on the U.S. Supreme Court's Opinion in *United States v. IBM*

Notice 96–37

PURPOSE

This notice provides instructions for filing claims for refund of insurance premium excise tax imposed by section 4371 of the Internal Revenue Code based on the Supreme Court's opinion in *United States v. International Business Machines Corp.*, 64 U.S.L.W. 4419 (June 10, 1996).

BACKGROUND

Section 4371(1) of the Code imposes a tax on each policy of insurance or reinsurance issued by any foreign insurer or reinsurer with respect to casualty insurance that is issued to or for, or in the name of, an insured as defined in section 4372(d) of the Code. The rate of tax is 4 percent of the premium paid on the policy.

In *U.S. v. IBM*, the Supreme Court held that the tax imposed by section 4371(1) of the Internal Revenue Code of 1986 may not be applied to premiums paid with respect to insurance covering risks associated with goods actually in export transit from the U.S. The Supreme Court's decision was based on the Export Clause of the U.S. Constitution, Art. I, sec. 9, cl. 5.

PROCEDURE FOR CLAIMING REFUND OF INSURANCE PREMIUM EXCISE TAX

Any taxpayer requesting a refund of insurance premium excise tax based on the *U.S. v. IBM* opinion must file a Form 8849, Claim for Refund of Excise Taxes. Refunds relating to insurance premium excise tax based on the *U.S. v. IBM* opinion may not be claimed as a credit against any other tax liability, and this notice provides the only procedure for claiming a refund.

In addition to the information required by the Form 8849, a claim for refund must be accompanied by documentation establishing that the tax for which a refund is claimed was paid with respect to insurance covering only goods actually in export transit from the U.S. In the case of a policy covering risks in addition to goods in export transit, the claim for refund must be accompanied by documentation establishing the portion of the insurance excise tax attributable to premiums paid only for insuring goods in actual export transit from the U.S.

The following statement should be typed or clearly written at the top of the Form 8849:

CLAIM FOR REFUND OF INSURANCE PREMIUM EXCISE TAX AS A RESULT OF *U.S. V. IBM.*

Any Form 8849 requesting a refund of insurance premium excise tax should be submitted to the following address:
Internal Revenue Service Center
P.O. Box 21086
Philadelphia, PA 19114

Weighted Average Interest Rate Update

Notice 96–38

Notice 88–73 provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 and as further amended by the Uruguay Round Agreements Act, Pub. L. 103–465 (GATT).

The average yield on the 30-year Treasury Constant Maturities for June 1996 is 7.06 percent.

The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	90% to 108% Permissible Range	90% to 110% Permissible Range
July	1996	6.92	6.23 to 7.47	6.23 to 7.61

Determination of Whether Income of a Controlled Foreign Corporation Earned Through a Partnership Is Subpart F Income

Notice 96–39

This Notice sets forth the Service's position on the Eighth Circuit's recent decision in *Brown Group, Inc. v. Commissioner*, 77 F.3d 217 (8th Cir. 1996), *vacating and remanding* 104 T.C. 105 (1995). This Notice also announces that the Service intends to issue regulations under Subpart F of the Internal Revenue Code describing how the aggregate approach to partnerships applies to determine the treatment of a controlled foreign corporation's ("CFC's") distributive share of partnership income for purposes of subpart F.

BACKGROUND

In *Brown Group*, a CFC incorporated in the Cayman Islands was a partner in a Cayman Islands partnership. The partnership was not a sham. It acted as a purchasing agent for the CFC's U.S. parent with respect to footwear manufactured in Brazil and received commission income from the U.S. parent as compensation for its efforts. The footwear imported by the U.S. parent was sold primarily in the United States. For its fiscal year ended November 1, 1986, the U.S. parent did not include as subpart F income the CFC's distributive share of the partnership's commission income.

At issue in *Brown Group* was whether the CFC partner's distributive share of the income of the Cayman Islands partnership was foreign base company sales income. If so, this income would be currently includible in the gross income of the CFC's U.S. shareholder as subpart F income. *See* sections 951(a)(1) and (b), 952(a), 954(d) and 957(a) of the Internal Revenue Code. Foreign base company sales income is defined under section 954(d) to include commission income from the purchase of personal property on behalf of a related person where the property that is purchased is both manufactured and sold for use outside the CFC's country of incorporation.

In *Brown Group*, the parties agreed that the commission income was earned from purchasing personal property that was both manufactured and sold for use outside the CFC's country of incorporation. The narrow issue in dispute was whether the footwear was purchased on behalf of a related person, as defined in section 954(d)(3) of the Code. It was undisputed that the U.S. parent, on whose behalf the purchases were made, was a related person with respect to the CFC. The Service argued that an aggregate theory of partnerships should apply, under which the CFC's distributive share of the partnership's commission income would be tested at the CFC level to determine whether it was foreign base company sales income. Accordingly, the related person determination would be made at the partner level, as if the purchases had been made directly by the CFC. The taxpayer argued that an entity theory of partnerships should apply, under which the CFC's distributive share of partnership income would be tested at the partnership level. The taxpayer maintained that, at the partnership level, the purchases were not made on behalf of a related person.

The Tax Court, after withdrawing an earlier opinion favorable to the taxpayer, held in a reviewed opinion that the CFC partner's distributive share of the partnership's commission income was foreign base company sales income. The Tax Court reached its conclusion based upon an analysis of the provisions and purposes of subpart F and subchapter K, as well as the case law discussing the application of the entity and aggregate theories of partnership taxation. The Tax Court's holding is consistent with the Service's published position in Rev. Rul. 89– 72, 1989–1 C.B. 257.

On appeal by the taxpayer, the Eighth Circuit vacated and remanded the decision of the Tax Court. The court concluded, based upon its application of the definition of related person in section 954(d)(3) of the Code, that the commission income was not foreign base company sales income at the partnership level and that the CFC partner's distributive share of this partnership income therefore was not subpart F income.

THE SERVICE'S POSITION

The Service disagrees with the opinion of the Eighth Circuit in *Brown Group*. To permit a CFC to avoid subpart F by earning income through a partnership under circumstances in which the income would be subpart F income if earned directly by the CFC would be contrary to the purposes of subpart F. *See* S. Rep. No. 1881, 87th Cong., 2d Sess. 78–79 (1962).

The legislative history of subchapter K indicates that, although a partnership is to be considered an entity in the treatment of transactions between a partner and a partnership, it need not be considered a separate entity for purposes of applying other provisions of the Code "if the concept of the partnership as a collection of individuals is more appropriate for such provisions." H.R. Conf. Rep. No. 2543, 83d Cong. 2d. Sess. 59 (1954). The courts have recognized that the aggregate approach may be applied in appropriate circumstances. *See Casel v. Commissioner*, 79 T.C. 424, 433 (1982); *Unger v. Commissioner*, T.C. Memo. 1990–15, *aff'd* 936 F.2d 1316 (D.C. Cir. 1991). Section 1.701–2(e) and (f) of the Income Tax Regulations confirmed the Commissioner's authority to treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purposes of any provision of the Code or regulations thereunder.

The Service intends to issue regulations under subpart F to confirm its position that whether a CFC partner's distributive share of partnership income is subpart F income generally is determined at the CFC partner level. Prior to the effective date of those regulations, the Service will rely on principles and authorities under subpart F and subchapter K to apply the aggregate approach, including section 1.701–2(e) and (f) of the regulations for periods for which it is effective.

Request for Comments on Procedures Relating to Voluntary and Involuntary Changes in Method of Accounting

Notice 96–40

This notice invites public comment on possible changes to Rev. Proc. 92–20, 1992–1 C.B. 685, which provides the general procedures for a taxpayer to change a method of accounting. These changes may include (1) adding procedures for changes in method of accounting made by the district director as part of an examination and by an appeals officer as part of a settlement, and (2) revising some of the existing procedures to better achieve prompt voluntary compliance with proper tax accounting principles.

BACKGROUND

Section 446(e) of the Internal Revenue Code and § 1.446–1(e) of the Income Tax Regulations state that, except as otherwise provided, a taxpayer must secure the consent of the Commissioner before changing a method of accounting for federal income tax purposes.

Section 1.446–1(e)(3)(ii) authorizes the Commissioner to prescribe administrative procedures setting forth the terms and conditions under which taxpayers will be permitted to change a method of accounting. The terms and conditions the Commissioner may prescribe include the taxable year for which the change in method of accounting is effective and the taxable year or years in which a § 481(a) adjustment is taken into account.

Rev. Proc. 92–20 sets forth the general procedures under § 1.446–1(e) for obtaining the consent of the Commissioner to change a method of accounting. Rev. Proc. 92–20 uses a gradation of incentives to encourage prompt voluntary compliance. Under this approach, taxpayers that voluntarily file a request to change prior to being contacted for an examination of their income tax returns receive the most favorable terms and conditions. Once contacted for an examination, taxpayers are generally precluded from requesting a change without the consent of the district director. However, some taxpayers that have been contacted for examination may request a change during certain "window periods." For example, certain taxpayers may request a change during the first 90 days after contact for examination, but will then receive terms and conditions less favorable than those available if they had requested a change prior to such contact. Other taxpayers requesting a change during certain other available window periods receive terms and conditions no less favorable than those available if they had requested the change prior to contact for examination. Taxpayers that are required by the district director to change their method of accounting as part of an examination receive the least favorable terms and conditions.

In addition, Rev. Proc. 92–20 generally provides less favorable terms and conditions for changes from a "Category A method" of accounting than from a "Category B method." A Category A method is any method that is specifically not permitted by the Code, regulations, or a decision of the Supreme Court or any method that differs from a method that is specifically required by any of these authorities. A Category B method is any method that is not a Category A method.

The Service also has provided a number of procedures for taxpayers to obtain automatic consent to change certain methods of accounting. Taxpayers complying with these procedures are deemed to have obtained the consent of the Commissioner to change their method of accounting.

REQUEST FOR PUBLIC COMMENT

Rev. Proc. 92–20 provides no guidance on changes in method of accounting made by the district director on examination or by an appeals officer in a settlement. In addition, the Service and Treasury are evaluating whether using window periods and characterizing a method of accounting as a Category A or B method are effective in encouraging prompt voluntary compliance. Accordingly, the Service and Treasury request comments on possible changes to Rev. Proc. 92–20 including, but not limited to, the following:

(1) What are the consequences to the Service and the taxpayer when the district director, as part of an examination, or an appeals officer, as part of a settlement, makes an adjustment that involves a method of accounting? For example, under what circumstances does such an adjustment constitute a change in method of accounting imposed by the Service (*e.g.*, only if the adjustment includes a § 481(a) adjustment)? When does such a change become final (*e.g.*, when the taxpayer agrees to assessment of the tax, when the period of limitations for filing a claim for refund expires, or at some other point)? What are the effects of such a change on taxable years for which a return has been filed and taxable years for which a return has not yet been filed?

(2) Are the various window periods of Rev. Proc. 92–20 effective in encouraging prompt voluntary compliance with

proper tax accounting principles? If not, what alternatives should the Service consider?

(3) Should the distinction between Category A and Category B methods of accounting be modified or eliminated? If so, what alternatives should the Service consider?

(4) Should the Service provide automatic consent procedures for more accounting method changes? If so, for what changes?

Taxpayers may submit comments in writing to:

Internal Revenue Service
Attn: CC:DOM:CORP:R (IA-Branch 7, Room 5228).
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044.

Alternatively, taxpayers may submit comments electronically via the IRS Internet site at:

http://www.irs.ustreas.gov/prod/tax_regs/comments.html.

All comments should be received by September 30, 1996. The comments submitted will be available for public inspection and copying.

1996 Section 43 Inflation Adjustment

Notice 96–41

Section 43(b)(3)(B) of the Internal Revenue Code requires the Secretary to publish an inflation adjustment factor. The enhanced oil recovery credit under § 43 for any taxable year is reduced if the "reference price," determined under § 29(d)(2)(C), for the calendar year preceding the calendar year in which the taxable year begins is greater than $28 multiplied by the inflation adjustment factor for that year.

The term "inflation adjustment factor" means, with respect to any calendar year, a fraction the numerator of which is the GNP implicit price deflator for the preceding calendar year and the denominator of which is the GNP implicit price deflator for 1990.

Because the reference price for the 1995 calendar year ($14.62) does not exceed $28 multiplied by the inflation adjustment factor for the 1996 calendar year, the enhanced oil recovery credit for qualified costs paid or incurred in 1996 is determined without regard to the phase-out for crude oil price increases.

Table 1 contains the GNP implicit price deflator used for the 1996 calendar year, as well the previously published GNP implicit price deflators used for the 1991 through 1995 calendar years.

Notice 96–41 TABLE 1

GNP IMPLICIT PRICE DEFLATORS

Calendar Year	*GNP Implicit Price Deflator*
1990	112.9 (used for 1991)
1991	117.0 (used for 1992)
1992	120.9 (used for 1993)
1993	124.1 (used for 1994)
1994	126.0 (used for 1995)
1995	107.5 (used for 1996)*

*Beginning in 1995, the GNP implict price deflator was rebased relative to 1992. The 1990 GNP implicit price deflator used to compute the 1996 § 43 inflation adjustment factor is 93.6

Table 2 contains the inflation adjustment factor and the phase-out amount for taxable years beginning in the 1996 calendar year as well as the previously published inflation adjustment factors and phase-out amounts for the 1991 through 1995 calendar years.

Notice 96–41 TABLE 2

INFLATION ADJUSTMENT FACTORS AND PHASE-OUT AMOUNTS

Calendar Year	*Inflation Adjustment Factor*	*Phase-out Amount*
1991	1.0000	0
1992	1.0363	0
1993	1.0708	0
1994	1.0992	0
1995	1.1160	0
1996	1.1485	0

1996 Marginal Production Rates

Notice 96–42

Section 613A(c)(6)(C) of the Internal Revenue Code defines the term "applicable percentage" for purposes of determining percentage depletion for oil and gas produced from marginal properties. The applicable percentage is the percentage (not greater than 25 percent) equal to the sum of 15 percent, plus one percentage point for each whole dollar by which $20 exceeds the reference price (determined under § 29(d)(2)(C)) for crude oil for the calendar year preceding the calendar year in which the taxable year begins. The reference price determined under § 29(d)(2)(C) for the 1995 calendar year is $14.62.

Table 1 contains the applicable percentages for marginal production for taxable years beginning in calendar years 1991 through 1996.

Notice 96–42 TABLE 1

APPLICABLE PERCENTAGE FOR MARGINAL PRODUCTION

Calendar Year	*Applicable Percentage*
1991	15 percent
1992	18 percent
1993	19 percent
1994	20 percent
1995	21 percent
1996	20 percent

Weighted Average Interest Rate Update

Notice 96–43

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 § 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 and as further amended by the Uruguay Round Agreements Act, Pub. L. 103–465 (GATT).

The average yield on the 30-year Treasury Constant Maturities for July 1996 is 7.03 percent.

The following rates were determined for the plan years beginning in the month shown on next page.

Month	Year	Weighted Average	90% to 108% Permissible Range	90% to 110% Permissible Range
August	1996	6.92	6.22 to 7.47	6.22 to 7.61

Miscellaneous Provisions Relating to the Tax Treatment of Partnership Items; Procedure and Administration; OMB Control Numbers; Correction

Notice 96–44

AGENCY: Internal Revenue Service, Treasury.

ACTION: Correcting amendment.

SUMMARY: This document contains a correction to temporary regulations (T.D. 8128 [1987–1 C.B. 325]), which were published in the **Federal Register** on Thursday, March 5, 1987 (52 FR 6779) relating to certain rules for the tax treatment of partnership items.

EFFECTIVE DATE: March 5, 1987.

SUPPLEMENTARY INFORMATION:

Background

The temporary regulations that are the subject of this correction is under sections 6221 thru 6233 of the Internal Revenue Code.

Need for Correction

As published, the temporary regulations (T.D. 8128) contains an error which may prove to be misleading and is in need of clarification.

* * * * *

Accordingly, 26 CFR part 301 is corrected by making the following correcting amendment:

PART 301—PROCEDURE AND ADMINISTRATION

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

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

§ 301.6231(a)(7)–1T [Correctly redesignated from § 301.6231(a)(7)–1]

Par. 2. Section 301.6231(a)(7)–1 is redesignated as § 301.6231(a)(7)–1T.

Michael L. Slaughter,
Acting Chief, Regulations Unit, Assistant Chief Counsel (Corporate).

(Filed by the Office of the Federal Register on July 18, 1996, 8:45 a.m., and published in the issue of the Federal Register for July 19, 1996, 61 F.R. 37683)

Weighted Average Interest Rate Update

Notice 96–45

Notice 88–73 provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 and as further amended by the Uruguay Round Agreements Act, Pub. L. 103–465 (GATT).

The average yield on the 30-year Treasury Constant Maturities for August 1996 is 6.84 percent.

The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	90% to 108% Permissible Range	90% to 110% Permissible Range
September	1996	6.91	6.22 to 7.46	6.22 to 7.60

Excise Taxes on Excess Benefit Transactions Engaged in by Certain Tax-Exempt Organizations

Notice 96–46

This notice summarizes certain aspects of Taxpayer Bill of Rights 2 related to excise taxes on excess benefit transactions involving organizations described in § 501(c)(3) (except private foundations) and § 501(c)(4). Taxpayer Bill of Rights 2, Pub. L. No. 104–168, 110 Stat. 1452, (TBOR2) was enacted July 30, 1996. This notice also provides guidance with respect to the filing of returns for these excise taxes, and solicits comments to be considered in drafting future guidance. See Notice 96–47, page 8, this Bulletin, for aspects of TBOR2 related to the express prohibition of private inurement for § 501(c)(4) organizations, and Notice 96–48, page 9 , this Bulletin, for disclosure requirements for, and increases in certain penalties on, exempt organizations generally.

I. In General

Section 1311(a) of TBOR2 creates new § 4958, which imposes excise taxes on excess benefit transactions. An **excess benefit transaction** subject to tax under § 4958 is any transaction in which an economic benefit is provided by an organization described in § 501(c)(3) (except for a private foundation) or § 501(c)(4) directly or indirectly to, or for the use of, any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing the benefit. A **disqualified person** is any person who was, at any time during the 5-year period ending on the date of the excess benefit transaction, in a position to exercise substantial influence over the affairs of the organization. Disqualified persons also include family members and certain entities in which at least 35 percent of the control or beneficial interests are held by persons described in the preceding sentence. An **organization manager** is an officer,

director, trustee, or any individual having powers or responsibilities similar to those of an officer, director, or trustee.

Section 4958 imposes three taxes. The first tax is equal to 25 percent of the excess benefit amount, and is to be paid by any disqualified person who engages in an excess benefit transaction (§ 4958(a)(1)). The second tax is equal to 200 percent of the excess benefit amount, and is to be paid by any disqualified person if the excess benefit transaction is not corrected within the taxable period (§ 4958(b)). The third tax is equal to 10 percent of the excess benefit amount, and is to be paid by any organization manager who knowingly participates in an excess benefit transaction (§ 4958(a)(2)). With respect to any one excess benefit transaction, the maximum amount of this third tax may not exceed $10,000.

II. Effective Date for Excise Taxes

The new § 4958 excise taxes apply to excess benefit transactions occurring on or after September 14, 1995. They do not apply, however, to any benefit arising from a transaction pursuant to any written contract that was binding on September 13, 1995, and continued in force through the time of the transaction.

III. Returns for Payment of Excise Taxes

Charities and other persons liable for certain Chapter 41 or Chapter 42 excise taxes must file returns on Form 4720 to calculate and report the taxes due. The Treasury Department will issue regulations providing that disqualified persons and organization managers (or their 35 percent controlled entities) liable for § 4958 excise taxes on excess benefit transactions are required to file an annual return on Form 4720. For excess benefit transactions that occurred after September 13, 1995, in a taxable year ending before December 31, 1996, the persons liable for payment of the excise taxes must use the 1995 Form 4720 to calculate and report those taxes. The Service will revise Form 4720 for taxable years ending on or after December 31, 1996.

The Treasury Department will also issue regulations which will provide that returns on Form 4720 for taxable years ending after September 13, 1995, and on or before July 30, 1996 (the date of TBOR2's enactment), will be due on December 15, 1996. Returns for taxable years ending after July 30, 1996, will be due on the 15th day of the fifth month following the close of that taxable year.

The person filing should clearly mark the top of the 1995 Form 4720 that it is for payment of § 4958 excise taxes. Use Part II–A, columns (a), (b), and (h) to report information about the person(s) liable and the amount of the tax; use Schedule A columns (b), (c), (e), and (f) (if a transaction with a disqualified person, using the 25 percent tax rate), or (b), (c), (e), and (g) (if a transaction with an organization manager, using the 10 percent tax rate) to provide other information requested about the transaction.

IV. Reporting Requirements for § 4958 Excise Taxes

Section 1312(a) of TBOR2 amends § 6033(b) to require § 501(c)(3) organizations to report the amounts of the taxes paid under § 4958 with respect to excess benefit transactions involving the organization, as well as any other information the Secretary may require concerning those transactions. Section 6033(f) is also amended to impose the same filing requirements on § 501(c)(4) organizations. These amendments only apply to returns for taxable years beginning after July 30, 1996. Accordingly, affected organizations do not have to include information on taxes paid under § 4958, or any other information that may be required with respect to excess benefit transactions, on their returns for taxable years beginning before July 31, 1996.

V. Comments on Future Guidance Invited

The Service invites comments on the amendments made by § § 1311(a) and 1312 of TBOR2 (new § 4958 and reporting requirements related to those excise taxes). The Service will consider these comments in drafting future guidance. In order to issue this guidance promptly, the Service requests that written comments be submitted by December 12, 1996. Send submissions to: CC:DOM:CORP:R (Notice 96–46), Room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (Notice 96–46), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet directly to the IRS internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html.

Private Inurement Expressly Prohibited for Section 501(c)(4) Organizations

Notice 96–47

This notice summarizes an important aspect of Taxpayer Bill of Rights 2 related to the amendment to § 501(c)(4) of the Internal Revenue Code. Taxpayer Bill of Rights 2, Pub. L. No. 104–168, 110 Stat. 1452, (TBOR2) was enacted July 30, 1996. See Notice 96–46, page 7, this Bulletin, for aspects of TBOR2 related to excise taxes on excess benefit transactions engaged in by § 501(c)(4) organizations and § 501(c)(3) organizations (except private foundations), and Notice 96–48, page 9 , this Bulletin, for disclosure requirements for, and increases in certain penalties on, exempt organizations generally.

Private Inurement Expressly Prohibited for § 501(c)(4) Organizations

TBOR2 amends § 501(c)(4) to expressly prohibit inurement of any part of the net earnings of an entity otherwise described in that section to the benefit of any private shareholder or individual. That amendment applies to inurement occurring on or after September 14, 1995. The amendment does not apply, however, to inurement occurring prior to January 1, 1997, if that inurement results from a written contract that was binding on September 13, 1995, and continued in force through the time that the inurement occurred.

Comments on Future Guidance Invited

The Service invites comments on the amendments made by § 1311(b) of TBOR2 (the amendment to § 501(c)(4)). The Service will consider these comments in drafting future guidance. In order to issue this guidance promptly, the Service requests that written comments be submitted by December 12, 1996. Send submissions to: CC:DOM:CORP:R (Notice 96–47), Room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (Notice 96–47), Courier's Desk, Internal Revenue Service, 1111 Constitution Av-

enue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet directly to the IRS internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html.

Tax-Exempt Organization Information Returns—Requirement to Provide Copies to the Public and Increases in Certain Penalties

Notice 96–48

This notice summarizes certain aspects of Taxpayer Bill of Rights 2 related to (1) inspection requirements for exempt organizations and (2) increases in certain penalties on exempt organizations. Taxpayer Bill of Rights 2, Pub. L. No. 104–168, 110 Stat. 1452, (TBOR2) was enacted July 30, 1996.

This notice also describes a provision of the Small Business Job Protection Act of 1996, Pub. L. No. 104–188, 110 Stat. 1755, enacted August 20, 1996, that increases certain penalties on exempt organizations for failing to satisfy inspection requirements.

This notice also solicits comments to be considered in drafting future guidance. See Notice 96–46, page 7, this Bulletin, for aspects of TBOR2 related to excise taxes on excess benefit transactions engaged in by certain tax-exempt organizations, and Notice 96–47, page 8, this Bulletin, for aspects of TBOR2 related to the express prohibition of private inurement for § 501(c)-(4) organizations.

I. Inspection Requirements Related to Annual Information Returns

Section 1313(a) of TBOR2 amends § 6104(e) with regard to the manner in which an exempt organization, other than a private foundation, must allow inspection by the public of its annual information returns and its application for exemption. Section 6104(e), as amended, provides that if a request is made, in person or in writing, for a copy of certain documents, an organization must provide the copies to the requester without charge, other than a reasonable fee for any reproduction and mailing costs. The documents that may be requested under § 6104(e) are (1) one or more of an exempt organization's three most recent information returns, and (2) the organization's application for recognition of exemption under § 501(a) (together with a copy of any supporting papers and any document issued by the Internal Revenue Service in response). If the request is made in person, the copies must be provided immediately. If the request is made in writing, the copies must be provided within 30 days.

Pursuant to § 6104(e)(3), this new requirement to provide copies without charge (other than a reasonable fee for any reproduction and mailing costs) does not apply if, in accordance with regulations promulgated by the Secretary, the organization has made the requested documents widely available. Additionally, the new § 6104(e) requirement does not apply if the Secretary determines, upon application by the organization, that the request is part of a harassment campaign and that compliance with the request is not in the public interest.

The requirement to provide copies without charge (other than a reasonable fee for any reproduction and mailing costs) does not take effect until 60 days after the Secretary of the Treasury first issues regulations under new § 6104-(e)(3). Until that time, the prior law governs the manner in which an exempt organization, other than a private foundation, must allow inspection of its annual information returns by the public.

Until regulations are issued, prior law requires tax-exempt organizations to show a requester copies of the organization's three most recent annual information returns, and the organization's application for exemption (together with a copy of any supporting papers and any document issued by the Internal Revenue Service in response), at the organization's principal place of business (and at other offices in certain instances). Although prior law requires the organization to allow inspection of the returns and requires the organization to allow the requester to take notes while inspecting the returns, it does not require the organization to provide a copy that the requester can take from the organization's office.

II. Increases in Certain Penalties

Failure to File Complete and Timely Annual Information Returns

Section 1314(a) of TBOR2 amends § 6652(c)(1)(A) to increase the penalties on exempt organizations for failure to file complete and timely annual information returns. Section 6652(c)(1)(A) provides that a failure to timely file an annual information return, failure to include any of the information required to be shown on the return, or failure to show the correct information, results in a penalty to be paid by the organization of $20 per day (increased from $10 per day) for each day during which the failure occurs. The maximum penalty under § 6652(c)(1)(A) with respect to any one return shall not exceed the lesser of $10,000 (increased from $5,000) or 5 percent of the gross receipts of the organization for the year.

Failure to Allow Inspection of Annual Returns and Exemption Applications

Section 1704(s) of the Small Business Job Protection Act, Pub. L. No. 104–188, 110 Stat. 1755 (SBJPA), enacted August 20, 1996, amends § § 6652(c)-(1)(C) and (D) to increase the penalties for failure to allow inspection of any return or application under § 6104(d) or § 6104(e). Under the amended § 6652-(c)(1)(C), any person failing to allow inspection of annual returns must pay $20 per day (increased from $10 per day) for each day during which such failure continues, not to exceed $10,000 (increased from $5,000). Under the amended § 6652(c)(1)(D), any person failing to allow inspection of an organization's application for exemption must pay $20 per day (increased from $10 per day) for each day such failure continues.

Willful Failure to Allow Inspection

Section 1313(b) of TBOR2 amends § 6685 to increase the penalty for a willful failure to allow inspection of any return or application for exemption under § § 6104(d) or (e) from $1,000 to $5,000. The amendment to § 6685 does not take effect until 60 days after the Secretary of the Treasury first issues regulations under new § 6104(e)(3).

Special Penalty for Large Tax-Exempt Organizations

Section 1314(b) of TBOR2 creates a new special penalty for large organizations under § 6652(c)(1)(A). Under this provision, a failure to timely file an annual information return, failure to include any of the information required to be shown on the return, or failure to show the correct information by an exempt organization with gross receipts exceeding $1,000,000 for any year results in a penalty to be paid by the organization of $100 per day for each day during which the failure occurs. The maximum penalty under § 6652(c)(1)

for an organization with gross receipts exceeding $1,000,000 shall not exceed $50,000.

The amended penalties in § 6652-(c)(1) apply to returns for taxable years ending on or after July 30, 1996.

III. Comments on Future Guidance Invited

The Service invites comments on the amendments to the Internal Revenue Code made by § § 1313 and 1314 of TBOR2 and § 1704(s) of SBJPA (inspection requirements and penalty increases). The Service will consider these comments in drafting future guidance. In particular, comments are requested concerning ways in which an organization can make the relevant documents widely available, and, therefore, qualify for exemption from the general requirements of § 6104(e)(3). The Service is interested in providing suitable or helpful alternatives for qualifying for the exemption. These could include, but are not limited to, electronic dissemination through the internet or other electronic databases, depositing copies at public libraries, or providing copies to third-party organizations that will make the documents available to the public for a reasonable fee. The Service is also interested in comments with respect to how these methods could satisfy requests made in person or in writing. The Service intends to expeditiously issue guidance on the § 6104(e)(3) exception, and therefore requests that written comments be submitted by November 12, 1996. Send submissions to: CC:DOM:CORP:R (Notice 96–48), Room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (Notice 96–48), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the internet by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html.

Compliance With Tax-Exempt Bond Arbitrage Requirements

Notice 96–49

Rev. Proc. 96–41, 1996–32 I.R.B. 9, is part of a continuing initiative of the Internal Revenue Service to address the complex compliance matters associated with the arbitrage yield restriction and rebate requirements of § 148 of the Internal Revenue Code. In particular, Rev. Proc. 96–41 provides a voluntary closing agreement program for issuers of state or local government bonds that may have used bond proceeds to pay more than fair market value for nonpurpose investments deposited into an advance refunding escrow. As discussed below, this notice requests comments on Rev. Proc. 96–41 and modifies section 5.01 of Rev. Proc. 96–41 by extending the deadline for requesting a closing agreement under the program. In the meantime, issuers can continue to take advantage of the closing agreement program.

Rev. Proc. 96–41 reflects the Service's efforts to provide issuers with a relatively standardized, voluntary procedure to identify and correct potential noncompliance with the arbitrage yield restriction and rebate requirements of § 148. As part of the standardized approach, the closing agreement program described in Rev. Proc. 96–41 utilizes the concept of spot price as the basis for the closing agreement amount. Rev. Proc. 96–41 acknowledges, however, that the use of spot price is for the administrative convenience of issuers of state or local government bonds and the Service. As indicated in Rev. Proc. 96–41, no inference should be drawn that spot price necessarily reflects fair market value in any particular case.

Since the release of Rev. Proc. 96–41, the Service has received written and oral comments on the revenue procedure. In response to these comments, the Service is reviewing the revenue procedure and is taking the following steps.

(1) The Service extends the deadline in section 5.01 of Rev. Proc. 96–41 for requesting a closing agreement under the revenue procedure from July 19, 1997, to a date that will be no earlier than 1 year from the date the Service publishes further guidance relating to the duration of the closing agreement program described in Rev. Proc. 96–41. See section 4.02 of Rev. Proc. 96–41, however, for a limitation on the use of the closing agreement program for issues under examination (or which come under examination).

(2) The Service invites interested parties to submit written comments on all aspects of Rev. Proc. 96–41. The Service is particularly interested in receiving comments and specific proposals on the following matters:

(i) What is an appropriate time period within which to request a closing agreement under the closing agreement program described in Rev. Proc. 96–41?

(ii) What methods or procedures are appropriate to determine spot price (including the range of values acceptable as spot price) for purposes of determining the closing agreement amount under section 6 of Rev. Proc. 96–41?

(iii) Are there other methods appropriate for determining the closing agreement amount that would be easier for the Service and issuers to apply?

(iv) Are alternative closing agreement programs warranted either for all types of issues or for particular types of issues such as (a) small issues, or (b) bonds issued on or prior to August 15, 1986, or prior to other effective dates of the Tax Reform Act of 1986?

The Service requests that comments (a signed original and eight (8) copies) be submitted in writing on or before December 17, 1996. Send submissions to: CC:DOM:CORP:R (Notice 96–49), Room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, comments (1) may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (Notice 96–49), Courier's Desk, Internal Revenue Service, 1111 Constitution Ave., NW, Washington, DC, or (2) may be submitted electronically via the Service's internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. All comments will be available for public inspection and copying.

A public hearing has been scheduled for January 15, 1997, at 10 a.m. in Room 332, Federal Trade Commission Building, 6th and Pennsylvania Ave., NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Federal Trade Commission Building lobby more than 15 minutes before the hearing starts.

The hearing will be subject to procedures similar to those described in 26 CFR 601.601(a)(3).

Persons that wish to present oral comments at the hearing must submit written comments by December 17, 1996, and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by December 24, 1996.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

EFFECT ON OTHER DOCUMENTS

Rev. Proc. 96–41, section 5.01 is modified by extending the deadline for requesting a closing agreement from July 19, 1997, to a date that will be no earlier than 1 year from the date the Service publishes further guidance relating to the duration of the closing agreement program described in Rev. Proc. 96–41.

Furnishing Statements Required With Respect To Certain Substitute Payments; Correction

Notice 96–50

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correcting amendment.

SUMMARY: This document contains a correction to final regulations (T.D. 8029 [1985–2 C.B. 303]), which were published in the **Federal Register** on Wednesday, June 5, 1985 (50 FR 23676) relating to statements required to be furnished by brokers and information returns of brokers.

EFFECTIVE DATE: June 5, 1985.

SUPPLEMENTARY INFORMATION:

Background

The final regulations that are the subject of this correction are under sections 6042, 6045 and 6049 of the Internal Revenue Code.

Need for Correction

The final regulations (T.D. 8029) omitted instructions to remove § 1.6045–2T and the entry for the OMB control number. It is the intent of this document to make these removals as of the publication of the final regulations.

* * * * *

Correcting Amendment to Regulations

Accordingly, 26 CFR parts 1 and 602 are corrected by making the following correcting amendments:

PART 1—INCOME TAXES

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

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

§ 1.6045–2T [Removed]

Par. 2. Section 1.6045–2T is removed.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

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

Authority: 26 U.S.C. 7805.

§ 602.101 [Amended]

Par. 4. Section 602.101(c) is amended by removing the entry for § 1.6045–2T from the table.

Cynthia E. Grigsby,
Chief, Regulations Unit,
Assistance Chief Counsel (Corporate).

(Filed by the Office of the Federal Register on September 4, 1996, 8:45 a.m., and published in the issue of the Federal Register for September 5, 1996, 61 F.R. 46719)

Inflation-Indexed Debt Instruments

Notice 96–51

The Department of the Treasury plans to issue securities that are adjusted for inflation and deflation ("Treasury Inflation-Protection Securities"). See Amendment to the Uniform Offering Circular for the Sale and Issue of Marketable Book-Entry Treasury Bills, Notes and Bonds, which was filed with the Federal Register on September 25, 1996. To provide guidance on the federal income tax treatment of these securities and other debt instruments with similar terms, the Internal Revenue Service (IRS) intends to issue proposed and temporary regulations under §§ 1275(d) and 1286 of the Internal Revenue Code prior to the first issuance of the securities. This notice describes, in general terms, the debt instruments that are expected to be subject to the regulations and how these instruments are expected to be treated under the regulations.

TREASURY INFLATION-PROTECTION SECURITIES

As described in the Offering Circular, a Treasury Inflation-Protection Security will provide for semiannual payments of interest and a payment of principal at maturity. In general, each payment will be adjusted to take into account any inflation or deflation that occurs between the issue date of the security and the payment date.

The principal amount of a Treasury Inflation-Protection Security will be adjusted for inflation and deflation based on monthly changes in the non-seasonally adjusted U.S. City Average All Items Consumer Price Index for All Urban Consumers (CPI-U), which is published by the Bureau of Labor Statistics of the Department of Labor. The inflation-adjusted principal amount of the security for the first day of any month will be determined by multiplying the principal amount at issuance by a fraction, the numerator of which is the value of the index for the adjustment date and the denominator of which is the value of the index for the issue date. The inflation-adjusted principal amount of the security for a day other than the first day of a month will be determined based on a straight-line interpolation between the inflation-adjusted principal amount for the first day of the month and the inflation-adjusted principal amount for the first day of the next month. The value of the index used to determine the adjustment for the first day of a particular month will be the value of the index reported for the third preceding month.

Each semiannual payment of interest will be determined by multiplying a single fixed rate of interest by the inflation-adjusted principal amount of the security for the date of the interest payment. Thus, although the interest rate will be fixed, the amount of each interest payment will vary with changes in the principal of the security as adjusted for inflation and deflation.

A Treasury Inflation-Protection Security also will provide for an additional payment at maturity if the security's inflation-adjusted principal amount for the maturity date is less than the security's principal amount at issuance. The amount of the additional payment will equal the excess of the security's princi-

pal amount at issuance over the security's inflation-adjusted principal amount for the maturity date.

INFLATION-INDEXED DEBT INSTRUMENTS

In general, the regulations will apply to an inflation-indexed debt instrument, regardless of the identity of the issuer. An inflation-indexed debt instrument generally will be defined in the regulations as a debt instrument that satisfies the following conditions:

(1) The debt instrument is issued for U.S. dollars and all payments of principal and interest on the instrument are denominated in U.S. dollars.

(2) The principal amount of the debt instrument is adjusted for inflation and deflation. The adjustment must be measured by changes in the current value of a single general price or wage index published monthly by an agency of the United States Government (e.g., the CPI-U). A current value of an index is a value of the index that has been updated and published within the six month period preceding the date of the adjustment.

(3) The debt instrument provides for an appropriate method to calculate its inflation-adjusted principal amount for each day to reflect the monthly changes in the current value of the price or wage index. For example, the inflation-adjusted principal amount for the first day of each month is determined by reference to the change in the index for the third preceding month, and the inflation-adjusted principal amount for any other day is determined based on straight-line interpolation between the inflation-adjusted principal amount for the first day of the month and the inflation-adjusted principal amount for the first day of the next month.

(4) Each stated interest payment on the debt instrument, if any, is computed by multiplying a single fixed rate of interest by the inflation-adjusted principal amount for the date of the interest payment.

(5) The payments on the debt instrument are not subject to any contingencies other than the inflation contingency. For this purpose, a contingency that is remote or incidental will be ignored. In addition, a payment will not be contingent merely because of the possibility of impairment by insolvency, default, or similar circumstances.

Notwithstanding the condition described in paragraph (5) above, a debt instrument will not fail to qualify as an inflation-indexed debt instrument merely because it provides for a minimum guarantee payment. A minimum guarantee payment is an additional payment that is made at maturity if the debt instrument's inflation-adjusted principal amount for the maturity date is less than the instrument's principal amount at issuance. The amount of the additional payment must be no more than the excess of the debt instrument's principal amount at issuance over the instrument's inflation-adjusted principal amount for the maturity date.

An example of a debt instrument that satisfies the above conditions is a Treasury Inflation-Protection Security.

If a debt instrument qualifies as an inflation-indexed debt instrument, one of two methods will apply to account for qualified stated interest and original issue discount (OID) on the instrument: the coupon bond method or the discount bond method. In general, both methods will measure the amount of qualified stated interest and OID that accrues on an inflation-indexed debt instrument based on changes in the principal amount of the debt instrument and constant yield principles.

The discount bond method will apply a formula to determine the amount of OID that accrues during an accrual period on an inflation-indexed debt instrument. This formula is based on changes in the inflation index over the term of the debt instrument and the yield of the debt instrument at issuance. In the case of certain inflation-indexed debt instruments, however, the accruals of OID on the debt instruments can easily be determined without the use of the formula. Therefore, the regulations will provide a simplified version of the discount bond method for these debt instruments (the coupon bond method).

COUPON BOND METHOD

The coupon bond method will apply to an inflation-indexed debt instrument that satisfies two conditions: First, there is no more than a de minimis difference between the debt instrument's issue price and its principal amount at issuance. Second, all stated interest payable on the debt instrument is qualified stated interest. For purposes of the regulations, stated interest will be qualified stated interest if it is unconditionally payable in cash at least annually. The coupon bond method will apply to Treasury Inflation-Protection Securities that are not stripped into principal and interest components.

If an inflation-indexed debt instrument qualifies for the coupon bond method, the qualified stated interest payable on the debt instrument will be taken into account under the taxpayer's regular method of accounting. Any increase in the inflation-adjusted principal amount will be treated as OID for the period in which the increase occurs. Any decrease in the inflation-adjusted principal amount (a deflation adjustment) will be taken into account under the rules for deflation adjustments described below.

For example, if a taxpayer who uses the cash receipts and disbursements method of accounting (cash method) holds a Treasury Inflation-Protection Security for an entire calendar year, the taxpayer generally will include in income the interest payments received on the security during the year. In addition, the taxpayer will include in income an amount of OID measured by subtracting the inflation-adjusted principal amount of the security for January 1 of the year from the inflation-adjusted principal amount of the security for January 1 of the next year. If the taxpayer uses an accrual method of accounting rather than the cash method, the taxpayer will include in income the qualified stated interest that accrued on the debt instrument during the year and an amount of OID measured by subtracting the inflation-adjusted principal amount of the security for January 1 of the year from the inflation-adjusted principal amount of the security for January 1 of the next year.

DISCOUNT BOND METHOD

If an inflation-indexed debt instrument does not qualify for the coupon bond method (e.g., because it is issued at a discount), the instrument will be subject to the discount bond method. In general, the discount bond method will require taxpayers to make current adjustments to their OID accruals on the debt instrument to account for changes in the inflation-adjusted principal amount.

Under the discount bond method, a taxpayer will accrue OID using the four steps provided under § 1.1272-1(b)(1) of the Income Tax Regulations (constant yield method). However, the debt instrument's yield to maturity will be determined as of the issue date by assuming no inflation or deflation, and the OID

allocable to an accrual period (n) will be determined by using the following formula:

$OID_{(n)} = \{AIP_{(n)} \times [r + inf_{(n)} + (r \times inf_{(n)})]\} - QSI_{(n)}$ where,

r = yield of the debt instrument determined as of the issue date by assuming no inflation or deflation, adjusted for the length of the accrual period;

$inf_{(n)}$ = percentage change in the inflation index for period (n);

$AIP_{(n)}$ = adjusted issue price at the beginning of period (n); and

$QSI_{(n)}$ = qualified stated interest allocable to period (n).

If the formula produces a negative amount of OID, this amount (deflation adjustment) will be taken into account under the rules for deflation adjustments described below.

DEFLATION ADJUSTMENTS

In general, a deflation adjustment will reduce the amount of interest includible in income by a holder with respect to the debt instrument for the taxable year. If the amount of the deflation adjustment exceeds the interest otherwise includible in income for the taxable year, the excess will be treated as an ordinary loss by the holder for the taxable year. However, the amount treated as an ordinary loss will be limited to the amount by which the holder's total interest inclusions on the debt instrument in prior taxable years exceed the total amount treated by the holder as an ordinary loss on the debt instrument in prior taxable years. If the deflation adjustment exceeds the interest otherwise includible in income by the holder with respect to the debt instrument for the taxable year and the amount treated as an ordinary loss for the taxable year, this excess will be carried forward to offset interest income on the debt instrument in subsequent taxable years. In general, any excess remaining upon the sale, exchange, or retirement of the debt instrument will result in a loss to the holder for federal income tax purposes. Similar rules will apply to determine an issuer's interest deductions and income for the debt instrument.

MINIMUM GUARANTEE

Under both the coupon bond method and the discount bond method, a minimum guarantee payment as described above generally will be ignored until the payment is made. If there is a minimum guarantee payment, the payment will be treated as a payment of interest.

ACCRUALS OF QUALIFIED STATED INTEREST

In certain situations, a taxpayer will have to determine how much qualified stated interest, if any, has accrued as of a certain date on an inflation-indexed debt instrument. The regulations will provide that the amount of accrued but unpaid qualified stated interest as of any date is determined by using the principles of § 1.446–3(e)(2)(ii) (relating to notional principal contracts). For example, if the interval between interest payment dates spans two taxable years, a taxpayer using an accrual method of accounting will determine the amount of accrued qualified stated interest for the first taxable year by reference to the inflation-adjusted principal amount for the last day of the taxable year.

SUBSEQUENT HOLDERS

For purposes of determining whether a holder acquires an inflation-indexed debt instrument at a premium or with market discount, the amount payable at maturity on the instrument will be treated as equal to the instrument's inflation-adjusted principal amount for the day the holder acquires the instrument. Any premium or market discount will be taken into account over the remaining term of the debt instrument by making the same assumption.

STRIPS

A Treasury Inflation-Protection Security will be eligible upon issuance for the Department of the Treasury's Separate Trading of Registered Interest and Principal of Securities (STRIPS) program. Under this program, the interest and principal components of a Treasury Inflation-Protection Security may be transferred as separate instruments (stripped bonds and coupons). In general, § 1286 treats the holder of a stripped bond (or coupon) as if the holder purchased a newly issued debt instrument that has OID. The regulations will provide that the holder of a component of a Treasury Inflation-Protection Security that is stripped under the Treasury STRIPS program must use the discount bond method to account for the OID on the component.

REOPENINGS

The regulations will provide that a reopening of Treasury Inflation-Protection Securities will be a qualified reopening for purposes of § 1.1275–2(d)(2), provided the reopening occurs not more than one year after the original securities were first issued to the public.

EFFECTIVE DATE

The regulations will apply to debt instruments issued on or after the date the regulations are published in the Federal Register.

REQUEST FOR COMMENTS

The IRS and the Department of the Treasury request comments on the rules described in this notice. Comments should be submitted in writing on or before October 28, 1996 to: CC:DOM:CORP:R (Notice 96–51), Room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, comments (1) may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (Notice 96–51), Courier's Desk, Internal Revenue Service, 1111 Constitution Ave., NW, Washington, DC, or (2) may be submitted electronically via the IRS internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. All comments will be available for public inspection and copying.

Work Opportunity Tax Credit — Pre-Screening Notice

Notice 96–52

This Notice provides temporary transition relief for employers with respect to the Work Opportunity Tax Credit (WOTC) that was enacted as part of the Small Business Job Protection Act of 1996, Pub. L. No. 104–188 (August 20, 1996).

BACKGROUND

The WOTC provides a tax credit for employers who hire individuals belonging to one of the following groups: (1) qualified recipients of benefits under AFDC or a successor program; (2) qualified veterans; (3) qualified ex-felons; (4) high-risk youth; (5) vocational rehabilitation referrals; (6) qualified summer youth employees; or (7) qualified food stamp recipients. *See* Internal Revenue Code section 51. The WOTC is effective for wages paid to qualified individuals whose first day of work for the employer is on or after October 1, 1996.

For purposes of the WOTC, a prospective employee is not considered a member of one of the targeted groups unless the individual is certified as such by a State Employment Security Agency (SESA). The SESA certification requirement may be satisfied in either of two ways:

Under one approach, an employer may receive a certification from a SESA, on or before the day the prospective employee begins work, stating that the individual is a member of a targeted group. Section 51(d)(11)(A)(i).

Under the other approach, the employer must complete a "pre-screening notice" with respect to the prospective employee on or before the day the individual is offered employment, and then, within 21 days after the individual begins work, must submit that notice, signed by the individual and the employer under penalties of perjury, to the SESA as part of a request for certification. Section 51(d)(11)(A)(ii). If an employer uses this approach, the employer must also receive a certification from the SESA that the individual is, in fact, a member of a targeted group before claiming the WOTC with respect to the individual.

The IRS on September 26, 1996, issued Form 8850, *Work Opportunity Credit Pre-Screening Notice and Certification Request*, to serve as the pre-screening notice. This Form will be available electronically beginning September 27, 1996, through the IRS Home Page on the World Wide Web (http://www.irs.ustreas.gov) or by modem directly to 703–321–8020 (not a toll-free number). Employers may also request copies of Form 8850 by calling 1–800–TAX–FORM (1–800–829–3676); however, copies of Form 8850 will not be available through this toll-free service until approximately October 15, 1996.

TEMPORARY TRANSITION RELIEF

This Notice provides temporary transition relief for employers that did not complete Form 8850 at the time a job offer was made if the following conditions are satisfied:

(1) The job offer was made on or after August 20, 1996, and on or before October 31, 1996.

(2) At the time the job offer was made, the employer reasonably believed, based on information provided by the prospective employee, that the individual was a member of a targeted group.

(3) Form 8850 is properly completed and signed by both the employer and the individual, and submitted to the SESA, by the later of (a) November 21, 1996, or (b) 21 days after the individual begins work for the employer.

An employer seeking to rely on the temporary transition relief provided by this Notice should write "FILED PURSUANT TO NOTICE 96–52" across the top of the Form 8850. The employer should also strike the words "I completed this form on or before the day a job was offered to the applicant and that" from the jurat preceding the signature line of the form.

If these conditions are satisfied, the Service will treat the Form 8850 as having been timely completed and submitted to the SESA in accordance with Code section 51(d)(11)(A)(ii). The SESA must, however, certify that the individual named in the form is, in fact, a member of a targeted group before the employer may claim the WOTC with respect to the individual.

Medical Savings Accounts

Notice 96–53

The Health Insurance Portability and Accountability Act of 1996 added section 220 to the Internal Revenue Code to permit eligible individuals to establish medical savings accounts (MSAs) under a pilot project beginning on January 1, 1997.

This notice provides certain basic information about MSAs. It does not attempt to summarize all of the specific rules that apply.

The notice is divided into seven parts. Part I of the notice explains what MSAs are and who can have them. Part II describes how MSAs can be established. Parts III and IV cover contributions to MSAs and distributions from MSAs. Part V deals with the statutory limit on the number of taxpayers who can use MSAs. Part VI relates to information reporting by MSA trustees and custodians, and Part VII addresses other matters relating to MSAs.

I. What Are MSAs and Who Can Have Them?

Q–1. What is an MSA?

A–1. An MSA is a tax-exempt trust or custodial account established for the purpose of paying medical expenses in conjunction with a high-deductible health plan. A number of the rules that apply to MSA are similar to rules that apply to individual retirement arrangements (IRAs). For example, like an IRA, an MSA is established for the benefit of an individual, and is "portable". Thus, if the individual is an employee who later changes employers or leaves the work force, the MSA does not stay behind with the former employer, but stays with the individual. However, because MSAs differ from IRAs in some important respects, taxpayers cannot use an IRA as an MSA, and cannot combine an IRA and an MSA in a single account.

Q–2. Who is eligible to have an MSA?

A–2. Two types of individuals are eligible to establish an MSA:

(1) an employee (or spouse of an employee) of a "small employer" that maintains an individual or family "high-deductible health plan" covering that individual (employee or spouse); or

(2) a self-employed person (or the spouse of a self-employed person) maintaining an individual or family "high-deductible health plan" covering that individual (self-employed person or spouse).

See A–6 and A–7 for additional limitations on who may establish MSAs.

Q–3. What is a "small employer" for MSA purposes?

A–3. An employer is a "small employer" for a calendar year if the employer employed an average of 50 or fewer employees on business days during either of the two preceding calendar years. Special rules apply to new employers, consolidated groups, and certain employers that have added employees. See Internal Revenue Code section 220(c)(4).

Q–4. What is a "high-deductible health plan" that makes someone eligible for an MSA?

A–4. A "high-deductible health plan" is a health plan that: (1) has an annual deductible of at least $1,500, and not more than $2,250, for individual (self-only) coverage; or (2) has an annual deductible of at least $3,000, and not more than $4,500, for family coverage (coverage of more than one individual). In addition, the annual out-of-pocket expenses under the plan cannot exceed $3,000 for individual coverage and $5,500 for family coverage. Out-of-

pocket expenses include deductibles, copayments and other amounts the participant must pay for covered benefits, but do not include premiums.

Q–5. Can a health maintenance organization (HMO) offer a high-deductible health plan?

A–5. Yes. A high-deductible health plan may be offered by a variety of entities, including insurance companies and health maintenance organizations (HMOs).

Q–6. What kind of other health coverage makes an individual ineligible for an MSA?

A–6. Except as described in A–7, an individual is ineligible for an MSA if the individual is covered under a health plan (whether as an individual, spouse, or dependent) that is not a high-deductible health plan (including being covered as a beneficiary under Medicare) as well as under a high-deductible health plan.

Q–7. What other kinds of health coverage may an individual maintain without losing eligibility for an MSA?

A–7. An individual remains eligible for an MSA if, in addition to a high-deductible health plan, the individual has coverage (whether provided through insurance or otherwise) for accidents, disability, dental care, vision care, long-term care, insurance for a specified disease or illness, insurance that pays a fixed amount per day (or other period) of hospitalization; or insurance under which substantially all of the coverage provided relates to liabilities from workers' compensation laws, torts, or ownership or use of property (such as automobile insurance).

Q–8. Are MSAs allowed under a cafeteria plan?

A–8. A high-deductible health plan (described in A–4) can be provided as part of a cafeteria plan. Such a high-deductible health plan can be used in conjunction with an MSA. However, the MSA must be established outside the cafeteria plan, because a cafeteria plan is not permitted to provide for contributions to an MSA. Outside of the cafeteria plan context, an employee will not be subject to taxation merely because the employee has a choice between employer contributions to an MSA and other employer-provided accident or health coverage.

II. How Can An MSA Be Established?

Q–9. How does an eligible individual establish an MSA?

A–9. Beginning January 1, 1997, any eligible individual (as described in A–2) can establish an MSA with a qualified MSA trustee or custodian, in much the same way that individuals establish IRAs with qualified IRA trustees or custodians. No permission or authorization from the Internal Revenue Service (IRS) is necessary to establish an MSA.

Q–10. Who is a qualified MSA trustee or custodian?

A–10. Any insurance company or any bank (including a similar financial institution as defined in Internal Revenue Code section 408(n)) can be a MSA trustee or custodian. In addition, any other persons already approved by the IRS to be trustees or custodians of IRAs are automatically approved to be MSA trustees or custodians. Persons other than banks, insurance companies, or previously approved IRA trustees or custodians may request approval to be a trustee or custodian in accordance with the procedures set forth in Treasury Regulation § 1.408–2(e) (relating to IRA nonbank trustees). An eligible individual who is an employee may establish a MSA without any involvement of the employer.

Q–11. How does an individual or small employer sign up for or enroll in the MSA pilot project?

A–11. Neither individuals nor small employers "sign up for", "apply for", or otherwise "enroll in" the MSA pilot project. Rather, as described in A–9, eligible individuals or small employers can proceed to arrange for the establishment of MSAs with qualified trustees or custodians without awaiting permission or authorization from the IRS. (Sections V and VI, below, give further information on the limits Congress imposed on the number of taxpayers who can contribute to MSAs, and reporting by trustees and custodians.)

III. Contributions to MSAs.

Q–12. Who may contribute to an MSA?

A–12. In the case of an MSA established by an employee or by the spouse of an employee, the account holder (employee or spouse, respectively) may contribute to the MSA. Alternatively, the employee's employer may contribute to the employee's or spouse's MSA. However, if an employer makes a contribution to an MSA for a given year, the account holder of that MSA may not contribute to any MSA for that year. (Additional restrictions apply if an employee's spouse receives MSA contributions. See Internal Revenue Code section 220(b)(5)(B).)

In the case of an MSA established by a self-employed individual or spouse, the account holder (the self-employed individual or the spouse, respectively) may contribute to the MSA.

Q–13. How much may be contributed to an MSA?

A–13. The maximum annual amount permitted to be contributed to an MSA for a year is (1) for high-deductible individual coverage, 65 percent of the deductible; and (2) for high-deductible family coverage, 75 percent of the deductible. The same annual contribution limit applies whether the contributions are made by an employee, an employer, or a self-employed person. The annual contribution limit is the sum of the limits determined separately for each month, based on status, eligibility and health plan coverage as of the first day of the month. Although the annual limitation is calculated using monthly data, the contribution for the year can be made in one or more payments, at the convenience of the individual or the employer, at any time within the deadline described in A–15.

For example, assume that an individual has self-only coverage under a high-deductible health plan with an annual deductible of $1,800. The annual contribution limit is 65 percent of $1,800 ($1,170), and the monthly contribution limit is $97.50 ($1,170/12). Assume further that the individual is an eligible individual for each of the first eight months of the year, but not thereafter. In that case, the contribution limit for the year is $780 (8 x $97.50).

Q–14. In what form may contributions be made to an MSA?

A–14. Contributions to an MSA must be made in cash. For example, contributions may not be made in the form of stock or other property.

Q–15. What is the tax treatment of an eligible individual's MSA contributions?

A–15. Contributions by an eligible individual to an MSA (which are subject to the limits described in A–13) are deductible in computing adjusted gross income. Accordingly, the contributions are deductible whether or not the eli-

gible individual itemizes deductions. The tax deduction for an employee or the employee's spouse, however, cannot exceed the individual's compensation attributable to the employer that sponsors the high-deductible plan covering the individual. For a self-employed individual, in addition to the contribution limits described in A–13, the tax deduction cannot exceed the individual's earned income from the trade or business with respect to which the high-deductible plan is established. In addition, the statute denies a tax deduction to any individual who may be claimed as a dependent on another taxpayer's return.

Q–16. What is the tax treatment of employer contributions to an eligible individual's MSA?

A–16. Employer contributions to an eligible individual's MSA (which are limited as described in A–13) are excludable from gross income, are not subject to withholding for income tax, and are not subject to other employment taxes (i.e., Social Security and Medicare taxes (FICA), federal unemployment tax (FUTA) or railroad retirement tax).

Q–17. What is the tax treatment of earnings on amounts in an MSA?

A–17. Earnings on amounts in an MSA are not taxable prior to distribution from the MSA. See A–21 regarding the taxation of distributions.

Q–18. When is the deadline for an eligible individual to make contributions to an MSA for any particular year?

A–18. An eligible individual may make MSA contributions for a particular tax year no later than the time prescribed by law (without extensions) for filing the individual's federal income tax return for that year. As in the case of IRAs, for calendar year taxpayers, generally the deadline for contributions to an MSA is April 15 following the year for which the contributions are made.

Q–19. What happens when MSA contributions exceed the amount that may be deducted or excluded from gross income?

A–19. Contributions by individuals are not deductible to the extent that they exceed the limits in A–13 or A–15 or if they are made by an individual who is not an eligible individual. Contributions by employers are included in gross income to, the extent that they exceed the limits in A–13 or if they are made on behalf of an individual who is not an eligible individual. In addition, under the statute an excise tax of six percent for each tax year is imposed on the account holder for these excess individual and employer contributions. If, however, the excess contributions for a tax year and the net income attributable to these excess contributions are paid to the account holder before the last day prescribed by law, including extensions, for filing the account holder's tax return for the tax year, then (1) the excise tax does not apply; (2) the distribution of the excess contributions is not taxed; and (3) the net income attributable to the excess contributions is included in the account holder's gross income for the tax year in which the distribution is made.

IV. Distributions From MSAs.

Q–20. When is an individual permitted to receive distributions from an MSA?

A–20. An individual is permitted to receive a distribution from an MSA at any time.

Q–21. How are distributions from an MSA taxed?

A–21. Distributions from an MSA are excludable from gross income if used for medical expenses of the MSA account holder and the account holder's family, with certain exceptions, and are includible in gross income if used for any other purpose. Under one such exception, in any year for which an MSA contribution is made, distributions from an MSA of that account holder to pay medical expenses are included in gross income if, for the month in which the expense was incurred, the individual for whom the expense was incurred was not covered under a high-deductible health plan or had coverage that makes a person ineligible for an MSA (see A–4 through A–7). If included in gross income, distributions generally are subject to an additional 15 percent tax. However, if distributions that are included in gross income are made after the account holder turns age 65, becomes disabled or dies, the additional 15 percent tax does not apply.

Q–22. What medical expenses are eligible for tax-free distributions?

A–22. Medical expenses are defined under section 213 of the Code, but do not include expenses for insurance other than long-term care insurance, premiums for "COBRA"-type health care continuation coverage, or premiums for health care coverage while an individual receives unemployment compensation.

Q–23. Must MSA trustees or custodians determine whether MSA distributions are used for medical expenses?

A–23. MSA trustees or custodians are not required to determine whether MSA distributions are used for medical expenses; individuals who have MSAs should make this determination.

V. Cap on Number of Taxpayers Using MSAs.

Q–24. Does the law limit the number of MSAs that can be established?

A–24. Yes. The statute authorizes MSAs as a "pilot project". Under the statute, the pilot project is scheduled to end in the year 2000; however, the ability to establish MSAs generally will end earlier if the number of taxpayers contributing (or receiving employer contributions) to an MSA exceeds certain statutory limits for 1997, 1998 or 1999. In general, in determining whether the limits are exceeded, certain previously uninsured individuals will not be counted.

Q–25. What happens after the pilot project ends?

A–25. After the pilot project ends, all eligible individuals (as described in A–2) who previously made or received MSA contributions (or who are employed by certain employers whose employees previously used MSAs) can make or receive MSA contributions, if they remain eligible individuals. In addition, individuals can continue to receive distributions from MSAs as described in A–20 through A–22.

Q–26. Do any special deadlines apply if the ability to establish MSAs generally ends early?

A–26. If the statutory limits are reached and therefore the ability to establish MSAs ends early (as referred to in A–24), an eligible individual who is not covered by a high-deductible health plan by a "cut-off date" specified in the law will be unable to establish an MSA, unless the individual's employer established a high-deductible health plan for its employees before that date and meets certain other requirements.

For employees of small employers, the law specifies two potential cut-off dates in 1997: September 1 and October 1. (For self-employed individuals, these dates are October 1, and November 1, 1997, respectively.) For each of 1998 and 1999, the potential cut-off date is October 1 of that year. If the employer's health plan has a regularly scheduled enrollment period that occurs during the

period between the potential cut-off date and the end of the relevant year, the potential cut-off date is deferred to December 31 of that year.

Q–27. How will a taxpayer know if the ability to establish MSA generally ends early?

A–27. If the statutory limits are reached and therefore the ability to establish MSAs generally ends early (as described in A–24), the IRS will make an announcement not later than October 1 of the relevant year stating the applicable cut-off date. The ability to establish MSAs will not be cut off before the announcement is made.

VI. Information Reporting by Trustees and Custodians.

Q–28. How will the number of MSAs be determined?

A–28. The statute requires MSA trustees and custodians to report by August 1 of each year (1997, 1998, and 1999) the number of MSAs established before July 1 of the year, and also to report by June 1, 1997, the number of MSAs established before May 1, 1997 (together with additional information). See Internal Revenue Code section 220(j). The IRS will release a form to be used in making these reports.

Q–29. What other information reporting is required?

A–29. Information reporting required for MSAs is similar to information reporting for IRAs. The IRS will release forms and instructions to report MSA contributions, distributions and deductions. For further information, contact the Information Reporting Call Site on (304) 263–8700 (not a toll-free number).

VII. Other Matters.

MSAs are subject to a variety of other statutory rules and provisions, many of which are not addressed in this notice. No inference should be drawn regarding issues not expressly addressed in this notice that may be suggested by a particular question or answer, or by the inclusion or exclusion of certain questions.

Among the statutory provisions not addressed in this notice are:

* The requirement that employers make comparable MSA contributions for all comparable participating employees.

* The investment restrictions on MSAs.

* The rollover rules for MSAs.

* The special rules that apply upon divorce or death of the account holder.

* The rules for allocating the deduction for MSA contributions between married people.

* The Congressionally mandated study as to the effects of MSAs in the small group market on selection (including adverse selection), health costs (including the impact on premiums of individuals with comprehensive coverage), use of preventive care, consumer choice, the scope of coverage of high-deductible plans purchased in conjunction with such accounts, and other issues.

The statutory provisions governing MSAs, including new section 220 of the Internal Code are contained in section 301 of the Health Insurance Portability and Accountability Act of 1996, P. L. No. 104–191, 110 Stat. 1936.

VIII. Comments Invited.

Comments are invited on new section 220 of the Internal Revenue Code. Written comments are requested by March 16, 1997. Send submissions to: CC:DOM:CORP:R (Notice 96–53), Room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (Notice 96–53), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the internet by submitting comments directly to the IRS internet site at htpi//www.irs.ustreas.gov/prod/tax_regs/comments.html.

Weighted Average Interest Rate Update

Notice 96–54

Notice 88–73 provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 and as further amended by the Uruguay Round Agreements Act, P.L. 103–465 (GATT).

The average yield on the 30-year Treasury Constant Maturities for September 1996 is 7.03 percent.

The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	90% to 108% Permissible Range	90% to 110% Permissible Range
October	1996	6.91	6.22 to 7.47	6.22 to 7.61

1997 Pension Plan Limitations[1]

Notice 96–55

Section 415 of the Internal Revenue Code provides for dollar limitations on benefits and contributions under qualified plans. Section 415 also requires that the Commissioner annually adjust these limits for cost-of-living increases. Other limitations applicable to deferred compensation plans are also affected by these adjustments.

Effective January 1, 1997, the limitation for the annual benefit under § 415(b)(1)(A) for defined benefit plans is increased from $120,000 to $125,000. For participants who separated from service before January 1, 1997, the limitation for defined benefit plans under § 415(b)(1)(B) is computed by multiplying the participant's compensation limitation, as adjusted through 1996 by 1.0294. The limitation for defined contribution plans under § 415(c)(1)(A) remains unchanged at $30,000.

The Code provides that various other dollar amounts are to be adjusted at the same time and in the same manner as the dollar limitation of § 415(b)(1)(A) is adjusted. These dollar amounts and

[1]Based on News Release IR–96–43, dated October 24, 1996.

the adjusted amounts are as follows:

The special limitation for qualified police or firefighters under § 415(b)(2)-(G) is increased from $66,000 to $70,000.

The limitation on the exclusion for elective deferrals under § 402(g)(1) remains unchanged at $9,500.

The dollar amount under § 409(o)(1)-(C)(ii) for determining the maximum account balance in an employee stock ownership plan subject to a 5-year distribution period is increased from $690,000 to $710,000, while the dollar amount used to determine the lengthening of the 5-year distribution period is increased from $135,000 to $140,000.

The threshold amount under § 4980A(c)(1)(B) regarding excess distributions is increased from $155,000 to $160,000.

The limitation used in the definition of highly compensated employee under § 414(q)(1)(B), as amended by the Small Business Job Protection Act of 1996, is $80,000.

The annual compensation limit under §§ 401(a)(17) and 404(l) is increased from $150,000 to $160,000.

The compensation amount under § 408(k)(2)(C) regarding simplified employee pension plans (SEPs) remains unchanged at $400. The compensation amount under § 408(k)(3)(C) for SEPs is increased from $150,000 to $160,000.

The compensation amount under § 408(p)(2)(A) regarding simple retirement accounts, as added by § 1421 of the Small Business Job Protection Act of 1996, is $6,000.

The limitation on deferrals under § 457(b)(2) and (c)(1) concerning eligible deferred compensation plans of state and local governments and of tax-exempt organizations remains unchanged at $7,500.

Administrators of defined benefit or defined contribution plans that have received favorable determination letters should not request new determination letters solely because of yearly amendments to adjust maximum limitations in the plans.

Tables for Figuring Amount Exempt from Levy on Wages, Salary, and Other Income

Notice 96–56

1. Table for Figuring Amount Exempt from Levy on Wages, Salary, and Other Income (Forms 668–W, 668–W(c), & 668–W(c)(DO)) 1997

Publication 1494, shown below, provides tables which show the amount of an individual's income that is exempt from a notice of levy used to collect delinquent tax in 1997.

(Amounts are for each pay period.)

Filing Status: Single							
Pay Period	Number of Exemptions Claimed on Statement						
	1	2	3	4	5	6	More Than 6
Daily	26.15	36.35	46.54	56.73	66.92	77.12	15.96 plus 10.19 for each exemption
Weekly	130.77	181.73	232.69	283.65	334.62	385.58	79.81 plus 50.96 for each exemption
Biweekly	261.54	363.46	465.38	567.31	669.23	771.15	159.62 plus 101.92 for each exemption
Semi-monthly	283.33	393.75	504.17	614.58	725.00	835.42	172.92 plus 110.42 for each exemption
Monthly	566.67	787.50	1008.33	1229.17	1450.00	1670.83	345.83 plus 220.83 for each exemption

Filing Status: Unmarried Head of Household							
Pay Period	Number of Exemptions Claimed on Statement						
	1	2	3	4	5	6	More Than 6
Daily	33.46	43.65	53.85	64.04	74.23	84.42	23.27 plus 10.19 for each exemption
Weekly	167.31	218.27	269.23	320.19	371.15	422.12	116.35 plus 50.96 for each exemption
Biweekly	334.62	436.54	538.46	640.38	742.31	844.23	232.69 plus 101.92 for each exemption
Semi-monthly	362.50	472.92	583.33	693.75	804.17	914.58	252.08 plus 110.42 for each exemption
Monthly	725.00	945.83	1166.67	1387.50	1608.33	1829.17	504.17 plus 220.83 for each exemption

Filing Status: Married Filing Joint (and Qualifying Widow(er)s)							
Pay Period	Number of Exemptions Claimed on Statement						
	1	2	3	4	5	6	More Than 6
Daily	36.73	46.92	57.12	67.31	77.50	87.69	26.54 plus 10.19 for each exemption
Weekly	183.65	234.62	285.58	336.54	387.50	438.46	132.69 plus 50.96 for each exemption
Biweekly	367.31	469.23	571.15	673.08	775.00	876.92	265.38 plus 101.92 for each exemption
Semi-monthly	397.92	508.33	618.75	729.17	839.58	950.00	287.50 plus 110.42 for each exemption
Monthly	795.83	1016.67	1237.50	1458.33	1679.17	1900.00	575.00 plus 220.83 for each exemption

Filing Status: Married Filing Separate							
Pay Period	Number of Exemptions Claimed on Statement						
	1	2	3	4	5	6	More Than 6
Daily	23.46	33.65	43.85	54.04	64.23	74.42	13.27 plus 10.19 for each exemption
Weekly	117.31	168.27	219.23	270.19	321.15	372.12	66.35 plus 50.96 for each exemption
Biweekly	234.62	336.54	438.46	540.38	642.31	744.23	132.69 plus 101.92 for each exemption
Semi-monthly	254.17	364.58	475.00	585.42	695.83	806.25	143.75 plus 110.42 for each exemption
Monthly	508.33	729.17	950.00	1170.83	1391.67	1612.50	287.50 plus 220.83 for each exemption

2. Table for Figuring Additional Exempt Amount for Taxpayers at Least 65 Years Old and/or Blind

Additional Exempt Amount

Filing Status	*	Daily	Wkly	Bi-Wkly	Semi-Mthly	Monthly
Single or Head of Household	1	3.85	19.23	38.46	41.67	83.33
	2	7.69	38.46	76.92	83.33	166.67
Any Other Filing Status	1	3.08	15.38	30.77	33.33	66.67
	2	6.15	30.77	61.54	66.67	133.33
	3	9.23	46.15	92.31	100.00	200.00
	4	12.31	61.54	123.08	133.33	266.67

* ADDITIONAL STANDARD DEDUCTION claimed on Parts 3, 4, & 5 of levy.

Examples

These tables show the amount exempt from a levy on wages, salary, and other income. For example:

1. A single taxpayer who is paid weekly and claims three exemptions (including one for the taxpayer) has $232.69 exempt from levy.

2. If the taxpayer in number 1 is over 65 and writes 1 in the ADDITIONAL STANDARD DEDUCTION space on Parts 3, 4, & 5 of the levy, $251.92 is exempt from this levy ($232.69 plus $19.23).

3. A taxpayer who is married, files jointly, is paid bi-weekly, and claims two exemptions (including one for the taxpayer) has $469.23 exempt from levy.

4. If the taxpayer in number 3 is over 65 and has a spouse who is blind, this taxpayer should write 2 in the ADDITIONAL STANDARD DEDUCTION space on Parts 3, 4, & 5 of the levy. Then, $530.77 is exempt from this levy ($469.23 plus $61.54).

Indian Tribal Casinos and Reporting Under Title 31

Notice 96–57

This notice clarifies the reporting requirements under the Internal Revenue Code for cash transactions of more than $10,000 from gaming activities for Indian tribal casinos with gross annual gaming revenues in excess of $1 million and with operations on Indian tribal lands. Effective August 1, 1996, these tribal casinos must comply with the currency transaction reporting, recordkeeping, and compliance-program requirements of the Bank Secrecy Act (BSA), 31 U.S.C. §§ 5311–5330 (1994). As a result, these tribal casinos are not required to report certain transactions under § 6050I of the Internal Revenue Code.

Section 6050I(a) generally requires any person who is engaged in a trade or business and who, in the course of that trade or business, receives cash in excess of $10,000 in one transaction (or two or more related transactions) to file an IRS Form 8300 (Report of Cash Payments Over $10,000 Received in a Trade or Business) with the Internal Revenue Service. However, § 6050I(c)(1) provides an exception from the reporting requirements of § 6050I(a) for cash received in a transaction reported under Title 31, if the Secretary determines that reporting under § 6050I would be duplicative.

The BSA and the regulations under Title 31 require certain financial institutions to report the receipt (or disbursement) of cash of more than $10,000 from certain transactions. See 31 U.S.C. § 5313 (1994) and 31 C.F.R. § 103.22(a)(2) (1996). Under § 5312(a)(2)(x) of the BSA and 31 C.F.R. § 103.11(n)(7)(i) the term "financial institution" includes a casino that has gross annual gaming revenues (as described in 31 C.F.R. § 103.11(n)(7)(ii)) in excess of $1 million.

Effective August 1, 1996, 31 C.F.R. § 103.11(n)(7)(i) was amended to provide that the term "casino" means a casino or gambling casino that is duly licensed or authorized to do business as such in the United States, whether under the laws of a State or of a Territory or Insular Possession of the United States, or under the Indian Gaming Regulatory Act or other federal, state, or tribal law or arrangement affecting Indian lands (including, without limitation, a casino operating on the assumption or under the view that no such authorization is required for casino operation on Indian lands), and that has gross annual gaming revenue in excess of $1 million. 61 Fed. Reg. 7055 (1996). This amendment is intended to apply only to Class III casinos.

Accordingly, effective August 1, 1996, any Class III Indian tribal casino having gross annual gaming revenue in excess of $1 million that engages in a cash transaction of more than $10,000 (as defined in 31 C.F.R. § 103.22(a)(2)) with respect to gaming activities must report that transaction under 31 U.S.C. § 5313 and the regulations thereunder and satisfy applicable recordkeeping and compliance-program requirements of 31 C.F.R. § 103. Such a casino is not also required to report that transaction under § 6050I of the Code.

Section 6050I continues to apply, however, to a transaction in which cash of more than $10,000 is received by such a casino from a nongaming business activity (such as a shop, restaurant, entertainment, or hotel). See 26 C.F.R. § 1.6050I–1(d)(2)(iii).

This notice does not affect the current reporting requirements applicable to a Class II gaming establishment.

Qualified State Tuition Programs

Notice 96–58

This notice provides guidance regarding certain reporting requirements and the transition rules applicable to "qualified State tuition programs" described in § 529 of the Internal Revenue Code, recently enacted by section 1806 of the Small Business Job Protection Act, Pub. L. 104–188 (the "Act"). The notice also solicits comments from the public on section 529.

Section 529 provides tax-exempt status to "qualified State tuition programs," meaning programs established and maintained by a State (or agency or instrumentality thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary entitling the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary, or (2) contribute to an account established for the sole purpose of meeting qualified higher education expenses of the designated beneficiary of the account.

Under § 529, qualified State tuition programs also must meet requirements relating to contributions, refunds, and maintenance of separate accounts for each designated beneficiary of the program. In addition, the program must prohibit investment direction by contributors or beneficiaries, the pledge or assignment of any interest in the program as security for a loan, and excess contributions.

In general, § 529 is effective for taxable years ending after August 20, 1996, the date of enactment. However, the Act includes a transition rule providing that if

> (1) a State maintains (on the date of enactment) a program under which persons may purchase tuition credits on behalf of, or make contributions for educational expenses of, a designated beneficiary, and (2) such program meets the requirements of a qualified State tuition program before the later of (a) one year after the date of enactment, or (b) the first day of the first calendar quarter after the close of the first regular session of the State legislature that begins after the date of enactment, then the provisions of the...[Act] will apply to contributions (and earnings allocable thereto) made before the date the program meets the requirements of a qualified State tuition program, without regard to whether the requirements of a qualified State tuition program are satisfied with respect to such contributions and earnings.... H.R. Conf. Rep. No. 737, 104th Cong., 2d Sess. 282 (1996). (Conference Report). The Internal Revenue Service will not assert income tax liability against a State tuition program for any period before the program meets the requirements of § 529 if the program qualifies for the transition rule.

Section 529(c)(3)(A) and (B) provides that any distribution made by or benefit furnished in-kind under a qualified State tuition program shall be includible in the gross income of the distributee in the manner as provided under § 72, to the extent not excluded from gross income under any other provision.

Section 529(d) authorizes the Internal Revenue Service to require qualified State tuition programs to file information reports for education furnished to beneficiaries or distributions made to individuals during any calendar year. Any reporting requirements promulgated under § 529(d) would apply in lieu of any other reporting requirement for a program that may apply with respect to information returns or payee statements on distributions.

The Internal Revenue Service is currently developing reporting requirements under § 529(d). However, because this legislation was enacted late in the year and because States are expected to need time to implement appropriate record-keeping, reporting will not be required for any distribution made by, or benefit furnished in-kind under, a qualified State tuition program prior to 1998. In addition, the Internal Revenue Service will not assess penalties against plan administrators who do not file information returns or provide payee statements on distributions made during 1997 and prior years.

Comments on Future Guidance Invited

The Internal Revenue Service invites comments on § 529, including the requirements for reporting distributions made by qualified State tuition programs, the requirements for qualification and operation of these programs, and the treatment for federal tax purposes of distributions made by these programs. These comments will be considered in drafting future guidance. Please send written comments by December 31, 1996, to: CC:DOM:CORP:R (Notice 96–58), Room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (Notice 96–58), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet directly to the IRS internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html.

Weighted Average Interest Rate Update

Notice 96–59

Notice 88–73 provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 and as further amended by the Uruguay Round Agreements Act, Pub. L. 103–465 (GATT).

The average yield on the 30-year Treasury Constant Maturities for October 1996 is 6.81 percent.

The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	90% to 108% Permissible Range	90% to 110% Permissible Range
November	1996	6.91	6.22 to 7.46	6.22 to 7.60

Interim Guidance on Sections 877, 1494, 6039F, and 6048

Notice 96–60

This notice provides guidance for taxpayers affected by the penalty provision of section 1494 and the filing requirements of section 6048(a) of the Internal Revenue Code ("Code"), as amended by the Small Business Job Protection Act of 1996 ("SBJPA"). This notice also provides guidance for taxpayers affected by the ruling request provision of section 877 of the Code, as amended by the Health Insurance Portability and Accountability Act of 1996 ("HIPAA"), and the information reporting requirements of section 6039F of the Code, as added by HIPAA.[1]

BACKGROUND

Section 877, as amended by HIPAA, generally provides that a former U.S. citizen who renounces his citizenship after February 5, 1995, or a former long-term lawful permanent resident who ceases to be taxed as a lawful permanent resident after that date, who had as a principal purpose for such renunciation or cessation the avoidance of U.S. taxes, will be taxed on all of his U.S. source income for the succeeding 10-year period. An individual who meets a tax liability or net worth test is considered to be tax motivated. A former citizen who satisfies certain criteria will not be subject to these tests if he submits a ruling request within one year of renunciation of U.S. citizenship for a determination by the Secretary as to whether such renunciation had as one of its principal purposes the avoidance of U.S. taxes. However, the statute provides that in no event will this one-year period expire before November 19, 1996 (the date that is 90 days after the enactment of HIPAA).

Section 6039F, as added by HIPAA, requires each individual who relinquishes U.S. citizenship after February 5, 1995, to provide an information statement to the U.S. Department of State, a diplomatic or consular officer of the United States, or a federal court at the time of expatriation. Any individual who ceases to be taxed as a lawful permanent resident after February 5, 1995, must provide a similar information statement with his U.S. tax return for that year. However, the statute provides that in no event will this information statement be required to be filed before November 19, 1996.

Section 1491 generally imposes an excise tax on the transfer of property by a U.S. person to a foreign corporation as paid-in surplus or as a contribution to capital, to a foreign estate or trust, or to a foreign partnership. Current regulations under section 1494 require a U.S. transferor to file a return on the date such a transfer is made. Section 1494(c), as added by SBJPA, imposes a penalty for the failure to file a required return with respect to any transfer described in section 1491 that occurs after August 20, 1996 (the date of enactment of SBJPA).

Section 6048(a), as amended by SBJPA, generally requires any U.S. person who transfers property to a foreign trust after August 20, 1996, to file an information return. The statute provides that this return must be filed no later than 90 days after the transfer (or such later date as the Secretary may prescribe).

INTERIM GUIDANCE

The Service intends to issue detailed guidance in these areas before the end of 1996. The forthcoming guidance will not require the submission of a ruling request under section 877, an information statement under section 6039F, or an information return under section 6048(a) before a date that is at least 60 days after the issuance of that guidance. Any such ruling request, information statement, or information return submitted within the time period set forth in the forthcoming guidance will be considered filed in a timely manner. In addition, no penalty will be imposed under section 1494(c) if a return required with respect to a section 1491 transfer is filed no later than 60 days after the issuance of the forthcoming guidance (or such later date specified in that guidance).

[1]There are currently two provisions of the Code designated as section 6039F. The Service intends to seek a technical correction to HIPAA to redesignate section 6039F of the Code, as added by HIPAA, as section 6039G.

Information Reporting for Discharges of Indebtedness: Waiver of Penalties in Certain Circumstances for Foreign Financial Entities

Notice 96–61

This notice extends the scope of the penalty relief granted in the preamble to the final Income Tax Regulations under § 6050P of the Internal Revenue Code relating to the reporting of discharges of indebtedness (61 F.R. 262, January 4, 1996).

Section 6050P requires an information return to be filed by an applicable entity, including an applicable financial entity, which discharges the indebtedness of any person if the amount discharged is $600 or more. Section 6050P(c)(2) provides that an applicable financial entity includes any financial institution described in § 581 or 591(a), any credit union, and any other corporation which is a direct or indirect subsidiary of such entity but only if, by virtue of being affiliated with the entity, the corporation is subject to supervision and examination by a Federal or State agency which regulates such other entities.

Section 1.6050P–1(d) of the regulations provides certain exceptions from the reporting requirements. Section 1.6050P–1(d)(4) reserves guidance as to the circumstances under which the reporting requirements will not apply to the discharge of indebtedness of foreign debtors held by foreign branches of U.S. financial institutions. Section 1.6050P–1(d)(4)(ii) identifies the criteria that must be met in order to treat indebtedness held by a foreign branch of a U.S. financial institution as being within the scope of the reserved guidance.

The preamble to the final regulations states, in part, that "the IRS and Treasury are continuing to study the issue of whether reporting is necessary in the case of foreign debtors whose debt is discharged by foreign branches of U.S. financial institutions. Accordingly, pending the issuance of further guidance, no penalties will be imposed if an applicable financial entity fails to report a discharge of indebtedness of a foreign debtor by a foreign branch of the entity."

After issuance of the final regulations, commentators requested that the penalty relief described in the preamble to the final regulations also apply to indebtedness held by foreign offices or branches of foreign financial institutions that are applicable financial entities under § 6050P(c)(2)(C).

The Internal Revenue Service has determined that, pending the issuance of further guidance, the relief granted in the preamble should be extended, as suggested by commentators. To accomplish this, the regulations will be amended to delete the word "U.S." from the heading of § 1.6050P–1(d)(4) and the introductory text in § 1.6050P–1(d)(4)(ii). Furthermore, no penalties

will be imposed if a foreign office or branch of a foreign applicable financial entity fails to report a discharge of indebtedness of a foreign debtor described in § 1.6050P–1(d)(4)(ii) after giving effect to the preceding sentence.

Logos and Identifying Slogans on Substitute Forms 1099

Notice 96–62

This notice informs payors who are required to report certain payments on Form 1099 that the Service intends to issue regulations permitting these payors to use certain logos and identifying slogans on substitute Forms 1099 required to be furnished to payees after December 31, 1995, and invites public comment on this matter.

The Internal Revenue Code generally requires that payors of interest (§ 6049), dividends (§ 6042), patronage dividends (§ 6044), and royalties (§ 6050N), make an information return, in the form prescribed by the Secretary, setting forth the amount of such payments and the name and address of the payee. The payor must also furnish the payee with a copy of the information return (the payee statement) in person or in a statement mailing. Payors may furnish either the official Form 1099 or an acceptable substitute payee statement.

The legislative history to the statement mailing requirement provides that only certain limited enclosures in the statement mailing can be made with the payee statement, specifically: (1) a check; (2) a letter explaining why no check is enclosed; and (3) a statement of the payee's specific account with the payor. The legislative history further provides that a mailing is not a statement mailing if it encloses any other material such as advertising, promotional material, or a quarterly or annual report. The legislative history explains that this additional material is not permitted because these enclosures may make it less likely that payees will recognize the importance of the payee statement and may not utilize the payee statement in completing their tax returns. *See* S. Rep. No. 99–318, 99th Cong., 2d Sess. at 191; and H.R. Conf. Rep. No. 99–841, 99th Cong., 2d Sess. at II–791.

The Service recently issued final regulations that apply to payee statements due after December 31, 1995. §§ 1.6042–4; 1.6044–5; 1.6049–6(e); and 1.6050N–1 of the Income Tax Regulations. These regulations provide that the mailing of payee statements must qualify as a statement mailing. To qualify, the mailing is permitted to contain only certain specified nontax enclosures, limited to: (1) a check; (2) a letter explaining why no check is enclosed; (3) a statement of the payee's account; and (4) a letter explaining the tax consequences of the information in the payee statement. *See, e.g.*, § 1.6042–4(d)(2)(i). The regulations prohibit other nontax enclosures and promotional or advertising materials and provide that even a *de minimis* amount of such material violates the statement mailing requirement. Although the regulations specifically permit logos on the envelope and on the permitted nontax enclosures identified above, they do not permit logos on the substitute Form 1099 itself. *See, e.g.*, § 1.6042–4(d)(2)(i).

The Service intends to amend the regulations to allow the use of certain logos and identifying slogans on substitute Forms 1099 required to be furnished to payees. The amended regulations generally will permit logos (including the name of the payor in any typeface, font, or stylized fashion and/or a symbolic icon) and identifying slogans, provided the logo or identifying slogan is used by the payor in the ordinary course of its trade or business. However, consistent with Congressional intent, the amended regulations will provide that use of a logo or identifying slogan must not make it less likely that a reasonable payee will recognize the importance of the payee statement for tax reporting purposes. Pending issuance of the amended regulations, the Service will not impose penalties in connection with a payor's use on a payee statement of a logo or an identifying slogan that satisfies these requirements.

Public comment invited. The Service invites public comment on this matter. Written comments may be submitted by mail to:

Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Attn: CC:CORP:T:R (IA–Branch 1), Room 5228
Washington, D.C. 20044;

or, alternatively, via the internet at: http://www.irs.ustreas.gov/prod/tax_regs/comments.html.

Request for Comments on the Desirability of Guidance Relating to Section 457 Nonqualified Deferred Compensation Plans of State and Local Government and Tax-Exempt Employers

Notice 96–63

This notice invites public comment on possible changes to procedures relating to requests for private letter rulings under § 457 of the Code. These changes may include (1) the publication of model amendments for existing § 457 plans in lieu of the issuance of rulings on individual plan amendments reflecting changes applicable to plans that meet the requirements of § 457(b) under the Small Business Job Protection Act of 1996, P.L. 104–188 ("SBJPA"), and (2) the creation of a Master and Prototype plan program for plans that meet the requirements of § 457(b).

BACKGROUND

Section 457 plans are nonqualified, deferred compensation plans established by state and local government and tax-exempt employers. These employers may establish either eligible plans that meet the requirements of § 457(b) or ineligible § 457(f) plans. The plans are subject to the specific requirements and deferral limitations of § 457 of the Code. Under § 457(a), compensation deferred pursuant to eligible plans that meet the requirements of § 457(b) and the income attributable to such deferred compensation is not taxable until the taxable year in which the deferred amounts are actually paid or made available to the plan participant or other beneficiary. In contrast, compensation deferred under a plan described in § 457(f) is included in the participant's or beneficiary's gross income for the first taxable year in which there is no substantial risk of forfeiture of the rights to the compensation. In addition, prior to the enactment of the SBJPA, § 457(b)(6) mandated that eligible plans under § 457(b) be unfunded and that plan assets not be set aside for the exclusive benefit of participants.

The SBJPA changed certain requirements for plans under § 457(b). Section 457(g), added by § 1448 of the SBJPA, now mandates that all assets and income of eligible state and local government plans (but not eligible plans of tax-exempt entities) must be held in trust for the exclusive benefit of participants and their beneficiaries. The trust require-

ment applies immediately to eligible plans established after August 20, 1996. For government plans already in existence on that date, the effective date of the § 457(g) requirement is January 1, 1999. However, a trust may be added to existing government plans at any time.

In addition, all plans that meet the requirements of § 457(b) may implement changes to § 457(e) made by § 1447 of the SBJPA. Section 457(e)(9) provides that certain benefits will not be treated as made available by reason of certain elections with regard to distributions from eligible § 457(b) plans. Also, § 457(e)(15) provides a cost-of-living adjustment for the maximum deferral amount under § § 457(b)(2) and (c)(1) of the Code. These amendments made by § 1447 of the SBJPA apply to taxable years beginning after December 31, 1996.

The Service is considering issuing model language that will provide plan sponsors of eligible plans that meet the requirements of § 457(b) with a streamlined method for amending their plans to comply with the new requirements of § 457. This model language can be adopted by existing eligible plans in lieu of receiving a new ruling under § 457(b). This approach will provide time and cost savings to employers who have previously received favorable ruling letters with respect to their § 457(b) plans.

In addition, the Service is considering the establishment of a ruling program for master and prototype § 457(b) plans that will consider the statutory changes to § 457 under the SBJPA. The Service believes that this type of program is particularly well suited to ruling requests under § 457(b). For example, under such a program, if a state creates a plan, it can then be adopted by the political subdivisions, agencies and instrumentalities of that state, without the need for individual rulings for each state employer that adopts the same plan. In addition, the prototype plan program could be used by banks, insurance companies and mutual fund companies, who may be interested in receiving advance rulings for plans that meet the requirements of § 457(b).

REQUEST FOR PUBLIC COMMENT

The Service is now evaluating possible changes to the advance letter ruling program for eligible § 457 plans. Accordingly, the Service requests comments concerning the usefulness of the model language and master and prototype plan approaches, and welcomes comments on any other useful approaches the Service might consider. Comments can be addressed to CC:DOM:CORP:R (Notice 96–63), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Alternatively, taxpayers may transmit comments electronically via the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. In the alternative, comments may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (Notice 96–63), Courier's Desk, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC.

Nondiscrimination Rules for Plans Maintained by Governments and Tax-Exempt Organizations

Notice 96–64

I. PURPOSE

This notice addresses certain issues relating to the nondiscrimination rules that apply to qualified plans maintained by governments and by organizations exempt from taxation under § 501(a) of the Internal Revenue Code ("tax-exempt organizations").

For governmental plans, this notice—

- Extends the date for applying the regulations under § 401(k) and (m) until the first plan year beginning on or after October 1, 1997 (or, if later, 90 days after the opening of the first legislative session beginning on or after October 1, 1997, of the governing body with authority to amend the plan, if that body does not meet continuously);
- Clarifies that deemed satisfaction of the § 401(a)(4) and § 410(b) nondiscrimination and minimum coverage rules also applies for purposes of the references to those sections under § 401(k) and (m);
- Provides a special option for applying the § 401(k) and (m) nondiscrimination tests for years before 1999; and
- Allows governments until the 2001 plan year to apply, for nondiscrimination purposes, a reasonable, good faith interpretation of existing law in determining which entities must be aggregated, with any further guidance applying prospectively for plan years beginning in or after 2001.

For plans maintained by tax-exempt organizations, this notice—

- Extends the date for applying the regulations under §§ 401(a)(4), 401(a)(5), 401(l), 410(b), 414(r), and 414(s) until the first plan year beginning on or after October 1, 1997;
- Extends the remedial amendment period and other administrative relief until the last day of the first plan year beginning on or after October 1, 1997;
- Extends through the 1997 plan year the relief under existing regulations permitting employees of certain tax-exempt entities to be disregarded in applying § 410(b) to a § 401(k) plan maintained by a taxable entity; and
- Allows tax-exempt organizations until the 2001 plan year to apply, for nondiscrimination purposes, a reasonable, good faith interpretation of existing law in determining which entities must be aggregated, with any further guidance applying prospectively for plan years beginning in or after 2001.

II. BACKGROUND

A. Governmental Plans

Announcement 95–48, 1995–23 I.R.B. 13, provides that, in the case of governmental plans described in § 414(d), the regulations under § 401(k) and (m) apply to plan years beginning on or after the later of January 1, 1997, or 90 days after the opening of the first legislative session beginning on or after January 1, 1997, of the governing body with authority to amend the plan, if that body does not meet continuously. The regulations under §§ 401(a)(4), 401(a)(26), 410(b), and 414(s) apply to plan years beginning on or after the later of January 1, 1999, or 90 days after the opening of the first legislative session beginning on or after January 1, 1999, of the governing body with authority to amend the plan, if that body does not meet continuously ("1999 legislative date"). For plan years beginning before the applicable effective date, governmental plans are deemed to satisfy §§ 401(a)(4), 401(a)(26), 401(k), 401(m), 410(b), and 414(s).

Announcement 95–48 also provides that the remedial amendment period under § 401(b) for governmental plans extends to the last day of the first plan year beginning on or after the later of January 1, 1999, or the 1999 legislative date. During the remedial amendment period, additional administrative relief provided under Notice 92–36, 1992–2 C.B. 364, continues to be available.

Announcement 95–48 solicited comments on the application of the nondis-

crimination requirements to governmental plans. Comments included discussion of state law restrictions on modifying benefits for current employees and noted that it may be difficult to identify the appropriate governmental entity to be treated as the employer for purposes of nondiscrimination testing. For example, in the case of a state-wide plan covering members of a particular occupation (such as public school teachers), questions have been raised whether the employers for testing purposes would be the special districts (such as the school districts), the local governments, or other governmental entities. Comments also raised the issue of whether deemed satisfaction of § 401(a)(4) and § 410(b) by a governmental plan applies for purposes of certain requirements under § 401(k) and (m).

B. Plans Maintained by Tax-Exempt Organizations

Announcement 95–48 provides that, in the case of plans maintained by tax-exempt organizations, other than church plans described in § 410(c)(1)-(B) ("nonelecting church plans"), the regulations under §§ 401(a)(4), 401(a)-(5), 401(l), 410(b), 414(r), and 414(s) apply to plan years beginning on or after January 1, 1997. For plan years beginning before that effective date, a plan maintained by a tax-exempt organization must be operated in accordance with a reasonable, good faith interpretation of §§ 401(a)(4), 401(a)(5), 401(l), 410(b), 414(r), and 414(s). The remedial amendment period for plans maintained by tax-exempt organizations was extended in Announcement 95–48 to the last day of the first plan year beginning on or after January 1, 1997. During the remedial amendment period, additional administrative relief provided under Notice 92–36 continues to be available. (See section V of Notice 92–36, and section IV of Rev. Proc. 94–13, 1994–1 C.B. 566, for the definition of "plan maintained by a tax-exempt organization.")

Announcement 95–48 solicited comments on the issue of which entities must be aggregated under § 414(b) and (c) (relating to the definition of employer) and on any other related nondiscrimination issues affecting tax-exempt organizations. No comments were submitted on behalf of tax-exempt organizations in response to Announcement 95–48, and the Treasury and the Service have not identified any other unique characteristics of tax-exempt organizations that require special rules for applying §§ 401(a)(4), 401(a)(5), 401(l), 410(b), 414(r), or 414(s) to plans maintained by tax-exempt organizations (other than nonelecting church plans).

C. Nonelecting Church Plans

Under Announcement 95–48, in the case of nonelecting church plans, the regulations under §§ 401(a)(4), 401(a)-(5), 401(l), and 414(s) apply to plan years beginning on or after January 1, 1999. For plan years beginning before that effective date, a nonelecting church plan must be operated in accordance with a reasonable, good faith interpretation of §§ 401(a)(4), 401(a)(5), 401(l), and 414(s). The remedial amendment period for nonelecting church plans was extended in Announcement 95–48 to the last day of the first plan year beginning on or after January 1, 1999. During the remedial amendment period, additional administrative relief provided under Notice 92–36 continues to be available.

III. EXTENSION OF EFFECTIVE DATES

A. Governmental Plans

Under the extension provided by this notice, in the case of governmental plans, the regulations under § 401(k) and (m) apply only to plan years beginning on or after the later of October 1, 1997, or 90 days after the opening of the first legislative session beginning on or after October 1, 1997, of the governing body with authority to amend the plan, if that body does not meet continuously. For plan years beginning before this extended effective date, governmental plans are deemed to satisfy § 401(k) and (m). The special rule in § 1.402(a)–1(d)(3)(v) of the Income Tax Regulations (providing an income tax deferral for certain elective contributions) is extended for the same period. The Treasury and the Service do not anticipate issuing any further guidance on the application of the regulations under § 401(k) and (m) to governmental plans prior to the effective date.

B. Plans Maintained by Tax-Exempt Organizations

Under the extension provided by this notice, in the case of plans maintained by tax-exempt organizations (other than nonelecting church plans), the regulations under §§ 401(a)(4), 401(a)(5), 401(l), 410(b), 414(r), and 414(s) apply only to plan years beginning on or after October 1, 1997. For plan years beginning before this extended effective date, such plans must be operated in accordance with a reasonable, good faith interpretation of these sections. The Treasury and the Service do not anticipate issuing any further guidance on the application of the regulations under these sections to plans maintained by tax-exempt organizations prior to the effective date.

C. Nonelecting Church Plans

As noted above, under Announcement 95–48, in the case of nonelecting church plans, the regulations under §§ 401(a)-(4), 401(a)(5), 401(l), and 414(s) do not apply until the 1999 plan year.

IV. EXTENSION OF REMEDIAL AMENDMENT PERIOD AND ADMINISTRATIVE RELIEF

A. Remedial Amendment Period

Notice 92–36 and Announcement 95–48 set forth the remedial amendment period described in § 401(b) applicable to governmental plans and plans maintained by tax-exempt organizations. The remedial amendment period is the period during which a plan may be amended retroactively to comply with certain plan qualification requirements. Notice 92–36 makes additional administrative relief available during the remedial amendment period. For example, the transition relief under Alternative II D of Notice 88–131, 1988–2 C.B. 546, applies. This permits, during the remedial amendment period, the continued accrual of certain benefits under a plan that would otherwise fail to comply with § 401(a)(4) until the plan is amended to comply with that section. In addition, for purposes of testing benefits, rights and features for the first plan year in which the regulations under § 401(a)(4) are effective, Notice 92–36 provides that any amendment made during the plan year regarding eligibility for a benefit, right or feature may be treated as if it had been in effect for the entire plan year.

B. Governmental Plans and Nonelecting Church Plans

As noted above, under Announcement 95–48, administrative relief under Notice 92–36, including the remedial amendment period, extends to the last day of the first plan year beginning on or after the later of January 1, 1999, or the 1999 legislative date in the case of governmental plans, and to the last day of the first plan year beginning on or

after January 1, 1999, in the case of nonelecting church plans.

C. Plans Maintained by Tax-Exempt Organizations

Under this notice, the remedial amendment period for plans maintained by tax-exempt organizations (other than nonelecting church plans) is extended to the last day of the first plan year beginning on or after October 1, 1997. The additional administrative relief provided under Notice 92–36 also applies through this extended remedial amendment period. Thus, in the case of a plan with a plan year of October 1 through September 30, any amendments required to comply with the regulations under §§ 401(a)(4), 401(a)(5), 401(l), 410(b), 414(r), and 414(s) for the plan year beginning October 1, 1997, must be made by September 30, 1998. In the case of a plan using a calendar plan year, these regulations are first effective for the 1998 plan year, and any amendments required to comply with these regulations for that year must be made by December 31, 1998.

V. SPECIAL RULES FOR § 401(k) AND (m) PLANS

A. Governmental Plans

1. Application of §§ 401(a)(4) and 410(b)

As noted above, for governmental plans, the regulations under §§ 401(a)(4), 401(a)(26), 410(b), and 414(s) apply to plan years beginning on or after the later of January 1, 1999, or the 1999 legislative date. For plan years beginning before the applicable effective date, governmental plans are deemed to satisfy these provisions. Certain provisions of § 401(k) and (m) and the regulations thereunder separately require that a plan, or certain aspects of a plan, satisfy § 401(a)(4) or 410(b). For example, § 401(k)(3)(A)(i) requires that the employees eligible to benefit under a cash or deferred arrangement satisfy § 410(b)(1). This notice clarifies that, for plan years beginning before the later of January 1, 1999, or the 1999 legislative date, a governmental plan is deemed to satisfy § 401(a)(4) and § 410(b) for all purposes, including for purposes of § 401(k) and (m). Thus, for example, a governmental plan that is subject to § 401(k) is deemed to satisfy § 401(k)(3)(A)(i) without regard to whether the group of eligible employees satisfies § 410(b)(1), and a governmental plan that is subject to § 401(m) is deemed to satisfy § 401(a)(4) and § 410(b) for purposes of § 1.401(m)–1(a)(2) and (e)(4).

2. Special Testing Rule

Under §§ 1.410(b)–7(c)(4)(ii)(C), 1.401(k)–1(g)(11), and 1.401(m)–1(f)(14), in the case of a plan that covers employees of more than one employer, the tests under § 401(k)(3) and § 401(m)(2) must be applied on an employer-by-employer basis. As discussed above, comments have noted that it may be difficult to identify the appropriate employer for purposes of testing a plan that covers employees of different governmental entities. Under this notice, for plan years beginning before the later of January 1, 1999, or the 1999 legislative date, in applying the tests under § 401(k)(3) and § 401(m)(2) to a governmental plan the employees covered by the plan may be treated as employed by a single governmental employer. Thus, the tests under § 401(k)(3) and § 401(m)(2) may be applied to a governmental plan on a plan-wide basis, notwithstanding the fact that the plan may cover employees of more than one governmental employer.

B. Plans Maintained by Controlled Groups Consisting of Tax-Exempt and Taxable Entities

Some employers consist of tax-exempt entities and taxable entities that must be aggregated under § 414(b) or (c) in determining whether a plan is qualified. Under § 401(k)(4)(B), prior to its amendment by § 1426 of the Small Business Job Protection Act of 1996 ("SBJPA"), tax-exempt organizations were precluded from establishing plans that included qualified cash or deferred arrangements under § 401(k). Thus, an employer that included both taxable and tax-exempt entities was only permitted to maintain a plan that included a qualified cash or deferred arrangement under § 401(k) for the taxable entities. However, the SBJPA amended § 401(k)(4)(B) to repeal this prohibition and permit tax-exempt entities to establish such plans for plan years beginning after 1996.

Special rules are provided in §§ 1.401(a)(26)–1(b)(4) and 1.410(b)–6(g) for a qualified cash or deferred arrangement under § 401(k) for the employees of a taxable entity that must be aggregated with a tax-exempt entity. Under these special rules, if certain requirements are met, the employees of the tax-exempt entity that are precluded from being covered in the qualified cash or deferred arrangement may be disregarded when determining whether the arrangement maintained by the taxable entity satisfies § 401(a)(26) or § 410(b). The special rules apply only to employees whose employer is precluded under § 401(k)(4)(B) from maintaining a qualified cash or deferred arrangement.

Beginning in 1997, these special rules would no longer apply because employees of a tax-exempt entity are permitted to be covered by a qualified cash or deferred arrangement. The Treasury and the Service recognize that this change presents practical issues for employers consisting of both tax-exempt and taxable entities as they consider possible redesign of their retirement programs in light of § 1426 of the SBJPA. Consequently, this notice extends the relief provided under § 1.410(b)–6(g) for these employers through the 1997 plan year. Through the 1997 plan year only, these employers may continue to disregard employees of tax-exempt entities when testing a qualified cash or deferred arrangement maintained by a taxable entity in accordance with § 1.410(b)–6(g).

Section 1432 of the SBJPA provides that, beginning in the 1997 plan year, § 401(a)(26) applies only to defined benefit plans. Accordingly, it is not necessary to extend the relief provided by § 1.401(a)(26)–1(b)(4) with respect to § 401(a)(26).

VI. 403(b) PLANS

Notice 89–23, 1989–1 C.B. 654, discusses the nondiscrimination requirements under § 403(b)(12)(A) for annuity contracts, custodial accounts, or retirement income accounts purchased under plans eligible for favorable tax treatment under § 403(b) ("403(b) plans"). Section 403(b)(12)(A)(i) provides that, with respect to nonelective contributions, a 403(b) plan must meet the requirements of §§ 401(a)(4), (5), (17) and (26), 401(m), and 410(b). Notice 89–23 provides that § 403(b)(12) is satisfied if an employer operates its 403(b) plan in accordance with a reasonable, good faith interpretation of § 403(b)(12). As provided in Announcement 95–48, until further guidance is issued, employers maintaining 403(b) plans may continue to rely on Notice 89–23. However, employers maintaining 403(b) plans may not continue to rely on a reasonable, good faith interpreta-

tion of § 401(a)(17), but must comply with the regulations under § 401(a)(17) as of the applicable effective dates set forth in § 1.401(a)(17)–1(d). Of course, for the period for which a qualified plan is deemed to satisfy any particular statutory nondiscrimination requirement, the nonelective contributions under a governmental 403(b) plan also are deemed to satisfy that requirement.

VII. APPLICATION OF § 414(b) AND (c)

Until further guidance is issued, governments and tax-exempt organizations (including churches) may apply a reasonable, good faith interpretation of existing law in determining which entities must be aggregated under § 414(b) and (c). Any further guidance will be applied on a prospective basis only and will not be effective before plan years beginning in 2001.

The Treasury and the Service invite specific suggestions for an aggregation standard or standards appropriate for tax-exempt organizations under § 414-(b), (c) and (o). In particular, comments are requested on the appropriateness of the standard described in Section V.B.2.a of Notice 89–23, under which two entities are in the same controlled group if at least 80% of the directors, trustees or other individual members of one entity's governing body are either representatives of or directly or indirectly control, or are controlled by, the other entity. However, because questions have arisen as to whether this standard would be appropriate and sufficient in all circumstances, the Treasury and the Service intend to consider alternative and additional standards as well.

VIII. COMMENTS

Comments or suggestions in response to this notice should be submitted by April 30, 1997, and should be addressed to: CC:DOM:CORP:T:R (Notice 96–64), Room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, D.C. 20044. Alternatively, taxpayers may hand-deliver comments between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:T:R (Notice 96–64), Courier's desk, Internal Revenue Service, 1111 Constitution Ave., NW, Washington, DC, or may submit comments electronically via the IRS internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html.

IX. EFFECT ON OTHER DOCUMENTS

Notice 89–23 and Notice 92–36 are modified.

Treatment of a Trust as Domestic or Foreign—Changes Made by the Small Business Job Protection Act

Notice 96–65

This notice provides guidance with respect to certain provisions of the Small Business Job Protection Act of 1996 (the "Act"), Public Law 104–188, 110 Stat. 1755 (August 20, 1996), dealing with the status of a trust as domestic or foreign under sections 7701(a)(30) and 7701(a)(31) of the Internal Revenue Code (the "Code"). The first section of this notice grants trusts that meet the conditions specified in this notice additional time to comply with the new domestic trust criteria contained in the Act and allows such trusts to continue to file as a domestic trusts during this period. The second section of this notice addresses the time and manner for making the election provided by the Act to apply the new trust criteria retroactively. The third section of this notice provides guidance regarding the application of sections 1491 through 1494 of the Code if the status of a trust changes from domestic to foreign.

BACKGROUND

Prior to the Act, the status of a trust as domestic or foreign turned upon the subjective determination of whether the trust was more comparable to a resident or a nonresident alien individual. See Rev. Rul. 60–181, 1960–1 C.B. 257, citing *B.W. Jones Trust v. Commissioner*, 46 B.T.A. 531 (1942), *aff'd*, 132 F.2d 914 (4th Cir. 1943). Section 1907(a) of the Act amended sections 7701(a)(30) and (31) of the Code to provide more objective criteria for determining the status of a trust. New section 7701(a)(30) provides that a trust will be treated as a domestic trust if a court within the United States is able to exercise primary supervision over the administration of the trust and one or more U.S. fiduciaries have the authority to control all substantial decisions of the trust. New section 7701(a)(31) provides that a foreign trust is any trust that is not a domestic trust.

Section 1491 imposes a 35 percent excise tax on a transfer of property by a U.S. person, including a domestic trust, to a foreign trust. In general, the excise tax is imposed on the excess of the fair market value of the property transferred over the adjusted basis of such property plus any gain recognized on the transfer by the U.S. person.

If a domestic trust becomes a foreign trust, such trust shall be treated for purposes of section 1491 as having transferred, upon becoming a foreign trust, all of its assets to a foreign trust. Act section 1907(b), amending section 1491. However, to the extent that a grantor or another person is treated as the owner of all or a portion of the trust under sections 673 through 679 when such trust becomes a foreign trust, the portion of the trust owned by such person is not taken into account in determining the assets treated as transferred to the foreign trust for purposes of section 1491. *See, e.g.*, Rev. Rul. 87–61, 1987–2 C.B. 219.

New sections 7701(a)(30) and (31) apply in determining the status of a trust for taxable years beginning after December 31, 1996. A trustee of a trust may, however, elect to have the new criteria apply to the first taxable year of the trust ending after August 20, 1996 (the date of enactment of the Act). Act section 1907(a)(3).

ADDITIONAL TIME TO COMPLY WITH NEW DOMESTIC TRUST CRITERIA

In the first taxable year that new section 7701(a)(30) applies, it is possible for a trust treated as a domestic trust under prior law to become a foreign trust solely by operation of the new law, notwithstanding that the trust may prefer to remain a domestic trust for U.S. tax purposes. In that event, the domestic trust may be subject to the 35 percent excise tax on any built-in gain in its assets as of the date of its change in status.

Certain existing domestic trusts that desire to remain domestic trusts may have difficulty meeting the new domestic trust criteria in section 7701(a)(30) prior to the first taxable year beginning after December 31, 1996. Treasury and the Service believe that these trusts should have a reasonable amount of time to comply with the new domestic trust criteria. Accordingly, a domestic trust in existence on August 20, 1996 ("existing trust"), may continue to file tax returns as a domestic trust for taxable years of the trust beginning after December 31, 1996, if the trust satisfies

the conditions of this notice. This relief is not available to a trust if an election has been made pursuant to section 1907(a)(3)(B) of the Act to apply the new trust criteria to the first taxable year of the trust ending after August 20, 1996.

An existing domestic trust must satisfy the following conditions to qualify for the relief provided by this section of the notice: (1) the trustee must initiate modification of the trust to conform with the domestic trust criteria by the due date (including extensions) for filing the trust's income tax return for its first taxable year beginning after December 31, 1996; (2) the trustee must complete the modification within two years of that date ("two-year period"); and (3) the trustee must attach a statement to the trust's income tax return as described below. If an existing domestic trust meets these conditions, it may continue to file as a domestic trust for taxable years of the trust beginning after December 31, 1996. For purposes of this notice, "modification" includes any action taken (judicial or nonjudicial) to reform, amend, modify, or alter the trust that is effective under local law.

The statement referred to above must be entitled "Election to Rely on Notice 96–65 to File as a Domestic Trust," and must be attached to the trust's income tax return for each taxable year that this notice is relied on to file as a domestic trust. The statement must be signed under penalties of perjury by the trustee and contain the following information:

(1) A statement that the trust is relying on this notice to file as a domestic trust for the taxable year;

(2) A statement that the trustee filed original income tax returns treating the trust as a domestic trust for each taxable year of the trust beginning after 1994, and will continue to file as a domestic trust while actions are being taken to meet the domestic trust criteria;

(3) The date on which actions to modify the trust to meet the domestic trust criteria were initiated and a brief description of both completed and forthcoming actions necessary to meet the domestic trust criteria;

(4) The name, taxpayer identification number, and address of any U.S. person who, but for the relief provided in this notice, would be treated as the owner of all or a portion of the trust under section 679 for any taxable year of the trust beginning after December 31, 1996; and

(5) A statement that, if the trust does not meet the domestic trust criteria in section 7701(a)(30) by the end of the two-year period, the trustee will file all of the trust's applicable returns (whether original or amended) for taxable years of the trust beginning after December 31, 1996, treating the trust as a foreign trust.

If the trust satisfies the trust criteria in section 7701(a)(30) by the end of the two-year period, the trust will be treated as a domestic trust during this period for all purposes of the Code. In the case of an existing domestic trust that fails to meet the conditions set forth in this notice to continue to file as a domestic trust, such trust will be treated as a foreign trust for all taxable years of the trust beginning after December 31, 1996, for all purposes of the Code. In that event, any U.S. person who is treated as owning all or a portion of the trust for any taxable year of the trust beginning after December 31, 1996, and any beneficiary whose tax liability was affected by the change in the trust's status must file amended returns in order to correctly report their income tax liability for any taxable year that the trust relied on this notice to file as a domestic trust.

If reasonable actions have been taken to meet the domestic trust criteria, but due to circumstances beyond the trustee's control the trust is unable to meet such criteria by the date set forth in this notice, the trustee may provide a written statement to the District Director having jurisdiction over the trust's return setting forth the reasons for failing to meet the domestic trust criteria in a timely manner. If the District Director determines that the failure was due to reasonable cause, the District Director may grant the trust an extension of time to meet such criteria. Whether an extension of time is granted shall be in the sole discretion of the District Director and, if granted, may contain such terms with respect to assessment as may be necessary to ensure that the correct amount of tax will be collected from the trust, its owners, and its beneficiaries. If the trust does not obtain an extension from the District Director before the end of the two-year period, then the trustee must treat the trust as a foreign trust for all taxable years of the trust beginning after December 31, 1996.

The following example illustrates the relief provided by this section of the notice. Assume a U.S. court has primary supervision over an existing domestic trust with a single foreign trustee. The trust, a calendar year taxpayer, is not treated as owned by the grantor or another person under sections 673 through 679. On April 1, 1998, the foreign trustee tenders his letter of resignation to take effect upon appointment of a new U.S. trustee. The trustee attaches the statement described in this notice to the trust's 1997 tax return. A new U.S. trustee is appointed on July 30, 1998, and the trustee attaches the required statement to the trust's 1998 tax return.

The trust may continue to file as a domestic trust for the 1997 and 1998 taxable years because (1) the trustee initiated modification of the trust by the due date for filing the trust's income tax return for its first taxable year beginning after December 31, 1996; (2) the modification was completed within two years of the due date for filing the trust's 1997 return; and (3) the trustee attached the required statement to the trust's 1997 and 1998 income tax returns.

If, however, a new U.S. trustee had not been appointed by the end of the two-year period, and an extension of time had not been granted by the District Director, the trust would have been treated as a foreign trust for all taxable years beginning after December 31, 1996. For purposes of section 1491 such trust would have been treated as having transferred all of its assets to a foreign trust upon becoming a foreign trust on January 1, 1997.

ELECTION TO APPLY NEW TRUST CRITERIA RETROACTIVELY

New sections 7701(a)(30) and (31) apply to determine whether a trust is domestic or foreign for taxable years beginning after December 31, 1996. However, under section 1907(a)(3)(B) of the Act, a trustee of a trust may elect to apply the new trust criteria to the first taxable year of the trust ending after August 20, 1996 ("the election year"). This section of the notice announces the time and manner for making the election.

If an election is made to apply new sections 7701(a)(30) and (31) to the trust's first taxable year ending after August 20, 1996, the new trust criteria must be applied for the entire election year. Thus, for example, if a domestic trust with the calendar year as its taxable year has a single foreign trustee, and that trustee elects to apply new sections 7701(a)(30) and (31) to the trust's 1996 taxable year, then the trust

will be treated as a foreign trust beginning on January 1, 1996.

To make the election, the trustee must attach a statement entitled "Election Under Section 1907(a)(3)(B) of the Small Business Job Protection Act of 1996 to Apply New Trust Criteria Retroactively," to the trust's income tax return for its first taxable year ending after August 20, 1996. The statement must be signed under penalties of perjury by the trustee and contain the following information:

(1) A statement that the trust is relying on this notice to apply the new trust criteria for its first taxable year ending after August 20, 1996;

(2) A declaration stating whether the trustee has filed an original U.S. income tax return treating the trust as a domestic trust for any of the three immediately preceding taxable years; and

(3) A declaration stating whether, during the election year, there has been a change in trust status.

If a trust changes status from domestic to foreign as a result of this election, the trustee must, as a condition of making the election, attach a statement agreeing to treat the change in trust status as a transfer of the trust's assets to a foreign trust for purposes of section 1491, except to the extent the grantor or another person is treated as the owner of the trust under sections 673 through 679 when such trust becomes a foreign trust.

APPLICATION OF SECTIONS 1491 THROUGH 1494

If the status of a trust changes from domestic to foreign as a result of the new law, whether or not by reason of an election to apply the new trust criteria retroactively, for purposes of section 1491 the trust will be treated as having made a transfer of all of its assets to a foreign trust upon becoming a foreign trust, except to the extent a grantor or another person is treated as the owner of the trust under sections 673 through 679 when such trust becomes a foreign trust. Act section 1907(b); *See also* H.R. Conf. Rep. No. 737, 104th Cong., 2d Sess. 338 (1996). In the case of an existing domestic trust that fails to meet the conditions set forth earlier in this notice to continue to file as a domestic trust, then to the extent there is a transfer of assets to the foreign trust for purposes of section 1491, such transfer will occur upon the trust becoming a foreign trust at the beginning of the first taxable year beginning after December 31, 1996.

Under section 1494(a), the excise tax imposed by section 1491 is due and payable at the time of the transfer. Treasury and the Service expect to issue regulations under section 1494 that will provide that any excise tax due on a transfer of assets to a foreign trust as a result of a change in trust status may be paid by attaching Form 926, and any applicable excise tax, to the trust's income tax return for the taxable year in which the transfer occurs. If the excise tax is not paid until the trust's income tax return for the year is filed, interest must be paid on the amount of excise tax due at the rates determined under section 6621, with respect to the period between the date on which the transfer occurred and the date on which the excise tax is actually paid. Until regulations are issued, the guidance provided by this section of the notice may be relied on by taxpayers. For penalties applicable for failure to report a transfer of property described in section 1491, *see* Act section 1902, adding section 1494(c) and Notice 96–60, 1996–49 I.R.B. 7.

In the case of an existing domestic trust that has relied in good faith on the first section of this notice to continue to file as a domestic trust, but fails to meet the criteria in section 7701(a)(30) by the end of the two-year period, the trustee must make a return on Form 926 no later than thirty day after the end of the two-year period to report a section 1491 transfer that occurs on the change in the trust's status, and to pay any excise tax and interest due. Form 926 may be attached to an amended return filed by the trustee for the first taxable year of the trust ending after December 31, 1996. If Form 926 is filed no later than thirty days after the end of the two-year period, no penalties will be imposed under section 1494(c).

Under section 1492, the excise tax imposed by section 1491 shall not apply to: transfers to certain exempt organizations (section 1492(1)); transfers described in section 367 (section 1492(2)(A)); transfers with respect to which an election has been made to apply principles similar to the principles of section 367 (section 1492(2)(B)); or transfers with respect to which an election has been made under section 1057 (section 1492(3)). A transfer to a foreign trust that occurs as a result of a change in trust status from domestic to foreign may be nontaxable under sections 1492(1) and (3). Such a transfer cannot be nontaxable under section 1492(2)(A) because the transfers described in section 367 are limited to transfers to foreign corporations.

Treasury and the Service are studying whether it is appropriate to allow a domestic trust that becomes a foreign trust to elect to apply principles similar to the principles of section 367 under section 1492(2)(B) and, if so, how such principles should be applied. Until further guidance is provided, a domestic trust that becomes a foreign trust may not avoid the section 1491 excise tax by electing principles similar to the principles of section 367, unless the trust obtains a private letter ruling with respect to the application of the principles of section 367 to its particular facts.

PAPERWORK REDUCTION ACT

The collections of information contained in this notice have been reviewed and approved by the Office of Management and Budget for review in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1506.

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

The collections of information in this notice are in the sections headed *Additional Time to Comply with New Domestic Trust Criteria* and *Election to Apply New Trust Criteria Retroactively.* This information is required by the IRS to assure compliance with the new provisions of the Small Business Job Protection Act of 1996. The likely respondents are individuals, business or other for-profit institutions, and not-for-profit institutions.

The estimated total annual reporting burden is 550 hours.

The estimated average annual burden per respondent is 27 minutes. The estimated number of respondents is 1,200.

The estimated annual frequency of responses is annually.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Weighted Average Interest Rate Update

Notice 96–66

Notice 88–73 provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 and as further amended by the Uruguay Round Agreements Act, Pub. L. 103–465 (GATT).

The average yield on the 30-year Treasury Constant Maturities for November 1996 is 6.48 percent.

The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	90% to 108% Permissible Range	90% to 110% Permissible Range
December	1996	6.89	6.20 to 7.44	6.20 to 7.58

Application of Section 401(a)(9) to Employees who Attain Age 70½ in 1996.

Notice 96–67

PURPOSE

This Notice addresses certain issues related to amendments, made by section 1404 of the Small Business Job Protection Act of 1996, Pub. L. 104–188 (SBJPA), to the minimum distribution requirements of section 401(a)(9) of the Internal Revenue Code. Specifically, the notice provides guidance on the application of section 401(a)(9), as amended by the SBJPA, to employees (other than 5-percent owners) who attain age 70½ in 1996 but who have not retired by the end of 1996.

BACKGROUND

Section 401(a)(9) provides that, in order for a plan to be qualified under section 401(a), distributions from the plan must commence no later than the "required beginning date". Similar rules apply to an individual retirement account or annuity (IRA) and a section 403(b) contract (*i.e.*, an annuity contract described in section 403(b), a custodial account described in section 403(b)(7) or a retirement income account described in section 403(b)(9)).

Prior to the amendments made by the SBJPA, section 401(a)(9)(C) generally defined required beginning date as April 1 of the calendar year following the calendar year in which an employee attained age 70½. This meant that an employee who attained age 70½ was required to commence distributions from the plan, even if the employee had not retired from employment with the employer maintaining the plan.

Section 1404 of the SBJPA amended the definition of required beginning date that applies to an employee who is not a 5-percent owner. The amendment provides that, in the case of such an employee, the required beginning date is April 1 of the calendar year following the later of the calendar year in which the employee attains age 70½ or the calendar year in which the employee retires. In the case of an employee who is a 5-percent owner, the required beginning date remains April 1 of the calendar year following the calendar year in which the 5-percent owner attains age 70½. The amendments made by section 1404 of the SBJPA apply to years beginning after December 31, 1996.

The amendments do not apply to the required beginning date for distributions from an IRA, including an IRA established in conjunction with a Simplified Employee Pension (SEP) or a SIMPLE Plan. In addition, the amendments do not affect the determination of the required beginning date for church plans and government plans, since, under the pre-SBJPA version of section 401(a)(9), the required beginning date for these plans already was April 1 of the calendar year following the later of the calendar year in which the employee attains age 70½ or the calendar year in which the employee retires.

Taxpayers have requested guidance on the application of the amendments to section 401(a)(9)(C) made by the SBJPA to employees who attain age 70½ in 1996, but have not retired by the end of 1996. This Notice is issued in response to those requests.

QUESTIONS AND ANSWERS

Q–1: What is the effective date of the amendments to section 401(a)(9) made by section 1404 of the SBJPA?

A–1: Section 401(a)(9), as amended by section 1404 of the SBJPA, applies in determining the amount of any minimum distribution required to be made during any calendar year beginning on or after January 1, 1997 (that was not required to be made during an earlier calendar year).

Q–2: Is a minimum distribution required to be made by April 1, 1997 for an employee (other than a 5-percent owner) who attains age 70½ in 1996, but has not retired from employment with the employer maintaining the plan by the end of 1996?

A–2: No. Such an employee's required beginning date is determined under section 401(a)(9), as amended by the SBJPA. Thus, the employee's required beginning date is not April 1, 1997. Instead, the employee's required beginning date is April 1 of the calendar year following the year in which the employee retires from employment with the employer maintaining the plan.

Q–3: If a plan distribution is made in 1996 to an employee (other than a 5-percent owner) who attains age 70½ in that year, but has not retired by the end of 1996 from employment with the employer maintaining the plan, is any portion of the distribution a required distribution for purposes of section 402(c)(4)(B)?

A–3: Yes. Section 402(c)(4)(B) provides that a distribution is not an eligible rollover distribution to the extent that it is required under section 401(a)(9). If a distribution is made during 1996 (*i.e.*, prior to the January 1, 1997 effective date of the SBJPA amendments to section 401(a)(9)), then, whether that distribution is a required distribution under section 401(a)(9) is determined by applying section 401(a)(9) as in effect prior to amendment by the SBJPA.

Under Q&A–7 of § 1.402(c)–2 of the Income Tax Regulations, a distribution in the year an employee attains age 70½ is treated as a required distribution under section 401(a)(9) to the extent that the total required minimum distribution under section 401(a)(9) for that year has not been satisfied. Therefore, although under Q&A–2 of this Notice, no distribution is required to be made by April 1, 1997 with respect to an employee (other than a 5-percent owner) who attains age 70½ during 1996, but has not retired by the end of that year, if a

distribution actually is made to such an employee in 1996, the distribution is treated as a required distribution to the extent that the total required minimum distribution under section 401(a)(9), as in effect prior to amendment by the SBJPA, has not been satisfied. Thus, to that extent, the distribution is not an eligible rollover distribution and is not subject to mandatory 20% withholding under section 3405(c). However, a distribution to such an employee in 1997 (*i.e.*, after the effective date of the SBJPA amendments) is not a required distribution under section 401(a)(9).

Q–4: How does the guidance provided in Q&A–2 and Q&A–3 of this Notice apply to the determination of the required minimum distribution from a section 403(b) contract?

A–4: In applying section 401(a)(9) to a section 403(b) contract to which contributions are made by an employer, an employee's required beginning date is determined under section 401(a)(9) in the same manner as it would be determined for a qualified plan maintained by that employer. Accordingly, the required beginning date with respect to a section 403(b) contract of an employee who attains age 70½ in 1996 and who has not retired from employment by the end of 1996 is determined under Q&A–2 of this Notice. Similarly, whether a distribution in 1996 from a section 403(b) contract is a required minimum distribution (and thus not an eligible rollover distribution) is determined in accordance with the guidance in Q&A–3 of this notice.

REQUEST FOR COMMENTS CONCERNING RELAXATION OF SECTION 411(d)(6)

Except to the extent provided by regulations, section 411(d)(6)(B) precludes a plan amendment that eliminates an optional form of benefit as it applies to benefits accrued as of the later of the adoption date or the effective date of the amendment. The right to commence benefit distributions in any form at a particular time is an optional form of benefit within the meaning of section 411(d)(6)(B) and Q&A–1(b) of § 1.411(d)–4 of the Income Tax Regulations. When it enacted section 1404 of the SBJPA, Congress did not alter the application of section 411(d)(6). Accordingly, an amendment that eliminates the right to receive a distribution prior to retirement (an in-service distribution) after age 70½ is precluded by section 411(d)(6) if the amendment applies to benefits accrued as of the later of the adoption date or the effective date of the amendment.

A plan that retains in-service distributions after age 70½ (either as a mandatory or an optional form of distribution) will satisfy the requirements of section 401(a)(9) as amended, and will not be prohibited by section 411(d)(6). However, the Service and the Treasury recognize the potential complexity of administering these distribution options. Therefore, the Service and the Treasury are considering the extent to which it is appropriate to exercise the authority in section 411(d)(6)(B) to permit plan amendments to eliminate the option to receive in-service distributions after age 70½. In making this determination, factors that the Service and the Treasury will take into account include the importance to plan participants of protecting the option to receive in-service distributions as well as the potential complexity to employers, plan administrators and participants of retaining the option.

The Service and the Treasury request comments concerning the extent to which a relaxation of section 411(d)(6) protection is appropriate for amendments that eliminate in-service distributions after age 70½ (*e.g.*, by limiting section 411(d)(6) protection to employees above a certain age). Because the Service and the Treasury have received requests that this guidance be provided on an expedited basis, comments are requested to be submitted by January 31, 1997.

Comments can be addressed to CC:DOM:CORP:R (Notice 96–67), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, comments may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (Notice 96–67), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. Alternatively, taxpayers may transmit comments electronically via the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html

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26 CFR 1.127-2: Educational Assistance Programs.

Definitions Relating to Application of Exclusion Under Section 127 of the Internal Revenue Code

Notice 96-68

This notice provides guidance regarding certain definitions affecting the proper tax treatment of educational assistance received by employees under § 127 of the Internal Revenue Code as amended by the Small Business Job Protection Act of 1996, Pub. L. 104-188 (the "Act").

Section 1202 of the Act restores the exclusion from gross income for up to $5,250 of educational assistance provided under an educational assistance program described in § 127, effective for an employee's first taxable year beginning after December 31, 1994. The Act amends the definition of "educational assistance" to provide that, for graduate level courses, the exclusion does not apply to expenses relating to courses "beginning after June 30, 1996." For this purpose, a "graduate level course" will be treated as meaning 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). This is the same definition set forth in Notice 89–33, 1989-1 C.B. 674, with respect to amendments made by the Technical and Miscellaneous Revenue Act of 1988, Pub. L. 100-647, relating to graduate level courses.

The amendment of the term "educational assistance" to exclude graduate level courses applies to courses beginning after June 30, 1996. Similarly, the § 127 exclusion only applies with respect to "courses beginning" before a specified date in 1997. For purposes of both of these provisions, a course ordinarily will be considered to begin on the first regular day of class for the course. The first regular day of class for any course that is offered during a regular academic term at an educational institution will be considered to be the first day on which regular classes generally begin for courses offered during that term. A regular academic term during which a course is offered might be, for example, a semester or, if the semester consists of more than one session, the

session during which the course is offered. The date on which an individual registers for or enrolls in a course does not determine when the course begins.

For example, assume an employee registers in January 1996 for a graduate level independent study course for the upcoming summer term. The course consists of working with a professor to write a paper. Other courses offered for the summer term hold their first regular class during the first week of June 1996. The first day on which regular classes are held in the term is Monday, June 3, 1996, and classes continue until August. The employee does not meet with the professor until the second week of July 1996. Under the preceding paragraph, the independent study course would be treated as beginning on or before June 30, 1996 for purposes of § 127. This is because regular classes for courses offered during the summer term in which this course was taken generally began on June 3, 1996.

The amendments to § 127 do not affect the tax treatment of educational benefits under any other section of the Internal Revenue Code including employment related education described in Treas. Reg. § 1.162-5.

Rev. Proc. 96-36

Use this revenue procedure to prepare Tax Year *1996* information returns for submission to Internal Revenue Service (IRS) using any of the following:

— Magnetic Tape
— Tape Cartridge
— 8mm (.315-inch) Tape Cartridge
*(Pilot for AS400 Operating Systems)
— 5¼-inch Diskette
— 3½-inch Diskette
— Electronic Filing
— (Bisynchronous)
— (Asynchronous)

IRS/MCC has discontinued processing 8-inch diskettes for tax year 1996, calendar year 1997. If you currently file information returns on 8-inch diskette, you need to change to one of the options listed above.

***For Tax Year 1996, the processing of 8mm tape cartridge as an acceptable form of magnetic media is offered as a pilot program for transmitters using AS400 systems only.**

Please read this publication carefully. Persons or businesses required to file information returns may be subject to penalties for failure to file or include correct information if they do not follow the instructions in this revenue procedure.

Table of Contents

Part A. General

Section 1. Purpose
Section 2. Nature of Changes—Current Year (Tax Year *1996*)
Section 3. Where to File and How to Contact the IRS, Martinsburg Computing Center
Section 4. Filing Requirements
Section 5. Form 8508, Request for Waiver from Filing Information Returns on Magnetic Media
Section 6. Vendor List
Section 7. Form 4419, Application for Filing Information Returns Magnetically/Electronically
Section 8. Test Files
Section 9. Filing of Information Returns Magnetically/Electronically and Retention Requirements
Section 10. Due Dates
Section 11. Extensions of Time
Section 12. Processing of Information Returns Magnetically/Electronically
Section 13. Corrected Returns
Section 14. Taxpayer Identification Number (TIN)
Section 15. Effect on Paper Returns

Section 16. Combined Federal/State Filing Program
Section 17. Definition of Terms
Section 18. State Abbreviations
Section 19. Major Problems Encountered

Part B. Magnetic Media Specifications

Section 1. General
Section 2. Tape Specifications
Section 3. Tape Cartridge Specifications
Section 4. *8mm (.315-inch) Tape Cartridge Specifications*
Section 5. 5¼-inch and 3½-inch Diskette Specifications
Section 6. Payer/transmitter "A" Record—General Field Descriptions
Section 7. Payer/transmitter "A" Record—Record Layout
Section 8. Payee "B" Record—General Field Descriptions and Record Layouts
Section 9. End of Payer "C" Record—Record Layout
Section 10. State Totals "K" Record—Record Layout
Section 11. End of Transmission "F" Record—Record Layout

Part C. Bisynchronous (Mainframe) Electronic Filing Specifications

Section 1. General
Section 2. Electronic Filing Approval Procedure
Section 3. Test Files
Section 4. Electronic Submissions
Section 5. Transmittal Requirements
Section 6. IBM 3780 Bisynchronous Communication Specifications
Section 7. Bisynchronous Electronic Filing Record Specifications

Part D. Asynchronous (IRP–BBS) Electronic Filing Specifications

Section 1. General
Section 2. Electronic Filing Approval Procedure
Section 3. Test Files
Section 4. Electronic Submissions
Section 5. Transmittal Requirements
Section 6. Information Reporting Program Bulletin Board System (IRP–BBS) Specifications
Section 7. IRP–BBS First Logon Procedures

Part E. Magnetic/Electronic Specification for Extensions of Time

Section 1. General Information
Section 2. Magnetic Tape, Tape Cartridge, 5¼- and 3½-inch Diskette, and IRP–BBS Specifications
Section 3. Record Layout

Part F. *Miscellaneous Information*

Section 1. *Addresses for MCC*
Section 2. *Phone Numbers for Contacting IRS/MCC Magnetic Media Reporting Program/ Information Returns Branch*
Section 3. *Preparation Instructions for External Label*
Section 4. *Related Forms for Filing Information Returns Magnetically/Electronically*

Part A. General

Revenue procedures are generally revised annually to reflect legislative and form changes. Comments concerning this revenue procedure, or suggestions for making it more helpful, can be addressed to:

Internal Revenue Service
Martinsburg Computing Center
Attn: IRB, Information Support Section
P. O. Box 1359, MS–360
Martinsburg, WV 25401

Sec. 1. Purpose

.01 The purpose of this revenue procedure is to provide the specifications for filing Forms 1098, 1099 series, 5498, and W–2G electronically or on magnetic media, which includes ½-inch magnetic tape; IBM 3480, 3490 or AS400 compatible tape cartridges; or 5¼- and 3½-inch diskettes with IRS. ***IRS/MCC has discontinued processing 8-inch diskettes***. This revenue procedure must be used for the preparation of Tax Year *1996* information returns and information returns for years prior to 1996 that are required to be filed. This revenue procedure must be used to prepare current and prior year information returns filed between January 1, *1997*, and December 31, *1997*. Specifications for filing the following forms are contained in this revenue procedure.

(a) Form 1098, Mortgage Interest Statement.
(b) Form 1099–A, Acquisition or Abandonment of Secured Property.
(c) Form 1099–B, Proceeds from Broker and Barter Exchange Transactions.
(d) Form 1099–C, Cancellation of Debt.
(e) Form 1099–DIV, Dividends and Distributions.
(f) Form 1099–G, Certain Government Payments.
(g) Form 1099–INT, Interest Income.
(h) Form 1099–MISC, Miscellaneous Income.
(i) Form 1099-OID, Original Issue Discount.
(j) Form 1099–PATR, Taxable Distributions Received from Cooperatives.
(k) Form 1099–R, Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
(l) Form 1099–S, Proceeds from Real Estate Transactions.
(m) Form 5498, Individual Retirement Arrangement Information.
(n) Form W–2G, Certain Gambling Winnings.

.02 Specifications for filing Forms W–2 on magnetic media are available from the Social Security Administration (SSA) **only**. Filers can call 1-800-SSA-1213 to obtain the phone number of the SSA Magnetic Media Coordinator for their area.

.03 The Internal Revenue Service, Martinsburg Computing Center (IRS/MCC) has the responsibility for processing Forms 1098, 1099 series, 5498, and W–2G filed magnetically or electronically. IRS/MCC does **not** process Forms W–2. Paper **and/or** magnetic media for Forms W–2 must be sent to SSA. IRS/MCC does, however, process waiver requests (Form 8508) and extension of time requests (Form 8809) for filing Forms W–2.

.04 In most cases, the box numbers on the paper forms correspond with the amount codes used to file magnetically/electronically; however, if discrepancies occur, the instructions in this revenue procedure govern.

.05 This revenue procedure also provides the requirements and specifications for magnetic media or electronic filing under the Combined Federal/State Filing Program.

.06 The following revenue procedures and publications provide more detailed filing procedures for certain other information returns.

(a) *1996* "Instructions for Forms 1099, 1098, 5498, and W–2G" provides specific instructions on completing and submitting information returns to IRS.
(b) Rev. Proc. 84–33, 1984–1 C.B. 502, regarding the optional method for agents to report and deposit backup withholding.
(c) Publication 1179, Rules and Specifications for Private Printing of Substitute Forms 1096, 1098, 1099 Series, 5498, and W–2G.
(d) Publication 1239, Specifications for Filing Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips, on Magnetic Tape and 5¼- or 3½-inch Diskettes.
(e) Publication 1187, Specifications for Filing Form 1042–S, Foreign Person's U.S. Source Income Subject to Withholding, Electronically or on Magnetic Tape, and 5¼- or 3½-inch Magnetic Diskettes.
(f) Publication 1245, Specifications for Filing Form W–4, Employee's Withholding Allowance Certificate, on Magnetic Tape, and 5¼- or 3½-inch Magnetic Diskette.

.07 This revenue procedure supersedes Rev. Proc. 95–29 and 95–29A published as Publication 1220 (Rev. *6–95*), Specifications for Filing Forms 1098, 1099, 5498, and W–2G Magnetically or Electronically.

.08 Refer to Part A, Sec. 17, for definitions of terms used in this publication.

Sec. 2. Nature of Changes—Current Year (Tax Year 1996)

.01 In this publication, all pertinent changes for *Tax Year 1996* have been emphasized by the use of ***italics***. This has been done for the convenience of the filers in identifying new information. Filers are still advised to read the publication in its entirety.

.02 Programming Changes

a. Payer/Transmitter "A" Record Changes:

(1) For all forms, Payment Year, Field Positions 2–3 must be incremented by one (from *95* to *96*) unless reporting prior year data.

b. Payer/Transmitter "B" Record Changes:

(1) For all forms, Payment Year, Field Positions 2–3 must be incremented by one (from *95* to *96*) unless reporting prior year data.

(2) Part B, Sec. 8: For Form 1099–R Distribution Codes, Field Positions 4–5, acceptable combinations of numeric distribution codes now include codes 8 and 4.

(3) Part B, Sec. 8: For Form 5498, a SEP Indicator has been added in Field Position 44.

.03 Editorial Changes—General

(a) Eight inch diskette processing has been eliminated by IRS/MCC. All references to 8-inch diskette processing have been deleted from this publication.

(b) Part A, Sec. 4.04 was included to inform payers of electronic filing

methods; *i.e.*, Mainframe and Information Reporting Program Bulletin Board System (IRP–BBS) electronic filing, and a brief overview of options available on the IRP–BBS.

(c) Part A, Sec. 5.14: Instructions have been added for obtaining an automatic waiver for filing Form 5498 for participants of Operation Joint Endeavor (Bosnia Region).

(d) Part A, Sec. 7.01: A chart has been added to clarify the ***guidelines for*** applications for a transmitter control code (TCC).

(e) Part A, Sec. 12.02 and 12.03: Information has been added regarding the Media Tracking Slip (Form 9267) which accompanies media returned to filers due to processing problems.

(f) Part A, Sec. 17: The Definition of Terms section has been expanded.

(g) Part B, Sec. 3.01(a): Tape cartridge specifications have been expanded to include IBM 3490E as acceptable media.

(h) Part F: Information in this part has been provided as a quick reference point for addresses and telephone numbers for IRS/MCC.

(i) Numerous statements have been added and bolded throughout the publication instructing filers not to report duplicate data which may result in erroneous penalty notices being generated.

.04 Editorial Changes—Magnetic Media Specifications

(a) Part B, Sec. 4: 8mm (.315-inch) tape cartridge specifications have been added. This is a pilot program for transmitters with AS400 operating systems only.

(b) Part B, Sec. 6: Instructions have been included for reporting IRA contributions for Operation Joint Endeavor (Bosnia Region) participants.

(c) Part B, Sec. 6, Payer/Transmitter "A" Record—General Field Descriptions—Field Positions 23–31, Form 5498: A note was added directing the filer to enter "1" in the IRA/SEP Indicator Field (position 44 of the Payee "B" Record) for a simplified employee pension (SEP).

(d) Part B, Sec. 8: A separate Payee "B" Record Layout Position 322–420, has been created for Form 1099–R.

(e) Part B, Sec. 8, Payee "B" Field Positions 4–5, Document Specific Code/Distribution Code for the Tax Year of Refund for 1099–G: A statement has been added to instruct filers to report the distribution code that reflects the tax year for which the REFUND was made, not 1996. Refund Years have been added to identify the valid corresponding code.

(f) Part B, Sec. 8, Payee "B" Record General Field Descriptions and Record Layout—IRA/SEP Indicator, Field Position 44: Text was added to the Description and Remarks to enter "1" for Form 5498 if reporting a contribution to a simplified employee pension (SEP). A note was also added to reflect the change.

(g) Part C, Sec. 6: IBM 3780 Bisynchronous communication has been expanded to include the specifications and circuit number of 304-264-7045 for Hayes OPTIMA 288 V.FC Smartmodem for 14400 bps transmissions.

(h) Part C, Sec. 7: A Type of File Indicator has been added in Field Position 44 for Extension File in the Bisynchronous Electronic Filing Record Specifications.

(i) Part E, Sec. 3, RECORD LAYOUT, Field Positions 6–14: Reference to the Foreign Entity Indicator has been corrected to read, Field Position 176, must be set to "X."

Sec. 3. Where to File and How to Contact the IRS, Martinsburg Computing Center (MCC)

.01 All information returns filed magnetically or electronically are processed at IRS/MCC. Files containing information returns, requests for IRS magnetic media and electronic filing information, undue hardship waivers, and requests for extensions of time to file returns or to furnish the statements to recipients are to be sent to the following addresses:

If by Postal Service:
IRS-Martinsburg Computing Center
P. O. Box 1359, MS-360
Martinsburg, WV 25401-1359

or

If by truck or air freight:
IRS-Martinsburg Computing Center
Information Reporting Program
Route 9 and Needy Road, MS-360
Martinsburg, WV 25401

.02 Send a magnetically filed extension of time request to one of the following addresses:

If by Postal Service:
IRS-Martinsburg Computing Center
Attn: Extension of Time Coordinator
P. O. Box 879, MS-360
Kearneysville, WV 25430

If by truck or air freight:
IRS-Martinsburg Computing Center
Attn: Extension of Time Coordinator
Route 9 and Needy Road, MS-360
Martinsburg, WV 25401

.03 Inquiries may be made between 8:30 a.m. and 4:30 p.m. Eastern time. The telephone numbers for magnetic media inquiries or electronic submissions are:

304-263-8700—Call Site—PART A, Sec 3.19

304-264-7070—IRP–BBS (Information Reporting Program Bulletin Board System)—PART D

304-264-7080—4.8 Modems—PART C

304-264-7040—9.6 Modems—PART C

304-264-7045—14.4 Modems—PART C

304-267-3367—TDD (Telecommunication Device for the Deaf)

304-264-5602—FAX MACHINE

(These are not toll-free telephone numbers.)

TO OBTAIN FORMS, CALL:

1-800-TAX-FORM (1-800-829-3676)

.04 The *1996* "Instructions for Forms 1099, 1098, 5498, and W–2G" have been included in the Publication 1220 for transmitter convenience. The Form 1096 is used only to transmit Copy A of paper Forms 1099, 1098, 5498, and W–2G. If filing paper returns, follow the mailing instructions on the Form 1096 and submit the paper returns to the appropriate IRS Service Center.

.05 Requests for paper Forms 1096, 1098, 1099 and W–2G, and publications unrelated to magnetic media/electronic filing should be requested by calling the "Forms Only Number" listed in your local telephone directory or by calling the IRS toll-free number **1-800-TAX-FORM (1-800-829-3676).**

.06 Questions pertaining to magnetic media filing of Forms W–2 **must** be

directed to the Social Security Administration (SSA). Filers can call 1-800-SSA-1213 to obtain the phone number of the SSA Magnetic Media Coordinator for their area.

.07 Payers **should not** contact IRS/MCC if they have received a penalty notice and need additional information, or are requesting an abatement of the penalty. Penalty notices contain an IRS representative's name and/or phone number for contact purposes; or, the payer may be instructed to respond in writing to the address provided. IRS/MCC does **not** issue penalty notices and does **not** have the authority to abate penalties. For penalty information, refer to the Penalty section of *1996* "Instructions for Forms 1099, 1098, 5498, and W-2G."

.08 A taxpayer or authorized representative may request a copy of a tax return or a Form W-2 filed with a return by submitting Form 4506, Request for Copy or Transcript of Tax Form, to IRS. This form may be obtained by calling **1-800-TAX-FORM (1-800-829-3676)**.

.09 The IRS Centralized Call Site answers both magnetic media and tax law questions relating to the filing of information returns (Forms 1096, 1098, 1099, 5498, 8027, W-2, W-2G, W-3, Questionable W-4's, and 1042S). The IRS/MCC Call Site also handles inquiries dealing with backup withholding due to missing and incorrect taxpayer identification numbers. The Call Site is located at IRS/MCC and operates in conjunction with the Information Reporting Program. The Call Site provides service to the payer community (financial institutions, employers, and other transmitters of information returns). Recipients of information returns (payees) should continue to contact 1-800-829-1040 or other numbers specified in the tax return instructions with any questions on how to report information returns.

The Call Site accepts calls from all areas of the country. The number to call is **304-263-8700** or Telecommunications Device for the Deaf **(TDD) 304-267-3367.** These are toll calls. Hours of operation for the Call Site are Monday through Friday, 8:30 a.m. to 4:30 p.m. Eastern Time. The Call Site is in operation throughout the year to handle payers', transmitters', and employers' questions. Due to the high demand for assistance at the end of January and February, it is advisable to call as soon as possible to avoid these peak filing seasons.

Sec. 4. Filing Requirements

.01 Under section 6011(e)(2)(A) of the Internal Revenue Code, any person, including a corporation, partnership, individual, estate, and trust, who is required to file 250 or more information returns must file such returns magnetically/electronically. **The 250 or more requirement applies separately for each type of return and also to each type of corrected return.** Even though payers may not be required to file magnetically/electronically, IRS encourages them to do so.

.02 All filing requirements that follow apply individually to each reporting entity as defined by its separate Taxpayer Identification Number (TIN) [Social Security Number (SSN), or Employer Identification Number (EIN)]. For example, if a corporation with several branches or locations uses the same EIN, the corporation must aggregate the total volume of returns to be filed for that EIN and apply the filing requirements to each type of return accordingly.

.03 Payers who are required to submit their information returns on magnetic media may choose to submit their documents by electronic filing. Payers who submit their information returns electronically are considered to have satisfied the magnetic media filing requirements.

.04 *IRS/MCC has two methods by which payers may submit their files electronically. Bisynchronous (mainframe) electronic filing, which can be found in Part C of this publication, or Asynchronous (Information Reporting Program Bulletin Board System), which is in Part D. An overview of some features provided on the IRP-BBS are as follows:*

- *Electronic filing of information returns to the IRS using dial-up modems*
- *Return notification of the acceptability of the data transmitted within 24 to 48 hours*
- *Electronic communication with IRS and Social Security bulletin board systems*
- *Access to information reporting publications*
- *Access to shareware*
- *Access to forms relating to the Information Reporting Program*
- *News about the latest changes and updates that affect the Information Reporting Program at IRS*
- *Answers to messages and questions left on the bulletin board*
- *IRP-BBS is available for public use and can be reached by dialing 304-264-7070*
- *Telephone lines are available 24 hours a day, 7 days a week. Routine maintenance is performed daily, at approximately 7:00 a.m. Eastern Time Zone.*
- *Questions, comments, or suggestions can be directed to the Systems Operator (SYSOP) through IRP-BBS.*

.05 The following requirements apply separately to both originals and corrections filed magnetically/electronically:

1098 1099-A 1099-B 1099-C 1099-DIV 1099-G 1099-INT 1099-MISC 1099-OID 1099-PATR 1099-R 1099-S 5498 W-2G	**250 or more of any** of these forms require magnetic media or electronic filing with IRS. These are stand alone documents and are not to be aggregated for purposes of determining the 250 threshold. For example, if you must file 100 Forms 1099-B and 300 Forms 1099-INT, Forms 1099-B need not be filed magnetically or electronically since they do not meet the threshold of 250. However, Forms 1099-INT must be filed magnetically or electronically since they meet the threshold of 250.

.06 The above requirements do not apply if the payer establishes undue hardship (see Part A, Sec. 5).

Sec. 5. Form 8508, Request for Waiver from Filing Information Returns on Magnetic Media

.01 If a payer is required to file on magnetic media but fails to do so (or fails to file electronically, in lieu of magnetic media filing) and does not have an approved waiver on record, the payer will be subject to a penalty of $50 per return. (For penalty information, refer to the Penalty section of the *1996* "Instructions for Forms 1099, 1098, 5498, and W-2G.")

.02 If payers are required to file original or corrected returns on magnetic media, but such filing would create an undue hardship, they may request a waiver from these filing requirements by submitting Form 8508, Request for Waiver From Filing Information Returns on Magnetic Media, to IRS/MCC.

.03 Even though a payer may submit up to 249 corrections on paper, IRS/MCC encourages magnetically or electronically submitted corrections. Once the 250 threshold has been met, filers are required to submit any returns of 250 or more magnetically or electronically. However, if a waiver for original documents is approved, any corrections for the same type of returns will be covered under this waiver.

.04 Generally, only the payer may sign the Form 8508. A transmitter may sign if given power of attorney; however, a letter signed by the payer stating this fact must be attached to the Form 8508.

.05 A transmitter must submit a separate Form 8508 for each payer. Do not submit a list of payers.

.06 All information requested on the Form 8508 must be provided to IRS for the request to be processed.

.07 The waiver, if approved, will provide exemption from magnetic media filing for the current tax year only. Payers may not apply for a waiver for more than one tax year at a time; application must be made each year a waiver is necessary.

.08 Form 8508 may be photocopied or computer-generated as long as it contains all the information requested on the original form.

.09 Filers are encouraged to submit Form 8508 to IRS/MCC at least 45 days before the due date of the returns. However, new brokers and new barter exchanges may request an undue hardship waiver by the end of the second month following the month in which they became a broker or barter exchange.

.10 File Form 8508 for Forms W-2 with IRS/MCC, not SSA.

.11 Waivers are evaluated on a case-by-case basis and are approved or denied based on criteria set forth under section 6011(e) of the Internal Revenue Code. The transmitter must allow a minimum of 30 days for IRS/MCC to respond to a waiver request.

.12 If a waiver request is approved, the transmitter should keep the approval letter on file. **The transmitter should not send a copy of the approved waiver to the service center where the paper returns are filed.**

.13 An approved waiver from filing information returns on magnetic media does not provide exemption from all filing. The payer must timely file information returns on acceptable paper forms with the appropriate submission processing site.

.14 Desert Storm/*Operation Joint Endeavor (Bosnia Region)* Contributions—If a payer is required to file a Form 5498 magnetically/electronically, the payer may request an **automatic** waiver to file Forms 5498 on paper for participants of Desert Storm *or Operations Joint Endeavor. The payer should clearly mark Desert Storm or Operations Joint Endeavor on the waiver request form.*

Sec. 6. Vendor List

.01 IRS/MCC prepares a list of vendors who support magnetic media or electronic filing. The Vendor List (Pub. 1582) contains the names of service bureaus that will produce files on the prescribed types of magnetic media or via electronic filing. It also contains the names of vendors who provide software packages for payers who wish to produce magnetic media or electronic files on their own computer systems. This list is provided, *upon request*, as a courtesy and in no way implies IRS/MCC approval or endorsement.

☛ **Note: If filers meet the filing requirements and engage a service bureau to prepare media on their behalf, the filers should be careful not to report duplicate data, which may cause penalty notices to be generated.**

.02 *A payer may request a Vendor List (Pub. 1582) by contacting IRS/MCC at 304-263-8700* or by way of letter (see Part A, Sec. 3). This information is also available from the Information Reporting Program Bulletin Board System (refer to Part D). Vendor names will not be provided over the telephone.

.03 A vendor, who offers a software package, has the ability to produce magnetic media for customers, or has the capability to electronically file information returns, and would like to be included on the list, must submit a written request to IRS/MCC. The request should be submitted by August 15 and must include:

(a) Company name
(b) Address (include city, state, and ZIP code)
(c) Telephone number (include area code)
(d) Contact person
(e) Type(s) of service provided (*e.g.*, service bureau and/or software)
(f) Type(s) of media offered (*e.g.*, magnetic tape or tape cartridge, 5¼- or 3½-inch diskettes, or electronic filing)
(g) Type of return

.04 The vendor list is updated annually. Therefore, any changes to information already on the vendor list must also be received by IRS/MCC no later than August 15 to be included on the most current vendor list.

Sec. 7. Form 4419, Application for Filing Information Returns Magnetically/Electronically

.01 Transmitters are required to submit Form 4419, Application for Filing Information Returns Magnetically/Electronically, to request authorization to file information returns with IRS/MCC. A single Form 4419 should be filed no matter how many types of returns the transmitter will be submitting magnetically/electronically. For example, if a transmitter plans to file Forms 1099-INT, one Form 4419 should be submitted. If, at a later date, another type of form is to be filed, the transmitter does not need to submit a new Form 4419.

EXCEPTIONS

An additional Form 4419 is required for filing each of the following types of returns: Forms 1042–S, 8027, and Questionable W–4.

FORM	*TITLE*	*EXPLANATION*
1042–S	*Foreign Person's U.S. Source Income Subject to Withholding*	*Payments subject to withholding under Chapter 3 of the Code, including interest, dividends, royalties, pensions and annuities, gambling winnings and compensation for personal services.*
8027	*Employer's Annual Information Return of Tip Income and Allocated Tips*	*Receipts from food or beverage operations, tips reported by employees, and allocated tips.*
Questionable W–4 (See Note)	*Employee's Withholding Allowance Certificate*	*Forms received during the quarter from employees still employed at the end of the quarter who claim the following:* *(a) More than 10 withholding allowances or* *(b) Exempt status and wages normally would be more than $200 a week.*

☛ **Note: Employers are not required to send other Forms W–4 unless notified to do so by the IRS.**

If filers wish to report both electronically and magnetically, only one Form 4419 needs to be submitted.

.02 Magnetic tape, tape cartridge, diskette, and electronically-filed returns may not be submitted to IRS/MCC until the application has been approved. Please read the instructions on the back of Form 4419 carefully. A Form 4419 is included in the Publication 1220 for the filer's use. This form may be photocopied. Additional forms may be obtained by calling 1-800-TAX-FORM (1-800-829-3676).

.03 Upon approval, a five-character alpha/numeric Transmitter Control Code (TCC) will be assigned and included in an approval letter. The TCC **must** be coded in the Payer "A" Record. If a transmitter uses more than one TCC to file, each TCC must be reported on separate media or in separate transmissions if filing electronically.

.04 A magnetic media reporting package containing the current revenue procedure, forms, and instructions will be sent to the attention of the contact person indicated on Form 4419. This package will be sent annually.

.05 If **any** of the information on the Form 4419 changes, please notify IRS/MCC in writing so that the IRS/MCC database can be updated. The transmitter should include the TCC in all correspondence.

.06 Form 4419 can be submitted at any time during the year; however, it **must** be submitted to IRS/MCC at least 30 days before the due date of the return(s). **For documents to be filed electronically using IBM 3780 bi-synchronous protocols, Form 4419 must be submitted at least 45 days prior to the due date of the returns (See Part C, Sec. 2).** This will allow IRS/MCC the minimum amount of time necessary to process and respond to applications. In the event that computer equipment or software is not compatible with IRS/MCC, a waiver may be requested to file returns on paper documents.

.07 IRS/MCC encourages transmitters who file for multiple payers to submit one application and to use the assigned TCC for all payers. Include a list of all payers and TINs with the Form 4419. Transmitters are encouraged to provide an updated list to IRS/MCC annually.

.08 If a payer's files are prepared by a service bureau, the payer may not need to submit an application to obtain a TCC. Some service bureaus will produce files, code their own TCC on the media, and send it to IRS/MCC for the payer. Other service bureaus will prepare magnetic media and return the media to the payer for submission to IRS/MCC. These service bureaus may require the payer to obtain a TCC to be coded in the "A" Record. Payers should contact their service bureaus for further information.

.09 Once a transmitter is approved to file magnetically or electronically, it is not necessary to reapply each year *unless*:

(a) The payer has discontinued filing magnetically or electronically for three years; the payer's TCC may have been reassigned by IRS/MCC.

(b) The payer's magnetic media files were transmitted in the past by a service bureau using the service bureau's TCC, but now the payer has computer equipment compatible with that of IRS/MCC and wishes to prepare his or her own files. The payer must request a TCC by filing Form 4419.

.10 One Form 4419 may be submitted regardless of how many types of media or methods used to file the return. A payer may apply for more than one TCC, but must code only one TCC per media. Notify IRS/MCC of any TCCs that will not be used so these numbers may be reassigned.

.11 In accordance with Regulations section 1.6041–7(b), payments by separate departments of a health care carrier to providers of medical and health care services may be reported on separate returns on magnetic media. In this case, the headquarters will be considered the transmitter, and the individual departments of the company filing reports will be considered payers. A single Form 4419 covering all departments filing on magnetic media should be submitted. One TCC may be used for all departments.

.12 Approval to file does not imply endorsement by IRS/MCC of the computer software or of the quality of tax preparation services provided.

Sec. 8. Test Files

.01 IRS/MCC does not require test files, **except** for filers wishing to

participate in the Combined Federal/State Filing Program (see Part A, Sec. 16, for further information concerning the Combined Federal/State Filing Program).

.02 IRS/MCC encourages first-time magnetic media or electronic filers to submit a test. The test file should consist of a sample of each type of record:

(a) Payer "A" Record (must not be fictitious data)
(b) Multiple Payee "B" Records **(at least 11 "B" Records per each "A" Record)**
(c) End of Payer "C" Record
(d) State Totals "K" Record, if participating in the Combined Federal/State Filing Program
(e) End of Transmission "F" Record

See PART B for record formats.

.03 Use the Test Indicator in the "A" Record to show that this is a test file.

.04 IRS/MCC will check the file to ensure it meets the specifications of this revenue procedure. For current filers, sending a test file will provide the opportunity to ensure that their software reflects any programming changes.

If unable to submit a magnetic or electronic test file, a hardcopy printout that shows a sample of each record type (A, B, C, and F) may be submitted. **The hard copy print test is *not acceptable* for Combined Federal/State Filing approval.**

.05 Tests should be sent to IRS/MCC between November 1 and December 31. The test file **must** be received at MCC by December 31 in order to be processed. Filers may begin submitting test tapes and diskettes after October 1; however, the data will not be processed until on or after November 1.

.06 For tests filed electronically, the transmitter must send the signed Form 4804, Transmittal of Information Returns Reported Magnetically/Electronically, the same day the transmission is made. For tests filed on magnetic tape, tape cartridge, 5¼- and 3½-inch diskette, the transmitter must include the signed Form 4804 in the same package with the corresponding magnetic media. Mark the "TEST" box in block 1 on the form. Also, check "TEST" on the external media label.

If submitting a hard copy printout, mark the printout as "TEST" and include name, telephone number, and address of a person who can be contacted to discuss its acceptability.

.07 IRS/MCC will send a letter of acknowledgment to indicate the test results. Unacceptable magnetic media files, along with documentation identifying the errors, will be returned. Resubmission of test files must be received by IRS/MCC no later than December 31.

.08 Successfully processed media will not be returned to filers.

Sec. 9. Filing of Information Returns Magnetically/Electronically and Retention Requirements

.01 Form 4804, Transmittal of Information Returns Reported Magnetically/Electronically, Form 4802, Transmittal of Information Returns Reported Magnetically/Electronically (Continuation), or computer-generated substitute, must accompany **all** magnetic media shipments. For electronic transmissions, the Form 4804 and Form 4802, if applicable, must be sent the same day as the electronic transmission. Form 4802, Transmittal of Information Returns Reported Magnetically/Electronically (Continuation), is a continuation of Form 4804 and should only be used if the filer is reporting more than four types of returns and/or more than four payers. Form 4802 is not a stand-alone form; it can only accompany Form 4804.

.02 IRS/MCC encourages the use of computer-generated substitutes for Form 4804/4802 (See **Note**). The substitutes must contain all information requested on the original forms including the affidavit and signature line. Photocopies are acceptable but an original signature is required.

☛ **Note: When using computer-generated forms, be sure to very clearly mark which tax year is being reported. This will eliminate a phone communication from IRS/MCC to question the tax year.**

.03 A transmitter may report for any combination of payers and/or documents in a submission. For example, if reporting Forms 1099–INT for Bank A, Forms 1099–DIV for Bank B, and Forms 1098 for Bank C, three separate tapes or diskettes need not be created. All three banks and all types of documents can be coded on one tape or diskette as long as each filing entity or type of return is separated by an "A" Record. Only one "F" Record may be used at the end of a transmission. Multiple tapes or diskettes can be sent in one package. Filers **must** include Form 4804, 4802, or computer-generated substitute with their shipment.

.04 Multiple types of media may be submitted in a shipment. However, submit a separate Form 4804 for each type of media.

.05 Current and prior year data may be submitted in the same shipment; however, each tax year must be on separate media, and a separate Form 4804 must be prepared to clearly indicate each tax year.

.06 Filers who have prepared their information returns in advance of the due date are encouraged to submit this information to IRS/MCC no earlier than January 1 of the year the return is due.

.07 Do not report duplicate information. If a filer submits returns magnetically/electronically, identical paper documents must not be filed. This may result in erroneous penalty notices.

.08 Form 4804 may be signed by the payer or the transmitter, service bureau, paying agent, or disbursing agent (all hereafter referred to as agent), on behalf of the payer. An agent may sign the Form 4804 if the agent has the authority to sign the affidavit under an agency agreement (either oral, written, or implied) that is valid under state law and adds the caption "FOR: (name of payer)."

☛ **Note: Failure to sign the affidavit on Form 4804 may delay processing or could result in the files being returned unprocessed.**

.09 Although an authorized agent may sign the affidavit, the payer is responsible for the accuracy of the Form 4804 and the returns filed. The payer will be liable for penalties for failure to comply with filing requirements.

.10 An external media label, must be affixed to each tape and diskette. If diskettes are used, and the operating system is not MS–DOS compatible, the operating system and hardware information **must** be provided. Failure to provide this information may result in the diskettes being returned to the filer. For instructions on how to prepare an

external media label, refer to PART F "Miscellaneous Information."

.11 On the outside of the shipping container, affix or attach a label which reads **IRB ____ of ____** reflecting the number of containers in the shipment (See labels in PART F). If there is only one container, mark the outside as Box *1* of *1*. For multiple containers, include the sequence (for example, Box 1 of 3, 2 of 3, 3 of 3).

.12 When submitting files include the following:

(a) A **signed** Form 4804;

(b) Form 4802, if applicable;

(c) External media label affixed to magnetic media;

(d) **IRB ____ of ____** outside label.

☛ **Note: See Parts C and D for electronic submission requirements.**

.13 If returns from different locations (using the same name and TIN) are submitted on the same file, IRS encourages the filer to consolidate each type of information return under one "A" Record. For example, all "B" Records for the same type of return should be together under one "A" Record and followed by the End of Payer "C" Record.

.14 IRS/MCC will not pay for or accept "Cash-on-Delivery" or "Charge to IRS" shipments of tax information that an individual or organization is legally required to submit.

.15 In general, payers should retain a copy of the information returns filed with IRS or have the ability to reconstruct the data for at least 3 years from the reporting due date, with the exception of Form 1099–C. A financial entity must retain a copy of Form 1099–C, Cancellation of Debt, or have the ability to reconstruct the data required to be included on the return, for at least 4 years from the date such return is required to be filed. Whenever backup withholding is imposed, a 4 year retention is required.

Sec. 10. Due Dates

.01 The due dates for filing paper returns with IRS also apply to magnetic media or electronic filing. Filing of information returns is on a calendar year basis, except for Form 5498, which is used to report amounts contributed during, or after (but not later than April 15) of the calendar year.

.02 Information returns filed magnetically/electronically for Forms 1098, 1099, and W–2G must be submitted to IRS/MCC postmarked no later than February 28. If using a delivery service other than postal service, **the actual date of receipt by IRS/MCC will be used as the submission date.** This should be considered in meeting filing requirements timely.

.03 The due date for furnishing statements to recipients is January 31. Form 5498 statements are due to the participants by January 31 for the fair market value of the account and by May 31 for contributions made to IRAs for the prior calendar year.

.04 Form 5498 filed magnetically/electronically must be submitted to IRS/MCC postmarked no later than May 31. Form 5498 is filed for contributions to be applied to *1996* that are made January 1, *1996*, through April *15, 1997*, and/or to report the fair market value of the IRA/SEP.

.05 If any due date falls on a Saturday, Sunday, or legal holiday, the return or statement is considered timely if filed or furnished on the next day that is not a Saturday, Sunday, or legal holiday.

.06 Use this revenue procedure to prepare information returns filed magnetically or electronically beginning January 1, *1997*, and received by IRS/MCC no later than December 31, *1997*.

Sec. 11. Extensions of Time

.01 An extension of time to file may be requested for Forms 1099, 1098, 5498, W–2G, W–2, and 1042–S.

.02 Form 8809, Request for Extension of Time to File Information Returns, should be submitted to IRS/MCC. This form may be used to request an extension of time to file information returns submitted on paper, magnetically or electronically.

.03 Requesting an extension of time for multiple payers may be done by submitting Form 8809 and attaching a list of the payer names and their TINs (EIN or SSN). **The listing must be attached to ensure that the extension is recorded for all payers.** Form 8809 may be computer-generated or photocopied. Be sure that all the pertinent information is included.

.04 Requests for an extension of time to file for more than 50 payers are required to be submitted magnetically or electronically (See **Note**). Requests for an extension of time for 10 to 50 payers are encouraged to be filed magnetically or electronically via IRP–BBS. (See Part E, Sec. 3, for the record format.) The request may be filed on tape, tape cartridge, 5¼- or 3½-inch diskette, or electronically through the IRP–BBS or mainframe.

☛ **Note:** *Form 4419, Application for Filing Information Returns Magnetically/Electronically, must be completed in order to file an extension request magnetically/electronically.*

.05 A magnetically filed request for an extension of time should be sent using the following addresses:

If by Postal Service: ✉

IRS-Martinsburg Computing Center
Attn: Extension of Time Coordinator
P. O. Box 879, MS-360
Kearneysville, WV 25430

If by truck or air freight: ✈

IRS-Martinsburg Computing Center
Attn: Extension of Time Coordinator
Route 9 and Needy Road, MS-360
Martinsburg, WV 25401

.06 Requests for extensions of time for multiple payers will be responded to with one approval letter, accompanied by a list of payers covered under that approval.

.07 As soon as it is apparent that a 30 day extension of time to file is needed, Form 8809 may be submitted. It will take a minimum of 30 days for IRS/MCC to respond to an extension request. Under certain circumstances a request for an extension of time could be denied. When a denial letter is received, any additional or necessary information may be resubmitted within 20 days.

.08 If an additional extension of time is needed, a second Form 8809 must be requested before the end of the initial extension. Line 7 on the form should be checked to indicate that an additional extension is being requested. **A second 30-day extension will be** approved only in cases of extreme hardship or catastrophic events. *When requesting a second 30-day extension of time, do not hold your files waiting for a response.*

.09 Form 8809 must be postmarked no later than the due date of

the return for which an extension is requested. If requesting an extension of time to file several types of forms, use one Form 8809, but the Form 8809 must be postmarked no later than the earliest due date. For example, if requesting an extension of time to file both Forms 1099–INT and 5498, submit Form 8809 postmarked on or before February 28. Complete more than one Form 8809 to avoid this problem.

.10 *If an extension request is approved, the approval letter should be kept on file. (The approval letter or copy of the approval letter for extension of time should not be sent to IRS/MCC with the magnetic media file or to the service center where the paper returns are filed.)*

.11 Request an extension for only one tax year.

.12 The extension request must be signed by the payer or a person who is duly authorized to sign a return, statement or other document for the payer.

.13 Failure to properly complete and sign the Form 8809 may cause delays in processing the request or result in a denial. Carefully read and follow the instructions on the back of the Form 8809.

.14 Form 8809 may be obtained by calling 1-800-TAX-FORM (1-800-829-3676).

.15 Request an extension of time to furnish the statements to recipient of Forms 1098, 1099, 5498, W–2G, W–2, and 1042–S by submitting a letter to IRS/MCC or to the payer's local District Director containing the following information:

(a) Payer Name
(b) TIN
(c) Address
(d) Type of Return
(e) Specify that the extension request is to provide statements to recipients.
(f) Reason for Delay
(g) Signature of Payer or Person Duly Authorized

Requests for an extension of time to furnish the statements of Forms 1098, 1099, 5498, W–2G, W–2, and 1042–S to recipients are not automatically approved; however, if approved, generally an extension will allow a maximum of 30 additional days from the due date to furnish the statements to the recipients. If the request is denied, the statements must be sent to the recipients timely. The request must be postmarked by the date on which the statements are due to the recipients.

Sec. 12. Processing of Information Returns Magnetically/Electronically

.01 All data received at IRS/MCC for processing will be given the same protection as individual income tax returns (Form 1040). IRS/MCC will process the data and determine if the records are formatted and coded according to this revenue procedure.

.02 If the data is formatted incorrectly, the file will be returned for replacement *accompanied with a Media Tracking Slip (Form 9267).* If media is returned, it is because IRS/MCC encountered errors (not limited to format) and was unable to process the media, therefore, requiring a replacement. Open all packages immediately.

.03 Files must be corrected and returned *with the Media Tracking Slip (Form 9267)* to IRS/MCC within 45 days from the date of the letter IRS/MCC included with the returned files. A penalty for failure to file correct information returns by the due date will be assessed if the files are not corrected and returned within the 45 days **or if the incorrect files are returned by IRS/MCC for replacement more than two times.** A penalty for intentional disregard of filing requirements will be assessed if a replacement file is not received. (For penalty information, refer to the Penalty section of the *1996* "Instructions for Forms 1099, 1098, 5498, and W–2G.") When possible, IRS/MCC may return only the portion of the file that needs replacement.

.04 Sample records identifying errors encountered will be provided with the returned media. It is the responsibility of the transmitter to check the entire file for similar errors.

.05 The following definitions have been provided to help distinguish between a correction and a replacement:

- A **correction** is an information return submitted by the transmitter to correct an information return that was previously submitted to IRS/MCC, but contained erroneous information.
- A **replacement** is an information return file that IRS/MCC has returned to the transmitter due to errors encountered during processing. *After necessary changes have been made, the file must be returned for processing along with the blue and white Media Tracking Slip (Form 9267) which was included in the shipment from IRS/MCC.*
- **Filers should never send anything to IRS/MCC marked "REPLACEMENT" unless IRS/MCC returned media to them.**

.06 IRS/MCC will not return media after successful processing. Therefore, if the transmitter wants proof that IRS/MCC received a shipment, the transmitter should select a service with tracing capabilities or one that will provide proof of delivery.

.07 IRS/MCC will work with filers as much as possible to assist with processing problems.

☛ **Note: If the filer is contacted by IRS/MCC, a prompt response is important. IRS/MCC may have information that the filer needs to correct his or her file.**

.08 IRS/MCC contacts payers who have submitted payee data with missing TINs in an attempt to prevent errors that could result in penalties. Payers who submit data with missing TINs and have taken the required steps to obtain this information are encouraged to attach a letter of explanation to the required Form 4804. This will prevent unnecessary contact from IRS/MCC. This letter, however, will not prevent backup withholding notices (CP2100 or CP2100A Notices) or penalties for missing or incorrect TINs.

.09 Do not use special shipping containers for transmitting data to IRS/MCC. Shipping containers will not be returned.

Sec. 13. Corrected Returns

.01 The magnetic media filing requirements of 250 information returns applies separately to both original and corrected returns.

E If a payer has 100 Forms 1099–A to
X be corrected, they can be filed on
A paper since they fall under the 250
M threshold. However, if the payer has
P 300 Forms 1099–B to be corrected,
L they must be filed magnetically or
E electronically since they meet the 250 threshold. If for some reason a payer cannot file the 300 corrections on magnetic media, to avoid penalties, a request for a waiver must be submitted before filing on paper. No waiver is required for corrections that fall under the required threshold.

.02 Corrections should be filed **as soon as possible**. Corrections filed after August 1 may be subject to the maximum penalty of $50 per return. Corrections filed prior to August 1 may be subject to a lesser penalty. (For information on penalties, refer to the Penalty Section of the *1996* "Instructions for Forms 1099, 1098, 5498, and W-2G.") However, if payers discover errors after August 1, they may still be required to file corrections so that they will not be subject to a penalty for intentional disregard of the filing requirements. Failure to correct information returns may result in penalties for failure to provide correct information. **All fields must be completed with the correct information, not just the data fields needing correction.** Submit corrections only for the returns filed in error, not the entire file. Furnish corrected statements to recipients as soon as possible.

.03 There are numerous types of errors, and in some cases, more than one transaction may be required to correct the initial error. **If the original return was filed as an aggregate, the filers must consider this in filing corrected returns.**

.04 Corrected returns may be included on the same medium as original returns; however, separate "A" Records are required. Corrected returns must be identified on the Form 4804 and the external media label by indicating "Correction."

☛ **Note: If filers discover that certain information returns were omitted on their original file, they must not submit these documents as corrections. They must submit them as originals.**

.05 If a payer discovers errors for prior years that affect a large number of payees, in addition to sending IRS the corrected returns and notifying the payees, a letter containing the following information should be sent to IRS/MCC:

(a) Name and address of payer
(b) Type of error (please explain clearly)
(c) Tax year
(d) Payer TIN
(e) TCC
(f) Type of Return
(g) Number of Payees

This information will be forwarded to the appropriate office in an attempt to prevent erroneous notices from being sent to the payees. The correction must be submitted on an actual information return document or filed magnetically/electronically. Provide the correct tax year in Box 2 of the Form 4804 and the external media label.

.06 Prior year data, original and corrected, **must** be filed according to the requirements of this revenue procedure. If submitting prior year corrections, use the record format for the current year and submit on separate media. However, use the actual year designation of the correction in field positions 2–3. If filing electronically, a separate transmission must be made for each tax year.

.07 In general, filers should submit corrections for returns to be filed within the last three calendar years (four years if the payment is a reportable payment subject to backup withholding under section 3406 of the Code).

.08 All paper returns, whether original or corrected, must be filed with the appropriate service center.

.09 Form 4804 and Form 4802, must be submitted with corrected files submitted magnetically or electronically.

.10 The "B" Record provides a 20-position field for the Payer's Account Number for the Payee. This number will help identify the appropriate incorrect return if more than one return is filed for a particular payee. **Do not enter a TIN in this field.** A payer's account number for the payee may be a checking account number, savings account number, serial number, or any other number assigned to the payee by the payer that will distinguish the specific account. This number should appear on the initial return and on the corrected return in order to identify and process the correction properly.

.11 The record sequence for filing corrections is the same as for original returns.

.12 Review the chart that follows. Errors normally fall under one of the two categories listed. Next to each type of error made is a list of instructions on how to file the corrected return.

Guidelines for Filing Corrected Returns Magnetically/Electronically

Error Made on the Original Return	How To File the Corrected Return
Two (2) separate transactions are required to make the following corrections properly. Following directions for **both** Transations 1 and 2 (See **Note 1**).	**Transaction 1:** Identify incorrect returns
1. Original return was filed with one or more of the following errors:	A. Prepare a new Form 4804/4802 that includes information related to this file.

Error Made on the Original Return	How To File the Corrected Return
(a) No Payee TIN (SSN or EIN) (b) Incorrect Payee TIN (c) Incorrect Payee Name (d) Wrong type of return indicator	B. Mark "Correction" in Block 1 of Form 4804. C. Prepare a new file. Make a separate "A" Record for each **type** of return being reported. The information in the "A" Record will be **exactly** the same as it was in the original submission. D. The Payee "B" Record must contain **exactly the same** information as submitted previously, except, insert a "G" in field position 7 of the "B" Record, and for all payment amounts, enter "0" (zero). E. Corrected returns submitted to IRS/MCC using a "G" coded "B" Record may be on the same tape or diskette as those returns submitted without the "G" code; however, separate "A" Records are required. F. Prepare a "C" Record. **Transaction 2:** Report the correct information A. Prepare a new file with the correct information in all records. B. Make a separate "A" Record for each type of return and each payer being reported. C. The "B" Record must show the correct Information as well as a "C" in field position 7. D. Corrected returns submitted to IRS/MCC using a "C" coded "B" Record may be on the same tape or diskette as those returns submitted without the "C" code; **however, separate "A" Records are required.** E. Prepare a "C" Record. F. Indicate "Correction" on the external media label.

☛ **Note 1: Payers who can show that they have reasonable cause (defined in the regulations under sections 6721-6724 of the Internal Revenue Code) are not required to make corrections for returns filed with a missing or incorrect name and/or TIN. These payers should change their records in order to submit correct information in the future. Payers who cannot show reasonable cause are encouraged to make corrections for the current processing year by August 1 to reduce applicable penalties. Corrections filed by August 1 will reduce the $50 per return penalty for filing returns with missing or incorrect information to $15 or $30. (For penalty information, refer to the Penalty section of the *1996* "Instructions for Forms 1099, 1098, 5498, and W-2G.") Corrections filed after August 1 will not reduce the penalty but will allow IRS to update the payee's records. The regulations for IRC sections 6721-6724 are available in Publication 1586, Reasonable Cause Regulations and Requirements as They Apply to Missing and Incorrect TINs. The publication may be obtained by calling 1-800-TAX-FORM (1-800-829-3676).**

ONE TRANSACTION IS REQUIRED TO MAKE THE FOLLOWING CORRECTIONS PROPERLY (See **Note 2**). 2. Original return was filed with one or more of the following errors: (a) Incorrect Payment Amount Codes in the "A" Record (b) Incorrect Payment amounts in the "B" Record (c) Incorrect Code in the Document Specific/ Distribution Code Field in the "B" Record (d) Incorrect Payee Address (e) Direct Sales Indicator	A. Prepare a new Form 4804/4802 that includes information relating to this new file. B. Mark "Correction" in Block 1 of Form 4804. C. Prepare a new file. Make separate "A" Records for each type of return being reported. Information in the "A" Record may be the same as it was in the original submission. D. The "B" Record must show the correct information as well as a "G" in field position 7. E. Corrected returns submitted to IRS/MCC using a "G" coded "B" Record may be on the same tape or diskette as those returns submitted without the "G" code; **however, separate "A" Records are required.** F. Prepare a "C" Record. G. Mark "Correction" on the external media label.

Error Made on the Original Return	How To File the Corrected Return

☛ **Note 2: If a filer is correcting the name and/or TIN in addition to any errors listed in item 2 of the chart, then two transactions will be required. If a filer is reporting "G" coded, "C" coded, and/or "Non-coded" (original) returns on the same media, they must be reported under separate "A" Records.**

Sec. 14. Taxpayer Identification Number (TIN)

.01 Section 6109 of the Internal Revenue Code requires a person to furnish his/her TIN to the person obligated to file the information return.

.02 The payee's TIN and name combination is used to associate information returns reported to IRS/MCC with corresponding information on tax returns. It is imperative that **correct** Social Security and Employer Identification Numbers for payees be provided to IRS/MCC. **Do not enter hyphens or alpha characters.** Entering all zeros, ones, twos, etc., will have the effect of an incorrect TIN.

.03 The payer and payee names with associated TINs should be consistent with the names and TINs used on other tax returns. Also, the name and TIN provided must belong to the owner of the account. If the account is recorded in more than one name, furnish the name and TIN of one of the owners of the account. The TIN provided **must** be associated with the name of the payee provided in the first name line of the "B" Record. For individuals, the payee TIN is generally the payee's Social Security Number. For other entities, the payee TIN is the payee's Employer Identification Number. For sole proprietors, the payee TIN may be either an SSN or EIN but **the sole proprietor's name** (not the business name) **must be used.**

.04 Failure to provide the correct name and corresponding TIN could result in a penalty and/or backup withholding notice (sometimes referred to as a "B" notice). (For penalty information, refer to the Penalty Section of the *1996* "Instructions for Forms 1099, 1098, 5498, and W–2G." For "B" Notice information, refer to the Backup Withholding Section of the same publication.)

.05 The following charts will help payers determine the TIN to be furnished to IRS/MCC for those persons for whom they are reporting information (payees).

Chart 1. Guidelines for Social Security Numbers

For this type of account-	In the Taxpayer Identification Number field of the Payee "B" Record, enter the SSN of-	In the First Payee Name Line of the Payee "B" Record, enter the name of-
1. Individual	The individual	The individual
2. Joint account (Two or more individuals, including husband and wife)	The actual owner of the account or, if combined funds, the first individual on the account.	The individual whose SSN is entered
3. Custodian account of a minor (Uniform Gift, or Transfers, to Minors Act)	The minor	The minor
4. The usual revocable savings trust account (grantor is also trustee)	The grantor-trustee	The grantor-trustee
5. A so-called trust account that is not a legal or valid trust under state law	The actual owner	The actual owner
6. Sole proprietorship	The owner (An SSN or EIN)	The owner, not the business name (the filer may enter the business name on the second name line).

Chart 2. Guidelines for Employer Identification Numbers

For this type of account-	In the Taxpayer Identification Number field of the Payee "B" Record, enter the EIN of-	In the First Payee Name line of the Payee "B" Record, enter the name of-
1. A valid trust, estate, or pension trust	Legal entity[1]	The legal trust, estate, or pension trust
2. Corporate	The corporation	The corporation
3. Association, club, religious, charitable, educational, or other tax-exempt organization	The organization	The organization

Chart 2. Guidelines for Employer Identification Numbers (Continued)

For this type of account-	In the Taxpayer Identification Number field of the Payee "B" Record, enter the EIN of-	In the First Payee Name line of the Payee "B" Record, enter the name of-
4. Partnership account held in the name of the business	The partnership	The partnership
5. A broker or registered nominee/ middleman	The broker or nominee/middleman	The broker or nominee/middleman
6. Account with Department of Agriculture in the name of a public entity (such as a state or local government, school district, or prison), that receives agriculture program payments	The public entity	The public entity
7. Sole proprietorship	The business (An EIN or SSN)	The owner, not the business name (the filer may enter the business name on the second name line).

[1]Do not furnish the identification number of the personal representative or trustee unless the name of the representative or trustee is used in the account title.

Sec. 15. Effect on Paper Returns

.01 Magnetic/electronic reporting of information returns eliminates the need to submit paper documents to the IRS. **CAUTION! Do not send Copy A of the paper forms to IRS/MCC in addition to magnetic media and electronic filing.** This will result in duplicate filing; therefore, erroneous notices could be generated.

.02 Payers are responsible for providing statements to the payees as outlined in the *1996* "Instructions for Forms 1099, 1098, 5498, and W–2G." Refer to these instructions for filing information returns on paper with the IRS and furnishing statements to recipients.

.03 Statements to recipients should be clear and legible. If the official IRS form is not used, the filer must adhere to the specifications and guidelines in Publication 1179, "Rules and Specifications for Private Printing of Substitute Forms 1096, 1098, 1099 Series, 5498, and W–2G."

Sec. 16. Combined Federal/State Filing Program

.01 The Combined Federal/State Filing Program was established to simplify information returns filing for the taxpayer. IRS/MCC will forward this information to participating states free of charge for approved filers. Separate reporting to those states is not necessary.

The following Information Returns may not be filed under this program:

Form 1098—Mortgage Interest Statement

Form 1099–A—Acquisition or Abandonment of Secured Property

Form 1099–B—Proceeds for Broker and Barter Exchange Transactions

Form 1099–C—Cancellation of Debt

Form 1099–S—Proceeds From Real Estate Transactions

and

Form W–2G—Certain Gambling Winnings

.02 To request approval to participate, a magnetic media or electronic test file coded for this program **must** be submitted to IRS/MCC between November 1 and December 31. **Hard copy print tests are not acceptable** for Combined Federal/State Filing approval.

.03 Attach a letter to the Form 4804 submitted with the test file to indicate a desire to participate in this program.

.04 A test file is only required for the first year. Each record, both in the test and the actual data file, must conform to this revenue procedure.

.05 If the test file is acceptable, IRS/MCC will send the filer an approval letter, and a Form 6847, Consent for Internal Revenue Service to Release Tax Information, which the payer **must** complete, sign, and return to IRS/MCC before any tax information can be released to the state. Filers must write their TCC on Form 6847. If the test file is not acceptable, IRS/MCC will return the media with a letter indicating the problems. The replacement test file must be returned to IRS/MCC postmarked on or before December 31.

.06 A separate Form 6847 is **required** for each payer. A transmitter may not combine payers on one Form 6847 even if acting as Attorney-in-Fact for several payers. Form 6847 may be computer-generated as long as it includes all information that is on the original form or it may be photocopied. If the Form 6847 is signed by an Attorney-in-Fact, the written consent from the payer must clearly indicate that the Attorney-in-Fact is empowered to authorize release of the information.

.07 Only code the records for participating states and for those payers who have submitted Form 6847.

.08 Some participating states require separate notification that the payer is filing in this manner. Since IRS/MCC acts as a forwarding agent only, **it is the payer's responsibility to contact the appropriate states for further information.**

.09 All corrections properly coded for the Combined Federal/ State Filing Program will be forwarded to the participating states.

.10 Participating states and corresponding valid state codes are listed in **Table 1** of this section. The appropriate state code **must** be entered for those documents that meet the state filing requirements; **do not use state abbreviations.**

.11 To simplify filing, some of the participating states have provided their information return reporting requirements (see **Table 2**). **Each state filing**

regulations are subject to change by the state. It is the payer's responsibility to contact the participating states to verify the criteria provided in this table.

.12 Upon submission of the actual files, the transmitter must be sure of the following:

(a) All records should be coded exactly as required by this revenue procedure.

(b) The "C" Record **must be** followed by a state total "K" Record for each state being reported.

(c) Payment amount totals and the valid participating state code must be included in the State Totals "K" Record.

(d) The last "K" Record **must be** followed by an "A" Record or an End of Transmission "F" Record (if this is the last record of the entire file).

Table 1. Participating States And Their Codes

State	Code	State	Code	State	Code
Alabama	01	Iowa	19	North Carolina	37
Arizona	04	Kansas	20	North Dakota	38
Arkansas	05	Maine	23	Oregon	41
California	06	Massachusetts	25	South Carolina	45
Delaware	10	Minnesota	27	Tennessee	47
District of Columbia	11	Mississippi	28	Wisconsin	55
Georgia	13	Missouri	29		
Hawaii	15	Montana	30		
Idaho	16	New Jersey	34		
Indiana	18	New Mexico	35		

Table 2. Dollar Criteria For State Reporting

STATE	1099-DIV	1099-G	1099-INT	1099-MISC	1099-OID	1099-PATR	1099-R	5498
Alabama	$1500	$ NR	$1500	$1500	$1500	$1500	$1500	NR
Arkansas	100	2500	100	2500	2500	2500	2500	[a]
District of Columbia[b]	600	600	600	600	600	600	600	NR
Hawaii	10	[a]	10	600	10	10	600	[a]
Idaho	10	10	10	600	10	10	600	[a]
Iowa	100	1000	1000	1000	1000	1000	1000	NR
Minnesota	10	10	10	600	10	10	600	[a]
Mississippi	600	600	600	600	600	600	600	NR
Missouri	NR	NR	NR	1200[c]	NR	NR	NR	NR
Montana	10	10	10	600	10	10	600	[a]
New Jersey	1000	1000	1000	1000	1000	1000	1000	NR
North Carolina	100	100	100	600	100	100	100	[a]
Tennessee	25	NR	25	NR	NR	NR	NR	NR
Wisconsin	NR	NR	NR	600	NR	NR	600	NR

The preceding list is for information purposes only. The state filing requirements are subject to change by the states. For complete information on state filing requirements, contact the appropriate state tax agencies.

Filing requirements for any state in TABLE 1 not shown in TABLE 2 are the same as the federal requirement.

NR = No filing requirement.

Footnotes:

a. All amounts are to be reported.

b. Amounts are for aggregates of several types of income from the same payer.

c. Missouri would prefer those returns filed with respect to non-Missouri residents to be sent directly to their state agency.

Sec. 17. Definition of Terms

Element	*Description*
Asynchronous Protocols	This type of data transmission is most often used by microcomputers, PCs and some minicomputers. Asynchronous transmissions transfer data at arbitrary time intervals using the start-stop method. Each character transmitted has its own start bit and stop bit.
b	Denotes a blank position. Enter blank(s) when this symbol is used (do not enter the letter "b"). This appears in numerous areas throughout the record descriptions.
Bisynchronous Protocols	For purposes of this publication, these are electronic transmissions made using IBM 3780 protocols. These transmissions must be in EBCDIC character code and use the Bell 208B (4800bps) or AT&T 2296A (9600bps) modems. Standard IBM 3780 space compression is acceptable.
Correction	A correction is an information return submitted by the payer to correct erroneous information previously submitted to IRS/MCC.

☛ **Note: A correction should not be confused with a REPLACEMENT. Only media returned to the filer by IRS/MCC due to processing problems should be marked REPLACEMENT.**

CUSIP Number	A number developed by the Committee on Uniform Security Identification Procedures to serve as a common denominator in communications among users for security transactions and security information.
Employer Identification Number (EIN) Electronic Filing	A nine-digit number assigned by IRS for federal tax reporting purposes. Submission of information returns using switched telecommunications network circuits. These transmissions use modems, dial-up phone lines, and asynchronous or bisynchronous protocols. See Parts A, C, and D of this publication for specific information on electronic filing.
File	For purposes of this revenue procedure, a file consists of all records submitted by a payer or transmitter, either magnetically or electronically.
Filer	Person responsible for submitting information returns to IRS.
Filing Year	*The year in which the information returns are being submitted to IRS/MCC (if magnetically) or service center (if paper).*
Golden Parachute Payment	A payment made by a corporation to a certain officer, shareholder, or highly compensated individual when a change in the ownership or control of the corporation occurs or when a change in the ownership of a substantial part of the corporate assets occurs.
Incorrect Taxpayer Identification Number (Incorrect TIN)	A TIN may be incorrect for several reasons: (a) The payee gave a wrong number (*e.g.*, the payee is listed as the only owner of an account but provided someone else's TIN). (b) A processing error (*e.g.*, the number was typed incorrectly). (c) The payee's status changed (*e.g.*, a payee name change was not conveyed to the IRS or SSA so that they could enter the change in their records).
Information Return	The vehicle for submitting required information about another person to IRS. Information returns are filed by financial institutions and by others who make certain types of payments as part of their trade or business.

Element	*Description*
	The information required to be reported on an information return includes interest, dividends, pensions, nonemployed compensation for personal services, stock transactions, sales of real estate, mortgage interest, and other types of information. For this revenue procedure, an information return is Form 1098, 1099–A, 1099–B, 1099–C, 1099–DIV, 1099–G, 1099–INT, 1099–MISC, 1099–OID, 1099–PATR, 1099–R, 1099–S, 5498, or W–2G.
Magnetic Media	For this revenue procedure, the term "magnetic media" refers to ½-inch magnetic tape; IBM 3480/3490/*3490E* or AS400 compatible tape cartridge; or 5¼- and 3½-inch diskette.
Media Tracking Slip	*Form 9267 accompanies media that IRS/MCC has returned to the filer for correction due to format or fatal errors encountered when trying to process media.* ***THIS MUST BE RETURNED WITH THE REPLACEMENT FILE.***
Missing Taxpayer Identification Number (Missing TIN)	The payee TIN on an information return is "missing" if: (a) there is no entry in the TIN field, (b) includes one or more alpha characters (a character or symbol other than an Arabic number) as one of the nine digits, OR (c) payee TIN has less than nine digits
PS 58 Costs	The current cost of life insurance under a qualified plan taxable under section 72(m) and Regulations section 1.72–16(b). (See Part B, Sec. 7, Payee "B" Record, Document Specific/Distribution Code, Category of Distribution, Code 9.)
Payee	Person or organization receiving payments from the payer, or for whom an information return must be filed. The payee includes a borrower (Form 1099–A), a debtor (1099–C), a participant (Form 5498), and a gambling winner (Form W–2G). For Form 1098, the payee is the individual paying the interest. For Form 1099–S, the payee is the seller or other transferor.
Payer	Includes the person making payments, a recipient of mortgage interest payments, a broker, a person reporting a real estate transaction, a barter exchange, a creditor, a trustee, or an issuer of an IRA or SEP, or a lender who acquires an interest in secured property or who has reason to know that the property has been abandoned. The payer will be held responsible for the completeness, accuracy, and timely submission of magnetic media files.
Replacement	A replacement is an information return file that IRS/MCC has returned to the transmitter due to errors encountered during processing.

☛ Note: ***Filers should never submit media to IRS/MCC marked "REPLACEMENT" unless IRS/MCC returned media to the filers. When sending "REPLACEMENT" media, be sure to include the Media Tracking Slip (Form 9267) which will accompany media returned by IRS/MCC. Media that has been incorrectly marked as REPLACEMENT may result in duplicate filing.***

Service Bureau	Person or organization with whom the payer has a contract to prepare and/or submit information return files to IRS/MCC. A parent company submitting data for a subsidiary is not considered a service bureau.
Social Security Number (SSN)	A nine-digit number assigned by SSA to an individual for wage and tax reporting purposes.
Special Character	Any character that is not a numeral, an alpha, or a blank.
SSA	Social Security Administration.

Element	*Description*
Statement to Recipient	For purposes of this revenue procedure, the copy of Form 1099, 1098, 5498, or W–2G that is required to be sent by the payer to the recipient to provide information to be reported on the recipient's tax return. When reporting Form 1098, the payer is the receiver of the mortgage interest and the recipient is the person making the interest payment. When reporting Form 1099–S, the payer is the entity reporting the transaction and the recipient is the seller or other transferor.
Taxpayer Identification Number (TIN)	May be either an Employer Identification Number (EIN) or Social Security Number (SSN).
Tax Year	*The year in which payments were made by a payer to a payee.*
Transfer Agent	The transfer agent, or paying agent, is the entity who has been contracted or authorized by the payer to perform the services of paying and reporting backup withholding (Form 945). The payer may be required to submit to IRS/MCC a Form 2678, Employer Appointment of Agent Under Section 3504 of the Internal Revenue Code, which notifies IRS/MCC of the transfer agent relationship.
Transmitter	Person or organization submitting file(s) magnetically/electronically. May be payer or agent of payer.
Transmitter Control Code (TCC)	A five character alpha/numeric number assigned by IRS/MCC to the transmitter prior to actual filing magnetically or electronically. This number is inserted in the "A" Record of the files and **must** be present before the file can be processed. An application Form 4419 must be filed with IRS/MCC to receive this number.
Vendor	*Service bureaus that will produce information return files on the prescribed types of magnetic media or via electronic filing for payers who meet the 250 threshold or may be unable to prepare their own media. Companies who provide software for payers who wish to produce their own media or electronic files.*

Sec. 18. State Abbreviations

.01 The following state abbreviations are to be used when developing the state code portion of address fields. This table provides state abbreviations only, and does not represent those states participating in the Combined Federal/State Filing Program.

State	Code	State	Code	State	Code
Alabama	AL	Kentucky	KY	Ohio	OH
Alaska	AK	Louisiana	LA	Oklahoma	OK
American Samoa	AS	Maine	ME	Oregon	OR
Arizona	AZ	Marshall Islands	MH	Pennsylvania	PA
Arkansas	AR	Maryland	MD	Puerto Rico	PR
California	CA	Massachusetts	MA	Rhode Island	RI
Colorado	CO	Michigan	MI	South Carolina	SC
Connecticut	CT	Minnesota	MN	South Dakota	SD
Delaware	DE	Mississippi	MS	Tennessee	TN
District of Columbia	DC	Missouri	MO	Texas	TX
Federated States		Montana	MT	Utah	UT
of Micronesia	FM	Nebraska	NE	Vermont	VT
Florida	FL	Nevada	NV	Virginia	VA
Georgia	GA	New Hampshire	NH	Virgin Island	VI
Guam	GU	New Jersey	NJ	Washington	WA
Hawaii	HI	New Mexico	NM	West Virginia	WV
Idaho	ID	New York	NY	Wisconsin	WI

State	Code	State	Code	State	Code
Illinois	IL	North Carolina	NC	Wyoming	WY
Indiana	IN	North Dakota	ND		
Iowa	IA	Northern			
Kansas	KS	Mariana Islands	MP		

.02 Filers must adhere to the city, state, and ZIP code format for U.S. addresses in the "B" Record. This also includes American Samoa, Federated States of Micronesia, Guam, Marshall Islands, Northern Mariana Islands, Puerto Rico, and the Virgin Islands.

.03 For foreign country addresses, filers may use a 40 position free format which should include city, province or state, postal code, and name of country in this order. This is allowable only if a "1" (one) appears in the Foreign Country Indicator Field of the "B" Record.

.04 When reporting APO/FPO addresses use the following format:

	EXAMPLE:
Payee Name	PVT Willard J. Doe
Mailing Address	Company F, PSC Box 100 167 Infantry REGT
Payee City	APO (or FPO)
*Payee State	AE, AA, or AP
Payee ZIP Code	098010100

* AE is the designation for ZIPs beginning with 090-098, AA for ZIP 340, and AP for ZIPs 962-966.

Sec. 19. Major Problems Encountered

IRS/MCC encourages filers to verify the format and content of each type of record to ensure the accuracy of the data. This may eliminate the need for IRS/MCC to return files for replacement. This may be important for those payers who have either had their files prepared by a service bureau (see **Note**) or who have purchased preprogrammed software packages. If a filer purchased a software package for a previous tax year, it may no longer be valid for reporting current tax year information returns. Following are some of the most frequently encountered problems with magnetic/electronic files submitted to IRS/MCC.

Some of the problems listed in the Major Problems Encountered may result in media being returned for replacement.

☛ **Note: If filers meet the filing requirements and engage a service bureau to prepare media on their behalf, the filers should be careful not to report duplicate data which may generate penalty notices.**

1. Discrepancy between IRS/MCC totals and totals in Payer "C" Records

The "C" Record is a summary record for a type of return for a given payer as reported in the "B" Records. IRS balances the total number of payees and payment amounts and compares them with totals in the "C" Records. Filers should verify the accuracy of the records because imbalances may necessitate return of files for replacement.

2. The Payment Amount Fields in the "B" Record do not correspond to the Amount Codes in the "A" Record

If codes 2, 4, and 7 appear in the Amount Codes Field of the "A" Record, then the "B" Record must show payment amounts in only Fields 2, 4, and 7, right-justified and unused positions **must be** zero (0) filled.

EXAMPLE:	"A" RECORD	247bbbbbb (Pos. 23–31)	—	('b' denotes a blank)
	"B" RECORD	0000867599 (Pos. 61–70)	—	(Payment Amount 2)
		0000709097 (Pos. 81–90)	—	(Payment Amount 4)
		0000044985 (Pos. 111–120)	—	(Payment Amount 7)

3. Blanks or invalid characters appear in Payment Amount Fields in the "B" Record

Money amounts must be right-justified and zero (0) filled. **Do not use blanks.**

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4. Incorrect TIN in Payer "A" Record

The Payer's TIN reported in positions 7–15 of the "A" Record must be correct in order for IRS/MCC to process the media. The TIN provided in the "A" Record should correspond with the name provided in the first payer name line.

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5. Bad Format

IRS/MCC receives data in prior year format. Be sure to use **the current revenue procedure (Publication 1220)** for formatting data.

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6. Incorrect tax year in the Payer "A" Record and the Payee "B" Record

The tax year in both the payee and payer record should reflect the year of the information that is being reported. Filers need to check their files to ensure that this information is correct.

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7. Incorrect reporting of Form W–2 information to IRS

Form W–2 information is submitted to SSA, and **not** to IRS/MCC. SSA has its own magnetic media reporting program and specifications for wage information, and the media containing Forms W–2 is submitted to SSA. Any media received at IRS/MCC that contains Form W–2 information will be returned to the filer. The local SSA office should be contacted for information concerning filing Forms W–2 on magnetic media.

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8. Excessive withholding credits

Generally, for most information returns, other than Forms 1099–MISC, 1099–R, and W–2G, Federal withholding amounts should **not** exceed 31 percent of the income reported. Validate the total reported in the withholding field against the total income reported.

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9. Incorrect format for TINs in the Payee "B" Record

A check of "B" Records should be made to ensure the Taxpayer Identification Numbers (TINs) are formatted correctly. There should be nine numerics, no alphas, hyphens, commas, or blanks. Incorrect formatting of TINs may result in a penalty. (For penalty information, refer to the Penalty section of the *1996* "Instructions for Forms 1099, 1098, 5498, and W–2G.")

IRS/MCC contacts filers who have submitted payee data with missing TINs in an attempt to prevent erroneous notices. Payers/transmitters who submit data with missing TINs and have taken the required steps to obtain this information are encouraged to attach a letter of explanation to the required Form 4804. This will prevent unnecessary contact from IRS/MCC. This letter, however, will not prevent backup withholding notices (CP2100 and CP2100A Notices) or penalties for missing or incorrect TINs. (For penalty information, refer to the Penalty section of the *1996* "Instructions for Forms 1099, 1098, 5498, and W–2G.")

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10. Distribution Codes for Form 1099–R reported incorrectly

Distribution Codes for Form 1099–R are being reported incorrectly or not being reported. See valid distribution codes for 1099–R in the Payee "B" Record layout.

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11. Incorrect Record Totals Listed on Form 4804

The Combined Total Payee Records listed on the Form 4804 (Box 9) are used in the verification process of information returns. The figure in this box should be the total number of Payee "B" Records contained on the media submitted with the Form 4804. The figures on the Form 4804 are compared against the total number of Payee "B" Records processed on the media. Imbalances may necessitate the return of the files for replacement.

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12. Invalid Use of IRA/SEP Indicator

The IRA/SEP Indicator for Form 1099–R should be used only for the reporting of a distribution from an IRA or SEP. The total amount distributed from an IRA or SEP should be reported in Payment Amount Field 2 (IRA/SEP Distribution).

Part B. Magnetic Media Specifications

Sec. 1. General

.01 The specifications contained in this part of the revenue procedure define the required format and contents of the records to be included in the magnetic media file.

.02 A provision is made in the "B" Records for Special Data Entries. These entries are optional. If the field is not utilized, enter blanks to maintain a fixed record length of 420 positions. The field is intended to serve one or both of these purposes:

(a) Contain information required by state or local governments. Filers who wish to use this option for satisfying state or local reporting requirements should contact the state or local department of revenue for filing instructions. (Also refer to Part A, Sec. 16.)

(b) Contain information for the filer's own personal use and used at the discretion of the filer to include information related to each individual return. IRS/MCC will not use the information supplied in this field. The length of this field will vary depending on the type of return.

.03 Transmitters should be consistent in the use of recording codes and density on files. If the media does not meet these specifications, it could be returned to the transmitter for replacement. Filers are encouraged to submit a test prior to submitting the actual file. Contact IRS/MCC for further information at 304-263-8700.

.04 Use "K" Records **only** if the payer is an approved Combined Federal/State filer.

Sec. 2. Tape Specifications

.01 IRS/MCC can process most magnetic tape files if the following specifications are followed:

(a) 9 track EBCDIC (Extended Binary Coded Decimal Interchange Code) with:
  (1) Odd parity.
  (2) A density of 1600 or 6250 CPI.
  (3) If transmitters use UNISYS Series 1100, they must submit an interchange tape.

(b) 9 track ASCII (American Standard Coded Information Interchange) with:
  (1) Odd parity.
  (2) A density of 1600 or 6250 CPI.

Transmitters should be consistent in the use of recording codes and density on files.

.02 All compatible tape files must have the following characteristics: Type of tape—½-inch (12.7 mm) wide, computer-grade magnetic tape on reels of up to 2,400 feet (731.52 m) within the following specifications:

(a) Tape thickness: 1.0 or 1.5 mils and

(b) Reel diameter: 10½-inch (26.67 cm), 8½-inch (21.59 cm), 7-inch (17.78 cm), or 6-inch.

.03 The tape records defined in this revenue procedure may be blocked subject to the following:

(a) A block must not exceed 32,760 tape positions.

(b) If the use of blocked records would result in a short block, all remaining positions of the block must be filled with 9's; however, the last block of the file may be filled with 9's or truncated. Do not pad a block with blanks.

(c) All records, except the header and trailer labels, may be blocked or unblocked. A record may not contain any control fields or block descriptor fields which describe the length of the block or the logical records within the block. The number of logical records within a block (the blocking factor) must be constant in every block with the exception of the last block which may be shorter (see item b above). The block length must be evenly divisible by 420.

(d) Records may not span blocks.

.04 Labeled or unlabeled tapes may be submitted.

.05 For the purposes of this revenue procedure the following must be used:

Tape Mark:

(a) Used to signify the physical end of the recording on tape.

(b) For even parity, use BCD configuration 001111 (8421).

(c) May follow the header label and precede and/or follow the trailer label.

.06 IRS/MCC can only read one data file on a tape. A data file is a group of records which may or may not begin with a tapemark, but **must** end with a trailer label. Any data beyond the trailer label cannot be read by IRS programs.

Sec. 3. Tape Cartridge Specifications

.01 In most instances, IRS/MCC can process tape cartridges that meet the following specifications:

(a) Must be IBM 3480, 3490, *3490E*, or AS400 compatible.

(b) Must meet American National Standard Institute (ANSI) standards, and have the following characteristics:
  (1) Tape cartridges will be ½-inch tape contained in plastic cartridges which are approximately 4-inches by 5-inches by 1-inch in dimension.
  (2) Magnetic tape will be chromium dioxide particle based ½-inch tape.
  (3) Cartridges must be 18-track or 36-track parallel (See **Note**).
  (4) Cartridges will contain 37,871 CPI or 75,742 CPI (characters per inch).
  (5) Mode will be full function.
  (6) The data may be compressed using EDRC (Memorex) or IDRC (IBM) compression.
  (7) Either EBCDIC (Extended Binary Coded Decimal Interchange Code) or ASCII (American Standard Coded Information Interchange) may be used.

.02 The tape cartridge records defined in this revenue procedure may be blocked subject to the following:

(a) A block **must not** exceed 32,760 tape positions.

(b) If the use of blocked records would result in a short block, all remaining positions of the block must be filled with 9's; however, the last block of the file may be filled with 9's or truncated. **Do not pad a block with blanks.**

(c) All records, except the header and trailer labels, may be blocked or unblocked. A rec-

ord may not contain any control fields or block descriptor fields which describe the length of the block or the logical records within the block. The number of logical records within a block (the blocking factor) must be constant in every block with the exception of the last block which may be shorter (see item b above). The block length must be evenly divisible by 420.

(d) Records may not span blocks.

.03 Tape cartridges may be labeled or unlabeled.

.04 For the purposes of this revenue procedure, the following must be used:

Tape Mark:

(a) Used to signify the physical end of the recording on tape.

(b) For even parity, use BCD configuration 001111 (8421).

(c) May follow the header label and precede and/or follow the trailer label.

☛ **Note: Filers should indicate on the external media label and transmittal Form 4804 whether the cartridge is 36-track or 18-track.**

Sec. 4. 8mm (.315-inch) Tape Cartridges

For Tax Year 1996, the processing of 8mm tape cartridge (also referred to as cassette) as an acceptable form of magnetic media is offered as a pilot program for transmitters with AS400 operations systems only.

.01 *In most instances, IRS/MCC can process tape cartridges that meet the following specifications:*

(a) *Must meet American National Standard Institute (ANSI) standards, and have the following characteristics:*

(1) *8mm (.315-inch) tape cartridges will be 2½-inch by 3¾-inch.*

(2) *Magnetic tape will be chromium dioxide particle based 8mm tape.*

(3) *Mode will be full function.*

(4) *Compressed data is not acceptable.*

(5) *Either EBCDIC (Extended Binary Coded Decimal Interchange Code) or ASCII (American Standard Coded Information Interchange) may be used. However, IRS/MCC encourages the use of EBCDIC. This information must appear on the external media label affixed to the cartridge.*

(6) *A file may consist of more than one cartridge, however, no more than 250,000 documents may be transmitted per file or per cartridge. The filename, for example; IRSTAX will contain a three digit extension. The extension will indicate the sequence of the cartridge within the file 1 of 3, 2 of 3, and 3 of 3 and would appear in the header label IRSTAX.001, IRSTAX.002, and IRSTAX.003 on each cartridge of the file.*

.02 *The 8mm (.315-inch) tape cartridge records defined in this revenue procedure may be blocked subject to the following:*

(a) *A block* **must not** *exceed 32,760 tape positions.*

(b) *If the use of blocked records would result in a short block, all remaining positions of the block must be filled with 9's; however, the last block of the file may be filled with 9's or truncated.* **Do not pad a block with blanks.**

(c) *All records, except the header and trailer labels, may be blocked or unblocked. A record may not contain any control fields or block descriptor fields which describe the length of the block or the logical records within the block. The number of logical records within a block (the blocking factor) must be constant in every block with the exception of the last block which may be shorter (see item b above). The block length must be evenly divisible by 420.*

(d) *'COPY' or 'SAVE' command must be used to store data on the cartridge.*

(e) *Extraneous data following the "F" record will result in media being returned for replacement.*

(f) *Records may not span blocks.*

(g) *No more than 250,000 documents per cartridge and per file.*

.03 *For faster processing, IRS/MCC encourages transmitters to use header labeled cartridges. IRSTAX may be used as a suggested filename.*

.04 *For the purposes of this revenue procedure, the following must be used:*

Tape Mark:

(a) *Used to signify the physical end of the recording on tape.*

(b) *For even parity, use BCD configuration 001111 (8421).*

(c) *May follow the header label and precede and/or follow the trailer label.*

.05 *If extraneous data follows the end of the file "F" Record, the file must be returned for replacement. Therefore, IRS/MCC encourages transmitters to use blank tape cartridges rather than cartridges previously used, in the preparation of data when submitting information returns.*

.06 *IRS/MCC can only read one data file on a tape. A data file is a group of records which may or may not begin with a tapemark, but must end with a trailer label. Any data beyond the trailer label cannot be read by IRS programs.*

Sec. 5. 5¼-inch and 3½-inch Diskette Specifications

.01 To be compatible, a diskette file must meet the following specifications:

(a) 5¼- or 3½-inches in diameter.

(b) Data must be recorded in standard ASCII code. For 5¼-inch diskettes, data may be recorded using EBCDIC if the diskette is created on an IBM System 36.

(c) Records must be a fixed length of 420 bytes per record.

(d) Delimiter character commas (,) must not be used.

(e) Positions 419 and 420 of each record have been reserved for use as carriage return/line feed (cr/lf) characters if applicable.

(f) Filename of IRSTAX must be used. Do not enter any other data in this field. If a file will consist of more than one diskette, the filename IRSTAX will contain a three-digit extension. This extension will indicate the sequence of the dis-

kettes within the file. For example, the first diskette will be named IRSTAX.001, the second diskette will be IRSTAX.002, etc.

(g) A diskette file may consist of multiple diskettes as long as the file naming conventions are followed.

(h) Diskettes must meet one of the following specifications:

Capacity	Tracks	Sides/Density	Sector Size
1.44 mb	96tpi	hd	512
1.44 mb	135tpi	hd	512
1.2 mb	96tpi	hd	512
720 kb	48tpi	ds/dd	512
360 kb	48tpi	ds/dd	512
320 kb	48tpi	ds/dd	512
180 kb	48tpi	ss/dd	512
160 kb	48tpi	ss/dd	512

.02 IRS/MCC encourages transmitters to use blank or currently formatted diskettes when preparing files (See Note). If extraneous data follows the end of file "F" Record, the file must be returned for replacement.

.03 IRS/MCC prefers that 5¼- and 3½-inch diskettes be created using MS-DOS; however, diskettes created using other operating systems may be acceptable.

☛ **Note: 3½-inch Diskettes Created on a System 36 or AS400 Are Not Acceptable.**

IRS/MCC has equipment that can convert diskettes created under most operating systems to the appropriate MS-DOS format. IRS/MCC strongly recommends that transmitters submit a test file for 5¼- and 3½-inch diskettes, especially if their data was not created using MS-DOS.

.04 Transmitters are encouraged to use high density diskettes. Low density diskettes are acceptable but must be formatted in low density.

.05 Transmitters should check media for viruses before submitting media to IRS/MCC.

Sec. 6. Payer/Transmitter "A" Record—General Field Descriptions

.01 The Payer/Transmitter "A" Record identifies the payer and transmitter of the magnetic media file and provides parameters for the succeeding Payee "B" Records. IRS computer programs rely on the absolute relationship between the parameters and data fields in the "A" Record and the data fields in the "B" Records to which they apply.

.02 The number of "A" Records depends on the number of payers and the different types of returns being reported. The payment amounts for one payer and for one type of return should be consolidated under one "A" Record if submitted on the same file.

.03 Do not submit separate "A" Records for each payment amount being reported. For example, if a payer is filing Form 1099–DIV to report Amount Codes 1, 2, and 3, all three amount codes should be reported under one "A" Record, not three separate "A" Records. For "B" Records that do not contain payment amounts for all three amount codes, enter zeros for those which have no payment to be reported.

.04 The first record on the file must be an "A" Record. A transmitter may include "B" Records for more than one payer on a tape or diskette. However, each **group** of "B" Records must be preceded by an "A" Record and followed by an End of Payer "C" Record. A single tape or diskette may contain different types of returns but the types of returns **must not** be intermingled. A separate "A" Record is required for each payer and each type of return being reported.

.05 All records must be a fixed length of 420 positions.

.06 An "A" Record may be blocked with "B" Records, however, the initial record on a file must be an "A" Record. IRS/MCC will accept an "A" Record after a "C" Record.

.07 Do not begin any record at the end of a block or diskette and continue the same record into the next block.

.08 All alpha characters entered in the "A" Record must be upper-case.

.09 When filing Form 1098, Mortgage Interest Statement, the "A" Record will reflect the name of the recipient of the interest referred to as the payer in these instructions. The "B" Record will reflect the individual paying the interest (borrower/payer of record) and the amount paid.

☛ **Note:** For all fields marked **Required**, a transmitter must provide the information described under Description and Remarks. For fields **not marked Required**, a transmitter must allow for the field, but may be instructed to enter blanks or zeros in the indicated media position(s) and for the indicated length. All records are now a fixed length of 420 positions.

Record Name: Payer/Transmitter "A" Record

Field Position	Field Title	Length	Description and Remarks
1	Record Type	1	**Required.** Enter "A."
2–3	Payment Year	2	**Required.** Enter *"96"* (unless reporting prior year data).

Record Name: Payer/Transmitter "A" Record—Continued

Field Position	Field Title	Length	Description and Remarks
4–6	Reel Sequence Number	3	The reel sequence number is incremented by 1 for each tape or diskette on the file starting with 001. The transmitter may enter blanks or zeros in this field. IRS/MCC bypasses this information. Indicate the proper sequence on the external media label.
7–15	Payer's TIN	9	**Required.** Must be the valid nine-digit Taxpayer Identification Number assigned to the payer. **Do not enter blanks, hyphens, or alpha characters.** All zeros, ones, twos, etc., will have the effect of an incorrect TIN. For foreign entities that are not required to have a TIN, this field may be blank. However, the Foreign Entity Indicator, position 49 of the "A" Record, should be set to "1" (one).
16–19	Payer Name Control	4	**Not a required field.** The Payer Name Control can be obtained only from the mail label on the Package 1099 that is mailed to most payers each December. To distinguish between Package 1099 and the Magnetic Media Reporting (MMR) Package, the Package 1099 contains instructions for paper filing only, and the mail label on the package contains a four (4) character name control. The MMR Package contains instructions for filing magnetically or electronically. The mail label **does not** contain a name control. Names of less than four (4) characters should be left-justified, filling the unused positions with blanks. If a Package 1099 has not been received or the Payer Name Control is unknown, this field must be blank filled.
20	Last Filing Indicator	1	Enter a "1" (one) if this is the last year the payer will file, otherwise, **enter blank.** Use this indicator if the payer will not be filing information returns under this payer name and TIN in the future either magnetically, electronically, or on paper.
21	Combined Federal/ State Filer	1	**Required** for the Combined Federal/State Filing Program. Enter "1" (one) if participating in the Combined Federal/State Filing Program, otherwise, enter blank. Refer to Part A, Sec. 16, for further information. Forms 1098, 1099–A, 1099–B, 1099–C, 1099–S, and W–2G cannot be filed under this program.
22	Type of Return	1	**Required.** Enter the appropriate code from the table below: *Type of Return* — *Code* 1098 — 3 1099–A — 4 1099–B — B 1099–C — 5 1099–DIV — 1 1099–G — F 1099–INT — 6 1099–MISC — A 1099–OID — D 1099–PATR — 7 1099–R — 9 1099–S — S 5498 — L W–2G — W
23–31	Amount Codes (See Note)	9	**Required.** Enter the appropriate amount codes for the type of return being reported. Generally, for each amount code entered in this field, a corresponding payment amount **must** appear in the Payee "B" Record. **In most cases, the box numbers on paper information returns correspond with the amount codes used to file magnetically/electronically. However, if discrepancies occur, this revenue procedure governs.**

Field Position	Field Title	Length	Description and Remarks

Example of Amount Codes:

If position 22 of the Payer/Transmitter "A" Record is "A" (for 1099–MISC) and positions 23–31 are "1247bbbbb", this indicates the payer is reporting any or all four payment amounts (1247) in all of the following "B" Records. **(In this example, "b" denotes blanks in the designated positions. Do not enter the letter 'b'.)**

The first payment amount field will represent rents;
the second will represent royalties;
the third will be all "0" (zeros);
the fourth will represent federal income tax withheld;
the fifth and sixth will be all "0" (zeros);
the seventh will represent nonemployed compensation;
and
the eighth and ninth will be all "0" (zeros).

Enter the amount codes in **ascending sequence** (*i.e.,* 1247bbbbb, left justify information, and fill unused positions with blanks. For further clarification of the amount codes, contact IRS/MCC. **(In this example, "b" denotes blanks in the designated positions. Do not enter the letter 'b'.)**

☛ **Note: A type of return and an amount code must be present in every Payer "A" Record even if no money amounts are being reported. For a detailed explanation of the information to be reported in each amount code, refer to the *1996* "Instructions for Forms 1099, 1098, 5498, and W–2G."**

Amount Codes **Form 1098**—Mortgage Interest Statement

For Reporting Mortgage Interest Received From Payers/Borrowers (Payer of Record) on Form 1098:

Amount Code	*Amount Type*
1	Mortgage interest received from payer(s)/borrower(s)
2	Points paid on purchase of principal residence
3	Refund of overpaid interest

Amount Codes **Form 1099–A**—Acquisition or Abandonment of Secured Property (See **Note 1**)

For Reporting the Acquisition or Abandonment of Secured Property on Form 1099–A:

Amount Code	*Amount Type*
2	Balance of principal outstanding
4	Fair market value of property

☛ **Note 1: If, in the same calendar year, a debt is canceled in connection with the acquisition or abandonment of secured property and the filer would be required to file both Forms 1099–A and 1099–C (Cancellation of Debt) for one debtor, the filer is required to file Form 1099–C only. See the *1996* "Instructions for Forms 1099, 1098, 5498, and W–2G" for further information on coordination with Form 1099–C.**

Amount Codes **Form 1099–B** Proceeds From Broker and Barter Exchange Transaction

For Reporting Payments on Form 1099–B:

Amount Code	*Amount Type*
2	Stocks, bonds, etc. (For forward contracts, See **Note 1**)
3	Bartering (Do not report negative amounts.)
4	Federal income tax withheld (backup withholding) (Do not report negative amounts.)
6	Profit or (loss) realized on Closed Regulated Futures or Foreign Currency Contracts in *1996* (See **Note 2**).
7	Unrealized profit or (loss) on open contracts—12/31/*95* (See **Note 2**).
8	Unrealized profit or (loss) on open contracts—12/31/*96* (See **Note 2**).
9	Aggregate profit or (loss) (See **Note 2**).

☛ **Note 1: The payment amount field associated with Amount Code 2 may be used to represent a loss from a closing transaction on a forward contract. Refer to the "B" Record — General Field Descriptions, Payment Amount Fields, for instructions on reporting negative amounts.**

Field Position	Field Title	Length	Description and Remarks

☛ **Note 2: Payment Amount Fields 6, 7, 8, and 9 are to be used for the reporting of regulated futures or foreign currency contracts.**

Amount Codes
Form 1099-C—Cancellation of Debt (See Note 1)

For Reporting Cancellation of Debt on Form 1099-C:

Amount Code	*Amount Type*
2	Amount of debt canceled (See **Note 2**)
3	Interest included in Amount Code 2
4	Penalties, fines, or administrative costs included in Amount Code 2
7	Fair market value of property (See **Note 3**)

☛ **Note 1: If, in the same calendar year, a debt is canceled in connection with the acquisition or abandonment of secured property for one debtor and the filer would be required to file both Forms 1099-C and 1099-A (Acquisition or Abandonment of Secured Property) the filer is required to file Form 1099-C only. See the 1996 "Instructions for Forms 1099, 1098, 5498, and W-2G" for further information on coordination with Form 1099-A.**

☛ **Note 2: A debt is any amount owed to the debtor including principal, interest, penalties, administrative costs, and fines, to the extent they are indebtedness under section 61(a)(12). The amount of debt discharged or canceled may be all or only part of the total amount owed. See the *1996* "Instructions for Forms 1099, 1098, 5498, and W-2G" for further information.**

☛ **Note 3: Amount Code 7 will be used only if a combined Form 1099-A and 1099-C is being filed. See the *1996* "Instructions for Forms 1099, 1098, 5498, and W-2G" for further information on reporting the fair market value of property and coordination with Form 1099-A.**

Amount Codes
Form 1099-DIV—Dividends and Distributions

For Reporting Payments on Form 1099-DIV:

Amount Code	*Amount Type*
1	Gross dividends and other distributions on stock (See **Note**)
2	Ordinary dividends (See **Note**)
3	Capital gain distributions (See **Note**)
4	Nontaxable distributions (if determinable) (See **Note**)
5	Investment expenses (See **Note**)
6	Federal income tax withheld (backup withholding)
7	Foreign tax paid
8	Cash liquidation distributions
9	Noncash liquidation distributions (show fair market value)

☛ **Note: Amount Code 1 MUST be present (unless the payer is using Amount Codes 8 or 9 only) and must equal the sum of amounts reported for Amount Codes 2, 3, 4, and 5. If an amount is present for Amount Code 1, there must be an amount present for Amount Codes 2-5 as applicable.**

Amount Codes
Form 1099-G—Certain Government Payments

For Reporting Payments on Form 1099-G:

Amount Code	*Amount Type*
1	Unemployment compensation
2	State or local income tax refunds, credits, or offsets
4	Federal income tax withheld (backup withholding)
6	Taxable grants
7	Agriculture payments

Amount Codes
Form 1099-INT—Interest Income

For Reporting Payments on Form 1099-INT:

Field Position	Field Title	Length	Description and Remarks
			Amount Code — *Amount Type* 1 — Interest income not included in Amount Code 3 2 — Early withdrawal penalty 3 — Interest on U.S. Savings Bonds and Treasury obligations 4 — Federal income tax withheld (backup withholding) 5 — Foreign tax paid
	Amount Codes **Form 1099–MISC**—Miscellaneous Income		For Reporting Payments on Form 1099–MISC: *Amount Code* — *Amount Type* 1 — Rents (See **Note 1**) 2 — Royalties (See **Note 2**) 3 — Other income 4 — Federal income tax withheld (backup withholding and withholding on payments of Indian gaming profits) 5 — Fishing boat proceeds 6 — Medical and health care payments 7 — Nonemployed compensation or crop insurance proceeds (See **Note 3**) 8 — Substitute payments in lieu of dividends or interest 9 — Excess golden parachute payments **(Filers: See Note 4)**

☛ **Note 1: If reporting the Direct Sales Indicator only, use Type of Return Code A for 1099–MISC in position 22, and Amount Code 1 in position 23 of the Payer "A" Record. All payment amount fields in the Payee "B" Record will contain zeros.**

☛ **Note 2: Do not report timber royalties under a "pay-as-cut" contract; these must be reported on Form 1099–S.**

☛ **Note 3: Amount Code 7 is normally used to report nonemployed compensation. However, Amount Code 7 may also be used to report crop insurance proceeds. See positions 4-5 of the "B" Record for instructions. If nonemployed compensation and crop insurance proceeds are being paid to the same payee, a separate "B" Record for each transaction is required.**

☛ **Note 4: For the convenience of the payer, the Special Data Entries Field in the Payee "B" Record may be used to report state and local income tax withheld. This information does not need to be reported to IRS.**

	Amount Codes **Form 1099–OID**—Original Issue Discount		For Reporting Payments on Form 1099–OID: *Amount Code* — *Amount Type* 1 — Original issue discount for *1996* 2 — Other periodic interest 3 — Early withdrawal penalty 4 — Federal income tax withheld (backup withholding)
	Amount Codes **Form 1099–PATR**—Taxable Distributions Received From Cooperatives		For Reporting Payments on Form 1099–PATR: *Amount Code* — *Amount Type* 1 — Patronage dividends 2 — Nonpatronage distributions 3 — Per-unit retain allocations 4 — Federal income tax withheld (backup withholding) 5 — Redemption of nonqualified notices and retain allocations **Pass-Through Credits** (See Note) 6 — For filers' use

Field Position	Field Title	Length	Description and Remarks
			Amount Code — *Amount Type* 7 — Energy investment credit 8 — Jobs credit 9 — Patron's Alternative Minimum Tax (AMT) Adjustment

☛ **Note: Amount Codes 6, 7, and 8 are reserved for the patron's share of unused credits that the cooperative is passing through to the patron. Other credits, such as the Indian employment credit may be reported in Amount Code 6. The title of the credit reported in Amount Code 6 should be reported in the Special Data Entries Field in the Payee "B" Record. The amounts shown for Amount Codes 6, 7, 8, and 9 must be reported to the payee. These Amount Codes and the Special Data Entries Field are for the convenience of the filer. This information is not needed by IRS/MCC.**

Amount Codes **Form 1099–R**—Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc. (See **Note 1**)

For Reporting Payments on Form 1099–R:

Amount Code	*Amount Type*
1	Gross distribution (See **Note 2**)
2	Taxable amount (See **Note 3**)
3	Capital gain (included in Amount Code 2)
4	Federal income tax withheld (See **Note 4**)
5	Employee contributions or insurance premiums
6	Net unrealized appreciation in employers' securities
8	Other
9	Total employee contributions

☛ **Note 1: Additional information may be required in the "B" Record. Refer to positions 44 through 48 of the "B" Record.**

☛ **Note 2: If the payment shown for Amount Code 1 is a total distribution, enter a "1" (one) in position 47 of the "B" Record. An amount must be shown in Amount Field 1.**

☛ **Note 3: If a distribution is a loss, do not enter a negative amount. For example, if stock is distributed but the value is less than the employee's after-tax contributions, enter the value of the stock in Amount Code 1, enter "0" (zero) in Amount Code 2, and enter the employee's contributions in Amount Code 5.**
If the taxable amount cannot be determined, enter a "1" (one) in position 48 of the "B" Record. If reporting an IRA/SEP distribution, generally include the amount of the distribution in the Taxable Amount (Payment Amount Field 2, positions 61-70) and enter a "1" (one) in the IRA/SEP Indicator Field (position 44). A "1" (one) may be entered in the Taxable Amount Not Determined Indicator Field (position 48) of the Payee "B" Record, but the amount of the distribution must still be reported in Payment Amount Fields 1 and 2. See the explanation for Box 2a of Form 1099–R in the *1996* "Instructions for Forms 1099, 1098, 5498, and W–2G" for more information on reporting the taxable amount.

☛ **Note 4: See the *1996* "Instructions for Forms 1099, 1098, 5498, and W–2G" for information concerning federal income tax withheld for Form 1099–R.**

☛ **Note: For payers who wish to report state or local income tax, see Part B, Section 7 (6) Payee "B" Record—Record Layout Positions 322-420 Form 1099–R.**

Amount Codes **Form 1099–S**—Proceeds From Real Estate Transactions

For Reporting Payments on Form 1099–S:

Amount Code	*Amount Type*
2	Gross proceeds (See **Note**)
5	Buyer's part of real estate tax

☛ **Note: Include payments of timber royalties made under a "pay-as-cut" contract, reportable under section 6050N. If timber royalties are being reported, enter "TIMBER" in the description field of the "B" Record. For more information, see Announcement 90–129, 1990–48 I.R.B. 10.**

Record Name: Payer/Transmitter "A" Record—Continued

Field Position	Field Title	Length	Description and Remarks
Amount Codes **Form 5498**—Individual Retirement Arrangement Information (See **Note**)			For Reporting Payments on Form 5498: *Amount Code* — *Amount Type* 1 — Regular IRA contributions made in *1996* and *1997* for *1996*. 2 — Rollover IRA contributions 3 — Life insurance cost included in Amount Code 1 4 — Fair market value of the account

☛ **Note: For information regarding Inherited IRAs, refer to the *1996* "Instructions for Forms 1099, 1098, 5498, and W-2G" and Rev. Proc. 89-52, 1989-2 C.B. 632. Beneficiary information must be given in the Payee Name Line Field of the "B" Record.**
If reporting IRA contributions for a Desert Storm/Shield participant for other than *1996* or an Operations Joint Endeavor (Bosnia Region) participant, enter "DS," for Desert Storm or "JE" for Joint Endeavor, the year for which the contribution was made, and the amount of the contribution in the Special Data Entries Field of the "B" Record. Do not enter the contributions in Amount Code 1.
For information concerning Desert Storm/Shield participant reporting, refer to the 1994 "Instructions for Forms 1099, 1098, 5498, and W-2G," or Notice 91-17, 1991-1 C.B. 319. The instructions for filing Form 5498 for Desert Storm/Shield participants will also apply to participants of Operation Joint Endeavor of the Bosnia Region.

Amount Codes **Form W-2G**—Certain Gambling Winnings			For Reporting Payments on Form W-2G: *Amount Code* — *Amount Type* 1 — Gross winnings 2 — Federal income tax withheld 3 — State income tax withheld (See **Note**) 7 — Winnings from identical wagers

☛ **Note: State income tax withheld is added for the convenience of the payer but need not be reported to IRS/MCC.**

32	Test Indicator	1	**Required**. Enter "T" if this is a **test** file, otherwise enter a blank.
33	Service Bureau Indicator	1	Enter "1" (one) if a service was used to develop and/or transmit files, otherwise, **enter blank**. See Part A, Sec. 17 for the definition of service bureau.
34–41	Blank	8	**Enter blanks.**
42–43	Magnetic Tape Filer Indicator	2	**Required** for magnetic tape/tape cartridge filers **only**. Enter the letters "LS" (in **uppercase only**). Use of this field by filers using other types of media will be acceptable but is not required.
44–48	Transmitter Control Code (TCC)	5	**Required**. Enter the five character alpha/numeric Transmitter Control Code assigned by IRS/MCC. A TCC must be obtained to file data on this program. **Do not enter more than one TCC per file.**
49	Foreign Entity Indicator	1	Enter a "1" (one) if the payer s a foreign entity and income is paid by the corporation to a U.S. resident. If the payer is not a foreign entity, enter a blank (See **Note**).

☛ **Note: If payers erroneously report entities as foreign, they may be subject to a penalty for providing incorrect information to IRS. Therefore, payers must be sure to code only those records as foreign entities that should be coded.**

50–89	First Payer Name Line	40	**Required**. Enter the name of the payer whose TIN appears in positions 7–15 of the "A" Record. Any extraneous information must be deleted. Left justify information, and fill unused positions with blanks. (Filers should not enter a transfer agent's name in this field. Any transfer agent's name should appear in the Second Payer Name Line Field.)

Record Name: Payer/Transmitter "A" Record—Continued

Field Position	Field Title	Length	Description and Remarks
☛ Note:			**When reporting Form 1098, Mortgage Interest Statement, the "A" Record will reflect the name and TIN of the recipient of the interest/the filer of Form 1098 (the payer). The "B" Record will reflect the individual paying the interest (the payer of record) and the amount paid. For Form 1099–S, the "A" Record will reflect the person responsible for reporting the transaction (the filer of Form 1099–S) and the "B" Record will reflect the seller/transferor.**
90–129	Second Payer Name Line	40	If the Transfer (or Paying) Agent Indicator (position 130) contains a "1" (one), this field must contain the name of the transfer (or paying) agent. If the indicator contains a "0" (zero), this field may contain either a continuation of the First Payer Name Line or blanks. Left justify information and fill unused positions with blanks.
130	Transfer Agent Indicator	1	**Required.** Identifies the entity in the Second Payer Name Line Field. (See Part A, Sec. 17 for a definition of transfer agent.) *Code* — *Meaning* 1 — The entity in the Second Payer Name Line Field is the transfer (or paying) agent. 0 (zero) — The entity shown is **not** the transfer (or paying) agent (*i.e.*, the Second Payer Name Line Field contains either a continuation of the First Payer Name Line Field or blanks).
131–170	Payer Shipping Address	40	**Required.** If the Transfer Agent Indicator in position 130 is a "1" (one), enter the shipping address of the transfer (or paying) agent. Otherwise, enter the **actual** shipping address of the payer. The street address should include number, street, apartment or suite number (or P. O. Box if mail is not delivered to street address). Left justify information, and fill unused positions with blanks.
171–210	Payer City, State, and ZIP Code	40	**Required.** If the Transfer Agent Indicator in position 130 is a "1" (one), enter the city, town, or post office, state abbreviation and ZIP Code of the transfer agent. Otherwise, enter the city, town, or post office, state, and ZIP Code of the payer. Left justify information, and fill unused positions with blanks.
211–290	Transmitter Name	80	**Required** if the payer and the transmitter are not the same. Enter the name of the transmitter in the manner in which it is used in normal business. The name of transmitter **must** be reported in the same manner throughout the entire file. Left justify information, and fill unused positions with blanks. If the payer and transmitter are the same, this field may be blank.
291–330	Transmitter Mailing Address	40	**Required** if the payer and transmitter are not the same. Enter the mailing address of the transmitter. Street address should include number, street, apartment or suite number (or P.O. Box if mail is not delivered to street address). Left justify information, and fill unused positions with blanks. If the payer and transmitter are the same, this field may be blank.
331–370	Transmitter City, State, and ZIP Code	40	**Required** if the payer and transmitter are not the same. Enter the city, town, or post office, state, and ZIP Code of the transmitter. Left justify information and fill unused positions with blanks. If the payer and transmitter are the same, this field may be blank.
371–418	Blank	48	**Enter blanks.**
419–420	Blank	2	Enter blanks or Carriage Return/Line Feed (CR/LF).

Sec. 7. Payer/Transmitter "A" Record—Record Layout

Record Type	Payment Year	Reel Sequence Number	Payer's TIN*	Payer Name Control*	Last Filing Indicator
1	2–3	4–6	7–15	16–19	20

Combined Federal/State Filer	Type of Return	Amount Codes	Test Indicator	Service Bureau Indicator
21	22	23–31	32	33

Blank	Magnetic Tape Filer Indicator	Transmitter Control Code	Foreign Entity Indicator	First Payer Name Line*	Second Payer Name Line*
34–41	42–43	44–48	49	50–89	90–129

Transfer Agent Indicator	Payer Shipping Address*	Payer City State And Zip Code*	Transmitter Name	Transmitter Mailing Address
130	131–170	171–210	211–290	291–330

Transmitter City, State, and Zip Code	Blank	Blank or CR/LF
331–370	371–418	419–420

☛ **Note: When reporting Form 1098, Mortgage Interest Statement, the "A" Record will reflect the name and TIN of the recipient of the interest (the payer). For Form 1099–S, the "A" Record will reflect the person responsible for reporting the transaction.**

Sec. 8. Payee "B" Record—General Field Descriptions and Record Layouts

.01 The "B" Record contains the payment information from the information returns. When filing information returns, the format for the "B" Records will remain constant and is a fixed length of 420 positions. The record layout for positions 1 through 321 is the same for all "B" Records. Positions 322 through 420 vary for Forms 1099–A, 1099–B, 1099–C, 1099–OID, 1099–S, and W–2G to accommodate variations within these forms. In the "A" Record, the amount codes that appear in tape or diskette positions 23 through 31 will be left-justified and filled with blanks. In the "B" Record, the filer **must** allow for all nine Payment Amount Fields. For those fields not used, enter "0's" (zeros). For example, a payer reporting on Form 1099–MISC, should ENTER "A" in tape position 22 of the "A" Record, Type of Return. If reporting payments for Amount Codes 1, 2, 4, and 7, the payer would report media positions 23 through 31 of the "A" Record as "1247bbbbb." (In this example, "b" denotes blanks. Do not enter the letter 'b'.) In the "B" Record:

Positions 51 through 60 for Payment Amount 1 will represent Rents.

Positions 61–70 for Payment Amount 2 will represent Royalties.

Positions 71–80 for Payment Amount 3 will be "0's" (zeros).

Positions 81–90 for Payment Amount 4 will represent Federal income tax withheld.

Positions 91–110 for Payment Amounts 5 and 6 will be "0's" (zeros).

Positions 111–120 for Payment Amount 7 will represent Nonemployee compensation.

Positions 121–140 for Payment Amounts 8 and 9 will be "0's" (zeros).

.02 The following specifications include a field in the payee records called "Name Control" in which the first four characters of the payee's surname are to be entered by the filer.

.03 If filers are unable to determine the first four characters of the surname, the Name Control Field may be left blank. Compliance with the following will facilitate IRS computer programs in generating the name control:

(a) The surname of the payee whose TIN is shown in the "B" Record should always appear first. If, however, the records have been developed using the first name first, the filer must leave a blank space between the first and last names.

(b) In the case of multiple payees, only the surname of the payee whose TIN (SSN or EIN) is shown in the "B" Record must be present in the First Payee Name Line. Surnames of any other payees may be entered in the Second Payee Name Line.

.04 See Part A, Sec. 14 for further information concerning Taxpayer Identification Numbers (TINs).

.05 A field is also provided in these specifications for Special Data Entries. This field may be used to record information required by state or local governments, or for the personal use of the filer. IRS does not use the data provided in the Special Data Entries Field, therefore, the IRS program does not check the content or format of the data entered in this field. It is the filer's option to use the Special Data Entry Field. If this field is coded, it will not affect the processing of the "B" Records.

.06 Those payers participating in the Combined Federal/State Filing Program must adhere to all of the specifications in Part A, Sec. 16, in order to participate in this program. Forms 1098, 1099–A, 1099–B, 1099–C, 1099–S, and W–2G cannot be filed under the Combined Federal/State Filing Program.

.07 All alpha characters entered in the "B" Record must be uppercase.

.08 Do not use decimal points (.) to indicate dollars and cents. Ten dollars must appear as 0000001000 in the payment amount field.

.09 IRS strongly encourages transmitters to review the data for accuracy before submission to prevent issuance of erroneous notices. Transmitters should be especially careful that the names, TINs, account numbers, types of income, and income amounts are correct.

.10 When reporting Form 1098, Mortgage Interest Statement, the "A" Record will reflect the name and TIN of the recipient of the interest, the filer of the Form 1098 (the payer). The "B" Record will reflect the individual paying the interest (borrower/payer of record) and the amount paid. For Form 1099–S, the "A" Record will reflect the person responsible for reporting the transaction (the filer of the Form 1099–S) and the "B" Record will reflect the seller/transferor.

☛ **Note: For all fields marked Required, the transmitter must provide the information described under Description and Remarks. For those fields not marked Required, the transmitter must allow for the field, but may be instructed to enter blanks or zeros in the indicated position(s) and for the indicated length. All records are a fixed length of 420 positions.**

Record Name: Payee "B" Record

Field Position	Field Title	Length	Description and Remarks
1	Record Type	1	**Required**. Enter "B."
2–3	Payment Year	2	**Required**. Enter "*96*" (unless reporting prior year data).
4–5	Document Specific/ Distribution Code	2	**Required** for Forms 1099–G, 1099–MISC, 1099–R and W–2G. For all other forms, or if not used, enter blanks.

Record Name: Payee "B" Record—Continued

Field Position	Field Title	Length	Description and Remarks
	Tax Year of Refund (**Form 1099–G only**)		**For Form 1099–G**, use only for reporting the tax year for which the *refund, credit, or offset (Amount Code 2) was issued. Enter in position 4; position 5 must be blank. If the refund, credit, or offset is not attributable to income from a trade or business, enter the **numeric** year from the table below for which the refund, credit, or offset was issued (*e.g.*, for *1995*, enter *5*). If the refund, credit or offset is exclusively attributable to income from a trade or business and is not of general application, enter the **alpha** equivalent of the year from the table below (*e.g.*, for *1995*, enter *E*).

Code For Tax Year Which Refund Was Issued

Tax Year For Which Refund Was Issued	**Code For General Refund*	**Code For Trade/Business Refund (Alpha Equivalent)*
1991	*1*	*A*
1992	*2*	*B*
1993	*3*	*C*
1994	*4*	*D*
1995	*5*	*E*
1986	*6*	*F*
1987	*7*	*G*
1988	*8*	*H*
1989	*9*	*I*
1990	*0*	*J*

***Be sure the distribution code reflects the tax year for which the REFUND was made, not the tax year of the Form 1099–G.**

	Crop Insurance Proceeds (**Form 1099–MISC only**)		**For Form 1099–MISC**, Enter "1" (one) in position 4 if the payments reported for Amount Code 7 are crop insurance proceeds. Position 5 will be blank.
	Distribution Code (**Form 1099–R only**) (For a detailed explanation of the Distribution Codes, see the *1996* "Instructions for Forms 1099, 1098, 5498, and W–2G.")		**For Form 1099–R**, enter the appropriate distribution code(s). More than one code may apply for Form 1099–R. If only one code is required, it must be entered in position 4 and position 5 must be blank. Enter at least one (1) distribution code. A **blank** in position 4 is **not** acceptable. Enter the applicable code from the table that follows. Position 4 must contain a numeric code in all cases except when using P, D, E, F, G, or H. Distribution Code A, B, or C, when applicable, must be entered in position 5 with the applicable numeric code in position 4. When using Code P for an IRA distribution under section 408(d)(4) of the Internal Revenue Code, the filer may also enter Code 1 if applicable. Only three numeric combinations are acceptable, Codes 8 and 1, Codes 8 and 2 and Codes 8 and 4, on one return. These three combinations can be used only if both codes apply to the distribution being reported. If more than one numeric code is applicable to different parts of a distribution, report two separate "B" Records.

Record Name: Payee "B" Record—Continued

Field Position	Field Title	Length	Description and Remarks
	Form 1099–R Continued		Distribution Codes E, F, and H cannot be used in conjunction with other codes. Distribution Code G may be used in conjunction with Distribution Code 4 **only**, if applicable.

Category	*Code*
Early (premature) distribution, no known exception	1*
Early (premature) distribution, exception applies (as defined in section 72(q), (t), or (v) of the Internal Revenue Code) (other than disability or death)	2*
Disability	3*
Death (includes payments to an estate or other beneficiary)	4*
Prohibited transaction	5*
Section 1035 exchange	6
Normal distribution	7*
Excess contributions plus earnings/excess deferrals (and/or earnings) taxable in *1996*	8*
PS 58 costs	9
Excess contributions plus earnings/excess deferrals taxable in *1995*	P*
May be eligible for 5- or 10-year tax option	A
May be eligible for death benefit exclusion	B
May be eligible for **both** A and B	C
Excess contributions plus earnings/excess deferrals taxable in *1994*	D*
Excess annual additions under section 415	E
Charitable gift annuity	F
Direct rollover to IRA	G
Direct rollover to qualified plan or tax-sheltered annuity	H

*** If reporting an IRA or SEP distribution, code a "1" (one) in position 44 of the "B" Record.**

	Type of Wager (**Form W–2G only**)		**For Form W–2G,** enter the applicable code in position 4. Position 5 will be blank.

Category	*Code*
Horse race track (or off-track betting of a horse track nature)	1
Dog race track (or off-track betting of a dog track nature)	2
Jai-alai	3
State-conducted lottery	4
Keno	5
Bingo	6
Slot machines	7
Any other type of gambling winnings	8

Record Name: Payee "B" Record—Continued

Field Position	Field Title	Length	Description and Remarks
6	2nd TIN Notice	1	For Forms 1099–B, 1099–DIV, 1099–INT, 1099–MISC, 1099–OID, and 1099–PATR only. Enter "2" to indicate notification by IRS/MCC twice within three calendar years that the payee provided an incorrect name and/or TIN combination, otherwise, **enter a blank.**
7	Corrected Return Indicator	1	Indicate a corrected return. *Code* *Definition* G If this is a one-transaction correction or the first of a two-transaction correction C If this is the second transaction of a two transaction correction Blank If this is not a return being submitted to correct information already processed by IRS.

☛ **Note: C, G, and non-coded records must be reported using separate Payer "A" Records. Refer to Part A, Sec. 13, for specific instructions on how to file corrected returns.**

8–11	Name Control	4	If determinable, enter the first four (4) characters of the surname of the person whose TIN is being reported in positions 15–23 of the "B" Record, otherwise, enter blanks. This is usually the payee. **If the name that corresponds to the TIN is not included in the first or second payee name line and the correct name control is not provided, a backup withholding notice may be generated for the record.** Surnames of less than four (4) characters should be left-justified, filling the unused positions with blanks. Special characters and imbedded blanks should be removed. In the case of a business, other than a sole proprietorship, use the first four significant characters of the business name. Disregard the word "the" when it is the first word of the name, **unless** there are only two words in the name. A dash (-) and an ampersand (&) are the only acceptable special characters. Surname prefixes are considered part of the surname, *e.g.*, for Van Elm, the name control would be VANE.

☛ **Note: Although extraneous words, titles, and special characters are allowed (*i.e.*, Mr., Mrs., Dr., apostrophe, or dash), this information may be dropped during subsequent IRS/MCC processing.**

The following examples may be helpful to filers in developing the Name Control:

	Name	*Name Control*
Individuals:		
	Jane *Brow*n	BROW
	John A. *Lee*	LEE*
	James P. *En*, Sr.	EN*
	John *O'Nei*ll	ONEI
	Mary *Van B*uren	VANB
	Juan *De Je*sus	DEJE
	Gloria A. *El-R*oy	EL-R
	Mr. John *Smit*h	SMIT
	Joe *McCa*rthy	MCCA
	Pedro *Torre*s-Lopes	TORR
	Maria *Lopez* Moreno**	LOPE
	Binh To *La*	LA*
	Nhat Thi *Pham*	PHAM
	Mark *D'Al*lesandro	DALL
Corporations:		
	The *Firs*t National Bank	FIRS
	*The H*ideaway	THEH
	A & B Cafe	A&BC
	11TH Street Inc.	11TH

Record Name: Payee "B" Record—Continued

Field Position	Field Title	Length	Description and Remarks
Sole Proprietor:			
			Name — *Name Control*
			Mark *Hem*lock DBA The Sunshine Club — HEML
Partnership:			
			Robert *Aspe*n and Bess Willow — ASPE
			Harold *Fir*, Bruce Elm, and Joyce Spruce et al Ptr — FIR*
Estate:			
			Frank *Whit*e Estate — WHIT
			Sheila *Blue* Estate — BLUE
Trusts and Fiduciaries:			
			*Dais*y Corporation Employee Benefit Trust — DAIS
			Trust FBO The *Cher*tyblossom Society — CHER
Exempt Organization:			
			*Labo*rer's Union, AFL-CIO — LABO
			*St. Be*rnard's Methodist Church Bldg. Fund — STBE

* Name Controls of less than four (4) significant characters must be left-justified and blank-filled.

** For Hispanic names, when two last names are shown for an individual, derive the name control from the first last name.

12	Direct Sales Indicator	1	**1099 MISC only.** Enter a "1" (one) to indicate sales of $5,000 or more of consumer products to a person on a buy/sell, deposit/commission, or any other commission basis for resale anywhere other than in a permanent retail establishment. Otherwise, enter a blank.

☛ **Note: If reporting direct sales only, use Type of Return "A" in position 22, and Amount Code 1 in position 23 of the Payer "A" Record. All payment amount fields in the Payee "B" Record will contain zeros.**

13	Blank	1	**Enter blank.**
14	Type of TIN	1	This field is used to identify the Taxpayer Identification Number (TIN) in positions 15–23 as either an Employer Identification Number (EIN), or a Social Security Number (SSN).* Enter the appropriate code from the following table:

*** While not a "Required" field, this information is important for the correct processing of the payee's TIN.**

Type of TIN		*Type of Account*
1	EIN	A business, organization, sole proprietor, or other entity
2	SSN	An individual, including a sole proprietor
Blank	N/A	If the type of TIN is not determinable, enter a blank.

15–23	Taxpayer Identification Number	9	**Required.** Enter the nine digit Taxpayer Identification Number of the payee (SSN or EIN). If an identification number has been applied for but not received, enter blanks. **Do not enter hyphens or alpha characters.** All zeros, ones, twos, etc. will have the effect of an incorrect TIN. If the TIN is not available, enter blanks (See Note).

☛ **Note: IRS/MCC contacts payers who have submitted payee data with missing TINs in an attempt to prevent erroneous notices. Payers who submit data with missing TINs, and have taken the required steps to obtain this information are encouraged to attach a letter of explanation to the required Form 4804. This will prevent unnecessary contact from IRS/MCC. This letter, however, will not prevent backup withholding notices (CP2100 or CP2100A) or penalties. (Refer to the Penalty section of the *1996* "Instructions for Forms 1099, 1098, 5498, and W-2G" for missing or incorrect TINs.)**

Record Name: Payee "B" Record—Continued

Field Position	Field Title	Length	Description and Remarks
24–43	Payer's Account Number for Payee	20	Enter any number assigned by the payer to the payee (*e.g.*, checking or savings account number). Filers are encouraged to use this field. **This number helps to distinguish individual payee records and should be unique for each document. Do not use the payee's TIN since this will not make each record unique.** This information is particularly useful when corrections are filed. This number will be provided with the backup withholding notification and may be helpful in identifying the branch or subsidiary reporting the transaction. Do not define data in this field in packed decimal format. If fewer than twenty characters are used, filers may either left or right justify, filling the remaining positions with blanks.
44	IRA/SEP Indicator	1	**Form 1099–R.** Enter "1" (one) if reporting a distribution from an IRA or SEP; otherwise, enter a blank (See **Note**). ***Form 5498. Enter "1" (one) if reporting Simplified Employee Pension (SEP).***

☛ **Note: For Form 1099–R, generally, report the total amount distributed from an IRA or SEP in Payment Amount Field 2 (Taxable Amount), as well as Payment Amount Field 1 (Gross Distribution) of the "B" Record. Filers may indicate the taxable amount was not determined by using the Taxable Amount Not Determined Indicator (position 48) of the "B" Record. However, still report the amount distributed in Payment Amount Fields 1 and 2. Refer to the *1996* "Instructions for Forms 1099, 1098, 5498, and W–2G" for exceptions.**

45–46	Percentage of Total Distribution	2	**Form 1099–R only.** Use this field when reporting a total distribution to more than one person, such as when a participant is deceased and a payer distributes to two or more beneficiaries. Therefore, if the percentage is 100, leave this field blank. If the percentage is a fraction, round off to the nearest whole number (for example, 10.4 percent will be 10 percent; 10.5 percent or more will be 11 percent). Enter the percentage received by the person whose TIN is included in positions 15–23 of the "B" Record. This field must be right-justified, and unused positions must be zero-filled. **If not applicable, enter blanks.** Filers need not enter this information for IRA or SEP distributions or for direct rollovers.
47	Total Distribution Indicator (See **Note**)	1	**Form 1099–R only.** Enter a "1" (one) only if the payment shown for Amount Code 1 is a total distribution that closed out the account; otherwise, enter a blank.

☛ **Note: A total distribution is one or more distributions within one tax year in which the entire balance of the account is distributed. Any distribution that does not meet this definition is not a total distribution.**

48	Taxable Amount Not Determined Indicator	1	**Form 1099–R only.** Enter a "1" (one) only if the taxable amount of the payment entered for Payment Amount Field 1 (Gross Distribution) of the "B" Record cannot be computed; otherwise, enter blank. If Taxable Amount Not Determined Indicator is used, enter "0's" (zeros) in Payment Amount Field 2 of the Payee "B" Record unless the IRA/SEP Indicator is present (See **Note**). Please make every effort to compute the taxable amount.

☛ **Note: If reporting an IRA or SEP distribution for Form 1099–R, the Taxable Amount Not Determined Indicator may be used; but, it is not required. If the IRA/SEP Indicator is present, generally, the amount of the distribution must be reported in both Payment Amount Fields 1 and 2. Refer to the *1996* "Instructions for Forms 1099, 1098, 5498, and W–2G" for more information.**

Record Name: Payee "B" Record—Continued

Field Position	Field Title	Length	Description and Remarks
49–50	Blank	2	**Enter blanks.**
	Payment Amount Fields (Must be numeric) (See **Note 1**)		**Required. Filers should allow for all payment amounts. For those not used, enter zeros.** For example: If position 22, Type of Return, of the "A" Record is "A" (for 1099–MISC) and positions 23–31, Amount Codes, are "1247bbbbb". This indicates the payer is reporting any or all four payment amounts (1247) in all of the following "B" Records. (In this example, "b" denotes blanks in the designated positions. Do not enter the letter 'b.') Payment Amount 1 will represent rents; Payment Amount 2 will represent royalties; Payment Amount 3 will be all "0's" (zeros); Payment Amount 4 will represent Federal income tax withheld; Payment Amounts 5 and 6 will be all "0's" (zeros); Payment amount 7 will represent nonemployed compensation, and Payment Amounts 8 and 9 will be all "0's" (zeros). Each payment field must contain 10 numeric characters (See **Note 2**). Each payment amount must be entered in U.S. dollars and cents. The right-most two positions represent cents in the payment amount fields. Do not enter dollar signs, commas, decimal points, or negative payments, except those items that reflect a loss on Form 1099–B. Positive and negative amounts are indicated by placing a "+" (plus) or "-" (minus sign) in the left-most position of the payment amount field. A negative over punch in the units position may be used, instead of a minus sign, to indicate a negative amount. If a plus sign, minus sign, or negative over punch is not used, the number is assumed to be positive. Negative over punch cannot be used in PC created files. Payment amounts must be right-justified and unused positions must be zero-filled. Federal income tax withheld cannot be reported as a negative amount on any form.

☛ **Note 1: Filers are instructed to enter numeric information in all payment fields when filing magnetically or electronically. However, when reporting information on the statement to recipient, the payer may be instructed to leave a box blank. Follow the guidelines provided in the paper instructions for the statement to recipient.**

☛ **Note 2: If a payer is reporting a *money amount in excess of 9999999999 (dollars and cents), it must be reported as follows:**

(1) The first Payee "B" Record MUST contain ***9999999999.**

(2) The second Payee "B" Record will contain the remaining money amount.

***DO NOT SPLIT THIS FIGURE IN HALF.**

51–60	Payment Amount 1*	10	The amount reported in this field represents payments for Amount Code 1 in the "A" Record.
61–70	Payment Amount 2*	10	The amount reported in this field represents payments for Amount Code 2 in the "A" Record.
71–80	Payment Amount 3*	10	The amount reported in this field represents payments for Amount Code 3 in the "A" Record.
81–90	Payment Amount 4*	10	The amount reported in this field represents payments for Amount Code 4 in the "A" Record.
91–100	Payment Amount 5*	10	The amount reported in this field represents payments for Amount Code 5 in the "A" Record.
101–110	Payment Amount 6*	10	The amount reported in this field represents payments for Amount Code 6 in the "A" Record.
111–120	Payment Amount 7*	10	The amount reported in this field represents payments for Amount Code 7 in the "A" Record.
121–130	Payment Amount 8*	10	The amount reported in this field represents payments for Amount Code 8 in the "A" Record.

Record Name: Payee "B" Record—Continued

Field Position	Field Title	Length	Description and Remarks
131–140	Payment Amount 9*	10	The amount reported in this field represents payments for Amount Code 9 in the "A" Record.

* If there are discrepancies between the payment amount fields and the boxes on the paper forms, the instructions in this revenue procedure govern.

141–160	Blank	20	**Enter blanks.**
161	Foreign Country Indicator	1	If the address of the payee is in a foreign country, enter a "1" (one) in this field; otherwise, enter blanks. When filers use this indicator, they may use a free format for the payee city, state, and ZIP Code. Address information must not appear in the First or Second Payee Name Line.
162–201	First Payee Name Line	40	**Required.** Enter the name of the payee (preferably surname first) whose Taxpayer Identification Number (TIN) was provided in positions 15–23 of the "B" Record. Left justify and fill unused positions with blanks. If more space is required for the name, utilize the Second Payee Name Line Field. If there are multiple payees, only the name of the payee whose TIN has been provided should be entered in this field. The names of the other payees may be entered in the Second Payee Name Line Field. If reporting information for a sole proprietor, the individual's name **must** always be present, preferably on the First Payee Name Line. The use of the business name is optional in the Second Payee Name Line Field.

☛ **Note: When reporting Form 1098, Mortgage Interest Statement, the "A" Record will reflect the name of the recipient of the interest (the payer). The "B" Record will reflect the individual paying the interest (the borrower/payer of record) and the amount paid. For Form 1099–S, the "B" Record will reflect the seller/transferor information.**

For Form 5498 Inherited IRAs, enter the beneficiary's name followed by the word "beneficiary." For example, "Brian Young as beneficiary of Joan Smith" or something similar that signifies that the IRA was once owned by Joan Smith. Filers may abbreviate the word "beneficiary" as, for example, "benef." Refer to the *1996* "Instructions for Forms 1099, 1098, 5498, and W–2G." The beneficiary's TIN must be reported in positions 15–23 of the "B" Record.

202–241	Second Payee Name Line	40	If there are multiple payees, (*e.g.*, partners, joint owners, or spouses), use this field for those names not associated with the TIN provided in position 15–23 of the "B" Record or if not enough space was provided in the First Payee Name Line, continue the name in this field. **Do not enter address information.** It is important that filers provide as much payee information to IRS/MCC as possible to identify the payee assigned the TIN. Left justify and fill unused positions with blanks. **Fill with blanks if no entries are present for this field.**
242–281	Payee Mailing Address	40	**Required.** Enter mailing address of payee. Street address should include number, street, apartment or suite number (or P.O. Box if mail is not delivered to street address). Left justify information and fill unused positions with blanks. This field **must not** contain any data other than the payee's mailing address.

For U.S. addresses, the payee city, state, and ZIP Code must be reported as a 29, 2, and 9 position field, respectively. **Filers must adhere to the correct format for the payee city, state, and ZIP Code. For foreign addresses,** filers may use the payee city, state, and ZIP Code as a continuous 40 position field. Enter information in the following order: city, province or state, postal code, and the name of the country. When reporting a foreign address, the Foreign Country Indicator in position 161 must contain a "1" (one).

282–310	Payee City	29	**Required.** Enter the city, town or post office. Left justify information and fill the unused positions with blanks. Enter APO or FPO if applicable. Do not enter state and ZIP Code information in this field.
311–312	Payee State	2	**Required.** Enter the valid U.S. Postal Service state abbreviations for states or the appropriate postal identifier (AA, AE, or AP) described in Part A, Sec. 18.
313–321	Payee ZIP Code	9	**Required.** Enter the valid nine digit ZIP Code assigned by the U.S. Postal Service. If only the first five digits are known, left justify information and fill the unused positions with blanks. For foreign countries, alpha characters are acceptable as long as the filer has entered a "1" (one) in the Foreign Country Indicator Field, located in position 161 of the "B" Record.

Standard Payee "B" Record Format For All Types of Returns up to Position 321

Record Type	Payment Year	Document Specific/ Distribution Code	2nd TIN Notice (Optional)	Corrected Return Indicator
1	2–3	4–5	6	7

Name Control	Direct Sales Indicator	Blank	Type of TIN	Taxpayer Identification Number	Payer's Account Number For Payee
8–11	12	13	14	15–23	24–43

IRA/SEP Indicator	Percentage of Total Distribution	Total Distribution Indicator	Taxable Amt Not Determined Indicator	Blank
44	45–46	47	48	49–50

Payment Amount 1	Payment Amount 2	Payment Amount 3	Payment Amount 4	Payment Amount 5
51–60	61–70	71–80	81–90	91–100

Payment Amount 6	Payment Amount 7	Payment Amount 8	Payment Amount 9
101–110	111–120	121–130	131–140

Blank	Foreign Country Indicator	First Payee Name Line	Second Payee Name Line	Payee Mailing Address
141–160	161	162–201	202–241	242–281

Payee City	Payee State	Payee Zip Code
282–310	311–312	313–321

Record Name: Payee "B" Record—Continued

Field Position	Field Title	Length	Description and Remarks

The following sections define the field positions for the different types of returns in the Payee "B" Record (positions 322–420):

(1) Forms 1098, 1099–DIV, 1099–G, 1099–INT, 1099–MISC, 1099–PATR, and 5498
(2) Form 1099–A
(3) Form 1099–B
(4) Form 1099–C
(5) Form 1099–OID
(6) Form 1099–R
(7) Form 1099–S
(8) Form W–2G

(1) Payee "B" Record—Record Layout Positions 322–420 Forms 1098, 1099–DIV, 1099–G, 1099–INT, 1099–MISC, 1099–PATR, and 5498

322–349	Blank	28	**Enter blanks.**
350–416	Special Data Entries	67	This portion of the "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact the state or local revenue departments for filing requirements. If this field is not utilized, **enter blanks.**
417–418	Combined Federal/ State Code	2	If this payee record is to be forwarded to a state agency as part of the Combined Federal/State Filing Program, enter the valid state code from Part A, Sec. 16, Table 1. For those payers or states **not** participating in this program or for forms not valid for state reporting, **enter blanks.**
419–420	Blank	2	Enter blanks, or carriage return/line feed (cr/lf) characters.

Payee "B" Record—Record Layout Positions 322–420

Forms 1098, 1099–DIV, 1099–G, 1099–INT, 1099–MISC, 1099–PATR, and 5498

Blank	Special Data Entries	Combined Federal/ State Code	Blank or CR/LF
322–349	350–416	417–418	419–420

(2) Payee "B" Record—Record Layout Positions 322–420 Form 1099–A

322–349	Blank	28	**Enter blanks.**
350–370	Special Data Entries	21	This portion of the "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact the state or local revenue departments for the filing requirements. If this field is not utilized, **enter blanks.**
371–376	Date of Lender's Acquisition or Knowledge of Abandonment	6	**Form 1099–A only.** Enter the acquisition date of the secured property or the date they first knew or had reason to know the property was abandoned, in the format MMDDYY (*i.e.*, 052296). **Do *NOT* enter hyphens or slashes.**
377	Liability Indicator	1	**Form 1099–A only.** Enter the appropriate indicator from the table below:

Record Name: Payee "B" Record—Continued
Form 1099–A

Field Position	Field Title	Length	Description and Remarks
	Liability Indicator		*Indicator* *Usage* 1 Borrower was personally liable for repayment of the debt. Blank Borrower was **not** liable for repayment debt.
378–416	Description of Property	39	**Form 1099–A only.** Enter a brief description of the property. For real property, enter the address, or if the address does not sufficiently identify the property, enter the section, lot and block. For personal property, enter the type, make and model (*e.g.*, Car-1995 Buick Regal or office equipment). Enter "CCC" for crops forfeited on Commodity Credit Corporation loans. If fewer than 39 positions are required, left justify information and fill unused positions with blanks.
417–418	Blank	2	**Enter blanks.**
419–420	Blank	2	**Enter blanks**, or carriage return/line feed (cr/lf) characters.

Payee "B" Record—Record Layout Positions 322–420 Form 1099–A

Blank	Special Data Entries	Date of Lender's Acquisition or Abandonment	Liability Indicator	Description of Property	Blank	Blank or Cr/lf
322–349	350–370	371–376	377	378–416	417–418	419–420

(3) Payee "B" Record—Record Layout Position 322–420 Form 1099–B

Field Position	Field Title	Length	Description and Remarks
322–349	Blank	28	**Enter blanks.**
350–359	Special Data Entries	10	This portion of the "B" Record may be used to record information for state or local government reporting or the filer's own purposes. Payers should contact the state or local revenue departments for the filing requirements. If this field is not utilized, **enter blanks.**
360	Gross Proceeds Indicator	1	**Form 1099–B only.** Enter the appropriate indicator from the following table, otherwise, **enter blanks.** *Indicator* *Usage* 1 Gross proceeds 2 Gross proceeds less commissions and option premiums
361–366	Date of Sale	6	**Form 1099–B only.** For broker transactions, enter the trade date of the transaction. For barter exchanges, enter the date when cash, property, a credit, or scrip is actually or constructively received in the format MMDDYY (*e.g.*, 052196). Enter blanks if this is an aggregate transaction. **Do *NOT* enter hyphens or slashes**
367–379	CUSIP Number	13	**Form 1099–B only.** For broker transactions only, enter the CUSIP (Committee on Uniform Security Identification Procedures) number of the item reported for Amount Code 2 (stocks, bonds, etc.). Enter blanks if this is an aggregate transaction. Enter "0" (zeros) if the number is not available. Right justify information and fill unused positions with blanks.

Payee "B" Record—Record Layout Positions 322–420 Form 1099–B—Continued

Field Position	Field Title	Length	Description and Remarks
380–418	Description	39	**Form 1099–B only.** If fewer than 39 characters are required, left justify information and fill unused positions with blanks. For broker transactions, enter a brief description of the disposition item (*e.g.*, 100 shares of XYZ Corp.). For regulated futures and forward contracts, enter "RFC" or other appropriate description and any amount subject to backup withholding (see **Note**). For bartering transactions, show the services or property provided.
419–420	Blank	2	Enter blanks, or carriage return/ line feed (cr/lf) characters.

☛ **Note: The amount withheld in these situations is to be included in Amount Code 4.**

Payee "B" Record—Record Layout Positions 322–420 Form 1099–B

Blank	Special Data Entries	Gross Proceeds Indicator	Date of Sale	CUSIP Number	Description
322–349	350–359	360	361–366	367–379	380–418

Blank or CR/LF
419–420

(4) Payee "B" Record—Record Layout Positions 322–420 Form 1099–C

Field Position	Field Title	Length	Description and Remarks
322–349	Blank	28	**Enter blanks.**
350–370	Special Data Entries	21	This portion of the "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact the state or local revenue departments for filing requirements. If this field is not utilized, **enter blanks.**
371–376	Date Canceled	6	**Form 1099–C only.** Enter the date the debt was canceled in the format of MMDDYY (*i.e.*, 052296). **Do not enter hyphens or slashes.**
377	Bankruptcy Indicator	1	**Form 1099–C only.** Enter "1" (one) to indicate the debt was discharged in bankruptcy. *Indicator* — *Usage* 1 — Debt was discharged in bankruptcy. Blank — Debt was **not** discharged in bankruptcy.
378–416	Debt Description	39	**Form 1099–C only.** Enter a description of the origin of debt, such as student loan, mortgage, or credit card expenditure. If a combined Form 1099–C and 1099–A is being filed, also enter a description of the property.
417–418	Blank	2	**Enter blanks.**
419–420	Blank	2	**Enter blanks**, or carriage return/line feed (cr/lf).

Payee "B" Record—Record Layout Positions 322–422 Form 1099–C

Blank	Special Data Entries	Date Canceled	Bankruptcy Indicator	Debt Description
322–349	350–370	371–376	377	378–416

Blank	Blank Or CR/LF
417–418	419–420

(5) Payee "B" Record—Record Layout Position 322–420 Form 1099–OID

Field Position	Field Title	Length	Description and Remarks
322–349	Blank	28	**Enter blanks.**
350–377	Special Data Entries	28	This portion of the "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact the state or local revenue departments for filing requirements. If this field is not used, **enter blanks.**
378–416	Description	39	**Required 1099–OID only**. Enter the CUSIP number, if any. If there is no CUSIP number, enter the abbreviation for the stock exchange and issuer, the coupon rate, and year of maturity (*e.g.*, NYSE XYZ 12 1/2 98). Show the name of the issuer if other than the payer. If fewer than 39 characters are required, left justify information and fill unused positions with blanks.
417–418	Combined Federal/ State Code	2	If payee record is to be forwarded to a state agency as part of the Combined Federal/State Filing Program, enter the valid state code from Part A, Sec. 16, Table 1. For those payers or states **not** participating in this program and for forms not valid for state reporting, **enter blanks.**
419–420	Blank	2	**Enter blanks** or carriage return/line feed (cr/lf) characters.

Payee "B" Record—Record Layout Positions 322–420 Form 1099–OID

Blank	Special Data Entries	Description	Combined Federal/ State Code	Blank or CR/LF
322–349	350–377	378–416	417–418	419–420

(6) Payee "B" Record—Record Layout Positions 322–420 1099–R

Field Position	Field Title	Length	Description and Remarks
322–349	Blank	28	**Enter blanks.**
350–396	Special Data Entries	*47*	This portion of the "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact the state or local revenue departments for filing requirements. If this field is not utilized, **enter blanks.**

Record Name: Payee "B" Record Form 1099–R—Continued

Field Position	Field Title	Length	Description and Remarks
397–406	*State Income Tax Withheld (Form 1099–R only)*	*10*	*State income tax withheld is for the convenience of the filers. This information does not need to be reported to IRS. The payment amount must be right justified and unused positions must be zero-filled. If not reporting state tax withheld, this field may be used as a continuation of the Special Data Entries field.*
407–416	*Local Income Tax Withheld (Form 1099–R only)*	*10*	*Local income tax withheld is for the convenience of the filers. This information does not need to be reported to IRS. Payment amount must be right justified and unused positions must be zero-filled. If not reporting local tax withheld, this field may be used as a continuation of the Special Data Entries field.*
417–418	Combined Federal/State Code	2	If this payee record is to be forwarded to a state agency as part of the Combined Federal/State Filing Program, enter the valid state code from Part A, Sec. 16, Table 1. For those payers or states **not** participating in this program or for forms not valid for state reporting, **enter blanks.**
419–420	Blank	2	**Enter blanks**, or carriage return/line feed (cr/lf) characters.

Payee "B" Record—Record Layout Positions 322–420 Form 1099–R

Blank	Special Data Entries	*State Income Tax Withheld (Form 1099–R Only)*	*Local Income Tax Withheld (Form 1099–R Only)*	Combined Federal/ State Code
322–349	*350–396*	*397–406*	*407–416*	417–418

Blank or CR/LF
419–420

(7) Payee "B" Record—Record Layout Positions 322–420 Form 1099–S

Field Position	Field Title	Length	Description and Remarks
322–349	Blank	28	**Enter blanks.**
350–372	Special Data Entries	23	This portion of the "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact the state or local revenue departments for filing requirements. If this field is not utilized, **enter blanks.**
373–378	Date of Closing	6	**Required Form 1099–S only.** Enter the closing date in the format MMDDYY (*e.g.*, 052296). **Do not enter hyphens or slashes.**
379–417	Address or Legal Description	39	**Required Form 1099–S only.** Enter the address of the property transferred (including city, state, and ZIP Code). If the address does not sufficiently identify the property, also enter a legal description, such as section, lot, and block. For timber royalties, enter "TIMBER." If fewer than 39 positions are required, left justify information and fill unused positions with blanks.

Record Name: Payee "B" Record—Form 1099-S—Continued

Field Position	Field Title	Length	Description and Remarks
418	Property or Services To Be Received	1	**Required Form 1099-S only.** Enter "1" (one) if the transferor received or will receive property (other than cash and consideration treated as cash in computing gross proceeds) or services as part of the consideration for the property transferred. Otherwise, **enter a blank.**
419–420	Blank	2	**Enter blanks** or carriage return/line feed (cr/lf) characters.

Payee "B" Record—Record Layout Positions 322–420 Form 1099-S

Blank	Special Data Entries	Date of Closing	Address Or Legal Description	Property Or Services Received	Blank or CR/LF
322–349	350–372	373–378	379–417	418	419–420

☛ **Note: When reporting Form 1099-S, the "B" Record will reflect the seller/transferor information.**

(8) Payee "B" Record—Record Layout Positions 322–420 Form W-2G

Field Position	Field Title	Length	Description and Remarks
322–352	Blank	31	**Enter blanks.**
353–358	Date Won	6	**Required Form W-2G only.** Enter the date of the winning event in the format MMDDYY (*e.g.*, 052296). **Do not enter hyphens or slashes.** This is not the date the money was paid, if paid after the date of the race (or game).
359–373	Transaction	15	**Required Form W-2G only.** For state-conducted lotteries, enter the ticket or other identifying number. For keno, bingo, and slot machines, enter the ticket or card number (and color, if applicable), machine serial number, or any other information that will help identify the winning transaction. All others, **enter blanks.**
374–378	Race	5	**Form W-2G only.** If applicable, enter the race (or game) relating to the winning ticket. Otherwise, **enter blanks.**
379–383	Cashier	5	**Form W-2G only.** If applicable, enter the initials of the cashier making the winning payment; otherwise, **enter blanks.**
384–388	Window	5	**Form W-2G only.** If applicable, enter the window number or location of the person paying the winnings; otherwise, **enter blanks.**
389–403	First ID	15	**Form W-2G only.** For other than state lotteries, enter the first identification number of the person receiving the winnings; otherwise, **enter blanks.**
404–418	Second ID	15	**Form W-2G only.** For other than state lotteries, enter the second identification number of the person receiving the winnings; otherwise, **enter blanks.**
419–420	Blank	2	**Enter blanks**, or carriage return/line feed (cr/lf) characters.

Payee "B" Record — Record Layout Positions 322–420 Form W-2G

Blank	Date Won	Transaction	Race	Cashier	Window	First Id
322–352	353–358	359–373	374–378	379–383	384–388	389–403

Second Id	Blank or CR/LF
404–418	419–420

Sec. 9. End of Payer "C" Record—Record Layout

.01 The End of Payer "C" Record is a fixed record length of 420 positions. The control total fields are each 15 positions in length.

.02 The "C" Record consists of the total number of payees and the totals of the payment amount fields filed by a given payer and/or a particular type of return. The "C" Record **must** be written after the last "B" Record for each type of return for a given payer. For each "A" Record and group of "B" Records on the file, there must be a corresponding "C" Record.

.03 In developing the "C" Record, for example, if a payer used Amount Codes 1, 3, and 6 in the "A" Record, the totals from the "B" Records will appear in Control Totals 1, 3, and 6 of the "C" Record. In this example, positions 26–40, 56–85, and 101–145 would be zero filled. Positions 146–420 would be blank filled.

.04 Payers/Transmitters should verify the accuracy of the totals since data with missing or incorrect "C" Records may be returned for replacement.

Field Position	Field Title	Length	Description and Remarks
1	Record Type	1	**Required.** Enter "C."
2–7	Number of Payees	6	**Required.** Enter the total numberof "B" Records covered by the preceding "A" Record. Right justify information and fill unused positions with zeros.
8–10	Blank	3	**Enter blanks.**
			Required. Accumulate totals of any payment amount fields in the "B" Record into the appropriate control total fields of the "C" Record. **Control totals must be right-justified and unused control total fields zero-filled.** All control total fields are 15 positions in length.
11–25	Control Total 1	15	
26–40	Control Total 2	15	
41–55	Control Total 3	15	
56–70	Control Total 4	15	
71–85	Control Total 5	15	
86–100	Control Total 6	15	
101–115	Control Total 7	15	
116–130	Control Total 8	15	
131–145	Control Total 9	15	
146–420	Blank	275	**Enter blanks.** Filers may enter carriage return/line feed (cr/lf) characters in positions 419-420.

End of Payer "C" Record—Record Layout

Record Type	Number of Payees	Blank	Control Total 1	Control Total 2	Control Total 3
1	2–7	8–10	11–25	26–40	41–55

End of Payer "C" Record—Record Layout—Continued

Control Total 4	Control Total 5	Control Total 6	Control Total 7	Control Total 8	Control Total 9	Blank or CR/LF
56–70	71–85	86–100	101–115	116–130	131–145	146–420

Sec. 10. State Totals "K" Record—Record Layout

.01 The State Totals "K" Record is a fixed record length of 420 positions. The control total fields are each 15 positions in length.

.02 The "K" Record is a summary for a given payer and a given state in the Combined Federal/State Filing Program, used **only** when state reporting approval has been granted.

.03 The "K" Record will contain the total number of payees and the totals of the payment amount fields filed by a given payer for a given state. The "K" Record(s) must be written after the "C" Record for the related "A" Record.

.04 In developing the "K" Record, for example, if a payer used Amount Codes 1, 3, and 6 in the "A" Record, the totals from the "B" Records coded for this state will appear in Control Totals 1, 3, and 6 of the "K" Record.

.05 There **must** be a separate "K" Record for **each state** being reported.

.06 Refer to Part A, Sec. 16 for the requirements and conditions that **must** be met to file via this program.

.07 *Control total fields have been added for the accumulated totals of state and local withholding fields from the "B" Records for Form 1099–R only for each state being reported.*

(1) State Totals "K" Record—Record Layout Forms 1099–DIV, 1099–G, 1099–INT, 1099–MISC, 1099–OID, 1099–PATR, and 5498

Field Position	Field Title	Length	Description and Remarks
1	Record Type	1	**Required.** Enter "K."
2–7	Number of Payees	6	**Required.** Enter the total number of "B" Records being coded for this state. Right justify information and fill unused positions with zeros.
8–10	Blank	3	**Enter blanks.**
			Required. Accumulate totals of any payment amount fields in the "B" Records for each state being reported into the appropriate control total fields of the appropriate "K" Record. **Control totals must be right-justified, and unused control total fields zero-filled.** All control total fields are 15 positions in length.
11–25	Control Total 1	15	
26–40	Control Total 2	15	
41–55	Control Total 3	15	
56–70	Control Total 4	15	
71–85	Control Total 5	15	
86–100	Control Total 6	15	
101–115	Control Total 7	15	
116–130	Control Total 8	15	
131–145	Control Total 9	15	
146–416	Blank	271	Reserved for IRS use. **Enter blanks.**
417–418	Combined Federal/ State Code	2	**Required.** Enter the code assigned to the state which is to receive the information. (Refer to Part A, Sec. 16 Table 1.)

Field Position	Field Title	Length	Description and Remarks
419–420	Blank	2	**Enter blanks** or carriage return/line feed (cr/lf) characters.

State Totals "K" Record—Record Layout

Record Type	Number of Payees	Blank	Control Total 1	Control Total 2	Control Total 3
1	2–7	8–10	11–25	26–40	41–55

Control Total 4	Control Total 5	Control Total 6	Control Total 7	Control Total 8	Control Total 9
56–70	71–85	86–100	101–115	116–130	131–145

Blank	Combined Federal/ State Code	Blank or CR/LF
146–416	417–418	419–420

(2) State Totals "K" Record—Record Layout Form 1099-R

Field Position	Field Title	Length	Description and Remarks
1	Record Type	1	**Required.** Enter "K."
2–7	Number of Payees	6	**Required.** Enter the total number of "B" Records being coded for this state. Right justify and fill unused positions with zeros.
8–10	Blank	3	**Enter blanks.**

Required. Accumulate totals of any payment amount fields in the "B" Records for each state being reported into the appropriate control total fields of the appropriate "K" Record. **Control totals must be right justified, and unused control total fields zero-filled.** All control total fields are 15 positions in length.

11–25	Control Total 1	15
26–40	Control Total 2	15
41–55	Control Total 3	15
56–70	Control Total 4	15
71–85	Control Total 5	15
86–100	Control Total 6	15
101–115	Control Total 7	15
116–130	Control Total 8	15
131–145	Control Total 9	15

146–386	Blank	*241*	Reserved for IRS use. **Enter blanks.**

Record Name: State Totals "K" Record 1099-R—Continued			
Field Position	Field Title	Length	Description and Remarks
387–401	*Control Total State Income Tax Withheld (Form 1099–R only)*	*15*	*Accumulate totals of the state income tax withheld field in the Payee "B" Record. Otherwise, enter blanks.*
402–416	*Control Total Local Income Tax Withheld (Form 1099–R only)*	*15*	*Accumulate totals of the local income tax withheld field in the Payee "B" Record. Otherwise, enter blanks.*
417–418	Combined Federal/State Code	2	**Required.** Enter the code assigned to the state which is to receive the information. (Refer to Part A, Sec. 16, Table 1.)
419–420	Blank	2	**Enter blanks** or carriage return/line feed (cr/lf) characters.

State Totals "K" Record—Record Layout—1099–R

Record Type	Number of Payees	Blank	Control Total 1	Control Total 2	Control Total 3
1	2–7	8–10	11–25	26–40	41–55

Control Total 4	Control Total 5	Control Total 6	Control Total 7	Control Total 8	Control Total 9
56–70	71–85	86–100	101–115	116–130	131–145

Blank	*Control Total State Income Tax Withheld (Form 1099–R Only*	*Control Total Local Income Tax Withheld (Form 1099–R Only)*	Combined Federal/ State Code	Blank or CR/LF
146–386	*387–401*	*402–416*	417–418	419–420

Sec. 11. End of Transmission "F" Record—Record Layout

.01 The end of transmission "F" Record is a fixed record length of 420 positions. The "F" Record is a summary of the number of payers in the entire file.

.02 This record should be written after the last "C" Record (or last "K" Record, when applicable) of the **entire** file.

Record Name: End of Transmission "F" Record			
1	Record Type	1	**Required.** Enter "F."
2–5	Number of "A" Records	4	Enter the total number of Payer "A" Records in the entire file (right justify and zero fill) or enter all zeros.
6–30	Zero	25	Enter zeros.
31–420	Blank	390	**Enter blanks.** Filers may enter carriage return/line feed (cr/lf) characters in positions 419–420.

End of Transmission "F" Record—Record Layout

Record Type	Number of "A" Records	Zeros	Blank or CR/LF
1	2–5	6–30	31–420

Part C. Bisynchronous (Mainframe) Electronic Filing Specifications

Sec. 1. General

.01 Bisynchronous electronic filing of Forms 1098, 1099, 5498, and W–2G information returns is offered as an alternative to magnetic media (tape, tape cartridge, or diskette) or paper filing, but is not a requirement. This method uses IBM 3780 communications protocols and is used primarily by mainframe filers. Electronic filing will fulfill the magnetic media requirements for those payers who are required to file magnetically. It may also be used by payers who are under the filing threshold requirement, but would prefer to file their information returns this way.

.02 The electronic filing of information returns is not affiliated with the Form 1040 electronic filing program. These two programs are totally independent, and filers must obtain separate approval to participate in each of them. All inquiries concerning the electronic filing of information returns should be directed to IRS/MCC. IRS/MCC personnel cannot answer questions or assist taxpayers in the filing of Form 1040 tax returns. Filers with questions of this nature will be directed to the Taxpayer Service toll free number **(1-800-829-1040)** for assistance.

.03 Filers participating in the electronic filing program for information returns will submit their returns to IRS/MCC by way of modems, and not through magnetic media or paper filing.

.04 If a request for extension is approved, transmitters who file electronically will be granted an extension of 30 days to file. Part A, Sec. 11, explains procedures for requesting extensions of time. Filers are encouraged to file their data as soon as possible.

.05 The formats of the "A", "B", "C", "K", and "F" Records are the same for electronically filed records as they are for 5¼- and 3½-inch diskettes, tapes, and tape cartridges. For electronically filed documents, each transmission is considered a separate file; therefore, each transmission **must** have an End of Transmission (EOT) "F" Record.

Sec. 2. Electronic Filing Approval Procedure

.01 Filers must obtain, or already have, a Transmitter Control Code (TCC) assigned to them prior to submitting their files electronically. (Filers who currently have a TCC for magnetic filing do not have to request a second TCC for electronic filing.) Refer to Part A, Sec. 7, for information on how to obtain a TCC.

.02 Filers using bisynchronous protocols must obtain an IRS/MCC-assigned password prior to submitting test or actual data files. To obtain a password, the following steps must be taken:

(a) Bisynchronous filers who already have a TCC must submit either Form 4419 or a letter to indicate that they wish to file information returns electronically. Another TCC will **not** be assigned. If a letter is submitted, it must contain the following:

1) Name and address of transmitter.
2) Transmitter Control Code.
3) Name and phone number of a contact person within the filer's organization to whom a password will be assigned.

(b) Within 30 days of receiving the application or letter, IRS/MCC will send Form 6086, Time Sharing Operation (TSO) Password Assignment, to the filer which will contain the password to be used for electronic submissions.

(c) Upon receipt of Form 6086, the user (person who will actually transmit the data) will separate the acknowledgment from the password. Both the user and the user's manager **must** sign the acknowledgment and mail to:

Chief, Security and Disclosure Branch
IRS, Martinsburg Computing Center
P. O. Box 1208, MS-370
Martinsburg, WV 25401

(d) The users or filers should retain a copy of the signed acknowledgment for their records. It is the filer's responsibility to ensure that the password is not compromised. Access to IRS/MCC computers will not be allowed without a valid password. After a password is received and the acknowledgment returned, the filer may submit a data file.

(e) For security reasons, all bisynchronous passwords will expire periodically, and a new password will automatically be assigned. If filers have any questions relating to the security procedures, and/or they need to report their password has been compromised, they must contact IRS/MCC as soon as possible at:

IRS/MCC
Information Returns Branch
P. O. Box 1359, MS-360
Martinsburg, WV 25401

or by calling: **304-263-8700.**

.03 It is the user's responsibility to remember the password and not allow the password to be compromised.

Sec. 3. Test Files

.01 Filers are not required to submit a test file; however, the submission of a test file is encouraged for first time electronic filers in order to resolve any data or communication problems prior to the filing season. If filers wish to submit an electronic test file for Tax Year *1996* (returns to be filed in 1997), it **must** be submitted to IRS/MCC ***no earlier than*** November 1, *1996*, through December 31, *1996*.

.02 If a filer encounters problems while transmitting electronic test files, contact IRS/MCC for assistance.

.03 A password must be obtained before submitting an electronic test file.

.04 Bisynchronous electronic test files will be processed and filers will be notified as to the acceptability of their data within 5 workdays of the date the data and transmittal Form 4804 are received by IRS/MCC.

.05 A test file is required from filers who want approval for the Combined Federal/State Filing Program. See Part A, Sec. 16, for further details.

Sec. 4. Electronic Submissions

.01 Electronically filed information may be submitted to IRS/MCC 7 days a week, 24 hours a day, except for routine maintenance/backup which is performed at 4:00 a.m. Eastern Time. Technical assistance will be available Monday through Friday between 8:30 a.m. and 4:30 p.m. Eastern Time by calling **304-263-8700.**

.02 Lengthy transmissions **(100,000 or more records)** are not encouraged since the transmission may be interrupted by line noise problems. **It is advisable to break lengthy files into multiple transmissions.**

.03 The time required to transmit information returns electronically will vary depending on the modem speed, if IBM 3780 data compression is used, and if the records are blocked. The following transmission rate was based on an actual test file received at MCC using 4800 bps, no compression, and one record per block:

4500 records **50 minutes**

Sec. 5. Transmittal Requirements

.01 All data submitted electronically is verified by transmittal Form 4804. The transmitter must send the signed Form 4804 the same day the transmission is made. No return is considered filed until a Form 4804 is received by IRS/MCC.

.02 Form 4804 can be ordered by calling the IRS toll free forms and publications order number **1-800-TAX-FORM (1-800-829-3676)** or it may be computer-generated. If a filer chooses to computer-generate Form 4804, all of the information contained on the original form, including the affidavit, must also be contained on the computer-generated form.

.03 The filer whose TCC is used in the "A" Record is responsible for submitting the transmittal Form 4804.

.04 Forms 4804 may be mailed to the following addresses:

If by Postal Service:

IRS-Martinsburg Computing Center
Attn: Electronic Filing Coordinator
P. O. 1359, MS-360
Martinsburg, WV 25401-1359

If by truck or air freight:

IRS-Martinsburg Computing Center
Attn: Electronic Filing Coordinator
Route 9 and Needy Road, MS-360
Martinsburg, WV 25401

.05 A signed Form 4804 submitted for electronically filed information returns may be faxed to IRS/MCC at the following number: **304-264-5602.** Faxed transmittals will allow IRS/MCC to begin processing the file immediately; however, a filer must still send the actual signed Form 4804 the same day as the electronic submission.

Sec. 6. IBM 3780 Bisynchronous Communication Specifications

.01 Transmissions using IBM 3780 bisynchronous protocols must be in EBCDIC character code. Modems must be compatible with either Bell 208B for 4800 bps transmissions, AT&T 2296A for 9600 bps transmissions, or *Hayes OPTIMA 288 V.FC Smartmodem for 14400 bps transmissions.* These modems are dial-up type modems using the Public Switched Telephone Network. IBM 3780 data compression is acceptable for any bisynchronous transmission. Records may be blocked up to 4096 bytes with INTER RECORD SEPARATORS.

.02 IRS/MCC will accept information returns filed electronically over switched telecommunications network circuits. For 4800 bps, the circuit will be **304-*264-7080.*** For 9600 bps, the circuit will be **304-*264-7040. For 14400 bps, the circuit will be 304-264-7045***. These circuits are equipped for bisynchronous transmission using the IBM 3780 protocol.

.03 The 4800 bps line terminates at a Bell 208B modem. The Bell 208B modem uses phase-shift keying and eight-phase modulation to transmit binary serial data signals over the telephone line in half-duplex mode. The following options have been selected:

— Transmit Level set to –4 dBm
— Compromise Equalizer in (4–Db Slope)
— DSR off in Analog Loop Mode
— Automatic Answer
— Transmitter Internally Timed
— RS–CS Interval of 50 ms

.04 The 9600 bps line terminates at an AT&T Dataphone II 2296A modem. The AT&T 2296A modem is a full-duplex, CCITT V.32 compatible unit which operates at 9600 bps or 4800 bps (fallback). The following options have been selected:

— Receiver Responds to Remote Loopback
— Loss-of-Carrier Disconnect
— Received-Space Disconnect
— Send-Space Disconnect
— Automatic Answer
— Answer on Ring 1
— DTR Interlock
— Retrain Enable
— Internal Timing
— CTS Controlled by RTS
— 0—1 ms RTS to CTS Delay
— CTS Dependent on Carrier
— RR Indicates Carrier
— 9600 Trellis Coding
— 4800 bps Fallback
— 4 dB Compromise Equalization

.05 *The 14400 bps line terminates at a Hayes OPTIMA 288 V.FC smartmodem. The Hayes OPTIMA smartmodem is a half-duplex, ITU-T (formerly CCITT) V.32 and V.32 bis compatible unit which operates at 14400 bps, 9600 bps, or 4800 bps (fallback). The following options have been selected:*

— Monitor DTR signal
— Assert DSR signal after handshake negotiation, but before connect result code
— Ring control S=1

Sec. 7. Bisynchronous Electronic Filing Record Specifications

.01 For bisynchronous filing there are two additional identifier records which must be used to transmit data. These records are 420 positions in length and are the first ($$REQUEST) and second ($$ADD) records sent in an electronic transmission. The purpose of these records is to provide the password and identity of the transmitter. The $$REQUEST, $$ADD, and the data file should be transmitted as one file. In some cases, filers have attempted to send the $$REQUEST and

$$ADD as separate files. Doing this will result in a failed transmission.

.02 With the exception of these additional records, the file format for electronic filing is the same as for magnetic media filing. The format of each of these records is as follows:

Record Name: $$REQUEST

Field Position	Field Title	Length	Description and Remarks
1–20	$$REQUEST Identifier Record	20	Enter the following characters: $$REQUEST ID=MSGFILE
21–420	Blank	400	**Enter blanks.**

Electronic Filing Identifier $$REQUEST RECORD--Record Layout

$$REQUEST Identifier Record	Blank
1–20	21–420

.03 Upon making contact with IRS/MCC and furnishing a valid password in the $$ADD identifier record, a data transmission session will commence. The transmission will continue until an End of Transmission (EOT) "F" record is received. At the end of each transmission, the following message should be received electronically by the filer: "DATA RECEIVED AT MCC" and the line will be disconnected. If this message is not received, there was a problem with the submission, and the filer should contact IRS/MCC immediately.

.04 Upon receiving a data file and transmittal Form 4804, IRS/MCC will release the data for further processing. If the media cannot be processed, the filer will be notified by either letter or telephone that the data must be retransmitted. This file name, if necessary, will be provided by IRS/MCC and is to be placed in positions 45–51 of the $$ADD record when the file is retransmitted.

Record Name: $$ADD

Field Position	Field Title	Length	Description and Remarks
1–9	$$ADD Identifier Record	9	Enter the following characters: $$ADD ID=
10–17	Password	8	Enter the password assigned by IRS/MCC. For information concerning the password, see Part C, Sec. 2.
18	Blank	1	Enter a blank.
19–26	BATCHID	8	Enter the following characters: BATCHID=
27	Quote	1	Enter a single quote (').
28–43	Transmitter Name	16	Enter the transmitter's name. This name should remain consistent in all transmissions. If the transmitter's name exceeds 16 positions, truncate the name.
44	Type of File Indicator	1	Enter the Type of File Indicator from the list below: O = Original filing T = Test File C = Correction file R = Replacement file E = *Extension File*
45–51	Replacement File Name	7	**Use this field only if this is a replacement file.** Enter the replacement file name which IRS/MCC has assigned to this file. This file name will be provided to the filer in the letter notifying them that a replacement file is necessary. If contact is made by telephone, the replacement file name will be given to the filer by IRS/MCC at that time. For other than replacement files, this field will contain blanks.

Record Name: $$ADD—Continued

Field Position	Field Title	Length	Description and Remarks
52	Quote	1	Enter a single quote (').
53–420	Blanks	368	**Enter blanks.**

Electronic Filing Identifier $$ADD Record—Record Layout

$$ADD Identifier Record	Password	Blank	Batchid	Quote	Transmitter Name
1–9	10–17	18	19–26	27	28–43

Type of File Indicator	Replacement File Name	Quote	Blanks
44	45–51	52	53–420

Part D. Asynchronous (IRP–BBS) Electronic Filing Specifications

Sec. 1. General

.01 Asynchronous electronic filing of Forms 1098, 1099, 5498, and W–2G, originals, corrections, and replacements of information returns is offered as an alternative to magnetic media (tape, tape cartridge, or diskette) or paper filing, but is not a requirement. Electronic filing using the Information Reporting Program Bulletin Board System (IRP–BBS) will fulfill the magnetic media requirements for those filers who are required to file magnetically. It may also be used by those payers who are under the filing threshold requirement, but would prefer to file their information returns this way. If the original file was sent magnetically, but was returned for replacement, the replacement may be transmitted electronically. Also, if the original file was submitted via magnetic media, any corrections may be transmitted electronically.

.02 The electronic filing of information returns is not affiliated with the Form 1040 electronic filing program. These two programs are totally independent, and filers must obtain separate approval to participate in each of them. All inquiries concerning the electronic filing of information returns should be directed to IRS/MCC. IRS/MCC personnel cannot answer questions or assist taxpayers in the filing of Form 1040 tax returns. Filers with questions of this nature will be directed to the Taxpayer Service toll-free number (**1-800-829-1040**) for assistance.

.03 Filers participating in the electronic filing program for information returns will submit their returns to IRS/MCC by way of modems and not through magnetic media or paper filing. *Files submitted in this manner must be in standard ASCII code.*

.04 If a request for extension is approved, transmitters who file electronically will be granted an extension of 30 days to file. Part A, Sec. 11, explains procedures for requesting extensions of time. Filers are encouraged to file their data as soon as possible.

.05 The formats of the "A", "B", "C", "K", and "F" Records are the same for electronically filed records as they are for 5¼- and 3½-inch diskettes, tapes, and tape cartridges and *must be in standard ASCII code.* For electronically filed documents, each transmission is considered a separate file; therefore each transmission **must** have an End of Transmission (EOT) "F" Record.

Sec. 2. Electronic Filing Approval Procedure

.01 Filers must obtain, or already have, a Transmitter Control Code (TCC) assigned to them prior to submitting their files electronically. (Filers who currently have a TCC for magnetic filing do not have to request a second TCC for electronic filing.) Refer to Part A, Sec. 7 for information on how to obtain a TCC.

.02 Once a TCC is obtained, filers using IRP-BBS assign their own passwords and do not need special approval.

.03 With all passwords, it is the user's responsibility to remember the password and not allow the password to be compromised. However, if filers do forget their password, call **304-263-8700** for assistance.

☛ **Note: Passwords on the IRP-BBS are case sensitive.**

Sec. 3. Test Files

.01 Filers are not required to submit a test file; however, the submission of a test file is encouraged for first time electronic filers in order to resolve any data or communication problems prior to the filing season. If filers wish to submit an electronic test file for Tax Year *1996* (returns to be filed in *1997*), it **must** be submitted to IRS/MCC **no earlier than** November 1, *1996*, through December 31, *1996*.

.02 If a filer encounters problems while transmitting the electronic test files, contact IRS/MCC for assistance.

.03 Filers can verify the status of their transmitted test data by dialing the

IRP–BBS. This information will be available within two workdays after their transmission is received by IRS/MCC.

.04 A test file is required from filers who want approval **for the Combined Federal/State Filing Program.** See Part A, Sec. 16 for further details.

Sec. 4. Electronic Submissions

.01 Electronically filed information may be submitted to IRS/MCC 24 hours a day, 7 days a week. Technical assistance will be available Monday through Friday between 8:30 a.m. and 4:30 p.m. Eastern Time by calling 304-263-8700.

.02 Filers may submit as many documents as they choose electronically. Filers are allowed 240 minutes a day; however, more time may be requested if needed. It may be advantageous to break down large files **(files in excess of *two* hours of transmission time)** into several smaller files. For example, if large files contain several types of returns or payers, transmit each return or payer as a separate file. As a result, if only one of the files is incorrect, a replacement would be needed for only the incorrect file.

.03 Do not transmit data using IRP–BBS January 1 through January 7. This will allow time for the IRP–BBS to be updated to reflect current year changes.

.04 Data compression is encouraged when submitting information returns by way of the IRP–BBS. MCC has the ability to decompress files created using several popular software compression programs such as ARC, LHARC, and PKZIP. Software data compression can be done alone or in conjunction with V.42bis hardware compression.

The time required to transmit information returns electronically will vary depending on the modem speed and the type of data compression used, if any. However, transmissions to IRP–BBS will be significantly faster than electronic filing to the mainframe. **The time required to transmit a file can be reduced by as much as 85 percent by using software compression and hardware compression.**

The following are actual transmission rates achieved in test uploads at MCC using compressed files (PKZIP) and the xmodem protocol. The actual transmission rates will vary depending on the protocol that is used. (Uploads will be approximately 25 percent faster when using the XMODEM-1K or ZMODEM protocols.)

Transmission Speed in bps	500 Records	2500 Records	10000 Records
2400	2 min 55 sec	10 min 25 sec	55 min 10 sec
9600	1 min 5 sec	4 min 35 sec	21 min 20 sec
19200	41 sec	2 min 51 sec	13 min 23 sec
38400	25 sec	1 min 55 sec	9 min 10 sec

.05 Files submitted to IRP–BBS must have a unique filename; therefore, the IRP–BBS will build the filename that must be used. The name will consist of the filer's TCC, submission type (T = Test, P = Production, C = Correction, and R = Replacement) and a sequence number. Filers may call the file anything they choose on their end. The sequence number will be incremented every time they send, or attempt to send, a file. Record the upload date, time, and filename. This information will be needed by MCC in order to identify the file if assistance is required and to complete Form 4804.

Sec. 5. Transmittal Requirements

.01 The results of the electronic transmission will be posted to the (F)ile Status area of the IRP–BBS, however, no further processing will occur until the signed Form 4804 is received. The transmitter must send the signed Form 4804 the same day the electronic transmission is made. No return is considered filed until a Form 4804 is received by IRS/MCC.

.02 Form 4804 can be ordered by calling the IRS toll-free forms and publication order number **1-800-TAX-FORM, (1-800-829-3676),** downloaded from the IRP–BBS, or it may be computer-generated. A copy of the form is also available in the back of this publication. If a filer chooses to computer-generate Form 4804, all of the information contained on the original form, including the affidavit, must also be contained on the computer-generated form.

.03 The filer whose TCC is used in the "A" Record is responsible for submitting the transmittal Form 4804.

.04 Forms 4804 may be mailed to the following addresses:

If by Postal Service:
IRS-Martinsburg Computing Center
Attn: Electronic Filing Coordinator
P. O. Box 1359, MS-360
Martinsburg, WV 25401-1359

If by truck or air freight:
IRS-Martinsburg Computing Center
Attn: Electronic Filing Coordinator
Route 9 and Needy Road, MS-360
Martinsburg, WV 25401

Sec. 6. Information Reporting Program Bulletin Board System (IRP–BBS) Specifications

.01 The IRP–BBS is an electronic bulletin board system available to filers of information returns. In addition to filing information returns electronically, the IRP–BBS provides other capabilities. Some of the advantages of IRP–BBS are as follows:

(1) Notification within two workdays as to the acceptability of the data transmitted.

(2) Immediate access to the latest changes and updates that affect the Information Reporting Program at IRS/MCC (program, legislative, etc.).

(3) Access to publications such as the Publication 1220 as soon as they are available.

(4) Capability to communicate with IRS/MCC personnel.

(5) Ability to retrieve information and files applicable to the IRP–BBS.

.02 The IRP–BBS is available for public use and accessible using various personal computer communications equipment; however, electronic submission of information returns is limited to holders of valid TCCs. A TCC is not needed to access those portions of the IRP–BBS that contain forms and publications or to leave questions or messages for IRS/MCC personnel.

.03 Filers using IRP–BBS can determine the acceptability of files submitted by checking the file status area of the bulletin board. These reports are not immediately available but will be available two workdays after the transmission is received by IRS/MCC.

.04 Contact the IRP–BBS by dialing **304-264-7070.** The communication software settings for IRP–BBS are:

— No parity
— Eight data bits
— One stop bit
— Full duplex

The communication software should be set up to use the fastest speed allowed by the filer's modem.

.05 Due to the large number of communication products available, it is impossible to provide specific information on a particular software package or hardware configuration. Filers should contact their software or hardware supplier for assistance.

.06 IRP–BBS software provides a menu-driven environment allowing access to different parts of IRP–BBS. Whenever possible, IRS/MCC personnel will provide assistance in resolving any communication problems with IRP–BBS.

.07 IRP–BBS can be accessed at speeds from 1200 to 28,800 bps. The speed is automatically negotiated for connection at the speed of the calling modem. The communication standards supported include Industry Standard 212A, V.22bis, V.32, V.32bis, V.34, and V.FC. Point-to-point error control is supported using the V.42 ITU-T standard or MNP 2–4. Data compression is supported using V.42bis ITU-T standard or MNP5.

Sec. 7. IRP–BBS First Logon Procedures

.01 The following information will be requested to set up the filer's user profile when logging onto the IRP–BBS for the first time.

(A) Enter the letter, that corresponds to the filer's terminal, from the following:

<A>	IBM PC	<B>	IBM w/ANSI	<C>	Atari
<D>	ADM-3	<E>	H19/Z19/H89	<F>	Televid 925
<G>	TRS-80	<H>	Vidtex	<I>	VT-52
<J>	VT-100	<CR>	if none of the above		

Most PCs, clones, etc., will select the IBM PC emulation. Machines with color, CGA, EGA, or VGA should select IBM w/ANSI.

(B) Upper/lower case, line feed needed, O (zero) nulls after each <CR>, do you wish to modify this? (Most users answer no.)

Common User Problems

Problem	Probable Cause	Solution
File does not upload/download	Not starting communication when prompted by 'Awaiting Start Signal'	Start upload/download on filers end
All files not processed	Compressing several files into one filename	Compress only one file for every filename
Replacement needed	Original data incorrect	Replacement must be submitted within 45 days of original transmission
Cannot determine file status	Not dialing back thru IRP–BBS to check the status of the file	Within 24 to 48 hours after sending a file, check under (F)ile Status for notification of acceptability
Transfer aborts before it starts	Transfer protocol mismatch	Ensure protocols match on both the sending and receiving ends
Loss of carrier during session	Incorrect modem setting on user's end	Reference your modem manual about increasing the value of the S10 register
Unreadable screens after selecting "IBM w/ANSI"	ANSI.SYS driver not loaded in the user's PC	Select non ANSI under (Y)our settings

IRS Encountered Problems

Problem	Probable Cause	Solution
IRS cannot complete final processing of data	User did not mail the Form 4804	Mail completed Form complete final 4804 the same day as the electronic transmission
IRS cannot determine which file is being replaced	User did not indicate which file is being replaced	Must enter the filename that is being being replaced under the replacement option
IRS cannot determine the type of file being sent	User incorrectly indicated T, P, C, or R for the type of file	When prompted, enter the correct type of file for data being sent
Incorrect file not replaced within 45 days	User did not dial back thru IRP–BBS to check the status of file	Within two workdays check under (F)ile Status for notification of acceptability
Duplicate data	Transmitter sends corrections for entire file	Only submit corrections for incorrect records

Part E. Magnetic/Electronic Specification for Extensions of Time

Sec. 1. General Information

.01 The specifications in Part E include the required 200-byte record format for extensions of time to file requests submitted on magnetic media or via electronically. Also included are the instructions for the information that is to be entered in the record. **Filers are advised to read this section in its entirety to ensure proper filing.**

.02 *Only filers who have been assigned a Transmitter Control Code may request an extension of time magnetically or electronically. If you meet the threshold of more than 50 payers when requesting an extension but are below the 250 documents threshold, you must still submit a Form 4419, Application for Filing Information Returns Magnetically/Electronically.* Requests for extensions of time may be made for Forms 1098, 1099, 5498, W–2G, W–2, and 1042–S.

.03 For Tax Year *1996* (returns due to be filed in *1997*), transmitters requesting an extension of time to file for **more than 50 payers** ***(not payees)*** **are required to file the extension request on magnetic media or electronically.** Transmitters requesting an extension of time for 10 to 50 payers *(not payees)* are encouraged to file the request magnetically or electronically. The request may be filed on tape, tape cartridge, 5¼- and 3½-inch diskette, or electronically through the IRP–BBS.

.04 For extension requests filed on magnetic media, the transmitter must send the completed, signed Form 8809, Request for Extension of Time to File Information Returns, in the same package as the corresponding media. For extension requests filed electronically, the transmitter must FAX the Form 8809 the same day the transmission is made.

.05 Transmitters should not submit a list of payer names and TINS with the Form 8809 with the magnetic media or electronic files. ***Box 6 of the Form 8809 must be completed with the total number of payer records (total number of payers) on the transmitter's extension of time file.***

.06 To be considered, an extension request must be postmarked or transmitted by the due date of the returns; otherwise, the request will be denied.

.07 The extension record format is also on the IRP–BBS and can be downloaded. **See Part D for more information on how to contact the IRP–BBS.**

.08 A magnetically-filed request for an extension of time should be sent using the following addresses:

If by Postal:

IRS-Martinsburg Computing Center
Attn: Extension of Time Coordinator
P. O. Box 879, MS-360
Kearneysville, WV 25430

If by truck or air freight:

IRS-Martinsburg Computing Center
Attn: Extension of Time Coordinator
Route 9 and Needy Road, MS-360
Martinsburg, WV 25401

Note: Due to the large volume of mail received by IRS/MCC and the time factor involved in processing the Form 8809, it is imperative that the attention line be present on all envelopes or packages containing Extension of Time (EOT) requests.

.09 If using a delivery service other than postal service, the actual date of receipt by IRS/MCC will be used as the submitted date. This should be considered in meeting filing requirements timely.

.10 Transmitters who submit their extensions of time requests magnetically or electronically will receive a letter from IRS/MCC with an attached list of the payers specifying approval and/or denial.

.11 Do not submit tax year *1996* extensions of time to file requests on magnetic media or electronically before January 1, *1997*.

.12 Filers may request an extension of time **as soon as they are aware** that an extension is necessary but not later than the due date of the return. It will take a minimum of 30 days for IRS/MCC to respond to an extension request. Under certain circumstances a request for an extension of time could be denied. In such cases, the transmitter receives a denial letter. When this denial letter is received, the transmitter has 20 days to provide the additional or necessary information and resubmit the extension request to IRS/MCC.

.13 Each piece of magnetic media **must** have an external media label containing the following information:

(a) Transmitter name

(b) Transmitter Control Code (TCC)

(c) Tax year

(d) The words "Extension of Time"

(e) Record count

.14 A request for an extension of time to file is not automatically granted. Approval or denial is dependent on information provided on the Form 8809.

.15 If the first request for an extension of time to file was submitted magnetically or electronically, additional extension requests should be submitted in the same manner.

.16 If an additional extension of time is needed, a second Form 8809 may be submitted before the end of the initial extension with a postmark reflecting the date mailed. Line 7 on the form should be checked to indicate that the original extension has been received and the additional extension is being requested.

.17 See Part A, Sec. 11, for complete information on requesting an extension of time to file information returns. If there are additional questions or concerns, contact IRS/MCC.

Sec. 2. Magnetic Tape, Tape Cartridge, 5¼- and 3½-inch Diskette and IRP–BBS Specifications

.01 Tape specifications are as follows:

(a) 9 track.

(b) EBCDIC (Extended Binary Coded Decimal Interchange Code) or ASCII (American Standard Coded Information Interchange) recording mode.

(c) 1600 or 6250 BPI.

(d) A block must not exceed 32,600 tape positions and must be a multiple of 200.

(e) Record length of 200 bytes.

(f) Labeled or unlabeled tapes may be submitted.

.02 Tape cartridge specifications are as follows:

(a) Must be IBM 3480, 3490, or AS400 compatible.

(b) Must meet American National Standard Institute (ANSI) standards and have the following characteristics:

(1) Tape cartridges will be 1/2-inch tape contained in plastic cartridges which are approximately 4-inches by 5-inches by 1-inch in dimension.

(2) Magnetic tape will be chromium dioxide particle based 1/2-inch tape.

(3) Cartridges will be 18-track or 36-track parallel. *Indicate on the external media label if the tape cartridge is 18- or 36-track.*

(4) Mode will be full function.

(5) The data may be compressed using EDRC (Memorex) or IDRC (IBM) compression.

(6) Either EBCDIC or ASCII.

(c) A block must not exceed 32,600 tape positions and must be a multiple of 200.

(d) Record length of 200 bytes.

(e) Labeled or unlabeled tape cartridges may be submitted.

.03 Diskette specifications are as follows:

(a) 5¼- or 3½-inches in diameter.

(b) ASCII recording mode **only**. Additional specifications may be found in Part B, Sec. 3, of this revenue procedure.

(c) Record length of 200 bytes.

(d) Diskettes must be created using the MS-DOS operating system.

(e) Filename of IRSEOT must be used. No other filenames are acceptable. If a file will consist of more than one diskette, the filename IRSEOT will contain a three-digit extension. This extension will indicate the sequence of the diskettes within the file. For example, the first diskette will be named IRSEOT.001, the second diskette will be named IRSEOT.002, etc.

(f) Delimiter character commas (,) must not be used.

(g) Positions 199 and 200 of each record have been reserved for use as carriage return/line feed (cr/lf) characters, if applicable.

.04 Bisynchronous electronic specifications include:

(a) Transmitter must have Transmitter Control Code number (TCC).

(b) Access phone numbers :

4800 bps	304-264-7080
9600 bps	304-264-7040
14400 bps	*304-265-7045*

(c) Data compression is encouraged.

☛ **Note: See Part C, Bisynchronous (Mainframe) Electronic Filing Specifications, for detailed information on filing with IRS/MCC via bisynchronous protocols.**

.05 IRP–BBS specifications include:

(a) Transmitter must have Transmitter Control Code number (TCC).

(b) IRP–BBS access phone number is **304-264-7070.**

(c) Communications software settings are:

— No parity

— Eight data bits

— One stop bit

— Full duplex

(d) Access speeds from 1200 to 28,800 bps.

(e) Data compression is encouraged.

☛ **Note: See Part D, IRP–BBS Electronic Filing Specifications, for detailed information on filing with IRS/MCC via IRP/BBS.**

Sec. 3. Record Layout

.01 Positions 6 through 174 of the following record should contain information about the **payer** for whom the extension of time to file is being requested. Do not enter transmitter information in these fields. **Only one TCC may be present in a file.**

Record Layout

Field Position	Field Title	Length	Description and Remarks
1–5	Transmitter Control Code (TCC)	5	**Required.** Enter the five digit Transmitter Control Code issued by IRS. **Only one TCC per file is acceptable.**
6–14	Payer TIN	9	**Required.** Must be the valid nine-digit EIN/SSN assigned to the payer. **Do not enter blanks, hyphens or alpha characters.** All zeros, ones, twos, etc. will have the effect of an incorrect TIN. For foreign entities that are not required to have a TIN, this field may be blank; however, the Foreign Entity Indicator, position 176, **must** be set to "X."
15–54	Payer Name	40	**Required.** Enter the name of the payer whose TIN appears in positions 6-14. Left justify information.
55–94	Second Payer Name	40	If additional space is needed, this field may be used to continue name line information (*e.g.*, % First National Bank), otherwise, **enter blanks.**
95–134	Payer Address	40	**Required.** Enter the payer's address. Street address should include number, street, apartment or suite number (or P.O. Box if mail is not delivered to a street address).
135–163	Payer City	29	**Required.** Enter payer city, town, or post office.
164–165	Payer State	2	**Required.** Enter payer valid U.S. Postal Service state abbreviation (refer to Part A, Sec. 18).
166–174	Payer ZIP Code	9	**Required.** Enter payer ZIP code. If using a five-digit ZIP code, left justify information and fill unused positions with blanks.
175	Document Indicator (See **Note**)	1	**Required.** Enter the document you are requesting an extension of time for using the following code: *Code* — *Document* 1 — W–2 2 — 1098, 1099–A, 1099–B, 1099–C, 1099–DIV, 1099–G, 1099–INT, 1099–MISC, 1099–OID, 1099–PATR, 1099–R, 1099–S, or W–2G 3 — 5498 4 — 1042–S 5 — REMIC Documents (1099–INT or 1099– OID)
176	Foreign Entity Indicator	1	Enter character "X" if Indicator the payer is a foreign entity.
177–198	Blank	22	**Enter blanks.**
199–200	Blank	2	**Enter blanks.** Diskette filers may code the ASCII carriage return/line feed (cr/lf) characters.

☛ **Note: Do not enter any other values in this field. Submit a separate record for each document. For example, if you are requesting an extension for 1099–INT and 5498 for the same payer, submit one record with "2" coded in this field and another record with "3" coded in this field. If you are requesting an extension for 1099–DIV and 1099–MISC for the same payer, submit one record with "2" coded in this field.**

Extension of Time Record Layout

Transmitter Control Code	Payer EIN	Payer Name	Second Payer Name	Payer Address	Payer City
1–5	6–14	15–54	55–94	95–134	135–163

Payer State	Payer Zip Code	Document Indicator	Foreign Entity Indicator	Blank
164–165	166–174	175	176	177–198

Blank or CR/LF
199–200

Part F. Miscellaneous Information

Sec. 1. Addresses for Martinsburg Computing Center

To submit an application to file, waiver request (forms), correspondence, and magnetic media files, use the following:

Mailing by U. S. Postal Service: ✉

IRS—Martinsburg Computing Center
P. O. Box 1359, MS-360
Martinsburg, WV 25401-1359

Shipping by truck or air freight: ✈

IRS—Martinsburg Computing Center
Information Reporting Program
Route 9 and Needy Road, MS-360
Martinsburg, WV 25401

To submit a magnetically filed extension of time request, use the following:

Mailing by U.S. Postal Service: ✉

IRS—Martinsburg Computing Center
ATTN: Extension of Time Coordinator
P. O. Box 879, MS-360
Kearneysville, WV 25430

Shipping by truck or air freight: ✈

IRS—Martinsburg Computing Center
ATTN: Extension of Time Coordinator
Route 9 and Needy Road, MS-360
Martinsburg, WV 25401

Sec. 2. Telephone Numbers for Contacting IRS/MCC

☎
Phone Numbers for
Contacting the Martinsburg Computing Center

Information Reporting Program Call Site:

?
304-263-8700

Between 8:30 a.m. and 4:30 p.m. Eastern Time

304-267-3367
Telecommunication Device for the Deaf (TDD)

Information Returns FAX Machine:

304-264-5602

Electronic Filing:

(IRP–BBS)
(Asynchronous)
304-264-7070
Mainframe Filing—(Bisynchronous Filing)
4.8 Modems 304-264-7080
9.6 Modems 304-264-7040
14.4 Modems 304-264-7045
HOURS OF OPERATION—
24 HOURS A DAY
7 DAYS A WEEK

Sec. 3 Preparation Instructions for Media Label

Media label, Form 5064, has been obsoleted. It is no longer necessary to use special labels from IRS for your media. Any pressure sensitive label can now be used as long as it contains the following information:

Type of filing: Indicate whether data is Original, Replacement, Test or Correction.

Tax Year: Indicate tax year for which media is submitted.

IRS TCC: (Transmitter Control Code): Provide TCC assigned to the transmitter. (See Part A, Section 7.)

Transmitter's name

Operating system/Hardware:

For 5¼- and 3½-inch diskette files, indicate the type of personal computer operating system, and software package used to create the media (for example: IBM.PC/AT-MSD/DOS, Apple MacIntosh/ MacWrite V2.2).

Recommended label format:

Type of filing _____
Tax Year _____ IRS TCC _____
Transmitter name _____
Operating system/Hardware _____
Number of payees _____
Transmitter number for media _____
Media sequence _____ of _____

For tape, indicate either EBCDIC or ASCII.

For tape cartridge, indicate operating system, either EBCDIC or ASCII, and either 18- or 36-track.

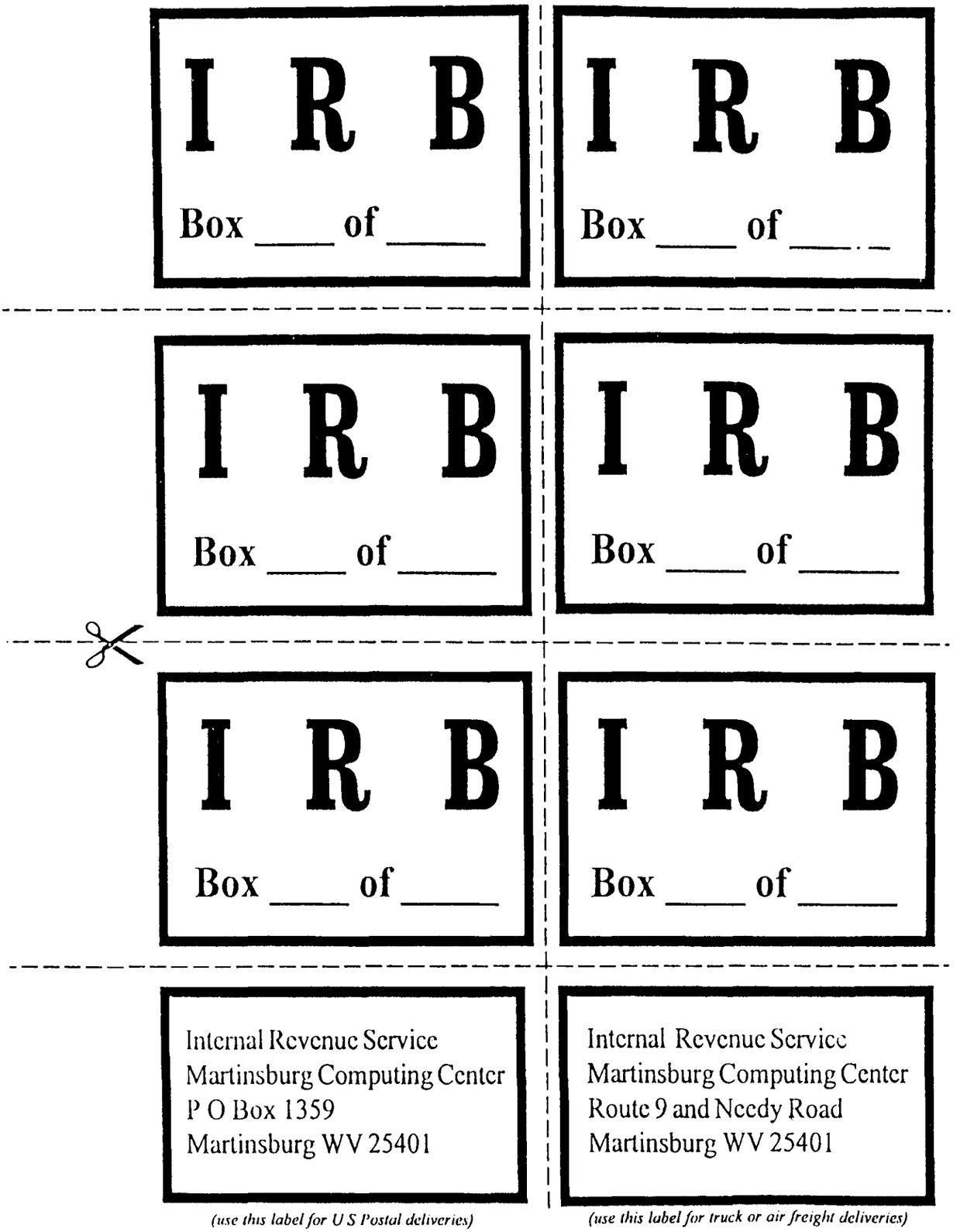
For 8mm tape cartridge, indicate operating system, and either EBCDIC or ASCII.

Number of payees: Indicate the total number of Payee "B" Records, Recipient "Q" Records for Form 1042S, or total number of establishments for Form 8027 reported on the media.

Transmitter number for media: If available, provide the in-house number assigned by your organization to the tapes, tape cartridges or diskettes.

Media sequence: Indicate sequence number of media and total number of media in file *(for example: Media sequence 1 of 3, 2 of 3, 3 of 3).*

Please affix external label to appropriate area on magnetic media. Do not hinder the ability to process media when affixing label.



(use this label for U S Postal deliveries)

(use this label for truck or air freight deliveries)

(Reproduce as needed)

To expedite handling, please affix these labels, or substitute labels, to the OUTSIDE of your shipping container.

This is the end of Publication 1220 for Tax Year 1996.

26 CFR 601.201: Rulings and determination letters.
(Also Part I, Sections 5, 103, 143; 1.25–4T, 1.103–1, 6a.103A–2.)

Rev. Proc. 96–37

SECTION 1. PURPOSE

This revenue procedure provides guidance concerning the United States and area median gross income figures that are to be used by issuers of qualified mortgage bonds, as defined in § 143(a) of the Internal Revenue Code, and issuers of mortgage credit certificates, as defined in § 25(c), in computing the housing cost/income ratio described in § 143(f)(5).

SECTION 2. BACKGROUND

.01 Section 103(a) provides that, except as provided in § 103(b), gross income does not include interest on any state or local bond. Section 103(b)(1) provides that § 103(a) shall not apply to any private activity bond that is not a "qualified bond" within the meaning of § 141. Section 141(e) provides that the term "qualified bond" includes any private activity bond that (1) is a qualified mortgage bond, (2) meets the volume cap requirements under § 146, and (3) meets the applicable requirements under § 147.

.02 Section 143(a)(1) provides that the term "qualified mortgage bond" means a bond that is issued as part of a "qualified mortgage issue". Section 143(a)(2)(A) provides that the term "qualified mortgage issue" means an issue of one or more bonds by a state or political subdivision thereof, but only if (i) all proceeds of the issue (exclusive of issuance costs and a reasonably required reserve) are to be used to finance owner- occupied residences; (ii) the issue meets the requirements of subsections (c),(d),(e),(f),(g),(h),(i), and (m)(7) of § 143; (iii) the issue does not meet the private business tests of paragraphs (1) and (2) of § 141(b); and (iv) with respect to amounts received more than 10 years after the date of issuance, repayments of $250,000 or more of principal on financing provided by the issue are used not later than the close of the first semi-annual period beginning after the date the prepayment (or complete repayment) is received to redeem bonds that are part of the issue.

.03 Section 143(f) imposes eligibility requirements concerning the maximum income of mortgagors for whom financing may be provided by qualified mortgage bonds. Section 25(c)(2)(A)(iii)(IV) provides that recipients of mortgage credit certificates must meet the income requirements of § 143(f). Generally, under §§ 143(f)(1) and 25(c)(2)(A)(iii)-(IV), these income requirements are met only 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. Under § 143(f)(6), the income limitation is reduced to 100 percent of the applicable median family income if there are fewer than three individuals in the family of the mortgagor.

.04 Section 143(f)(4) provides that the term "applicable median family income" means the greater of (A) the area median gross income for the area in which the residence is located or (B) the statewide median gross income for the state in which the residence is located.

.05 Section 143(f)(5) provides for an upward adjustment of the income limitations in certain high housing cost areas. Under § 143(f)(5)(C), a high housing cost area is a statistical area for which the housing cost/income ratio is greater than 1.2. The housing cost/income ratio is determined under § 143(f)(5)(D) 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 purchase price for the area 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 the existing housing average purchase price for the United States), whichever results in the housing cost/income ratio being closer to 1. This income adjustment applies only to bonds issued and nonissued bond amounts elected after December 31, 1988.

.06 The Department of Housing and Urban Development (HUD) has computed the median gross income for the United States, the states, and statistical areas within the states. The income information was released to the HUD regional offices on December 14, 1995, and may be obtained by calling the HUD reference service at 1–800–245–2691, or, in the Washington, D.C., area, at 301–251–5154. The Internal Revenue Service annually publishes only the median gross income for the United States.

.07 The most recent nationwide average purchase prices and average area purchase price safe harbor limitations were published on September 6, 1994, in Rev. Proc. 94–55, 1994–2 C.B. 716.

SECTION 3. APPLICATION

.01 When computing the housing cost/income ratio under § 143(f)(5), issuers of qualified mortgage bonds and mortgage credit certificates must use $41,600 as the median gross income for the United States. See section 2.06 of this revenue procedure.

.02 When computing the housing cost/income ratio under § 143(f)(5), issuers of qualified mortgage bonds and mortgage credit certificates must use the area median gross income figures released by HUD on December 14, 1995. See section 2.06 of this revenue procedure.

SECTION 4. EFFECT ON OTHER REVENUE PROCEDURES

.01 Rev. Proc. 95–32, 1995–28 I.R.B. 6, is obsolete except as provided in section 5.02 of this revenue procedure.

.02 This revenue procedure does not affect the effective date provisions of Rev. Rul. 86–124, 1986–2 C.B. 27. Those effective date provisions will remain operative at least until the Service publishes a new revenue ruling that conforms the approach to effective dates set forth in Rev. Rul. 86–124 to the general approach taken in this revenue procedure.

SECTION 5. EFFECTIVE DATES

.01 Issuers must use the United States and area median gross income figures specified in section 3 of this revenue procedure for commitments to provide financing that are made, or (if the purchase precedes the financing commitment) for residences that are purchased, in the period that begins on December 14, 1995, the date HUD released the income figures, and ends on the date when these United States and area median gross income figures are rendered obsolete by a new revenue procedure.

.02 Notwithstanding section 5.01 of this revenue procedure, issuers may continue to rely on the United States and area median gross income figures specified in Rev. Proc. 95–32 with respect to bonds originally sold and nonissued bond amounts elected not later than August 14, if the commitments or pur-

chases described in section 5.01 are made not later than October 14, 1996.

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26 CFR 601.203: Offers in compromise.
(Also Part I, Section 7122; 301.7122–1)

Rev. Proc. 96–38

SEC. 1. PURPOSE

This revenue procedure provides guidance to taxpayers who wish to submit offers in compromise on photocopies or computer generated copies of Form 656, Offer in Compromise, published by the Service at the time the taxpayer makes the offer. This revenue procedure also establishes the conditions under which the Service will process offers submitted on such forms. Specifically, this revenue procedure sets forth the required content of a photocopied or a computer generated Form 656 and states that taxpayers who submit offers on such copies authorize the Service to treat them as verbatim duplicates of the Form 656 published by the Service.

SEC. 2. CHANGES

.01 This revenue procedure provides guidance to taxpayers who wish to submit offers in compromise on photocopies or computer generated copies of Form 656, Offer in Compromise, which the Service publishes and processes when the taxpayer makes the offer.

.02 This revenue procedure declares Rev. Proc. 57–41, 1957–2 C.B. 1119 and Rev. Proc. 80–6, 1980–1 C.B. 586 obsolete.

SEC. 3. PROCEDURE

.01 The Service administers an offer in compromise program whereby a taxpayer may submit an offer to compromise a tax liability based on doubt as to liability or doubt as to collectibility. These offers are submitted on Form 656, Offer in Compromise, which is revised by the Service when necessary.

.02 The Service will receive for processing legible photocopies or computer generated copies that are verbatim duplicates of the most current, revised version of Form 656, Offer in Compromise, published by the Service when the taxpayer makes the offer. However, this procedure only applies to revised versions of Form 656 showing a revision date after September 1993. (See Sec. 6 for a description of the revised versions of Form 656 to which this revenue procedure applies.) An offer submitted on a photocopy or computer generated copy of Form 656 must be printed on the same size paper the Service uses to publish Forms 656 at the time the offer is made. (The Service currently publishes Form 656 on paper measuring eight and one-half by eleven inches).

.03 When a taxpayer makes an offer on a form that appears to be a photocopy or computer generated copy of Form 656, then pursuant to the terms of that form, the taxpayer authorizes the Service to treat the copy as a verbatim duplicate of the Service's most currently revised version of Form 656 that has a revision date after September 1993.

.04 An offer submitted on a photocopy or computer generated copy of Form 656 must bear the taxpayer's original signature and initials, if required. The Service will not process an offer in compromise bearing a signature or initials that were duplicated by electronic or photographic means, *i.e.*, a facsimile transmission or photocopy.

.05 If a taxpayer submits an offer in compromise on a photocopy or computer generated copy of Form 656 and the terms and conditions of the offer appear on any page other than the front and reverse sides of the signature page, then the taxpayer must initial and date all pages containing terms and conditions of the offer.

.06 The decision whether to process photocopies or computer generated copies of Form 656 remains within the Service's discretion.

SEC. 4. INQUIRIES

Inquiries regarding this revenue procedure should be directed to Internal Revenue Service, Office of Special Procedures CP:CO:C:SP, 1111 Constitution Avenue, NW, Washington, DC 20224.

SEC. 5. EFFECT ON OTHER REVENUE PROCEDURES

This revenue procedure declares Rev. Proc. 57–41, 1957–2 C.B. 1119 and Rev. Proc. 80–6, 1980–1 C.B. 586 obsolete. Rev. Proc. 57–41 is obsolete because it required taxpayers to use a revision of Form 656 that is not currently published or processed by the Service. Rev. Proc. 80–6 is obsolete because the delegations and procedural matters described therein have been superseded, *i.e.*, delegations of authority are now set forth in Delegation Order No. 11 (Rev. 24) and IRM Handbook 1229; all other procedural matters described therein are now set forth in Delegation Order No. 11 (Rev. 24), IRM Handbook 1229, IRM 57(10)0 through 57(10)(23).4, IRM 8(13)20 through 8(13)70, and CCDM (34)510 through (34)560.

SEC. 6. EFFECTIVE DATE

This revenue procedure is effective when published. It applies to all revisions of Form 656, Offer in Compromise, showing a revision date after September 1993. The Service is currently revising Form 656. The version of Form 656 currently published by the Service bears the revision date of September 1993. This revenue procedure shall not apply to the September 1993 version of Form 656, and the Service will not process substitute forms based on that version, but will process substitute forms based on the next revised version.

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26 CFR 601.201: Rulings and determination letters.
(Also §§ 355; 1.355–2.)

Rev. Proc. 96–39

SECTION 1. PURPOSE

This revenue procedure amplifies Rev. Proc. 96–3, 1996–1 I.R.B. 82, which sets forth the areas of the Internal Revenue Code under the jurisdiction of the Associate Chief Counsel (Domestic) and the Associate Chief Counsel (Employee Benefits and Exempt Organizations) relating to issues on which the Internal Revenue Service will not issue advance rulings or determination letters.

SECTION 2. BACKGROUND

Section 5 of Rev. Proc. 96–3 sets forth those 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 355(a) of the Internal Revenue Code applies to distributions to a shareholder with respect to stock, or to a security holder in exchange for securities, of stock or securities of a corporation controlled by the distributing corporation immediately before the distribution. In cases in which there have been negotiations, agreements or arrangements with respect to transactions or events which, if consummated before the distribution, would result in the distribution of stock or securities of a corporation which is not controlled by the distributing corporation, the Service intends to study further the proper evaluation of the facts and circum-

stances to determine whether the requirements of § 355 are satisfied.

SECTION 3. PROCEDURE

Rev. Proc. 96–3 is amplified by adding to Section 5 the following:

Section 355.—Distribution of Stock or Securities of a Controlled Corporation.—Whether a distribution of stock or securities is described in § 355(a)(1) if there have been negotiations, agreements or arrangements with respect to transactions or events which, if treated as consummated before the distribution, would result in the distribution of stock or securities of a corporation which is not controlled by the distributing corporation (or, if stock is retained by the distributing corporation, in a distribution of an amount of stock not constituting control).

SECTION 4. EFFECTIVE DATE

This revenue procedure will apply to all ruling requests postmarked or, if not mailed, received on or after July 23, 1996.

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26 CFR 601.201: Rulings and determination letters. (Also Part I, § 501; 1.501(a)–1.)

Rev. Proc. 96–40

SEC. 1. PURPOSE

The purpose of this revenue procedure is to modify Rev. Proc. 80–27, 1980–1 C. B. 677, by identifying the one central location where all filers of reports required of group parents to maintain group exemptions should send the required annual reports.

SEC. 2. BACKGROUND

Rev. Proc. 80–27, provides, in § 6.02, for nine separate locations to which group parents should send the annual information required to maintain a group exemption letter. These designations were generally based upon the locations of the service centers closest to the filers. The Service has now centralized the filing of the required information in the Internal Revenue Service Center, Ogden, Utah.

SEC. 3. CHANGES

.01 Rev. Proc. 80–27 is modified by deleting the text of § 6.02 in its entirety and substituting the following:

Filers of the information listed in § 6.01 should send the report to:

Ogden Service Center
Mail Stop 6271
1000 South 1200 West
Ogden, UT 84404–4749

SEC. 4. EFFECTIVE DATE

This revenue procedure is effective for all group exemption filings submitted on or after July 1, 1996, to comply with the requirements of § 6 of Rev. Proc. 80–27.

SEC. 5. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 80–27 is modified.

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26 CFR 601.202: Closing agreements. (Also Part I, §§ 103, 148, 7121.)

Rev. Proc. 96–41

SECTION 1. PURPOSE

This revenue procedure applies to an issuer of state or local bonds that has used the proceeds of state or local bonds sold prior to July 19, 1996, to pay more than fair market value for nonpurpose investments deposited into an advance refunding escrow. It provides a program under which an issuer may request a closing agreement pursuant to which the purchase of those investments alone will not be sufficient to cause §§ 103(b)(2) and 148 of the Internal Revenue Code to apply to those bonds.

SECTION 2. BACKGROUND

.01 Section 103(a) provides, in general, that gross income does not include interest on any state or local bond. Section 103(b)(2) provides, however, that this exclusion from gross income does not apply to arbitrage bonds.

.02 Section 148(a)(1) provides, in general, that bonds of an issue are arbitrage bonds if any portion of the proceeds of the issue is "reasonably expected" on the issue date of the issue to be used directly or indirectly to acquire higher yielding investments.

.03 Section 1.148–1(b) of the Income Tax Regulations provides that an issuer's expectations or actions are reasonable only if a prudent person in the same circumstances as the issuer would have those same expectations or take those same actions, based on all the objective facts and circumstances. Section 1.148–1(b) also provides that factors relevant to a determination of reasonableness include the level of inquiry by the issuer into factual matters.

.04 Section 148(f) provides, in general, that bonds of an issue are arbitrage bonds unless the earnings from the investment of bond proceeds in excess of the yield on the issue are rebated to the United States. The rebate requirement of § 148(f) is generally not based on reasonable expectations.

.05 Section 1.148–6(c) provides that gross proceeds of an issue of bonds are not allocated to a payment for a nonpurpose investment in an amount greater than the fair market value of that investment on the purchase date. For this purpose only, the fair market value of a nonpurpose investment is adjusted to take into account qualified administrative costs allocable to that investment.

.06 Section 1.148–5(d)(6)(i) generally defines fair market value as the price at which a willing buyer would purchase from a willing seller in a bona fide, arm's-length transaction. Fair market value generally is determined on the date on which a contract to purchase the nonpurpose investment becomes binding (that is, the trade date rather than the settlement date).

.07 Section 1.148–5(d)(6)(iii) provides that the purchase price of a guaranteed investment contract is treated as its fair market value on the purchase date if the issuer makes a bona fide solicitation for a guaranteed investment contract that meets the requirements of that section. The definition of guaranteed investment contract in § 1.148–1(b) generally does not include the purchase of investments for an escrow for an advance refunding transaction.

.08 Section 1.148–2(d)(2)(ii) defines "materially higher yield" for investments in an advance refunding escrow as 0.001 percent higher than the yield on the issue.

.09 An issuer cannot avoid the application of § 148 by giving away the prohibited arbitrage profit. *See* 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II–746 (1986), 1986–3 (Vol. 4) C.B. 746. The deflection of arbitrage through the purchase of investments at other than fair market value is prohibited. H.R. Rep. No. 426, 99th Cong., 1st Sess. 556 (1985), 1986–3 (Vol. 2) C.B. 556.

.10 Issuers of advance refunding bonds commonly enter into an agreement to purchase United States Treasury securities that are to be deposited into an escrow to pay the refunded prior issue of bonds. In most cases, an issuer enters into this investment purchase agreement on the same date it enters into an agreement to sell its advance refunding bonds. That date (the "sale date") is often several weeks before the issue date of the issue of bonds.

.11 In a typical tax-exempt advance refunding transaction, the obligation to purchase the Treasury securities is contingent on the issuance and sale of the advance refunding bonds, which in turn are commonly subject to contingencies that are standard in the municipal bond industry (such as the ability of bond counsel to render an unqualified opinion on the validity of the bonds).

.12 In general, a valuation method must take into account all pertinent information. A valuation method that singles out one economic factor and disregards other significant economic factors is erroneous. *See, e.g., Powers v. Commissioner*, 312 U.S. 259, 260 (1941), 1941–1 C.B. 448; *Guggenheim v. Rasquin*, 312 U.S. 254 (1941), 1941–1 C.B. 445; *Commissioner v. McCann*, 146 F.2d 385 (2d Cir. 1944).

.13 Certain state and local government issuers, and certain sellers of Treasury securities to state and local government issuers, of advance refunding bonds have used a valuation method that results in prices for those Treasury securities that exceed the fair market value of the securities. It has been asserted that the risk of nonsettlement justifies the inclusion of the cost of a hedge (such as a put option on Treasury securities) in the fair market value of the Treasury securities to protect the seller against any increase in interest rates between the sale date (trade date) and the issue date (settlement date).

.14 In these transactions, a substantial mark-up of the price of Treasury securities for the risk of nonsettlement is inappropriate for two reasons. First, the risk of nonsettlement is remote. In addition, the seller of the Treasury securities is in a position to benefit if interest rates fall. This potential for benefit should reduce the weight given to the potential for loss if rates should rise. In general, nonsettlement is not more likely when interest rates rise than when they fall.

.15 In other cases, issuers have entered into agreements to purchase open market Treasury securities to be deposited into an escrow to pay the refunded prior issue of bonds. On the same date, issuers have subscribed to purchase United States Treasury securities—State and Local Government Series ("SLGS") from the United States Department of the Treasury, Bureau of Public Debt to pay the same refunded prior issue of bonds. In effect, this arrangement provides a call option on the open market Treasury securities to the seller of those securities.

.16 In the case of simultaneous SLGS subscription and forward purchase contracts, the issuer and the seller of the open market Treasury securities agree on the sale date that, if the advance refunding bonds are issued and if interest rates decline between the sale date and the issue date of the advance refunding bonds so that the value of the nonpurpose investments increases, the issuer will purchase the SLGS. In this case, the seller will not be obligated to deliver the open market Treasury securities to the issuer. Alternatively, if the advance refunding bonds are issued and if interest rates remain the same or increase between the sale date and the issue date so that the value of the nonpurpose investments remains the same or decreases, the issuer will be obligated to purchase the open market Treasury securities. In this case, the seller will be obligated to deliver the open market Treasury securities to the issuer for deposit into the advance refunding escrow. In addition, the issuer will not purchase the SLGS. In such a case, by subscribing for the SLGS, the issuer in effect provides a call option on the open market Treasury securities to the seller of the open market Treasury securities. For purposes of the arbitrage rules, the fair market value of the open market Treasury securities under the agreement with the seller must accordingly be reduced by the value of this call option.

.17 Even if the issuer obtains certifications that the purchase price being paid for nonpurpose investments does not exceed the fair market value of those investments, an issue may nevertheless fail to meet the reasonable expectations standard of § 148(a). Further, in general, an agreement between unrelated persons about price does not presumptively establish fair market value in a situation where one party to the agreement lacks financial incentive to obtain the best price. *See Raymond v. Commissioner*, 114 F.2d 140 (7th Cir.), *cert. denied*, 311 U.S. 710 (1940).

.18 All the facts and circumstances are considered in the determination of whether the proceeds of the issue are to be invested at a materially higher yield. Factors strongly tending to establish that an issuer does not reasonably expect the proceeds of the issue to be invested at a materially higher yield are (1) the use of a bona fide bidding procedure to reasonably probe the market for the fair market value of nonpurpose investments and (2) reasonable due diligence by the issuer to review the method used to determine the fair market value of Treasury securities. One important factor tending to establish that a bidding procedure is bona fide is that it is conducted by a person that does not have a material financial interest in the transaction (for example, as the seller of Treasury securities to the issuer).

.19 Some issuers have obtained Treasury securities for an advance refunding escrow by using procedures that generally are designed to conform to the safe harbor for guaranteed investments contracts in § 1.148–5(d)(6)(iii). Although that safe harbor does not expressly apply to the purchase of Treasury securities for an advance refunding escrow, the Internal Revenue Service will apply the principles underlying that safe harbor to the purchase of those nonpurpose investments. Absent extraordinary circumstances, a bona fide bidding procedure consistent with the principles of the safe harbor for guaranteed investments contracts is rebuttably presumed to establish fair market value for transactions to which this revenue procedure is applicable, even in cases where the forward price paid for Treasury securities is greater than the spot price of those Treasury securities. Other procedures may also establish fair market value.

.20 If promulgated as a final regulation, § 1.148–5(d)(6)(v) of the proposed Income Tax Regulations, published in the Federal Register on June 27, 1996 (61 Fed. Reg. 33405), would provide a rebuttable presumption for establishing fair market value for Treasury securities purchased other than directly from the United States Treasury for those transactions described in the regulation.

SECTION 3. DESCRIPTION OF THE CLOSING AGREEMENT PROGRAM FOR ADVANCE REFUNDING ESCROWS

.01 Under the program established by this revenue procedure, the Service will enter into closing agreements with the issuers of bonds. These closing agreements will resolve the effect of the payment of more than fair market value for the nonpurpose investments for yield restriction and rebate purposes under § 148. The closing agreements will not resolve any other matters.

.02 The closing agreements will provide that, for purposes of § 148, the amount paid by the issuer for the Treasury securities deposited into an advance refunding escrow will be treated as the fair market value for those nonpurpose

investments. For purposes of computing rebate under § 148(f), the closing agreement amount will not be treated as a rebate payment.

.03 This program is a compliance program but is not based upon an examination of an issue of bonds by the Service.

.04 Because this program does not arise out of an examination, consideration under this program does not preclude or impede an examination of the issuer, the bondholders, or the issue of bonds by the Service with respect to matters not addressed in the closing agreement.

.05 The intent underlying this program is to treat expeditiously all requests for closing agreements which are submitted in accordance with sections 5 and 6 of this revenue procedure. Accordingly, negotiations with the issuers on the basis of mitigating circumstances of individual cases will not be entertained under the terms of this revenue procedure.

SECTION 4. SCOPE

.01 This revenue procedure applies to any issue of advance refunding bonds which was sold prior to July 19, 1996, and issued prior to August 19, 1996, and the proceeds of which were used to purchase nonpurpose investments pursuant to an agreement that is substantially similar to an agreement to purchase described in sections 2.13 or 2.15 of this revenue procedure.

.02 An issue of bonds that is under an examination by the Service is not eligible for the program. An issue of bonds is under examination if the issuer of the bonds has been contacted in any manner by the Service for the purpose of scheduling any type of examination of that issue of bonds. For issuers that do not avail themselves of a closing agreement under this revenue procedure, the Service will treat the purchase of nonpurpose investments with the proceeds of an issue of bonds as being subject to the usual procedures governing tax consequences. The result upon any examination by the Service of the issue of bonds could be different from the terms of this revenue procedure, depending on the merits of the issuer's position.

.03 For purposes of this revenue procedure, "issuer" means only the entity that actually issues the bonds and not a conduit borrower of the issue.

SECTION 5. PROCEDURE

.01 The issuer seeking relief must request a closing agreement within 1 year from July 19, 1996, following the procedures in this revenue procedure.

.02 The issuer must request a closing agreement using Form 10001, which is shown as an exhibit at the end of this revenue procedure.

.03 The closing agreement will be prepared by the Service and, in general, will be in substantially the same form as the model closing agreement set forth in Announcement 95–61, Exhibit (7)(10)-(15)0–6, 1995–32 I.R.B. 54, 74, or any successor of Announcement 95–61.

.04 As a condition to executing a closing agreement under this procedure, the issuer must agree to pay, simultaneously with the execution by the issuer of the closing agreement, the closing agreement amount computed under section 6 of this revenue procedure.

.05 The Service will not challenge whether an issuer paid more than fair market value for Treasury securities that are purchased other than directly from the United States Treasury and deposited into an advance refunding escrow in a transaction described in section 2.13 of this revenue procedure if:

(1) The amount paid for the Treasury securities does not exceed the spot price as described in section 6.02 of this revenue procedure;

(2) The period between the sale date and the issue date of the issue of bonds was not greater than 1 month; and

(3) The Treasury securities are purchased prior to July 19, 1996.

SECTION 6. CLOSING AGREEMENT AMOUNT

.01 The closing agreement amount is equal to:

(1) The excess of the amount paid by the issuer for the nonpurpose investments deposited in the advance refunding escrow over the spot price (as described in section 6.02 of this revenue procedure) of those nonpurpose investments (this excess is referred to as the "differential amount"); plus

(2) Interest on the differential amount from the issue date of the bonds to the date of payment at an interest rate equal to the yield on the issue of bonds.

.02 The spot price is the noncontingent price on the trade date of a nonpurpose investment for delivery on the next business day after the trade date.

.03 In the case of an agreement to purchase Treasury securities described in section 2.15 of this revenue procedure, the differential amount must include the value of a call option on an equivalent portfolio of Treasury securities for the period from the sale date to the issue date of the advance refunding bonds at a strike price for the portfolio equal to the price established in the agreement.

.04 Use of the spot price as the basis for the settlement amount under this revenue procedure is for the administrative convenience of state and local government issuers and the Service and does not reflect a view by the Service that the spot price closely reflects the fair market value in all cases of a contingent forward price for the portfolio. For example, in many cases, use of the noncontingent forward price for Treasury securities may be a more accurate basis for determining the fair market value of the contingent forward price.

.05 Use of the spot price of the nonpurpose investments is not permitted if the period between the sale date and the issue date of the issue of bonds was greater than 1 month.

SECTION 7. INQUIRIES

Inquiries in regard to this revenue procedure should be directed to:

Internal Revenue Service
CP:E:EO:T:4 Room 6236
1111 Constitution Ave. NW
Washington, DC 20224

SECTION 8. EFFECTIVE DATE

This revenue procedure is effective July 19, 1996, and applies to state or local bonds described in section 4.01 of this revenue procedure.

Form **10001** (July 1996)	Department of the Treasury - Internal Revenue Service **Request for Closing Agreement Relating to Advance Refunding Issue Under Sections 148 and 7121 and Rev. Proc. 96-41**	**OMB No. 1545-1492**

Reporting Authority

1. Issuer's name	2. Issuer's employer identification number

3. Address *(Number, street, city, state, ZIP Code)*

Refunding Bonds

4. Name of issue

5. Principal amount of issue	6. Sale date of issue *(mmddyy)*

7. Enter Regulations under IRC 148 that apply to the issue

Open Market Securities Information

8. Name*(s)* of seller*(s)* of open market securities purchased for advance refunding escrow

Amounts

9. Amount actually paid by the issuer for the open market securities	
10. The spot price of the open market securities on the sale date of the open market securities	
11. Amount of brokerage commission paid to the seller of the open market securities, if any	
12. The value of a call option if a subscription for United States securities - State and Local Government Series was cancelled in connection with the purchase of the open market securities	
13. Proposed closing agreement amount	

14. Attach copies of the following documents:

(a) Complete and filed Form 8038 or 8038-G of refunding issue	(e) A statement detailing any oral and other terms of the agreement for the open market securities
(b) Final offering document	(f) A statement explaining the financial sources and methodology upon which the spot price in line 10 is based
(c) Arbitrage certificate	(g) Escrow agreement
(d) Confirmations and receipts of the open market securities purchased	(h) A statement explaining the computation of the proposed closing agreement amount in line 13

Under penalties of perjury, I declare that I have examined this request, including accompanying documents, and that, to the best of my knowledge and belief, the facts presented in support of the requested closing agreement are true, correct and complete.

Your signature	Title	Date *(mmddyy)*
Print name	Telephone number	

For Paperwork Reduction Act Notice, see back of this form. Catalog No. 22534X Form **10001** (7-96)

Paperwork Reduction Act Notice

We ask for this information to carry out the Internal Revenue laws of the United States. We need it to ensure that taxpayers are complying with these laws and to allow us to figure and collect the right amount of tax. You are required to give us this information if you wish to request to enter into a closing agreement in accordance with the provisions of Revenue Procedure 96-41.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by Code section 6103.

The time needed to complete this form will vary depending on individual circumstances. The estimated average time is 3 hours.

If you have comments concerning the accuracy of this time estimate or suggestions for making this form simpler, we would be happy to hear from you. You can write to the Tax Forms Committee, Western Area Distribution Center, Rancho Cordova, CA 95743-0001. **Do Not** send the form to this address. Instead, see the "Where to File" instructions below.

Effective Date: Requests for closing agreements must be submitted using this form within one year from July 19, 1996.

Where to File:

Requests for closing agreements must be sent to the following address:

Internal Revenue Service
Attention: CP:E:EO
P.O. Box 120
Ben Franklin Station
Washington, D.C. 20044

Who Must Sign:

A request for a closing agreement must be signed by the issuer. The person who signs for an issuer must be an official of the issuer who has personal knowledge of the facts and whose duties are not limited to obtaining a closing agreement from the Service.

Computing of Closing Agreement Amount:

See section 6 of Revenue Procedure 96-41 for the computation of the closing agreement amount.

Spot Price:

Use of the spot price of the nonpurpose investments is not permitted if the period between the sale date and the issue date of the bonds was greater than one month. The issuer must submit an alternative calculation establishing the fair market value for Treasury securities in such instances. See section 6 of Revenue Procedure 96-41 for additional information on the spot price.

26 CFR 601.602: Forms and instructions.
(Also Part I, Sections 408, 6041, 6041A, 6042, 6043, 6044, 6045, 6047, 6049, 6050A, 6050B, 6050D, 6050E, 6050H, 6050J, 6050N, 6050P; 1.408–5, 1.408–7, 1.6041–1, 7.6041–1, 1.6042–2, 1.6042–4, 1.6044–2, 1.6044–5, 1.6045–1, 5f.6045–1, 1.6045–2, 1.6045–4, 1.6047–1, 1.6049–4, 1.6049–6, 1.6049–7, 1.6050A–1, 1.6050B–1, 1.6050D–1, 1.6050E–1, 1.6050H–1, 1.6050H–2, 1.6050J–1T, 1.6050N–1, 1.6050P–1)

Rev. Proc. 96–42

CONTENTS

PART A. GENERAL

SECTION 1. PURPOSE
SECTION 2. NATURE OF CHANGES
SECTION 3. REQUIREMENTS FOR ACCEPTABLE SUBSTITUTE FORMS 1096, 1098, 1099, 5498, AND W–2G
SECTION 4. DEFINITIONS
SECTION 5. INSTRUCTIONS FOR PREPARING PAPER FORMS THAT WILL BE FILED WITH THE IRS (COPY A)
SECTION 6. MAGNETIC MEDIA AND ELECTRONIC FILING
SECTION 7. SUBSTITUTE STATEMENTS TO RECIPIENTS AND FORM RECIPIENT COPIES

PART B. SPECIFICATIONS FOR SUBSTITUTE FORMS TO BE FILED WITH IRS (EXCEPT W–2G)

SECTION 1. GENERAL
SECTION 2. SPECIFICATIONS FOR FORM 1096 AND COPY A OF FORM 1098, 1099, AND 5498

PART C. SPECIFICATIONS FOR SUBSTITUTE FORMS W–2G TO BE FILED WITH IRS

SECTION 1. GENERAL
SECTION 2. SPECIFICATIONS FOR COPY A FOR FORMS W–2G

PART D. ADDITIONAL INSTRUCTIONS FOR FORMS 1098, 1099, 5498, AND W–2G

SECTION 1. OTHER COPIES
SECTION 2. OMB REQUIREMENTS
SECTION 3. REPRODUCTION PROOFS
SECTION 4. EFFECT ON OTHER REVENUE PROCEDURES

PART E. EXHIBITS

EXHIBIT A. FORM 1098
EXHIBIT B. FORM 1099–A
EXHIBIT C. FORM 1099–B
EXHIBIT D. FORM 1099–C
EXHIBIT E. FORM 1099–DIV
EXHIBIT F. FORM 1099–G
EXHIBIT G. FORM 1099–INT
EXHIBIT H. FORM 1099–MISC
EXHIBIT I. FORM 1099–OID
EXHIBIT J. FORM 1099–PATR
EXHIBIT K. FORM 1099–R
EXHIBIT L. FORM 1099–S
EXHIBIT M. FORM W–2G
EXHIBIT N. FORM 5498
EXHIBIT O. FORM 1096

PART A. GENERAL

SECTION 1. PURPOSE

.01 The purpose of this revenue procedure is to set forth the requirements for:

1. Using official Internal Revenue Service (IRS) forms to file information returns with IRS,

2. Preparing acceptable substitutes of the official IRS forms to file information returns, and

3. Using such official or acceptable substitute forms to furnish information to a recipient.

This revenue procedure contains specifications for the following information returns:

(a) Form 1098 Mortgage Interest Statement;
(b) Form 1099–A Acquisition or Abandonment of Secured Property;
(c) Form 1099–B Proceeds From Broker and Barter Exchange Transactions;
(d) Form 1099–C Cancellation of Debt;
(e) Form 1099–DIV Dividends and Distributions;
(f) Form 1099–G Certain Government Payments;
(g) Form 1099–INT Interest Income;
(h) Form 1099–MISC Miscellaneous Income;
(i) Form 1099–OID Original Issue Discount;
(j) Form 1099–PATR Taxable Distributions Received From Cooperatives;
(k) Form 1099–R Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.;
(l) Form 1099–S Proceeds From Real Estate Transactions;
(m) Form W–2G Certain Gambling Winnings;
(n) Form 5498 Individual Retirement Arrangement Information; and
(o) Form 1096 Annual Summary and Transmittal of U.S. Information Returns.

.02 For the purpose of this revenue procedure, a substitute form or statement is one that is not printed by the IRS. For a substitute form or statement to be acceptable to the IRS, it must conform to the official form or the specifications outlined in this revenue procedure. DO NOT SUBMIT ANY SUBSTITUTE FORMS OR STATEMENTS TO IRS FOR APPROVAL. Private printers cannot state "This is an IRS approved form." Further, only those forms that conform to the official form or comply with the specifications set forth herein are acceptable. See Part A, Section 7, for the specifications that apply to form recipient statements (generally Copy B).

.03 Filers who make payments to certain persons (payees) (or in some cases receive payments) during a calendar year are required by the Internal Revenue Code (IRC) to file information returns with the IRS reflecting these payments. Further, as discussed below, these filers must provide this information to their payees.

.04 In general, the manner in which a filer must file an information return is governed by section 6011 of the IRC. A filer must file information returns on magnetic media or on paper. Under section 6011 of the IRC, a filer who is required to file 250 or more information returns (of any one type) during a calendar year must file those returns on magnetic media. Filers required to file less than 250 returns during a calendar year may, but are not required to, file such information returns on magnetic media (small volume filers). The IRS explains these legal requirements for filing information returns (and providing a copy to a payee) in the annual publication of Instructions for Forms 1099, 1098, 5498, and W–2G.

.05 Copies of the official forms for the reporting year and the instruction booklet may be obtained by calling our toll-free number **1–800–TAX–FORM (1–800–829–3676)**.

.06 The IRS prints and provides the forms on which various payments must be reported. Alternatively, filers may prepare substitute copies of these IRS forms and use such forms to report payments to the IRS.

.07 IRS operates a centralized call site, located at the Martinsburg Comput-

ing Center (MCC), to answer questions related to information returns, penalties, and backup withholding. The call site phone number is **304–263–8700**. The number for Telecommunications Device for the Deaf (TDD) is **304–267–3367**. These are not toll-free numbers.

.08 IRS has established a personal computer based Information Reporting Bulletin Board System (IRP–BBS) at MCC. This system provides information about forms and publications, including this revenue procedure, news of the latest changes, answers to questions, access to shareware, and other features. The IRP–BBS is available for public use and can be reached by dialing **304–264–7070**. The IRP–BBS is compatible with most modems. For more information concerning this system, call MCC at **304–263–8700 (not a toll-free number) Monday through Friday 8:30 A. M. to 4:30 P. M. eastern time**.

SEC. 2. NATURE OF CHANGES

.01 The text and exhibits were updated for tax year 1996.

.02 The phone number for the Information Reporting Bulletin Board System (IRP–BBS) has been changed. See Part A, Sec. 1.08.

.03 On Form 5498, new box 5 (check box for simplified employee pension (SEP)) was added. See Exhibit N.

.04 A statement regarding the acceptance of handwritten forms has been added to Part A, Section 5.04.

.05 A note requesting that a phone number be included on statements to recipients has been added to Part A, Sections 7.01(7) and 7.02(2).

.06 A note referring to the correct form measurements has been added to Part B, Sec. 2.01.

.07 The note regarding new verbiage for paper and ink specifications for substitute forms has been deleted from Part B, Sec. 2.02. The current specifications are applicable to our new OCR equipment. Therefore, it is not necessary to change the current specifications.

.08 New procedures for obtaining Reproducible copies were added to Part D, Sec. 3.

SEC. 3 REQUIREMENTS FOR ACCEPTABLE SUBSTITUTE FORMS 1096, 1098, 1099, 5498, and W–2G

.01 Paper substitutes for Form 1096 and Copy A of Forms 1098, 1099, 5498, and W–2G that totally conform to the specifications contained in this revenue procedure may be privately printed and filed as returns with the IRS. The reference to the Department of the Treasury - Internal Revenue Service should be included on all such forms. The Catalog Number (Cat. No.) shown on the 1996 Forms 1096, 1098, 1099, 5498, and W–2G is used for IRS distribution purposes and need not be printed on any substitute forms.

If you are uncertain of any specification set forth herein and want that specification clarified, you may submit a letter citing the specification in question, giving your understanding and interpretation of the specification, and enclosing an example of the form (if appropriate) to:

Internal Revenue Service
ATTN: T:S:P:S - SAL (IRP Coordinator)
1111 Constitution Avenue, NW
Washington, DC 20224

NOTE: Allow at least 45 days for the IRS to respond.

.02 Copy B (Form 1098 - For Payer, Form 1099–A - For Borrower, Form 1099–C - For Debtor, Form 1099–S - For Transferor, Other Forms 1099 - For Recipient, Form 5498 - For Participant, and Forms W–2G and 1099–R - To Be Attached To the Federal Tax Return), and Copy C- (Form 1099–R For Recipient's Records and Form W–2G For Winner's Records) must contain the information specified in PART A Section 7 in order to constitute a "statement" or "official form" under the applicable provisions of the Internal Revenue Code. The format of this information is at the discretion of the filer with the exception of the location of the tax year, form number and form name specified in Part A Section 7.01(6) and composite Form 1099 statements specified in PART A Sections 7.02 and 7.04.

.03 Forms 1096, 1098, 1099, 5498, and W–2G are subject to annual review and possible change. Therefore, filers are cautioned against overstocking supplies of privately printed substitutes. THE SPECIFICATIONS CONTAINED IN THIS REVENUE PROCEDURE APPLY TO 1996 FORMS ONLY.

.04 Proposed substitutes for Copy A that do not conform to the specifications in this revenue procedure are not acceptable. Further, if you file such forms with IRS, you may be subject to a penalty for failure to file an information return under section 6721 of the Internal Revenue Code (IRC). Generally, the penalty is $50 for each failure to file a form (up to $250,000) that the IRS cannot accept as a return because it does not meet the provisions in this revenue procedure. No IRS office is authorized to allow deviations from this revenue procedure.

SEC. 4. DEFINITIONS

.01 The term "form recipient" means the person to whom you are required by law to furnish a copy of the official form or information statement: *i.e.*, for Form 1098, the recipient is the "payer/borrower"; Form 1099–A, the "borrower"; Form 1099–C, the "debtor"; Form 1099–S, the "transferor"; other Forms 1099, the payment recipient; Form 5498, the "participant"; and Form W–2G, the "winner."

.02 The term "filer" means the person or organization required by law to file a form listed in PART A Section 1.01 with the IRS. Thus, a filer may be a payer, a creditor, a recipient of mortgage interest payments, a broker, a barter exchange, a person reporting real estate transactions, a trustee or issuer of an individual retirement arrangement (including an IRA or SEP), or a lender who acquires an interest in secured property or who has reason to know that the property has been abandoned.

.03 A corrected (or amended) return is one that corrects information previously reported to IRS. (A voided return will not correct previously reported information.)

.04 The term "substitute form" means a paper substitute of Copy A of an official form listed in PART A Section 1.01 that totally conforms to the provisions in this revenue procedure.

.05 The term "substitute form recipient statement" means a paper statement of the information reported on a form listed in PART A Section 1.01 that must be furnished to a person (form recipient), as so defined under the applicable provisions of the Internal Revenue Code and the applicable regulations.

.06 A composite substitute statement is one in which two or more required statements (e.g., Forms 1099–INT and 1099–DIV) are furnished to the recipient on one document. However, each statement must be separately designated and must contain all the requisite Form 1099 information except as provided in Part A Section 7. A composite statement CANNOT be filed with the IRS. See PART A Section 7.02 and 7.04 for more information on composite statements.

SEC. 5. INSTRUCTIONS FOR PREPARING PAPER FORMS THAT WILL BE FILED WITH THE IRS (Copy A)

.01 The form recipient's name, street address, city, state, and ZIP code information should be TYPED OR MACHINE PRINTED IN BLACK INK on separate lines. Carbon copies and photocopies are not acceptable. The city, state, and ZIP code must be on the same line.

.02 The name of the appropriate form recipient must be shown on the first or second name line in the area on the form provided for the form recipient's name and address. No descriptive information or other name may precede the form recipient's name. Only ONE form recipient's name may appear on the first name line of the form. If the names of multiple recipients must be set forth on the form, on the first name line insert the recipient name that corresponds to the taxpayer identification number (TIN) used for information reporting purposes. Place the other form recipients' names, on the succeeding name line (up to 2 name lines are allowable). Because certain states require that trust accounts be provided in a different format, *generally* filers should provide information returns reflecting payments to trust accounts with (1) the trust's employer identification number (EIN) in the recipient's TIN area, (2) the trust's name on the recipient's first name line, and (3) the name of the trustee on the recipient's second name line.

.03 You should use the **account number** box for an account number designation. This number must not appear anywhere else on the form, and this box may not be used for any other item. Showing the account number is optional. However, it may be to your benefit to include the recipient's account number or designation on paper documents if your system of records uses the account number or designation in conjunction with, or rather than, the name, social security number, or employer identification number for identification purposes. If you furnish the account number, the IRS will include it in future notices to you about backup withholding. If you use window envelopes and reduced rate mail to mail statements to recipients, be sure the account number does not appear in the window. Otherwise the Postal Service may not accept them for mailing.

.04 Although forms completed in handwriting will be accepted, in order for IRS to process the submitted forms in the most economical manner, the IRS prefers that filers TYPE OR MACHINE PRINT data entries. In addition, filers should insert data in the *middle of blocks* well separated from other printing and guidelines, and take other measures to guarantee a clear, dark black, sharp image.

.05 Machine printed forms should be printed using a 6 lines/inch option.

.06 Machine printed forms should be printed in 10 pitch pica (*i.e.*, 10 print positions per inch) or 12 pitch elite (*i.e.*, 12 print positions per inch). Proportional spaced fonts are unacceptable.

.07 To correct returns, enter an "X" within the checkbox located at the top of the form making the correction, to the left of the word "CORRECTED." DO NOT type the words CORRECTED RETURN on the Form 1096, 1098, 1099, 5498, or W–2G. See "Corrected Returns" in the 1996 "Instructions for Forms 1099, 1098, 5498, and W–2G."

.08 If you make an error while typing or printing a Form 1098, 1099, or 5498, enter an "X" in the "VOID" box at the top of the form. An entry in the "VOID" box will not correct previously filed information returns. See "Void Returns" in the 1996 "Instructions for Forms 1099, 1098, 5498, and W–2G."

.09 DO NOT use a felt tip marker. The machine used to "read" paper forms generally cannot "read" this ink type.

.10 Substitute forms prepared in continuous or strip form must be burst and stripped to conform to the size specified for a single sheet before they are filed with IRS. The size specified *does not include pinfeed holes*. Pinfeed holes MUST NOT be present on forms filed with the IRS.

.11 Use decimal points to indicate dollars and cents. **DO NOT** use dollar signs ($), ampersands (&), asterisks (*), commas (,), or other special characters in the numbered money boxes. Example: 2000.00 is acceptable.

.12 DO NOT FOLD Forms 1096, 1098, 1099, or 5498 being mailed to IRS. Mail these forms flat in an appropriately sized envelope or box. Folded documents cannot be readily moved through the scanner transport used in IRS processing.

.13 *DO NOT STAPLE* Forms 1096 to the returns being transmitted. Staple holes in the vicinity of the return code number reduce the IRS's ability to machine scan the type of documents.

.14 **DO NOT** type other information on Copy A. **DO NOT** cut or separate the individual forms on the sheet of forms of Copy A (except Forms W–2G).

.15 MAIL completed paper forms to the IRS service center specified on the back of Form 1096 and in the 1996 "Instructions for Forms 1099, 1098, 5498, and W–2G." Specific information needed to complete the forms in this revenue procedure is given in those instructions. A chart is included in those instructions giving a quick guide to which form must be filed to report a particular payment.

SEC. 6. MAGNETIC MEDIA AND ELECTRONIC FILING

.01 All forms listed in Section 1.01 (except Form 1096) may be filed magnetically or electronically. The IRS encourages all filers including nominees (hereafter collectively referred to as filers) to file information returns on magnetic media or electronically instead of on paper forms.

.02 Any person who is required to file 250 or more (of any one type of form) information returns for one calendar year MUST file on magnetic media unless an undue hardship waiver is requested and received. To request a one year waiver of the magnetic media filing requirements, for the current tax year only, submit Form 8508, Request for Waiver From Filing Information Returns on Magnetic Media. See Publication 1220 Part A, Sec. 5, for more information. Specifications for filing information returns on magnetic media are contained in Publication 1220, "Specifications for Filing Forms 1098, 1099, 5498, and W–2G Magnetically or Electronically." Copies of this publication may be obtained by calling **1–800–TAX–FORM (1–800–829–3676)**. Payers who do not comply with the magnetic media filing requirements and who are not granted a waiver may be subject to penalties. **Note:** Filing electronically will satisfy the magnetic media filing requirements. Refer to Publication 1220, Part C, Bisynchronous (Mainframe) Electronic Filing Specifications and Part D, Asynchronous (IRB–BBS) Electronic Filing Specifications.

SEC. 7. SUBSTITUTE STATEMENTS TO FORM RECIPIENTS AND FORM RECIPIENT COPIES

If you are not using the official IRS form to furnish statements to your recipients, your substitute statements must comply with the rules in this section. In general, see Regulations sections 1.6042–4, 1.6044–5, 1.6049–6, and 1.6050N–1 on the manner in which certain statements must be provided to recipients (statement mailing requirements for most Forms 1099–DIV and 1099–INT, all Forms 1099–OID and 1099–PATR, and Form 1099–MISC or 1099–S for royalties).

.01 SUBSTITUTE STATEMENTS TO RECIPIENTS - Forms 1099–INT (except for interest reportable under section 6041), DIV (except for section 404(k) dividends)), OID, and PATR ONLY. The requirement to furnish form recipients with an official Form **1099–INT, DIV, OID, or PATR** may be met by furnishing Copy B of the official form or by furnishing a substitute Form 1099 (form recipient statement) if it contains the same language as that of the official IRS form (such as aggregate amounts paid to the form recipient, any backup withholding, the name, address, and TIN of the person making the return, and any other information required by the official form). Information not required by the official form should not be included on the substitute form except for state tax withholding information. You may enter a total of the individual accounts listed on the form only if they have been paid by the same payer. For example, if you are listing interest paid on several accounts by one financial institution on **Form 1099–INT**, you may also enter the total interest amount. You may also enter a date next to the corrected box if that box is checked.

The form recipient statement, *e.g.*, Copy B of a substitute form for **1099–INT, 1099–DIV, 1099–OID, and 1099–PATR**, must comply with the following requirements.

(1) Box captions and numbers that are applicable must be clearly identified, using the same wording and numbering as on the official form. However on **Form 1099–INT**, if box 3 is not on your substitute form, you may drop "not included in box 3" from the box 1 caption.

(2) The form recipient statement must contain all applicable form recipient instructions provided on the front and back of the official IRS form. Those instructions may be provided on a separate sheet of paper.

(3) The form recipient statement must contain the following statement in bold and conspicuous type, "This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported."

(4) The caption "Federal income tax withheld" must be in bold face type on the form recipient statement.

(5) The form recipient statement must contain the Office of Management and Budget (OMB) number as shown on the official IRS form. See Part D, Section 2.

(6) The form recipient statement must contain the tax year (e.g., 1996), form number (e.g., Form 1099–INT), and form name (e.g., Interest Income) of the official IRS Form 1099 for which it substitutes prominently displayed together in one area of the statement. For example, the tax year, form number, and form name could be shown in the upper right part of the statement. Each copy must be appropriately labeled (such as Copy B, For Recipient) (see PART D Section 1.02 for applicable labels of forms). DO NOT include the words "Substitute for" or "In lieu of" on the form recipient statement.

(7) Layout and format of the form is at the discretion of the filer. However, IRS encourages the use of statements with boxes so that the statement has the appearance of a form and can be easily distinguished from other nontax statements. **NOTE:** Please include your telephone number on statements to recipients you provide so that taxpayers can contact you directly with questions.

(8) With respect to dividend income, a mutual fund family may separately state on one document (*e.g.*, one piece of paper) the dividend income earned by a recipient from each fund within the family of funds as required by Form **1099–DIV**. However, each fund and its earnings must be separately stated. The form must contain an instruction to the recipient that each fund's dividends and name, not the name of the mutual fund family, must be reported on the recipient's tax return. The form cannot contain an aggregate total of all funds. Moreover, a mutual fund family may furnish a single statement (as a single filer) for Form 1099–INT, DIV, and OID information. Each fund and its earnings must be separately stated. The form must contain an instruction to the recipient that each fund's earnings and name, not the name of the mutual fund family, is to be reported on the shareholder's tax return. The form cannot contain an aggregate total of all funds.

.02 COMPOSITE SUBSTITUTE STATEMENTS - **FORMS 1099–INT (except for interest reportable under section 6041), DIV (except for section 404(k) dividends)), OID, AND PATR ONLY.** - A composite form recipient statement is permitted for reportable payments of interest, dividends, original issue discount, and/or patronage dividends (**Forms 1099–INT, DIV, OID or PATR**) when one payer is reporting more than one of these payments during a calendar year to the same form recipient. Generally, do not include any other Form 1099 information (*e.g.*, 1098 or 1099–A) on a composite statement with the information required on the forms listed in the preceding sentence. **Exception:** A filer may include Form **1099–B** information on a composite form with the forms listed above. Although the composite form recipient statement may be on one sheet, the format of the composite form recipient statement must satisfy the following requirements in addition to the requirements listed in Section 7.01 above.

(1) All information pertaining to a particular type of payment must be located and blocked together on the form and must be separate from any information covering other types of payments included on the form. For example, if you are reporting interest and dividends, the **Form 1099–INT** information must be presented separately from the **Form 1099–DIV** information.

(2) The tax year, form number, and form name of the official IRS forms for which the composite form recipient statement substitutes must be prominently displayed together in one area at the beginning of each appropriate block of infor-

mation. **NOTE:** Please include your telephone number on statements to recipients you provide so that taxpayers can contact you directly with questions.

(3) Any information required by the official IRS forms that would otherwise be repeated in each information block is only required to be listed once in the first information block on the composite form. For example, there is no requirement to report the name of the filer in each information block. This rule does not apply to any money amounts, *e.g.*, Federal income tax withheld, or to any other information that applies to money amounts.

(4) A composite statement shall be considered an acceptable substitute only if the type of payment and the recipient's tax obligation with respect to the payment are no less clear than if each required statement were furnished separately on an official form.

.03 SUBSTITUTES STATEMENTS TO RECIPIENTS - FORMS 1098, 1099–A, 1099–B, 1099–C, 1099–G, 1099–MISC, 1099–R, 1099–S, 5498, W–2G, AND CERTAIN FORMS 1099–INT AND 1099–DIV. Statements to form recipients of payments reportable on **Forms 1098, 1099–A, 1099–B, 1099–C, 1099–G, 1099–MISC, 1099–R, 1099–S, 5498, 1099–DIV only for section 404(k) dividends reportable under section 6047, and 1099–INT only for interest of $600 or more made in the course of a trade or business reportable under section 6041** can be, but are not required to be, copies of the official forms. If you do not use the official form as the form recipient statement, the substitute recipient statement must meet the following requirements:

(1) The tax year, form number, and form name must be the same as the official form, and must be prominently displayed together in one area of the statement.

(2) The filer's and the form recipient's identifying information required on the official IRS form must be included.

(3) All applicable money amounts and information, including box numbers, required to be reported to the form recipient must be titled on the form recipient statement in substantially the same manner as those on the official IRS form. The caption "Federal income tax withheld" must be in bold face type on the form recipient statement. **Exception:** If you are reporting a payment as "Other income" in box 3, **Form 1099–MISC**, you may substitute appropriate explanatory language for the box title. For example, for payments of accrued wages and leave to a beneficiary of a deceased employee, you might change the title of box 3 to "Beneficiary payments" or something similar. **(You cannot make this change on Copy A.)**

(4) Appropriate instructions to the form recipient, similar to those on the official IRS form, must be provided to aid in the proper reporting of the items on the form recipient's income tax return. For payments reported on **Form 1099–B**, the requirement to include instructions that are substantially similar to those on the official IRS form may be satisfied by providing form recipients with a single set of instructions with respect to all Forms 1099–B statements required to be furnished in a calendar year. **NOTE:** If Federal income tax withheld is shown on **Form 1099–R or W–2G**, Copy B (to be attached to the tax return) and Copy C (for recipient's/winner's records) *must* be furnished to the recipient. If Federal income tax withheld is not shown on **Form 1099–R or W–2G**, only Copy C is required to be furnished. However, instructions similar to those contained on the back of the official Copy B and Copy C of **Form 1099–R** must be furnished to the recipient. For convenience, you may choose to provide both Copies B and C of Form 1099–R to the recipient.

(5) The quality of carbon used to produce statements to recipients must meet new standards as follows:

(a) all copies must be *CLEARLY LEGIBLE;*

(b) all copies must have the capability to be photocopied;

(c) fading must not be of such a degree as to preclude legibility and the ability to photocopy. In general, black chemical transfer inks are preferred; other colors are permitted only if the above standards are met. Hot wax and cold carbon spots are NOT permitted on any of the internal form plies. These spots are permitted on the back of a mailer top envelope ply.

(6) A mutual fund family may separately state on one document (*e.g.*, one piece of paper) the Form **1099–B** information for a recipient from each fund as required by Form **1099–B**. However, the gross proceeds, *etc.*, from each transaction within a fund must be separately stated. The form must contain an instruction to the recipient that each fund's amount and name, not the name of the mutual fund family, must be reported on the recipient's tax return. The form cannot contain an aggregate total of all funds.

(7) For **Form 1099–S**, Proceeds From Real Estate Transactions, you may use a Uniform Settlement Statement under the Real Estate Settlement Procedures Act of 1974 (RESPA), as the written statement to the transferor if it is conformed by including on the statement the legend described in (8)(e) below and by designating which information on the Uniform Settlement Statement is being reported to IRS on **Form 1099–S**.

(8) Form recipient statements must contain the following legends:

(a) **Form 1098**—(i) "The information in boxes 1, 2 and 3 is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if the IRS determines that an underpayment of tax results because you overstated a deduction for this mortgage interest or for these points or because you did not report this refund of interest on your return." (ii) "The amount shown may not be fully deductible by you on your Federal income tax return. Limitations based on the cost and value of the secured property may apply. In addition, you may only deduct an amount of mortgage interest to the extent it was incurred by you, actually paid by you, and not reimbursed by another person."

(b) **Form 1099–A and 1099–C**—"This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a

negligence penalty or other sanction may be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported."

(c) **1099–B, 1099–DIV, 1099–G, 1099–INT, 1099–MISC, and W–2G** (Copy C)— "This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported." Copy B of Form **W–2G** must state "This information is being furnished to the Internal Revenue Service. Report this income on your Federal tax return. If this form shows Federal income tax withheld in box 2, attach this copy to your return."

(d) **Form 1099–R, Copy B**—"Report this income on your Federal tax return. If this form shows Federal income tax withheld in box 4, attach this copy to your return. This information is being furnished to the Internal Revenue Service." **Form 1099–R, Copy C**—"This information is being furnished to the Internal Revenue Service."

(e) **Form 1099–S**—"This is important tax information and is being furnished to Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this item is required to be reported and the IRS determines that it has not been reported."

(f) **Form 5498**—"The information in boxes 1, 2, 3, 4 and 5 is being furnished to the Internal Revenue Service." **Note:** If the trustee does not issue **Form 5498** to a participant because no contributions were made to an IRA for the year, a year-end statement issued to the participant reporting the fair market value of the account must contain a similar legend designating which information is being furnished to IRS.

.04 COMPOSITE SUBSTITUTE STATEMENT - FORMS SPECIFIED IN 7.03 ONLY. - A composite form recipient statement for forms specified in 7.03 is permitted when one filer is reporting more than one of the related payments during a calendar year to the same form recipient. A composite statement is not allowable for a combination of forms listed in 7.01 and forms listed in 7.03 except that a filer may report **Form 1099–B** information on a composite form with the forms listed in 7.01 as described in 7.02. Although the composite form recipient statement may be on one sheet, the format of the composite form recipient statement must satisfy the requirements listed in items (1), (2), (3) and (4) of 7.02 above in addition to the requirements specified in 7.03. A composite statement of **Forms 1098 and 1099–INT** (for interest reportable under section 6049) IS NOT ALLOWABLE.

PART B - SPECIFICATIONS FOR SUBSTITUTE FORMS TO BE FILED WITH IRS (EXCEPT FORM W–2G)

SEC. 1. GENERAL

.01 The following specifications prescribe the format requirements for **Forms 1096** and Copy A of **Forms 1098, 1099, and 5498. (See Part C for Form W–2G specifications.)**

.02 The form identifying number (*e.g.*, 9191 for **Form 1099–DIV**) must be printed in non-reflective black carbon-based ink in print positions 15 through 19 using an OCR A font. The checkboxes located to the right of the form identifying number must be 10-point boxes, the void checkbox is in print position 25 and the corrected checkbox in position 33. These measurements are from the left edge of the paper, not including the perforated strip.

SEC. 2. SPECIFICATIONS FOR FORMS 1096 AND COPY A OF FORMS 1098, 1099 AND 5498

.01 The substitute form must be an exact replica of the official IRS reproduction proof with respect to layout and contents. **NOTE:** To determine the correct form measurements, see Exhibits A through O at the end of this publication. The specifications for Copy A of Forms 1098, 1099 and 5498 are provided in Exhibits A through N, and specifications for Form 1096 are provided in Exhibit O.] Hot wax and cold carbon spots are not permitted on any of the internal form plies. These spots are permitted on the back of a mailer top envelope ply. Use of chemical transfer paper for Copy A is acceptable. The Government Printing Office (GPO) symbol must be deleted.

.02 Color and quality of paper for Copy A (cut sheets and continuous pinfeed forms) as specified by JCP Code 0–25, dated November 29, 1978, must be white 100% bleached chemical wood, optical character recognition (OCR) bond produced in accordance with the following specifications:

NOTE: Reclaimed fiber in any percentage is permitted provided the requirements of this standard are met.

(1) Acidity: Ph value, average, not less than 4.5

(2) Basis Weight 17 x 22
500 cut sheets 18–20
Metric equivalent—g/m^2 75
A Tolerance of ±5 pct. shall be allowed.

(3) Stiffness: Average, each direction, not less than—milligrams 50

(4) Tearing strength: Average, each direction, not less than—grams 40

(5) Opacity: Average, not less than—percent 82

(6) Thickness: Average—inch—0.0038
Metric equivalent—mm—0.097
A tolerance of +0.0005 inch (0.0127 mm) shall be allowed.
Paper shall not vary more than 0.0004 inch (0.0102 mm) from one edge to the other.

(7) Porosity: Average, not less than—seconds 10

(8) Finish (smoothness): Average, each side—seconds 20–5
For information only, the Sheffield equivalent—units 170–100

(9) Dirt: Average, each side, not to exceed—parts per million 8

.03 All printing on Forms 1098, 1099, and 5498 must be in red OCR dropout ink, Flint J–6983 (formerly Sinclair-Valentine) or an exact match, except for the 4-digit form identifying numbers, which must be printed in non-reflective carbon-based black ink. The shaded areas of any substitute form should generally correspond to that present on the official form. Printing on Form 1096 above the statement: **"Please return this entire page to the Internal Revenue Service. Photocopies are NOT acceptable."** must be in red OCR dropout ink (except for the 4 digit form identifying number 6969). All printing including and below the statement described in the previous sentence may be in any shade or tone of black ink. Black ink should only appear on the lower portion of the reverse side of

Form 1096 where it would not bleed through and interfere with scanning. The instructions to filers are printed on the back of the copy designated for the Payer, Recipient for 1098, Lender for Form 1099–A, Creditor for 1099–C, Filer for 1099–S, or Trustee or Issuer for Form 5498 in any ink color or tone. Separation between fields must be 0.1 inch. Other than the Form 1099–R, the numbered captions are printed as a solid with no shaded background. Other printing requirements are discussed below.

OCR Specifications

The contractor must have or initiate a quality control program to assure OCR ink density. In addition, the contractor must have access to either a MacBeth PCM–II tester or a Kidder 082A tester to evaluate the ink at regular intervals throughout a shift.

Paper and Ink

Readings will be made when printed on approved 20 lb. white OCR bond with a reflectance of not less than 80%. Black ink used must not have a reflectance greater than 15%. These readings are based on requirements of the "REI Input 80 Model C1 & D" Optical Scanner using Flint Ink (formerly known as Sinclair - Valentine J–6983 red ink) or equal.

MacBeth PCM II Tester

The tested Print Contrast Signal (PCS) values when using the MacBeth PCM–II tester on the "C" scale must range from .01 minimum to .06 maximum.

Kidder 082A Tester

The tested Print Contrast Signal (PCS) values when using the Kidder 082A tester on the Infra Red (IR) scale must range from .12 minimum to .21 maximum. White calibration disc must be 100%, sensitivity must be set at one (1).

Alternative Tester

If an alternative tester is used it must be approved by the Government so that tested (PCS) values can be established with this equipment. Approval may be obtained by writing to the following address:

Commissioner of Internal Revenue
Attn: HR:F:P:P Room 1237
Tax Forms Procurement Analyst
1111 Constitution Avenue, NW
Washington, DC 20224

.04 Typography - Type must be substantially identical in size and shape with corresponding type on the official form. All rules are either ½-point or ¾-point. Rules must be identical to that on the official IRS form. NOTE: The form identifying number must be nonreflective carbon-based black ink in OCR A Font.

05 Dimension - Three Forms 1098, 1099, or 5498 (Copy A) are contained on a single page, except Form 1099–R which contains two documents per page, which is 8 inches wide (exclusive of any snap-stubs and/or pinfeed holes) by 11 inches deep. There is a .33 inch top margin from the top of the corrected box, and there is a .25 inch right margin. There is a 1/32" (0.0313") tolerance for the right margin. These measurements are constant for all **Forms 1098, 1099 and 5498**. The measurements will be shown only once in the exhibit section of this publication, on the **Form 1098**. Exceptions to these measurements will be shown on the remainder of exhibits. If the right and top margins are properly aligned, the left margin for all forms will be correct. All margins must be free of all printing. See Exhibits A through O in this publication for the correct form measurements.

.06 The depth of the individual trim size of each form on a page must be the same as that of the official form (3⅔ inches, except 5½ inches for Form 1099–R).

.07 The words "For Paperwork Reduction Act Notice and instructions for completing this form, see *Instructions for Forms 1099, 1098, 5498, and W–2G*" ***must*** be printed on Copy A (and Copy C). The words "For more information and the Paperwork Reduction Act Notice, see the Instructions for Forms 1099, 1098, 5498, and W–2G" ***must*** **be printed on Form 1096.**

.08 The OMB Number *must* be printed on Copies A and Form 1096 in the same location as that on the official form.

.09 *Privately printed continuous substitute forms (Copy A) must be perforated at each 11" (3 per page, or 2 per page for 1099–R) page depth. No perforations are allowed between the 3⅔" forms (or 5½" for Form 1099–R) on a single copy page of Copy A.*

.10 The words "*Do NOT Cut or Separate Forms on This Page*" must be printed in red dropout ink (as required by form specifications) between the three, or two for **Forms 1099–R**. NOTE: Perforations are required between all the other individual copies (Copies B and C, and Copies 1 and 2 for **Form 1099–R and Form 1099–MISC**, and Copy D for **Form 1099–R**) included in the set.

.11 Chemical transfer paper is permitted for Copy A only if the following standards are met:

(1) Only chemically backed paper is acceptable for Copy A.

(2) Carbon coated forms are not permitted. Front and back chemically treated paper cannot be processed properly by machine.

(3) Chemically transferred images must be black in color.

.12 Hot wax and cold carbon spots are NOT permitted for Copy A. Interleaved carbon should be black and must be of good quality to assure legibility of information on all copies to preclude smudging. All copies must be CLEARLY LEGIBLE. Fading must not be of such a degree as to preclude legibility.

.13 Printer's symbol — The GPO symbol must not be printed on substitute Copy A. Instead, the employer identification number (EIN) of the forms printer must be entered in the bottom margin on the face of each individual form of Copy A, or the bottom margin on the reverse side of each Form 1096. **THE FORM MUST NOT CONTAIN THE STATEMENT "IRS APPROVED."**

.14 A postal indicia may be used if it meets the following criteria: a) it is printed in the OCR ink color prescribed for the form; and b) no part of the indicia is within 1 print position of the scannable area.

PART C. SPECIFICATIONS FOR SUBSTITUTE FORMS W–2G TO BE FILED WITH IRS

SEC. 1. GENERAL

.01 The following specifications prescribe the format requirements for **Form W–2G**—COPY A ONLY.

.02 A filer may file a substitute **Form W–2G** with the IRS (hereinafter referred to as "substitute Copy A"). The substitute form (filed with the IRS) must be an exact replica of the official form with respect to layout and contents.

SEC. 2. SPECIFICATIONS FOR COPY A FOR FORMS W–2G

.01 Color and Quality of Paper—Paper for Copy A must be white chemi-

cal wood bond, or equivalent, 20 pound (basis 17 X 22–500), plus or minus 5 percent. The paper must consist substantially of bleached chemical wood pulp and be free from unbleached or ground wood pulp or recycled printed paper. It also must be suitably sized to accept ink without feathering.

.02 Color and Quality of Ink—All printing must be in a high quality non-gloss black ink. Bar codes should be free from picks and voids.

.03 Typography—The type must be substantially identical in size and shape with that on the official form. All rules on the document are either ½ point (.007 inch), 1 point (0.015 inch), or 3 point (0.045). Vertical rules must be parallel to the left edge of the document; horizontal rules, to the top edge.

.04 Dimensions—The official form is 8 inches wide x 3⅔ inches deep, exclusive of a ⅔ inch snap stub on the left side of the form. The snap feature is not required on substitutes. The top and right margins must be ¼ inch plus or minus .0313. If the top and right margins are properly aligned, the left margin for all forms will be correct. All margins must be free of any printing. If the substitute forms are in continuous or strip form, they must be burst and stripped to conform to the size specified for a single form.

(1) The width of a substitute Copy A must be 8 inches. The left margin must be free of all printing other than that shown on the official form.

(2) The depth of a substitute Copy A must be 3⅔ inches.

.05 Hot wax and cold carbon spots are not permitted on any of the internal form plies. These spots are permitted on the back of a mailer top envelope ply. Interleaved carbons, if used, should be black and of good quality to preclude smudging.

.06 Printer's Symbol—The Government Printing Office (GPO) symbol must not be printed on substitute Forms W–2G. Instead the employer identification number (EIN) of the forms printer must be printed in the bottom margin on the face of each individual form of Copy A of such substitute forms. The form must not contain the statement "IRS approved."

PART D. ADDITIONAL INSTRUCTIONS FOR FORMS 1098, 1099, 5498, AND W–2G

SEC. 1. OTHER COPIES

.01 Copies B, C, and in some cases D, 1, and 2, are included in the official assembly for the convenience of the filer. There is no legal requirement that privately printed substitute forms include all these copies, Copies B, and in some cases Copies C, will satisfy the requirement of the law and regulations concerning the statement of information that is required to be furnished to the form recipient. **NOTE:** If Federal income tax withheld is shown on **Form W–2G or 1099–R**, Copy B (to be attached to the tax return) and Copy C **must** be furnished to the recipient. Copy D (**Forms 1099–R and W–2G**) may be desired as a filer record copy. Only Copy A should be filed with the IRS.

.02 Arrangement of Assembly- The parts of the assembly must be arranged, from top to bottom, as follows: (a) All forms-Copy A "For Internal Revenue Service Center." (b) Form 1098- Copy B "For Payer"; Copy C "For Recipient." (c) Form 1099–A- Copy B "For Borrower"; Copy C "For Lender." (d) Form 1099–C Copy B "For Debtor"; Copy C "For Creditor"; (e) Forms 1099–B, 1099–DIV, 1099–G, 1099–INT, 1099–OID, and 1099–PATR- Copy B "For Recipient"; Copy C "For Payer." (f) Form 1099–MISC- Copy 1 "For State Tax Department"; Copy B "For Recipient"; Copy 2 "To be filed with recipient's state income tax return, when required."; Copy C "For Payer." (g) Form 1099–R- Copy 1 "For State, City, or Local Tax Department"; Copy B "Report this income on your Federal tax return. If this form shows Federal income tax withheld in box 4, attach this copy to your return."; Copy C "For Recipient's Records"; Copy 2 "File this copy with your state, city, or local income tax return, when required."; Copy D "For Payer." (h) Form 1099–S- Copy B "For Transferor"; Copy C "For Filer." (i) Form 5498– Copy B "For Participant"; Copy C "For Trustee or Issuer." (j) Form W–2G- Copy 1 "For State Tax Department"; Copy B "Report this income on your Federal tax return. If this form shows Federal income tax withheld in box 2, attach this copy to your return." Copy C "For Winner's Records"; Copy 2 "Attach this copy to your state income tax return, if required."; Copy D "For Payer."

.03 Perforations are required between forms on all copies except Copy A to enable the separation of individual forms. Copy A of Form W–2G may be perforated.

SEC. 2. OMB REQUIREMENTS

.01 Office of Management and Budget (OMB) Requirements for Substitute Forms—Public Law 96–511 requires that: (1) OMB approve Internal Revenue Service tax forms, (2) each form show (in the upper right corner) the OMB approval number, and (3) the form (or its instructions) state why IRS is collecting the information, how it will be used and whether it must be given to IRS. The official IRS forms or instructions contain this information and any substitute must contain it also.

.02 The OMB requirements for substitute IRS forms are:

(1) All substitute forms, **including substitute statements to recipients,** must show the OMB number as it appears on the official IRS form;

(2) For Copy A, the OMB number must appear exactly as shown on the official IRS form;

(3) For any copy other than Copy A, the OMB number must use one of the following formats:

(a) OMB No. XXXX–XXXX (preferred) or;

(b) OMB # XXXX–XXXX.

(4) All substitute forms (Copy A only) must state "For Paperwork Reduction Act Notice, see Instructions for Forms 1099, 1098, 5498, and W–2G."

.03 The official OMB numbers may be obtained from reproduction proofs or official IRS printed forms.

SEC 3. REPRODUCIBLE COPIES

.01 As of April 30, 1996, IRS discontinued taking orders for reproducible and information copies of federal tax materials. However, there will be several new options available to obtain federal tax material in the future. The new options are:

(1) **Internal Revenue Information Services (IRIS)**—IRIS is housed within FedWorld, known also as the Electronic Marketplace of U.S. Government Information. IRIS at FedWorld can be reached by:

(a) Modem (dial up) at (703) 321–8020,

(b) by Internet - Telnet to iris.irs.ustreas.gov

(c) by File Transfer Protocol (FTP) connect to - ftp.irs.ustreas.gov

(d) or by World Wide Web http://www.irs.ustreas.gov

(2) **IRS Federal Tax Forms CD-ROM**—The IRS also offers an alternative to downloading electronic files from IRIS and provides prior-year access to tax forms and instructions through it's Federal Tax Forms CD-ROM. First offered during 1994, the CD will again be available for the upcoming filing season. For system requirements and to order the 1996 Federal Tax Forms CD-ROM contact the Government Printing Office's (GPO's) Superintendent of Documents either:

(a) by telephone (202) 521-1800; or

(b) electronically through GPO's Federal Bulletin Board on (202) 512-1387.

(3) **Government Printing Office Superintendent of Documents Bookstores**—The Government Printing Office Superintendent of Documents Bookstores also sell individual copies of tax forms, instructions and publications. Call (202) 521-1800 to find the bookstore nearest to you.

.02 Forms 1096, 1098, 1099 Series, and 5498 are provided electronically on the IRS home page, IRIS bulletin board system, and on the Federal Tax Forms CD-ROM, but **CANNOT** be used for filing with IRS when printed from a conventional laser printer. These forms contain drop-out ink requirements as described in Part B, Section 2. of this publication.

SEC. 4. EFFECT ON OTHER REVENUE PROCEDURES

Revenue Procedure 95-30, 1995-1 C.B. 27 I.R.B. 9, covering paper returns and statements for payments made during the 1995 calendar year is hereby superseded.

Exhibit A

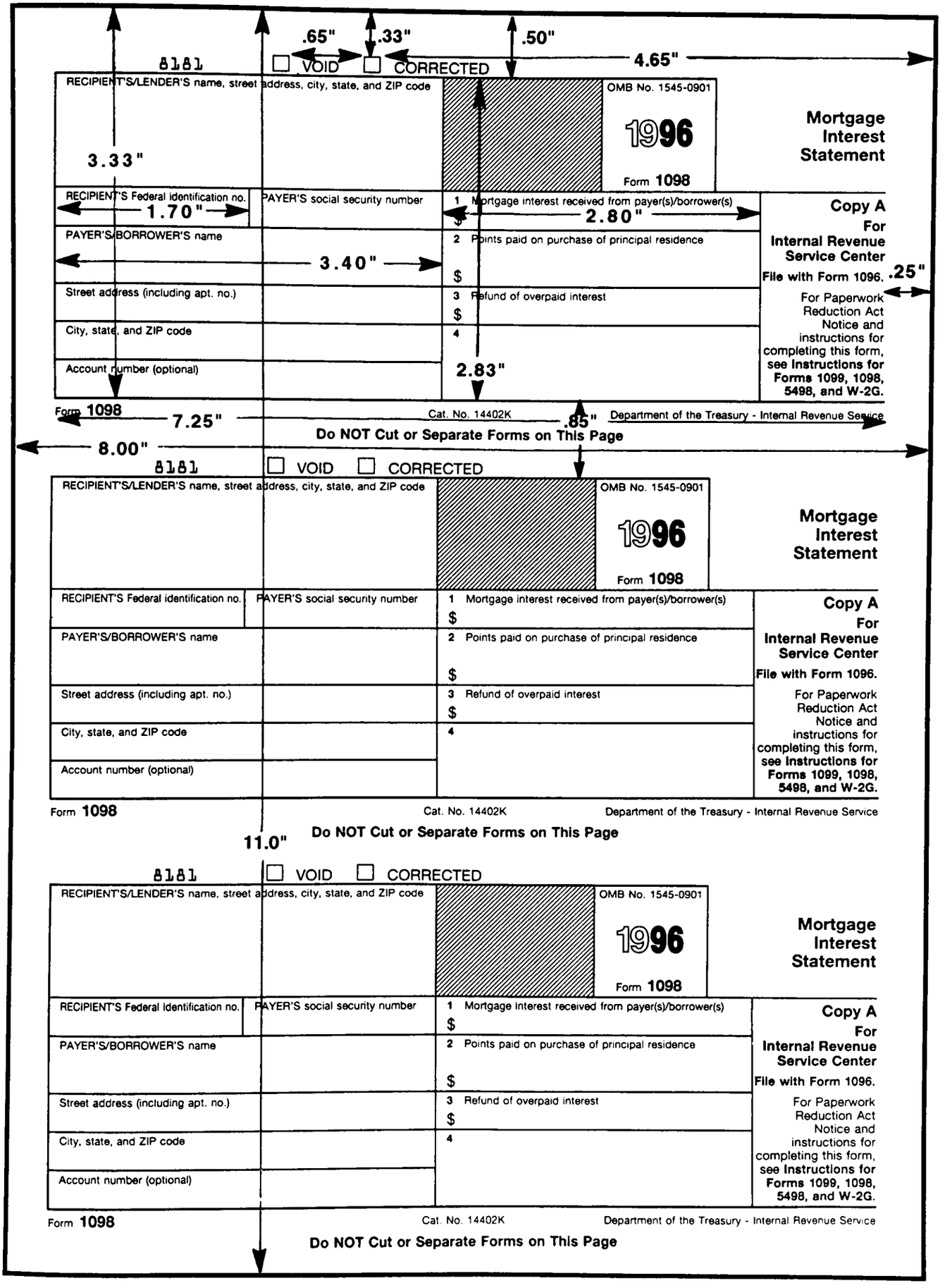
.65"
.33"
.50"
4.65"
8181
VOID
CORRECTED
RECIPIENT'S/LENDER'S name, street address, city, state, and ZIP code
OMB No. 1545-0901
1996
Form 1098
Mortgage Interest Statement
3.33"
RECIPIENT'S Federal identification no.
1.70"
PAYER'S social security number
1 Mortgage interest received from payer(s)/borrower(s)
$
2.80"
PAYER'S/BORROWER'S name
2 Points paid on purchase of principal residence
3.40"
$
Street address (including apt. no.)
3 Refund of overpaid interest
$
City, state, and ZIP code
4
Account number (optional)
2.83"
Copy A For Internal Revenue Service Center
File with Form 1096.
.25"
For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Form 1098
7.25"
Cat. No. 14402K
.85"
Department of the Treasury - Internal Revenue Service
Do NOT Cut or Separate Forms on This Page
8.00"
8181
VOID
CORRECTED
RECIPIENT'S/LENDER'S name, street address, city, state, and ZIP code
OMB No. 1545-0901
1996
Form 1098
Mortgage Interest Statement
RECIPIENT'S Federal identification no.
PAYER'S social security number
1 Mortgage interest received from payer(s)/borrower(s)
$
PAYER'S/BORROWER'S name
2 Points paid on purchase of principal residence
$
Street address (including apt. no.)
3 Refund of overpaid interest
$
City, state, and ZIP code
4
Account number (optional)
Copy A For Internal Revenue Service Center
File with Form 1096.
For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Form 1098
Cat. No. 14402K
Department of the Treasury - Internal Revenue Service
11.0"
Do NOT Cut or Separate Forms on This Page
8181
VOID
CORRECTED
RECIPIENT'S/LENDER'S name, street address, city, state, and ZIP code
OMB No. 1545-0901
1996
Form 1098
Mortgage Interest Statement
RECIPIENT'S Federal identification no.
PAYER'S social security number
1 Mortgage interest received from payer(s)/borrower(s)
$
PAYER'S/BORROWER'S name
2 Points paid on purchase of principal residence
$
Street address (including apt. no.)
3 Refund of overpaid interest
$
City, state, and ZIP code
4
Account number (optional)
Copy A For Internal Revenue Service Center
File with Form 1096.
For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Form 1098
Cat. No. 14402K
Department of the Treasury - Internal Revenue Service
Do NOT Cut or Separate Forms on This Page

Exhibit B

8080 ☐ VOID ☐ CORRECTED

LENDER'S name, street address, city, state, and ZIP code		OMB No. 1545-0877 1996 Form 1099-A **Acquisition or Abandonment of Secured Property**
LENDER'S Federal identification number / BORROWER'S identification number	1 Date of lender's acquisition or knowledge of abandonment (MMDDYY)	2 Balance of principal outstanding $
BORROWER'S name	3	4 Fair market value of property $
Street address (including apt. no.)	5 Was borrower personally liable for repayment of the debt? ☐ Yes ☐ No	
City, state, and ZIP code	6 Description of property	
Account number (optional)		

Copy A For Internal Revenue Service Center
File with Form 1096.

For Paperwork Reduction Act Notice and instructions for completing this form, see **Instructions for Forms 1099, 1098, 5498, and W-2G.**

1.4" ← 1.4" → 1.8"

Form **1099-A** Cat. No. 14412G Department of the Treasury - Internal Revenue Service

Do NOT Cut or Separate Forms on This Page

8080 ☐ VOID ☐ CORRECTED

LENDER'S name, street address, city, state, and ZIP code | OMB No. 1545-0877 1996 Form 1099-A Acquisition or Abandonment of Secured Property

LENDER'S Federal identification number | BORROWER'S identification number | 1 Date of lender's acquisition or knowledge of abandonment (MMDDYY) | 2 Balance of principal outstanding $

BORROWER'S name | 3 | 4 Fair market value of property $

Street address (including apt. no.) | 5 Was borrower personally liable for repayment of the debt? ☐ Yes ☐ No

City, state, and ZIP code | 6 Description of property

Account number (optional)

Copy A For Internal Revenue Service Center
File with Form 1096.

For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.

Form 1099-A Cat. No. 14412G Department of the Treasury - Internal Revenue Service

Do NOT Cut or Separate Forms on This Page

8080 ☐ VOID ☐ CORRECTED

LENDER'S name, street address, city, state, and ZIP code | OMB No. 1545-0877 1996 Form 1099-A Acquisition or Abandonment of Secured Property

LENDER'S Federal identification number | BORROWER'S identification number | 1 Date of lender's acquisition or knowledge of abandonment (MMDDYY) | 2 Balance of principal outstanding $

BORROWER'S name | 3 | 4 Fair market value of property $

Street address (including apt. no.) | 5 Was borrower personally liable for repayment of the debt? ☐ Yes ☐ No

City, state, and ZIP code | 6 Description of property

Account number (optional)

Copy A For Internal Revenue Service Center
File with Form 1096.

For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.

Form 1099-A Cat. No. 14412G Department of the Treasury - Internal Revenue Service

Do NOT Cut or Separate Forms on This Page

Exhibit C

7979 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code	1a Date of sale (MMDDYY) 1b CUSIP No.	OMB No. 1545-0715 1996 Form 1099-B	**Proceeds From Broker and Barter Exchange Transactions**
	2 Stocks, bonds, etc. $	Reported to IRS ☐ Gross proceeds ☐ Gross proceeds less commissions and option premiums — 1.9"	
PAYER'S Federal identification number / RECIPIENT'S identification number	3 Bartering	4 Federal income tax withheld $ 3.9"	**Copy A For Internal Revenue Service Center**
RECIPIENT'S name	5 Description		**File with Form 1096.**
	Regulated Futures Contracts		
Street address (including apt. no.)	6 Profit or (loss) realized in 1995 $ 1.4"	7 Unrealized profit or (loss) on open contracts—12/31/94 $ 1.4"	For Paperwork Reduction Act Notice and instructions for completing this form, see **Instructions for Forms 1099, 1098, 5498, and W-2G.**
City, state, and ZIP code	8 Unrealized profit or (loss) on open contracts—12/31/95 $	9 Aggregate profit or (loss) $ 4.1"	
Account number (optional) 2.8" / 2nd TIN Not. ☐ .60"			

Form **1099-B** Cat. No. 14411V Department of the Treasury - Internal Revenue Service

Do NOT Cut or Separate Forms on This Page

7979 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code	1a Date of sale (MMDDYY) 1b CUSIP No.	OMB No. 1545-0715 1996 Form 1099-B	**Proceeds From Broker and Barter Exchange Transactions**
	2 Stocks, bonds, etc. $	Reported to IRS ☐ Gross proceeds ☐ Gross proceeds less commissions and option premiums	
PAYER'S Federal identification number / RECIPIENT'S identification number	3 Bartering $	4 Federal income tax withheld $	**Copy A For Internal Revenue Service Center**
RECIPIENT'S name	5 Description		**File with Form 1096.**
	Regulated Futures Contracts		
Street address (including apt. no.)	6 Profit or (loss) realized in 1995 $	7 Unrealized profit or (loss) on open contracts—12/31/94 $	For Paperwork Reduction Act Notice and instructions for completing this form, see **Instructions for Forms 1099, 1098, 5498, and W-2G.**
City, state, and ZIP code	8 Unrealized profit or (loss) on open contracts—12/31/95 $	9 Aggregate profit or (loss) $	
Account number (optional) / 2nd TIN Not. ☐			

Form **1099-B** Cat. No. 14411V Department of the Treasury - Internal Revenue Service

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7979 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code	1a Date of sale (MMDDYY) 1b CUSIP No.	OMB No. 1545-0715 1996 Form 1099-B	**Proceeds From Broker and Barter Exchange Transactions**
	2 Stocks, bonds, etc. $	Reported to IRS ☐ Gross proceeds ☐ Gross proceeds less commissions and option premiums	
PAYER'S Federal identification number / RECIPIENT'S identification number	3 Bartering $	4 Federal income tax withheld $	**Copy A For Internal Revenue Service Center**
RECIPIENT'S name	5 Description		**File with Form 1096.**
	Regulated Futures Contracts		
Street address (including apt. no.)	6 Profit or (loss) realized in 1995 $	7 Unrealized profit or (loss) on open contracts—12/31/94 $	For Paperwork Reduction Act Notice and instructions for completing this form, see **Instructions for Forms 1099, 1098, 5498, and W-2G.**
City, state, and ZIP code	8 Unrealized profit or (loss) on open contracts—12/31/95 $	9 Aggregate profit or (loss) $	
Account number (optional) / 2nd TIN Not. ☐			

Form **1099-B** Cat. No. 14411V Department of the Treasury - Internal Revenue Service

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Exhibit D

8585 ☐ VOID ☐ CORRECTED

CREDITOR'S name, street address, city, state, and ZIP code		OMB No. 1545-1424 **1996** Form **1099-C**	**Cancellation of Debt**
CREDITOR'S Federal identification number / DEBTOR'S identification number	1 Date canceled ←1.40"→	2 Amount of debt canceled ←1.40"→	**Copy A For Internal Revenue Service Center File with Form 1096.** For Paperwork Reduction Act ←1.40"→ Notice and instructions for completing this form, see **Instructions for Forms 1099, 1098, 5498, and W-2G.**
DEBTOR'S name ←3.40"→	3 Interest included in box 2 $	4 Penalties, fines, admin. costs included in box 2 $	
Street address (including apt. no.)	5 Debt description		
City, state, and ZIP code			
Account number (optional)	6 Check for bankruptcy ☐	7 Fair market value of property $	

Form **1099-C** Cat. No. 26280W Department of the Treasury - Internal Revenue Service

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8585 ☐ VOID ☐ CORRECTED

CREDITOR'S name, street address, city, state, and ZIP code		OMB No. 1545-1424 **1996** Form **1099-C**	**Cancellation of Debt**
CREDITOR'S Federal Identification number / DEBTOR'S identification number	1 Date canceled	2 Amount of debt canceled $	**Copy A For Internal Revenue Service Center File with Form 1096.** For Paperwork Reduction Act Notice and instructions for completing this form, see **Instructions for Forms 1099, 1098, 5498, and W-2G.**
DEBTOR'S name	3 Interest included in box 2 $	4 Penalties, fines, admin. costs included in box 2 $	
Street address (including apt. no.)	5 Debt description		
City, state, and ZIP code			
Account number (optional)	6 Check for bankruptcy ☐	7 Fair market value of property $	

Form **1099-C** Cat. No. 26280W Department of the Treasury - Internal Revenue Service

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8585 ☐ VOID ☐ CORRECTED

CREDITOR'S name, street address, city, state, and ZIP code		OMB No. 1545-1424 **1996** Form **1099-C**	**Cancellation of Debt**
CREDITOR'S Federal identification number / DEBTOR'S identification number	1 Date canceled	2 Amount of debt canceled $	**Copy A For Internal Revenue Service Center File with Form 1096.** For Paperwork Reduction Act Notice and instructions for completing this form, see **Instructions for Forms 1099, 1098, 5498, and W-2G.**
DEBTOR'S name	3 Interest included in box 2 $	4 Penalties, fines, admin. costs included in box 2 $	
Street address (including apt. no.)	5 Debt description		
City, state, and ZIP code			
Account number (optional)	6 Check for bankruptcy ☐	7 Fair market value of property $	

Form **1099-C** Cat. No. 26280W Department of the Treasury - Internal Revenue Service

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Exhibit E

9191 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code		1a Gross dividends and other distributions on stock (Total of 1b, 1c, 1d, and 1e) $	OMB No. 1545-0110 **1996** Form **1099-DIV**	**Dividends and Distributions**
		1b Ordinary dividends $ ◄—1.4"—►		
PAYER'S Federal identification number	RECIPIENT'S identification number	1c Capital gain distributions $	2 Federal income tax withheld $	**Copy A For Internal Revenue Service Center** **File with Form 1096.** For Paperwork Reduction Act Notice and instructions for completing this form, see **Instructions for Forms 1099, 1098, 5498, and W-2G.**
RECIPIENT'S name		1d Nontaxable distributions $	3 Foreign tax paid $	
Street address (including apt. no.)		1e Investment expenses $	4 Foreign country or U.S. possession	
City, state, and ZIP code		**Liquidation Distributions**		
Account number (optional) ◄—2.8"—►	2nd TIN Not. ☐	5 Cash $	6 Noncash (Fair market value) $ ◄—4.1"—►	

Form **1099-DIV** ◄—.60"—► Cat. No. 14415N Department of the Treasury - Internal Revenue Service

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9191 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code		1a Gross dividends and other distributions on stock (Total of 1b, 1c, 1d, and 1e) $	OMB No. 1545-0110 **1996** Form **1099-DIV**	**Dividends and Distributions**
		1b Ordinary dividends $		
PAYER'S Federal identification number	RECIPIENT'S identification number	1c Capital gain distributions $	2 Federal income tax withheld $	**Copy A For Internal Revenue Service Center** **File with Form 1096.** For Paperwork Reduction Act Notice and instructions for completing this form, see **Instructions for Forms 1099, 1098, 5498, and W-2G.**
RECIPIENT'S name		1d Nontaxable distributions $	3 Foreign tax paid $	
Street address (including apt. no.)		1e Investment expenses $	4 Foreign country or U.S. possession	
City, state, and ZIP code		**Liquidation Distributions**		
Account number (optional)	2nd TIN Not. ☐	5 Cash $	6 Noncash (Fair market value) $	

Form **1099-DIV** Cat. No. 14415N Department of the Treasury - Internal Revenue Service

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9191 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code		1a Gross dividends and other distributions on stock (Total of 1b, 1c, 1d, and 1e) $	OMB No. 1545-0110 **1996** Form **1099-DIV**	**Dividends and Distributions**
		1b Ordinary dividends $		
PAYER'S Federal identification number	RECIPIENT'S identification number	1c Capital gain distributions $	2 Federal income tax withheld $	**Copy A For Internal Revenue Service Center** **File with Form 1096.** For Paperwork Reduction Act Notice and instructions for completing this form, see **Instructions for Forms 1099, 1098, 5498, and W-2G.**
RECIPIENT'S name		1d Nontaxable distributions $	3 Foreign tax paid $	
Street address (including apt. no.)		1e Investment expenses $	4 Foreign country or U.S. possession	
City, state, and ZIP code		**Liquidation Distributions**		
Account number (optional)	2nd TIN Not. ☐	5 Cash $	6 Noncash (Fair market value) $	

Form **1099-DIV** Cat. No. 14415N Department of the Treasury - Internal Revenue Service

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Exhibit F

8686 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code	1 Unemployment compensation ← 1.4" → $	OMB No. 1545-0120 1996 Form 1099-G	Certain Government Payments
	2 State or local income tax refunds, credits, or offsets $		
PAYER'S Federal identification number / RECIPIENT'S identification number	3 Box 2 amount is for tax year	4 Federal income tax withheld $	Copy A For Internal Revenue Service Center File with Form 1096.
RECIPIENT'S name	5	6 Taxable grants $	For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Street address (including apt. no.)	7 Agriculture payments $	8 The amount in box 2 applies to income from a trade or business ▶ ☐	◀1.15
City, state, and ZIP code			
Account number (optional)			

Form **1099-G** Cat. No. 14438M Department of the Treasury - Internal Revenue Service

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8686 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code	1 Unemployment compensation $	OMB No. 1545-0120 1996 Form 1099-G	Certain Government Payments
	2 State or local income tax refunds, credits, or offsets $		
PAYER'S Federal identification number / RECIPIENT'S identification number	3 Box 2 amount is for tax year	4 Federal income tax withheld $	Copy A For Internal Revenue Service Center File with Form 1096.
RECIPIENT'S name	5	6 Taxable grants $	For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Street address (including apt. no.)	7 Agriculture payments $	8 The amount in box 2 applies to income from a trade or business ▶ ☐	
City, state, and ZIP code			
Account number (optional)			

Form **1099-G** Cat. No. 14438M Department of the Treasury - Internal Revenue Service

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8686 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code	1 Unemployment compensation $	OMB No. 1545-0120 1996 Form 1099-G	Certain Government Payments
	2 State or local income tax refunds, credits, or offsets $		
PAYER'S Federal identification number / RECIPIENT'S identification number	3 Box 2 amount is for tax year	4 Federal income tax withheld $	Copy A For Internal Revenue Service Center File with Form 1096.
RECIPIENT'S name	5	6 Taxable grants $	For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Street address (including apt. no.)	7 Agriculture payments $	8 The amount in box 2 applies to income from a trade or business ▶ ☐	
City, state, and ZIP code			
Account number (optional)			

Form **1099-G** Cat. No. 14438M Department of the Treasury - Internal Revenue Service

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Exhibit G

9292 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code	Payer's RTN (optional)	OMB No. 1545-0112 **1996** Form **1099-INT**	**Interest Income**
PAYER'S Federal identification number / RECIPIENT'S identification number	1 Interest income not included in box 3 $		**Copy A For Internal Revenue Service Center** **File with Form 1096.** For Paperwork Reduction Act Notice and instructions for completing this form, see **Instructions for Forms 1099, 1098, 5498, and W-2G.**
RECIPIENT'S name	2 Early withdrawal penalty $	3 Interest on U.S. Savings Bonds and Treas. obligations $	
Street address (including apt. no.)	4 Federal income tax withheld $		
City, state, and ZIP code	5 Foreign tax paid	6 Foreign country or U.S. possession	
Account number (optional) / 2nd TIN Not. ☐	$		

1.4" 2.8" 4.1" .60"

Form **1099-INT** Cat. No. 14410K Department of the Treasury - Internal Revenue Service

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9292 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code	Payer's RTN (optional)	OMB No. 1545-0112 **1996** Form **1099-INT**	**Interest Income**
PAYER'S Federal identification number / RECIPIENT'S identification number	1 Interest income not included in box 3 $		**Copy A For Internal Revenue Service Center** **File with Form 1096.** For Paperwork Reduction Act Notice and instructions for completing this form, see **Instructions for Forms 1099, 1098, 5498, and W-2G.**
RECIPIENT'S name	2 Early withdrawal penalty $	3 Interest on U.S. Savings Bonds and Treas. obligations $	
Street address (including apt. no.)	4 Federal income tax withheld $		
City, state, and ZIP code	5 Foreign tax paid	6 Foreign country or U.S. possession	
Account number (optional) / 2nd TIN Not. ☐	$		

Form **1099-INT** Cat. No. 14410K Department of the Treasury - Internal Revenue Service

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9292 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code	Payer's RTN (optional)	OMB No. 1545-0112 **1996** Form **1099-INT**	**Interest Income**
PAYER'S Federal identification number / RECIPIENT'S identification number	1 Interest income not included in box 3 $		**Copy A For Internal Revenue Service Center** **File with Form 1096.** For Paperwork Reduction Act Notice and instructions for completing this form, see **Instructions for Forms 1099, 1098, 5498, and W-2G.**
RECIPIENT'S name	2 Early withdrawal penalty $	3 Interest on U.S. Savings Bonds and Treas. obligations $	
Street address (including apt. no.)	4 Federal income tax withheld $		
City, state, and ZIP code	5 Foreign tax paid	6 Foreign country or U.S. possession	
Account number (optional) / 2nd TIN Not. ☐	$		

Form **1099-INT** Cat. No. 14410K Department of the Treasury - Internal Revenue Service

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Exhibit H

9595 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code	1 Rents $ (1.4")	OMB No. 1545-0115	Miscellaneous Income
	2 Royalties $	1996	
	3 Other income $	Form 1099-MISC	
PAYER'S Federal identification number / RECIPIENT'S identification number	4 Federal income tax withheld $	5 Fishing boat proceeds $	Copy A For Internal Revenue Service Center
RECIPIENT'S name	6 Medical and health care payments $	7 Nonemployee compensation $	File with Form 1096.
Street address (including apt. no.)	8 Substitute payments in lieu of dividends or interest $	9 Payer made direct sales of $5,000 or more of consumer products to a buyer (recipient) for resale ► ☐ (1.15")	For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
City, state, and ZIP code	10 Crop insurance proceeds $	11 State income tax withheld $	
Account number (optional) (2.8") / 2nd TIN Not. ☐ (.60")	12 State/Payer's state number	(4.1")	

Form 1099-MISC Cat. No. 14425J Department of the Treasury - Internal Revenue Service

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9595 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code	1 Rents $	OMB No. 1545-0115	Miscellaneous Income
	2 Royalties $	1996	
	3 Other income $	Form 1099-MISC	
PAYER'S Federal identification number / RECIPIENT'S identification number	4 Federal income tax withheld $	5 Fishing boat proceeds $	Copy A For Internal Revenue Service Center
RECIPIENT'S name	6 Medical and health care payments $	7 Nonemployee compensation $	File with Form 1096.
Street address (including apt. no.)	8 Substitute payments in lieu of dividends or interest $	9 Payer made direct sales of $5,000 or more of consumer products to a buyer (recipient) for resale ► ☐	For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
City, state, and ZIP code	10 Crop insurance proceeds $	11 State income tax withheld $	
Account number (optional) / 2nd TIN Not. ☐	12 State/Payer's state number		

Form 1099-MISC Cat. No. 14425J Department of the Treasury - Internal Revenue Service

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9595 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code	1 Rents $	OMB No. 1545-0115	Miscellaneous Income
	2 Royalties $	1996	
	3 Other income $	Form 1099-MISC	
PAYER'S Federal identification number / RECIPIENT'S identification number	4 Federal income tax withheld $	5 Fishing boat proceeds $	Copy A For Internal Revenue Service Center
RECIPIENT'S name	6 Medical and health care payments $	7 Nonemployee compensation $	File with Form 1096.
Street address (including apt. no.)	8 Substitute payments in lieu of dividends or interest $	9 Payer made direct sales of $5,000 or more of consumer products to a buyer (recipient) for resale ► ☐	For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
City, state, and ZIP code	10 Crop insurance proceeds $	11 State income tax withheld $	
Account number (optional) / 2nd TIN Not. ☐	12 State/Payer's state number		

Form 1099-MISC Cat. No. 14425J Department of the Treasury - Internal Revenue Service

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Exhibit I

9696 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code	1 Original issue discount for 1995 $ ← 1.4" →	OMB No. 1545-0117 1996 Form 1099-OID	Original Issue Discount
	2 Other periodic interest $		
PAYER'S Federal identification number / RECIPIENT'S identification number	3 Early withdrawal penalty $	4 Federal income tax withheld $	Copy A For Internal Revenue Service Center File with Form 1096. For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
RECIPIENT'S name	5 Description		
Street address (including apt. no.)			
City, state, and ZIP code			
Account number (optional) ← 2.8" → / 2nd TIN Not. ☐	← 4.1" →		

Form 1099-OID Cat. No. 14421R Department of the Treasury - Internal Revenue Service

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9696 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code	1 Original issue discount for 1995 $	OMB No. 1545-0117 1996 Form 1099-OID	Original Issue Discount
	2 Other periodic interest $		
PAYER'S Federal identification number / RECIPIENT'S identification number	3 Early withdrawal penalty $	4 Federal income tax withheld $	Copy A For Internal Revenue Service Center File with Form 1096. For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
RECIPIENT'S name	5 Description		
Street address (including apt. no.)			
City, state, and ZIP code			
Account number (optional) / 2nd TIN Not. ☐			

Form 1099-OID Cat. No. 14421R Department of the Treasury - Internal Revenue Service

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9696 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code	1 Original issue discount for 1995 $	OMB No. 1545-0117 1996 Form 1099-OID	Original Issue Discount
	2 Other periodic interest $		
PAYER'S Federal identification number / RECIPIENT'S identification number	3 Early withdrawal penalty $	4 Federal income tax withheld $	Copy A For Internal Revenue Service Center File with Form 1096. For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
RECIPIENT'S name	5 Description		
Street address (including apt. no.)			
City, state, and ZIP code			
Account number (optional) / 2nd TIN Not. ☐			

Form 1099-OID Cat. No. 14421R Department of the Treasury - Internal Revenue Service

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Exhibit J

9797 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code	1 Patronage dividends $ ← 1.4" →	OMB No. 1545-0118	Taxable Distributions Received From Cooperatives
	2 Nonpatronage distributions $	1996	
	3 Per-unit retain allocations $	Form 1099-PATR	
PAYER'S Federal identification number / RECIPIENT'S identification number	4 Federal income tax withheld $		Copy A For Internal Revenue Service Center File with Form 1096.
RECIPIENT'S name	5 Redemption of nonqualified notices and retain allocations $		For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Street address (including apt. no.)	6 $	7 Energy investment credit $	
City, state, and ZIP code	8 Jobs credit $	9 Patron's AMT adjustment $	
Account number (optional) ← 2.8" →	2nd TIN Not. ☐	← 4.1" →	

Form 1099-PATR Cat. No. 14435F Department of the Treasury - Internal Revenue Service

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9797 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code	1 Patronage dividends $	OMB No. 1545-0118	Taxable Distributions Received From Cooperatives
	2 Nonpatronage distributions $	1996	
	3 Per-unit retain allocations $	Form 1099-PATR	
PAYER'S Federal identification number / RECIPIENT'S identification number	4 Federal income tax withheld $		Copy A For Internal Revenue Service Center File with Form 1096.
RECIPIENT'S name	5 Redemption of nonqualified notices and retain allocations $		For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Street address (including apt. no.)	6 $	7 Energy investment credit $	
City, state, and ZIP code	8 Jobs credit $	9 Patron's AMT adjustment $	
Account number (optional)	2nd TIN Not. ☐		

Form 1099-PATR Cat. No. 14435F Department of the Treasury - Internal Revenue Service

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9797 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code	1 Patronage dividends $	OMB No. 1545-0118	Taxable Distributions Received From Cooperatives
	2 Nonpatronage distributions $	1996	
	3 Per-unit retain allocations $	Form 1099-PATR	
PAYER'S Federal identification number / RECIPIENT'S identification number	4 Federal income tax withheld $		Copy A For Internal Revenue Service Center File with Form 1096.
RECIPIENT'S name	5 Redemption of nonqualified notices and retain allocations $		For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Street address (including apt. no.)	6 $	7 Energy investment credit $	
City, state, and ZIP code	8 Jobs credit $	9 Patron's AMT adjustment $	
Account number (optional)	2nd TIN Not. ☐		

Form 1099-PATR Cat. No. 14435F Department of the Treasury - Internal Revenue Service

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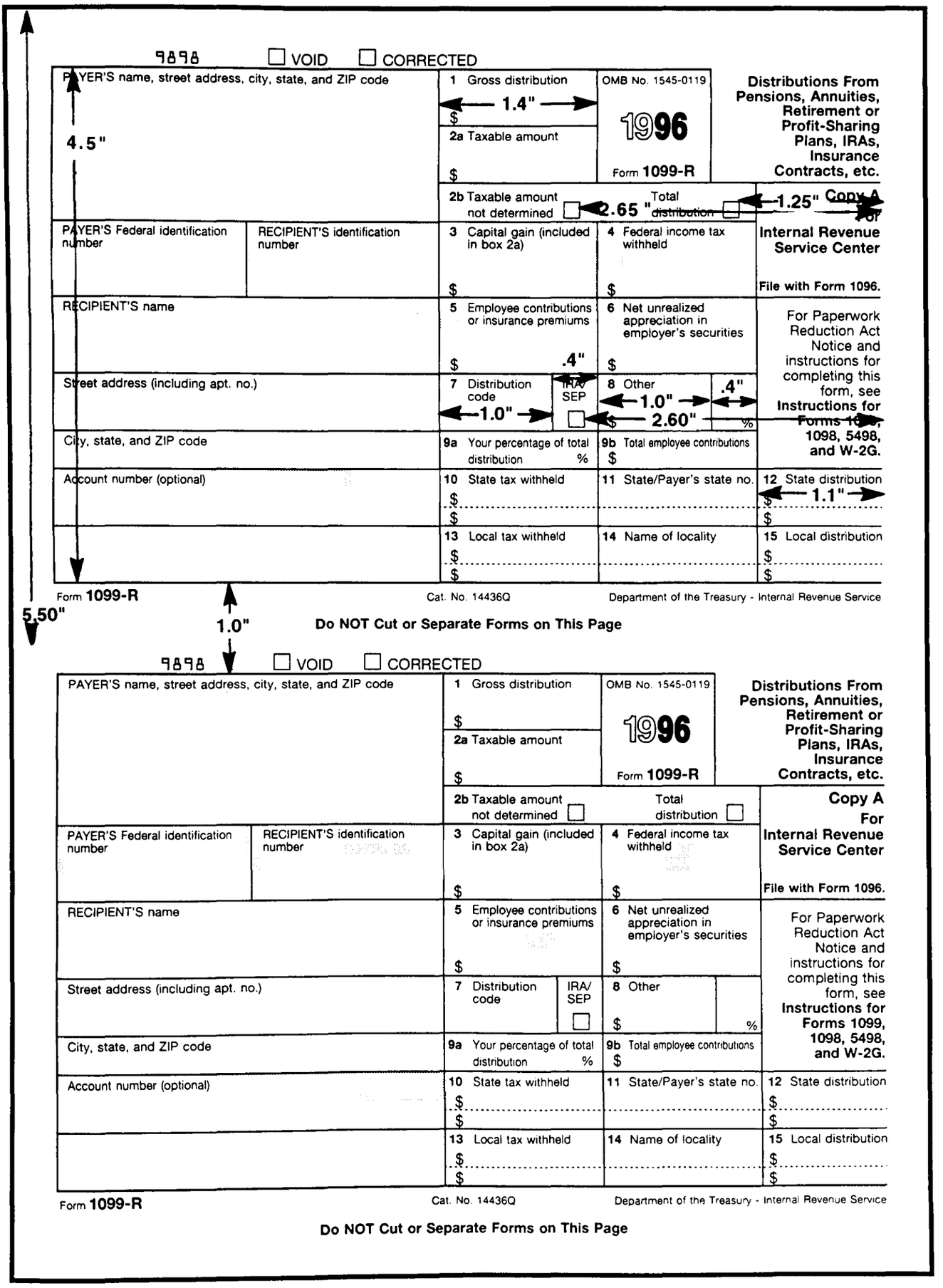
Exhibit K


9898 ☐ VOID ☐ CORRECTED
PAYER'S name, street address, city, state, and ZIP code
1 Gross distribution
$
1.4"
OMB No. 1545-0119
1996
Form 1099-R
Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
4.5"
2a Taxable amount
$
2b Taxable amount not determined ☐ Total distribution ☐
2.65"
1.25"
Copy A For Internal Revenue Service Center
File with Form 1096.
PAYER'S Federal identification number
RECIPIENT'S identification number
3 Capital gain (included in box 2a)
$
4 Federal income tax withheld
$
RECIPIENT'S name
5 Employee contributions or insurance premiums
$
.4"
6 Net unrealized appreciation in employer's securities
$
Street address (including apt. no.)
7 Distribution code
1.0"
IRA/ SEP ☐
8 Other
1.0"
$ 2.60"
.4"
%
For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
City, state, and ZIP code
9a Your percentage of total distribution %
9b Total employee contributions
$
Account number (optional)
10 State tax withheld
$
$
11 State/Payer's state no.
12 State distribution
1.1"
$
$
13 Local tax withheld
$
$
14 Name of locality
15 Local distribution
$
$
Form 1099-R
Cat. No. 14436Q
Department of the Treasury - Internal Revenue Service
5.50"
1.0"
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9898 ☐ VOID ☐ CORRECTED
PAYER'S name, street address, city, state, and ZIP code
1 Gross distribution
$
OMB No. 1545-0119
1996
Form 1099-R
Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
2a Taxable amount
$
2b Taxable amount not determined ☐ Total distribution ☐
Copy A For Internal Revenue Service Center
File with Form 1096.
PAYER'S Federal identification number
RECIPIENT'S identification number
3 Capital gain (included in box 2a)
$
4 Federal income tax withheld
$
RECIPIENT'S name
5 Employee contributions or insurance premiums
$
6 Net unrealized appreciation in employer's securities
$
Street address (including apt. no.)
7 Distribution code
IRA/ SEP ☐
8 Other
$
%
For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
City, state, and ZIP code
9a Your percentage of total distribution %
9b Total employee contributions
$
Account number (optional)
10 State tax withheld
$
$
11 State/Payer's state no.
12 State distribution
$
$
13 Local tax withheld
$
$
14 Name of locality
15 Local distribution
$
$
Form 1099-R
Cat. No. 14436Q
Department of the Treasury - Internal Revenue Service
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Exhibit L

7575 ☐ VOID ☐ CORRECTED

FILER'S name, street address, city, state, and ZIP code	1 Date of closing (MMDDYY) 1.4"	OMB No. 1545-0997	Proceeds From Real Estate Transactions
	2 Gross proceeds $	1996 Form 1099-S	

FILER'S Federal identification number 1.7"	TRANSFEROR'S identification number 1.7"	3 Address or legal description (including city, state, and ZIP code) 2.8"	Copy A For Internal Revenue Service Center File with Form 1096.
TRANSFEROR'S name			For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G. 1.15"
Street address (including apt. no.)			
City, state, and ZIP code		4 Check here if the transferor received or will receive property or services as part of the consideration. ► ☐	
Account number (optional)		5 Buyer's part of real estate tax $	

Form 1099-S Cat. No. 64292E Department of the Treasury - Internal Revenue Service

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7575 ☐ VOID ☐ CORRECTED

FILER'S name, street address, city, state, and ZIP code	1 Date of closing (MMDDYY)	OMB No. 1545-0997	Proceeds From Real Estate Transactions
	2 Gross proceeds $	1996 Form 1099-S	

FILER'S Federal identification number	TRANSFEROR'S identification number	3 Address or legal description (including city, state, and ZIP code)	Copy A For Internal Revenue Service Center File with Form 1096.
TRANSFEROR'S name			For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Street address (including apt. no.)			
City, state, and ZIP code		4 Check here if the transferor received or will receive property or services as part of the consideration. ► ☐	
Account number (optional)		5 Buyer's part of real estate tax $	

Form 1099-S Cat. No. 64292E Department of the Treasury - Internal Revenue Service

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7575 ☐ VOID ☐ CORRECTED

FILER'S name, street address, city, state, and ZIP code	1 Date of closing (MMDDYY)	OMB No. 1545-0997	Proceeds From Real Estate Transactions
	2 Gross proceeds $	1996 Form 1099-S	

FILER'S Federal identification number	TRANSFEROR'S identification number	3 Address or legal description (including city, state, and ZIP code)	Copy A For Internal Revenue Service Center File with Form 1096.
TRANSFEROR'S name			For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Street address (including apt. no.)			
City, state, and ZIP code		4 Check here if the transferor received or will receive property or services as part of the consideration. ► ☐	
Account number (optional)		5 Buyer's part of real estate tax $	

Form 1099-S Cat. No. 64292E Department of the Treasury - Internal Revenue Service

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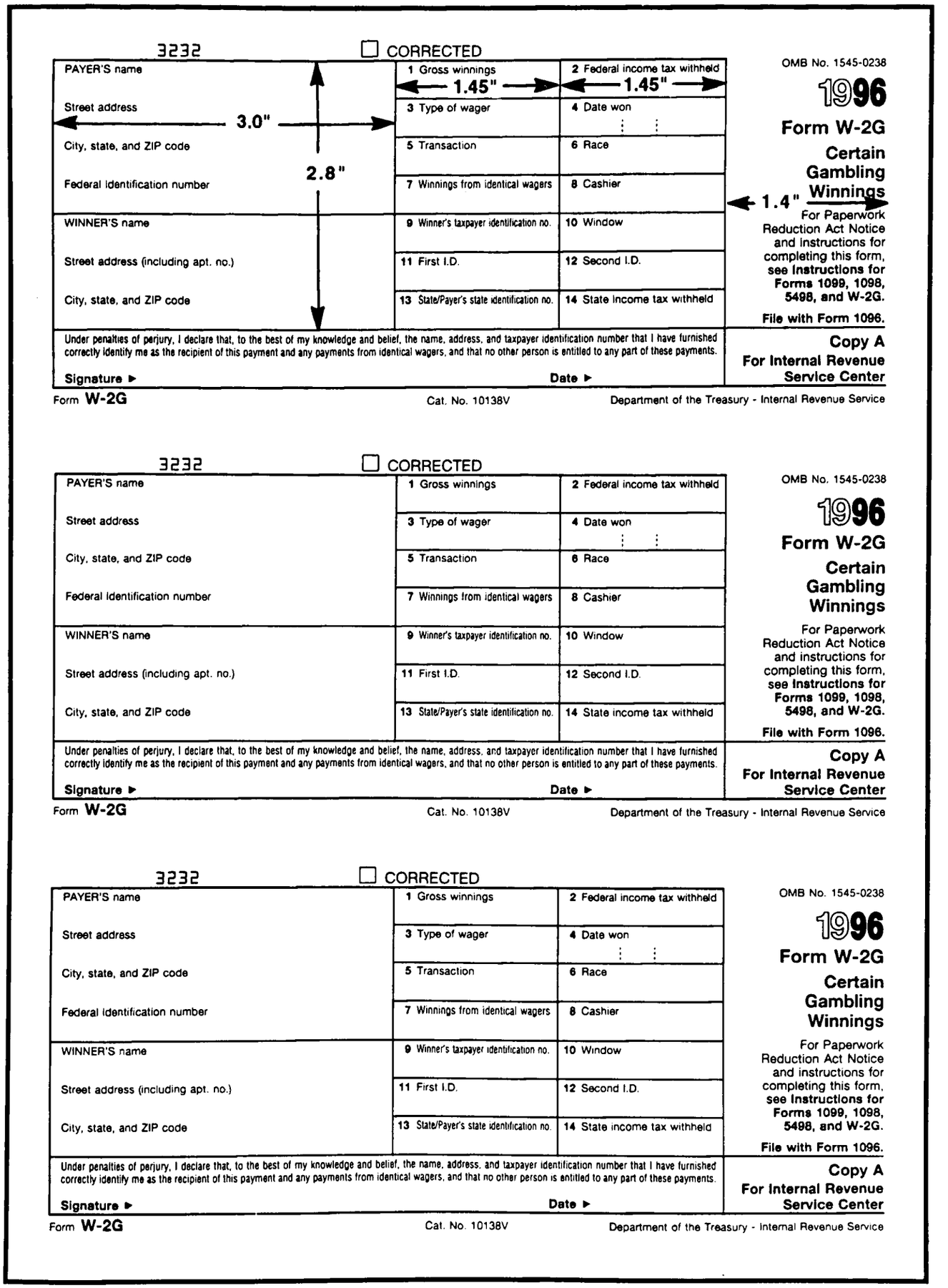
Exhibit M



3232 ☐ CORRECTED

PAYER'S name	1 Gross winnings	2 Federal income tax withheld
Street address	3 Type of wager	4 Date won
City, state, and ZIP code	5 Transaction	6 Race
Federal Identification number	7 Winnings from identical wagers	8 Cashier
WINNER'S name	9 Winner's taxpayer identification no.	10 Window
Street address (including apt. no.)	11 First I.D.	12 Second I.D.
City, state, and ZIP code	13 State/Payer's state identification no.	14 State income tax withheld

1.45" 1.45" 3.0" 2.8" 1.4"

Under penalties of perjury, I declare that, to the best of my knowledge and belief, the name, address, and taxpayer identification number that I have furnished correctly identify me as the recipient of this payment and any payments from identical wagers, and that no other person is entitled to any part of these payments.

Signature ▶ Date ▶

OMB No. 1545-0238

1996

Form W-2G

Certain Gambling Winnings

For Paperwork Reduction Act Notice and instructions for completing this form, see **Instructions for Forms 1099, 1098, 5498, and W-2G.**

File with Form 1096.

Copy A For Internal Revenue Service Center

Form **W-2G** Cat. No. 10138V Department of the Treasury - Internal Revenue Service

3232 ☐ CORRECTED

PAYER'S name	1 Gross winnings	2 Federal income tax withheld
Street address	3 Type of wager	4 Date won
City, state, and ZIP code	5 Transaction	6 Race
Federal Identification number	7 Winnings from identical wagers	8 Cashier
WINNER'S name	9 Winner's taxpayer identification no.	10 Window
Street address (including apt. no.)	11 First I.D.	12 Second I.D.
City, state, and ZIP code	13 State/Payer's state identification no.	14 State income tax withheld

Under penalties of perjury, I declare that, to the best of my knowledge and belief, the name, address, and taxpayer identification number that I have furnished correctly identify me as the recipient of this payment and any payments from identical wagers, and that no other person is entitled to any part of these payments.

Signature ▶ Date ▶

OMB No. 1545-0238

1996

Form W-2G

Certain Gambling Winnings

For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.

File with Form 1096.

Copy A For Internal Revenue Service Center

Form W-2G Cat. No. 10138V Department of the Treasury - Internal Revenue Service

3232 ☐ CORRECTED

PAYER'S name	1 Gross winnings	2 Federal income tax withheld
Street address	3 Type of wager	4 Date won
City, state, and ZIP code	5 Transaction	6 Race
Federal Identification number	7 Winnings from identical wagers	8 Cashier
WINNER'S name	9 Winner's taxpayer identification no.	10 Window
Street address (including apt. no.)	11 First I.D.	12 Second I.D.
City, state, and ZIP code	13 State/Payer's state identification no.	14 State income tax withheld

Under penalties of perjury, I declare that, to the best of my knowledge and belief, the name, address, and taxpayer identification number that I have furnished correctly identify me as the recipient of this payment and any payments from identical wagers, and that no other person is entitled to any part of these payments.

Signature ▶ Date ▶

OMB No. 1545-0238

1996

Form W-2G

Certain Gambling Winnings

For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.

File with Form 1096.

Copy A For Internal Revenue Service Center

Form W-2G Cat. No. 10138V Department of the Treasury - Internal Revenue Service

Exhibit N

2828 ☐ VOID ☐ CORRECTED

TRUSTEE'S or ISSUER'S name, street address, city, state, and ZIP code	1 Regular IRA contributions made in 1995 and 1996 for 1995 $ ← 1.4" →	OMB No. 1545-0747 1996 Form 5498	Individual Retirement Arrangement Information
	2 Rollover IRA contributions $		

TRUSTEE'S or ISSUER'S Federal identification no.	PARTICIPANT'S social security number	3 Life insurance cost included in box 1 $	Copy A For Internal Revenue Service Center File with Form 1096.
PARTICIPANT'S name		4 Fair market value of account $	For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Street address (including apt. no.)		5 Check for SEP ☐	
City, state, and ZIP code			
Account number (optional)			

Form 5498 Cat. No. 50010C Department of the Treasury - Internal Revenue Service

Do NOT Cut or Separate Forms on This Page

2828 ☐ VOID ☐ CORRECTED

TRUSTEE'S or ISSUER'S name, street address, city, state, and ZIP code	1 Regular IRA contributions made in 1995 and 1996 for 1995 $	OMB No. 1545-0747 1996 Form 5498	Individual Retirement Arrangement Information
	2 Rollover IRA contributions $		

TRUSTEE'S or ISSUER'S Federal identification no.	PARTICIPANT'S social security number	3 Life insurance cost included in box 1 $	Copy A For Internal Revenue Service Center File with Form 1096.
PARTICIPANT'S name		4 Fair market value of account $	For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Street address (including apt. no.)		5 Check for SEP ☐	
City, state, and ZIP code			
Account number (optional)			

Form 5498 Cat. No. 50010C Department of the Treasury - Internal Revenue Service

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2828 ☐ VOID ☐ CORRECTED

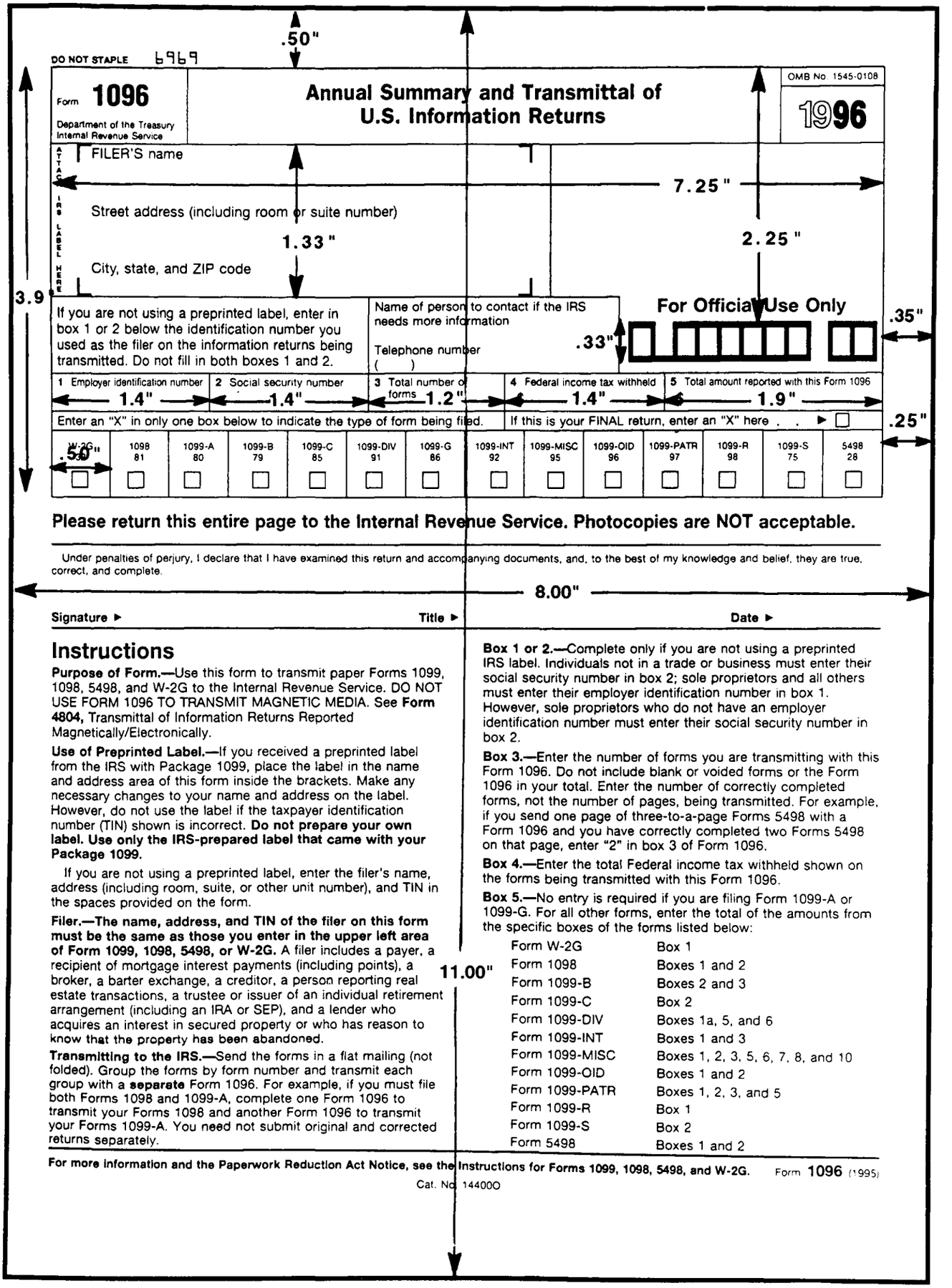
TRUSTEE'S or ISSUER'S name, street address, city, state, and ZIP code	1 Regular IRA contributions made in 1995 and 1996 for 1995 $	OMB No. 1545-0747 1996 Form 5498	Individual Retirement Arrangement Information
	2 Rollover IRA contributions $		

TRUSTEE'S or ISSUER'S Federal identification no.	PARTICIPANT'S social security number	3 Life insurance cost included in box 1 $	Copy A For Internal Revenue Service Center File with Form 1096.
PARTICIPANT'S name		4 Fair market value of account $	For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Street address (including apt. no.)		5 Check for SEP ☐	
City, state, and ZIP code			
Account number (optional)			

Form 5498 Cat. No. 50010C Department of the Treasury - Internal Revenue Service

Do NOT Cut or Separate Forms on This Page

Exhibit O



DO NOT STAPLE 6969

Form **1096**
Department of the Treasury
Internal Revenue Service

Annual Summary and Transmittal of U.S. Information Returns

OMB No. 1545-0108

1996

ATTACH LABEL HERE

FILER'S name

Street address (including room or suite number)

City, state, and ZIP code

If you are not using a preprinted label, enter in box 1 or 2 below the identification number you used as the filer on the information returns being transmitted. Do not fill in both boxes 1 and 2.

Name of person to contact if the IRS needs more information

Telephone number ( )

For Official Use Only

1 Employer identification number	2 Social security number	3 Total number of forms	4 Federal income tax withheld	5 Total amount reported with this Form 1096
			$	$

Enter an "X" in only one box below to indicate the type of form being filed.

If this is your FINAL return, enter an "X" here . . ▶ ☐

W-2G	1098 81	1099-A 80	1099-B 79	1099-C 85	1099-DIV 91	1099-G 86	1099-INT 92	1099-MISC 95	1099-OID 96	1099-PATR 97	1099-R 98	1099-S 75	5498 28
☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐

Please return this entire page to the Internal Revenue Service. Photocopies are NOT acceptable.

Under penalties of perjury, I declare that I have examined this return and accompanying documents, and, to the best of my knowledge and belief, they are true, correct, and complete.

Signature ▶ Title ▶ Date ▶

Instructions

Purpose of Form.—Use this form to transmit paper Forms 1099, 1098, 5498, and W-2G to the Internal Revenue Service. DO NOT USE FORM 1096 TO TRANSMIT MAGNETIC MEDIA. See **Form 4804,** Transmittal of Information Returns Reported Magnetically/Electronically.

Use of Preprinted Label.—If you received a preprinted label from the IRS with Package 1099, place the label in the name and address area of this form inside the brackets. Make any necessary changes to your name and address on the label. However, do not use the label if the taxpayer identification number (TIN) shown is incorrect. **Do not prepare your own label. Use only the IRS-prepared label that came with your Package 1099.**

If you are not using a preprinted label, enter the filer's name, address (including room, suite, or other unit number), and TIN in the spaces provided on the form.

Filer.—The name, address, and TIN of the filer on this form must be the same as those you enter in the upper left area of Form 1099, 1098, 5498, or W-2G. A filer includes a payer, a recipient of mortgage interest payments (including points), a broker, a barter exchange, a creditor, a person reporting real estate transactions, a trustee or issuer of an individual retirement arrangement (including an IRA or SEP), and a lender who acquires an interest in secured property or who has reason to know that the property has been abandoned.

Transmitting to the IRS.—Send the forms in a flat mailing (not folded). Group the forms by form number and transmit each group with a **separate** Form 1096. For example, if you must file both Forms 1098 and 1099-A, complete one Form 1096 to transmit your Forms 1098 and another Form 1096 to transmit your Forms 1099-A. You need not submit original and corrected returns separately.

Box 1 or 2.—Complete only if you are not using a preprinted IRS label. Individuals not in a trade or business must enter their social security number in box 2; sole proprietors and all others must enter their employer identification number in box 1. However, sole proprietors who do not have an employer identification number must enter their social security number in box 2.

Box 3.—Enter the number of forms you are transmitting with this Form 1096. Do not include blank or voided forms or the Form 1096 in your total. Enter the number of correctly completed forms, not the number of pages, being transmitted. For example, if you send one page of three-to-a-page Forms 5498 with a Form 1096 and you have correctly completed two Forms 5498 on that page, enter "2" in box 3 of Form 1096.

Box 4.—Enter the total Federal income tax withheld shown on the forms being transmitted with this Form 1096.

Box 5.—No entry is required if you are filing Form 1099-A or 1099-G. For all other forms, enter the total of the amounts from the specific boxes of the forms listed below:

Form W-2G	Box 1
Form 1098	Boxes 1 and 2
Form 1099-B	Boxes 2 and 3
Form 1099-C	Box 2
Form 1099-DIV	Boxes 1a, 5, and 6
Form 1099-INT	Boxes 1 and 3
Form 1099-MISC	Boxes 1, 2, 3, 5, 6, 7, 8, and 10
Form 1099-OID	Boxes 1 and 2
Form 1099-PATR	Boxes 1, 2, 3, and 5
Form 1099-R	Box 1
Form 1099-S	Box 2
Form 5498	Boxes 1 and 2

For more information and the Paperwork Reduction Act Notice, see the Instructions for Forms 1099, 1098, 5498, and W-2G. Form **1096** (1995)

Cat. No. 14400O

26 CFR 601.201: Rulings and determination letters.
(Also §§ 355; 1.355–3.)

Rev. Proc. 96–43

SECTION 1. PURPOSE

This revenue procedure amplifies Rev. Proc. 96–3, 1996–1 I.R.B. 82, which sets forth the areas of the Internal Revenue Code under the jurisdiction of the Associate Chief Counsel (Domestic) and the Associate Chief Counsel (Employee Benefits and Exempt Organizations) relating to issues on which the Internal Revenue Service will not issue advance rulings or determination letters.

SECTION 2. BACKGROUND

Section 4 of Rev. Proc. 96–3 sets forth those areas in which rulings or determination letters will not ordinarily be issued. Section 355(a) of the Internal Revenue Code applies to distributions of stock or securities of a corporation controlled by the distributing corporation if each of the corporations is engaged in the active conduct of a trade or business. Section 355(b) provides that a corporation is engaged in such conduct if, among other things, it is directly engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the transaction) which is so engaged.

SECTION 3. PROCEDURE

Rev. Proc. 96–3 is amplified by adding to section 4 the following:

Section 355.—Distribution of Stock and Securities of a Controlled Corporation.—Whether a distribution of stock or securities is described in § 355(a)(1) when the gross assets of the trades or businesses relied on to satisfy the active trade or business requirement of § 355(b) will have a fair market value that is less than 5 percent of the total fair market value of the gross assets of the corporation directly conducting the trades or businesses. The Service may rule that the trades or businesses satisfy the active trade or business requirement of § 355(b) if it can be established that, based upon all relevant facts and circumstances, the trades or businesses are not de minimis compared with the other assets or activities of the corporation and its subsidiaries.

SECTION 4. EFFECTIVE DATE

This revenue procedure will apply to all ruling requests postmarked or, if not mailed, received on or after August 8, 1996.

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26 CFR 601.201: Rulings and determination letters
(Also Part I, Sections 846; 1.846–1.)

Rev. Proc. 96–44

SEC. 1. PURPOSE

This revenue procedure prescribes the loss payment patterns and discount factors for the 1996 accident year. These factors will be used for computing discounted unpaid losses under § 846 of the Internal Revenue Code. See Rev. Proc. 92–47, 1992–1 C.B. 980, for background concerning the loss payment patterns and application of the discount factors.

SEC. 2. SCOPE

This revenue procedure applies to any taxpayer that is required to discount its unpaid losses under § 846 for a line of business using discount factors published by the Secretary.

SEC. 3. TABLES OF DISCOUNT FACTORS

.01 The following tables present separately for each line of business the discount factors under § 846 for accident year 1996. All the discount factors presented in this section were determined using the applicable interest rate under § 846(c) for 1996, which is 6.63 percent, and by assuming all loss payments occur in the middle of the calendar year.

.02 If the groupings of individual lines of business on the annual statement changes, taxpayers must discount the unpaid losses on the resulting lines of business in accordance with the discounting patterns that would have applied to those unpaid losses based on their classification on the 1990 annual statement.

.03 Tables

Tables of Discount Factors
Section 846
- 1996 -
Interest rate: 6.63 percent

Homeowners/Farmowners

Tax Year	Cumulative Losses Paid (%)	Estimated Losses Paid Each Year (%)	Discounted Unpaid Losses at Year End (%)	Unpaid Losses at Year End (%)	Discount Factor (%)
AY+ 0	66.8753	66.8753	30.6325	33.1247	92.4763
AY+ 1	90.4633	23.5880	8.3060	9.5367	87.0955
AY+ 2	93.3914	2.9281	5.8331	6.6086	88.2656
AY+ 3	95.7081	2.3167	3.8276	4.2919	89.1817
AY+ 4	97.4081	1.7000	2.3259	2.5919	89.7376
AY+ 5	98.6271	1.2190	1.2214	1.3729	88.9620
AY+ 6	99.1528	0.5257	0.7595	0.8472	89.6468
AY+ 7	99.5425	0.3897	0.4074	0.4575	89.0559
AY+ 8	99.7318	0.1893	0.2390	0.2682	89.1020
AY+ 9	99.8063	0.0745	0.1779	0.1937	91.8346
AY+10	N/A	0.0745	0.1127	0.1192	94.5850

Tax Year	Cumulative Losses Paid (%)	Estimated Losses Paid Each Year (%)	Discounted Unpaid Losses at Year End (%)	Unpaid Losses at Year End (%)	Discount Factor (%)
AY+11	N/A	0.0745	0.0432	0.0447	96.8412
AY+12	N/A	0.0447	0.0000	0.0000	N/A

Private Passenger Auto Liability/Medical

Tax Year	Cumulative Losses Paid (%)	Estimated Losses Paid Each Year (%)	Discounted Unpaid Losses at Year End (%)	Unpaid Losses at Year End (%)	Discount Factor (%)
AY+ 0	34.7617	34.7617	58.9016	65.2383	90.2868
AY+ 1	66.2963	31.5346	30.2435	33.7037	89.7336
AY+ 2	81.2140	14.9177	16.8444	18.7860	89.6646
AY+ 3	89.8272	8.6132	9.0671	10.1728	89.1303
AY+ 4	94.4549	4.6277	4.8895	5.5451	88.1776
AY+ 5	96.8788	2.4239	2.7107	3.1212	86.8495
AY+ 6	98.1526	1.2738	1.5751	1.8474	85.2614
AY+ 7	98.6962	0.5436	1.1182	1.3038	85.7661
AY+ 8	99.0485	0.3523	0.8286	0.9515	87.0805
AY+ 9	99.2667	0.2182	0.6582	0.7333	89.7569
AY+10	N/A	0.2182	0.4765	0.5151	92.5079
AY+11	N/A	0.2182	0.2828	0.2969	95.2452
AY+12	N/A	0.2182	0.0762	0.0787	96.8412
AY+13	N/A	0.0787	0.0000	0.0000	N/A

Commercial Auto/Truck Liability/Medical

Tax Year	Cumulative Losses Paid (%)	Estimated Losses Paid Each Year (%)	Discounted Unpaid Losses at Year End (%)	Unpaid Losses at Year End (%)	Discount Factor (%)
AY+ 0	20.8439	20.8439	69.0004	79.1561	87.1701
AY+ 1	47.3136	26.4697	46.2421	52.6864	87.7685
AY+ 2	65.6475	18.3340	30.3760	34.3525	88.4244
AY+ 3	79.0481	13.4005	18.5522	20.9519	88.5467
AY+ 4	86.8945	7.8465	11.6798	13.1055	89.1220
AY+ 5	92.4503	5.5558	6.7172	7.5497	88.9736
AY+ 6	95.5751	3.1247	3.9359	4.4249	88.9483
AY+ 7	97.3052	1.7302	2.4103	2.6948	89.4420
AY+ 8	98.1469	0.8417	1.7009	1.8531	91.7885
AY+ 9	98.8549	0.7080	1.0826	1.1451	94.5428
AY+10	N/A	0.7080	0.4233	0.4371	96.8412
AY+11	N/A	0.4371	0.0000	0.0000	N/A

Workers' Compensation

Tax Year	Cumulative Losses Paid (%)	Estimated Losses Paid Each Year (%)	Discounted Unpaid Losses at Year End (%)	Unpaid Losses at Year End (%)	Discount Factor (%)
AY+ 0	22.3366	22.3366	64.2484	77.6634	82.7268
AY+ 1	50.6941	28.3575	39.2256	49.3059	79.5557
AY+ 2	66.1886	15.4945	25.8264	33.8114	76.3837
AY+ 3	74.4228	8.2342	19.0359	25.5772	74.4253
AY+ 4	79.5663	5.1434	14.9867	20.4337	73.3432
AY+ 5	83.7227	4.1564	11.6883	16.2773	71.8077
AY+ 6	86.1316	2.4089	9.9758	13.8684	71.9321
AY+ 7	88.4452	2.3136	8.2482	11.5548	71.3830
AY+ 8	88.9625	0.5173	8.2608	11.0375	74.8434
AY+ 9	89.9266	0.9641	7.8130	10.0734	77.5606
AY+10	N/A	0.9641	7.3355	9.1093	80.5270

Tax Year	Cumulative Losses Paid (%)	Estimated Losses Paid Each Year (%)	Discounted Unpaid Losses at Year End (%)	Unpaid Losses at Year End (%)	Discount Factor (%)
AY+11	N/A	0.9641	6.8263	8.1453	83.8070
AY+12	N/A	0.9641	6.2833	7.1812	87.4975
AY+13	N/A	0.9641	5.7044	6.2171	91.7536
AY+14	N/A	0.9641	5.0871	5.2530	96.8412
AY+15	N/A	5.2530	0.0000	0.0000	N/A

Commercial Multiple Peril

Tax Year	Cumulative Losses Paid (%)	Estimated Losses Paid Each Year (%)	Discounted Unpaid Losses at Year End (%)	Unpaid Losses at Year End (%)	Discount Factor (%)
AY+ 0	33.4193	33.4193	56.7613	66.5807	85.2519
AY+ 1	59.1296	25.7103	33.9757	40.8704	83.1303
AY+ 2	67.4080	8.2784	27.6799	32.5920	84.9284
AY+ 3	75.7571	8.3491	20.8936	24.2429	86.1844
AY+ 4	83.8673	8.1102	13.9041	16.1327	86.1858
AY+ 5	89.5799	5.7126	8.9270	10.4201	85.6710
AY+ 6	93.4124	3.8325	5.5614	6.5876	84.4217
AY+ 7	95.6455	2.2331	3.6242	4.3545	83.2276
AY+ 8	96.9571	1.3116	2.5101	3.0429	82.4887
AY+ 9	97.4497	0.4926	2.1678	2.5503	85.0017
AY+10	N/A	0.4926	1.8029	2.0577	87.6150
AY+11	N/A	0.4926	1.4137	1.5651	90.3275
AY+12	N/A	0.4926	0.9988	1.0725	93.1260
AY+13	N/A	0.4926	0.5563	0.5799	95.9349
AY+14	N/A	0.4926	0.0845	0.0873	96.8412
AY+15	N/A	0.0873	0.0000	0.0000	N/A

Medical Malpractice

Tax Year	Cumulative Losses Paid (%)	Estimated Losses Paid Each Year (%)	Discounted Unpaid Losses at Year End (%)	Unpaid Losses at Year End (%)	Discount Factor (%)
AY+ 0	3.7026	3.7026	69.6231	96.2974	72.3001
AY+ 1	11.5535	7.8510	66.1321	88.4465	74.7708
AY+ 2	21.9296	10.3761	59.8022	78.0704	76.6003
AY+ 3	32.8555	10.9259	52.4848	67.1445	78.1669
AY+ 4	46.6164	13.7609	41.7548	53.3836	78.2165
AY+ 5	60.9092	14.2928	29.7641	39.0908	76.1409
AY+ 6	69.2349	8.3257	23.1402	30.7651	75.2157
AY+ 7	71.6574	2.4225	22.1728	28.3426	78.2316
AY+ 8	73.7610	2.1036	21.4707	26.2390	81.8275
AY+ 9	77.8395	4.0786	18.6826	22.1605	84.3062
AY+10	N/A	4.0786	15.7097	18.0819	86.8808
AY+11	N/A	4.0786	12.5396	14.0033	89.5476
AY+12	N/A	4.0786	9.1594	9.9248	92.2886
AY+13	N/A	4.0786	5.5551	5.8462	95.0206
AY+14	N/A	4.0786	1.7118	1.7676	96.8412
AY+15	N/A	1.7676	0.0000	0.0000	N/A

Special Liability (Ocean Marine, Aircraft (all Perils), Boiler and Machinery)

Tax Year	Cumulative Losses Paid (%)	Estimated Losses Paid Each Year (%)	Discounted Unpaid Losses at Year End (%)	Unpaid Losses at Year End (%)	Discount Factor (%)
AY+ 0	31.2231	31.2231	61.1626	68.7769	88.9290
AY+ 1	68.2247	37.0016	27.0091	31.7753	85.0004

Tax Year	Cumulative Losses Paid (%)	Estimated Losses Paid Each Year (%)	Discounted Unpaid Losses at Year End (%)	Unpaid Losses at Year End (%)	Discount Factor (%)
AY+ 2	80.2858	12.0611	16.3453	19.7142	82.9115
AY+ 3	85.4166	5.1308	12.1308	14.5834	83.1827
AY+ 4	89.4028	3.9862	8.8189	10.5972	83.2194
AY+ 5	93.2493	3.8465	5.4316	6.7507	80.4607
AY+ 6	94.0515	0.8022	4.9634	5.9485	83.4397
AY+ 7	95.8901	1.8386	3.3939	4.1099	82.5788
AY+ 8	97.7995	1.9093	1.6473	2.2005	74.8580
AY+ 9	97.9920	0.1925	1.5577	2.0080	77.5737
AY+10	N/A	0.1925	1.4621	1.8155	80.5381
AY+11	N/A	0.1925	1.3603	1.6230	83.8157
AY+12	N/A	0.1925	1.2517	1.4304	87.5033
AY+13	N/A	0.1925	1.1359	1.2379	91.7563
AY+14	N/A	0.1925	1.0124	1.0454	96.8412
AY+15	N/A	1.0454	0.0000	0.0000	N/A

Other Liability

Tax Year	Cumulative Losses Paid (%)	Estimated Losses Paid Each Year (%)	Discounted Unpaid Losses at Year End (%)	Unpaid Losses at Year End (%)	Discount Factor (%)
AY+ 0	9.9737	9.9737	68.4086	90.0263	75.9874
AY+ 1	21.8819	11.9082	60.6475	78.1181	77.6356
AY+ 2	32.5583	10.6764	53.6438	67.4417	79.5409
AY+ 3	41.4543	8.8960	48.0142	58.5457	82.0115
AY+ 4	56.3583	14.9040	35.8074	43.6417	82.0485
AY+ 5	71.6763	15.3180	22.3638	28.3237	78.9578
AY+ 6	78.0397	6.3635	17.2755	21.9603	78.6670
AY+ 7	82.2566	4.2168	14.0665	17.7434	79.2771
AY+ 8	85.2754	3.0188	11.8818	14.7246	80.6934
AY+ 9	87.4014	2.1260	10.4742	12.5986	83.1378
AY+10	N/A	2.1260	8.9734	10.4727	85.6836
AY+11	N/A	2.1260	7.3730	8.3467	88.3341
AY+12	N/A	2.1260	5.6665	6.2207	91.0905
AY+13	N/A	2.1260	3.8469	4.0948	93.9461
AY+14	N/A	2.1260	1.9066	1.9688	96.8412
AY+15	N/A	1.9688	0.0000	0.0000	N/A

Special Property (Fire, Allied Lines, Inland Marine, Earthquake, Glass, Burglary, and Theft)

Tax Year	Cumulative Losses Paid (%)	Estimated Losses Paid Each Year (%)	Discounted Unpaid Losses at Year End (%)	Unpaid Losses at Year End (%)	Discount Factor (%)
AY+ 0	57.7817	57.7817	39.8533	42.2183	94.3982
AY+ 1	88.3390	30.5573	10.9415	11.6610	93.8306
AY+ 2	N/A	5.8305	5.6463	5.8305	96.8412
AY+ 3	N/A	5.8305	0.0000	0.0000	N/A

Auto Physical Damage

Tax Year	Cumulative Losses Paid (%)	Estimated Losses Paid Each Year (%)	Discounted Unpaid Losses at Year End (%)	Unpaid Losses at Year End (%)	Discount Factor (%)
AY+ 0	84.1827	84.1827	15.2177	15.8173	96.2092
AY+ 1	98.8697	14.6870	1.0606	1.1303	93.8306
AY+ 2	N/A	0.5651	0.5473	0.5651	96.8412
AY+ 3	N/A	0.5651	0.0000	0.0000	N/A

Fidelity, Surety, Financial Guaranty, Mortgage Guaranty

Tax Year	Cumulative Losses Paid (%)	Estimated Losses Paid Each Year (%)	Discounted Unpaid Losses at Year End (%)	Unpaid Losses at Year End (%)	Discount Factor (%)
AY+ 0	25.1728	25.1728	68.7158	74.8272	91.8327
AY+ 1	57.6281	32.4553	39.7578	42.3719	93.8306
AY+ 2	N/A	21.1859	20.5167	21.1859	96.8412
AY+ 3	N/A	21.1859	0.0000	0.0000	N/A

Other (including Credit, Accident and Health)

Tax Year	Cumulative Losses Paid (%)	Estimated Losses Paid Each Year (%)	Discounted Unpaid Losses at Year End (%)	Unpaid Losses at Year End (%)	Discount Factor (%)
AY+ 0	63.6725	63.6725	34.1976	36.3275	94.1369
AY+ 1	88.8927	25.2202	10.4220	11.1073	93.8306
AY+ 2	N/A	5.5536	5.3782	5.5536	96.8412
AY+ 3	N/A	5.5536	0.0000	0.0000	N/A

International (Composite)

Tax Year	Cumulative Losses Paid (%)	Estimated Losses Paid Each Year (%)	Discounted Unpaid Losses at Year End (%)	Unpaid Losses at Year End (%)	Discount Factor (%)
AY+ 0	30.8006	30.8006	58.6213	69.1994	84.7137
AY+ 1	56.9235	26.1229	35.5330	43.0765	82.4881
AY+ 2	68.6906	11.7671	25.7379	31.3094	82.2050
AY+ 3	76.7697	8.0791	19.1017	23.2303	82.2275
AY+ 4	83.5336	6.7639	13.3837	16.4664	81.2783
AY+ 5	88.9725	5.4390	8.6546	11.0275	78.4822
AY+ 6	91.6218	2.6493	6.4927	8.3782	77.4953
AY+ 7	93.4305	1.8087	5.0554	6.5695	76.9538
AY+ 8	94.3638	0.9333	4.4269	5.6362	78.5443
AY+ 9	95.0595	0.6957	4.0020	4.9405	81.0046
AY+10	N/A	0.6957	3.5490	4.2448	83.6078
AY+11	N/A	0.6957	3.0659	3.5492	86.3851
AY+12	N/A	0.6957	2.5509	2.8535	89.3943
AY+13	N/A	0.6957	2.0016	2.1578	92.7611
AY+14	N/A	0.6957	1.4160	1.4622	96.8412
AY+15	N/A	1.4622	0.0000	0.0000	N/A

Reinsurance A

Tax Year	Cumulative Losses Paid (%)	Estimated Losses Paid Each Year (%)	Discounted Unpaid Losses at Year End (%)	Unpaid Losses at Year End (%)	Discount Factor (%)
AY+ 0	35.8044	35.8044	58.7668	64.1956	91.5432
AY+ 1	72.2671	36.4628	25.0109	27.7329	90.1850
AY+ 2	79.1294	6.8622	19.5830	20.8706	93.8306
AY+ 3	N/A	10.4353	10.1057	10.4353	96.8412
AY+ 4	N/A	10.4353	0.0000	0.0000	N/A

Reinsurance B (Composite)

Tax Year	Cumulative Losses Paid (%)	Estimated Losses Paid Each Year (%)	Discounted Unpaid Losses at Year End (%)	Unpaid Losses at Year End (%)	Discount Factor (%)
AY+ 0	30.8006	30.8006	58.6213	69.1994	84.7137
AY+ 1	56.9235	26.1229	35.5330	43.0765	82.4881
AY+ 2	68.6906	11.7671	25.7379	31.3094	82.2050

Tax Year	Cumulative Losses Paid (%)	Estimated Losses Paid Each Year (%)	Discounted Unpaid Losses at Year End (%)	Unpaid Losses at Year End (%)	Discount Factor (%)
AY+ 3	76.7697	8.0791	19.1017	23.2303	82.2275
AY+ 4	83.5336	6.7639	13.3837	16.4664	81.2783
AY+ 5	88.9725	5.4390	8.6546	11.0275	78.4822
AY+ 6	91.6218	2.6493	6.4927	8.3782	77.4953
AY+ 7	93.4305	1.8087	5.0554	6.5695	76.9538
AY+ 8	94.3638	0.9333	4.4269	5.6362	78.5443
AY+ 9	95.0595	0.6957	4.0020	4.9405	81.0046
AY+10	N/A	0.6957	3.5490	4.2448	83.6078
AY+11	N/A	0.6957	3.0659	3.5492	86.3851
AY+12	N/A	0.6957	2.5509	2.8535	89.3943
AY+13	N/A	0.6957	2.0016	2.1578	92.7611
AY+14	N/A	0.6957	1.4160	1.4622	96.8412
AY+15	N/A	1.4622	0.0000	0.0000	N/A

Reinsurance C

Tax Year	Cumulative Losses Paid (%)	Estimated Losses Paid Each Year (%)	Discounted Unpaid Losses at Year End (%)	Unpaid Losses at Year End (%)	Discount Factor (%)
AY+ 0	23.0513	23.0513	69.1110	76.9487	89.8144
AY+ 1	47.1565	24.1051	48.8016	52.8435	92.3512
AY+ 2	73.1742	26.0177	25.1708	26.8258	93.8306
AY+ 3	N/A	13.4129	12.9892	13.4129	96.8412
AY+ 4	N/A	13.4129	0.0000	0.0000	N/A

Miscellaneous Casualty (Composite)

Tax Year	Cumulative Losses Paid (%)	Estimated Losses Paid Each Year (%)	Discounted Unpaid Losses at Year End (%)	Unpaid Losses at Year End (%)	Discount Factor (%)
AY+ 0	73.9503	73.9503	24.6750	26.0497	94.7226
AY+ 1	93.7601	19.8099	5.8549	6.2399	93.8306
AY+ 2	N/A	3.1199	3.0214	3.1199	96.8412
AY+ 3	N/A	3.1199	0.0000	0.0000	N/A

Long Lines (Composite)

Tax Year	Cumulative Losses Paid (%)	Estimated Losses Paid Each Year (%)	Discounted Unpaid Losses at Year End (%)	Unpaid Losses at Year End (%)	Discount Factor (%)
AY+ 0	30.8006	30.8006	58.6213	69.1994	84.7137
AY+ 1	56.9235	26.1229	35.5330	43.0765	82.4881
AY+ 2	68.6906	11.7671	25.7379	31.3094	82.2050
AY+ 3	76.7697	8.0791	19.1017	23.2303	82.2275
AY+ 4	83.5336	6.7639	13.3837	16.4664	81.2783
AY+ 5	88.9725	5.4390	8.6546	11.0275	78.4822
AY+ 6	91.6218	2.6493	6.4927	8.3782	77.4953
AY+ 7	93.4305	1.8087	5.0554	6.5695	76.9538
AY+ 8	94.3638	0.9333	4.4269	5.6362	78.5443
AY+ 9	95.0595	0.6957	4.0020	4.9405	81.0046
AY+10	N/A	0.6957	3.5490	4.2448	83.6078
AY+11	N/A	0.6957	3.0659	3.5492	86.3851
AY+12	N/A	0.6957	2.5509	2.8535	89.3943
AY+13	N/A	0.6957	2.0016	2.1578	92.7611
AY+14	N/A	0.6957	1.4160	1.4622	96.8412
AY+15	N/A	1.4622	0.0000	0.0000	N/A

26 CFR 601.201: Rulings and determination letters
(Also Part I, Sections 832, 846; 1.832–4, 1.846–1.)

Rev. Proc. 96–45

SEC. 1. PURPOSE

This revenue procedure prescribes the salvage discount factors for the 1996 accident year. These factors will be used for computing discounted estimated salvage recoverable under § 832 of the Internal Revenue Code.

SEC. 2. BACKGROUND

Section 832(b)(5)(A) requires that all estimated salvage recoverable (including that which cannot be treated as an asset for state accounting purposes) be taken into account in computing the deduction for losses incurred. Under § 832(b)-(5)(A), paid losses are to be reduced by salvage and reinsurance recovered during the taxable year. This amount is adjusted to reflect changes in discounted unpaid losses on nonlife insurance contracts and in unpaid losses on life insurance contracts. An adjustment is then made to reflect any changes in discounted estimated salvage recoverable and in reinsurance recoverable.

Pursuant to § 832(b), the amount of estimated salvage is determined on a discounted basis in accordance with procedures established by the Secretary.

SEC. 3. SCOPE

This revenue procedure applies to any taxpayer that is required to discount estimated salvage recoverable under § 832.

SEC. 4. APPLICATION

.01 The following tables present separately for each line of business the discount factors under § 832 for the 1995 accident year. All the discount factors presented in this section were determined using the applicable interest rate under § 846(c) for 1996, which is 6.63 percent, and by assuming all estimated salvage is recovered in the middle of each calendar year. See Rev. Proc. 91–48, 1991–2 C.B. 760, for background regarding the tables.

.02 These tables must be used by taxpayers irrespective of whether they elected to discount unpaid losses using their own historical experience under § 846.

.03 Tables.

Tables of Discount Factors
Salvage Recoverable
- 1996 -
Interest rate: 6.63 percent

Homeowners/Farmowners

Tax Year	Discount Factor (%)
AY+ 0	92.4763
AY+ 1	87.0955
AY+ 2	88.2656
AY+ 3	89.1817
AY+ 4	89.7376
AY+ 5	88.9620
AY+ 6	89.6468
AY+ 7	89.0559
AY+ 8	89.1020
AY+ 9	91.8346
AY+10	94.5850
AY+11	96.8412

Private Passenger Auto Liability/Medical

Tax Year	Discount Factor (%)
AY+ 0	90.2868
AY+ 1	89.7336
AY+ 2	89.6646
AY+ 3	89.1303
AY+ 4	88.1776
AY+ 5	86.8495
AY+ 6	85.2614
AY+ 7	85.7661
AY+ 8	87.0805
AY+ 9	89.7569
AY+10	92.5079
AY+11	95.2452
AY+12	96.8412

Commercial Auto/Truck Liability/Medical

Tax Year	Discount Factor (%)
AY+ 0	87.1701
AY+ 1	87.7685
AY+ 2	88.4244
AY+ 3	88.5467
AY+ 4	89.1220
AY+ 5	88.9736
AY+ 6	88.9483
AY+ 7	89.4420
AY+ 8	91.7885
AY+ 9	94.5428
AY+10	96.8412

Workers' Compensation

Tax Year	Discount Factor (%)
AY+ 0	82.7268
AY+ 1	79.5557
AY+ 2	76.3837
AY+ 3	74.4253
AY+ 4	73.3432
AY+ 5	71.8077
AY+ 6	71.9321
AY+ 7	71.3830
AY+ 8	74.8434
AY+ 9	77.5606
AY+10	80.5270
AY+11	83.8070
AY+12	87.4975
AY+13	91.7536
AY+14	96.8412

Commercial Multiple Peril

Tax Year	Discount Factor (%)
AY+ 0	85.2519
AY+ 1	83.1303
AY+ 2	84.9284
AY+ 3	86.1844
AY+ 4	86.1858
AY+ 5	85.6710
AY+ 6	84.4217
AY+ 7	83.2276
AY+ 8	82.4887
AY+ 9	85.0017
AY+10	87.6150
AY+11	90.3275
AY+12	93.1260
AY+13	95.9349
AY+14	96.8412

Medical Malpractice

Tax Year	Discount Factor (%)
AY+ 0	72.3001
AY+ 1	74.7708
AY+ 2	76.6003
AY+ 3	78.1669
AY+ 4	78.2165
AY+ 5	76.1409
AY+ 6	75.2157
AY+ 7	78.2316
AY+ 8	81.8275
AY+ 9	84.3062
AY+10	86.8808
AY+11	89.5476
AY+12	92.2886
AY+13	95.0206
AY+14	96.8412

Special Liability (Ocean Marine, Aircraft (all Perils), Boiler and Machinery)

Tax Year	Discount Factor (%)
AY+ 0	88.9290
AY+ 1	85.0004
AY+ 2	82.9115
AY+ 3	83.1827
AY+ 4	83.2194
AY+ 5	80.4607
AY+ 6	83.4397
AY+ 7	82.5788
AY+ 8	74.8580
AY+ 9	77.5737
AY+10	80.5381
AY+11	83.8157
AY+12	87.5033
AY+13	91.7563
AY+14	96.8412

Other Liability

Tax Year	Discount Factor (%)
AY+ 0	75.9874
AY+ 1	77.6356
AY+ 2	79.5409
AY+ 3	82.0115
AY+ 4	82.0485
AY+ 5	78.9578
AY+ 6	78.6670
AY+ 7	79.2771
AY+ 8	80.6934
AY+ 9	83.1378
AY+10	85.6836
AY+11	88.3341
AY+12	91.0905
AY+13	93.9461
AY+14	96.8412

Special Property (Fire, Allied Lines, Inland Marine, Earthquake, Glass, Burglary, and Theft)

Tax Year	Discount Factor (%)
AY+ 0	89.4016
AY+ 1	91.1418
AY+ 2	92.1391
AY+ 3	93.5634
AY+ 4	94.5558
AY+ 5	96.2074
AY+ 6	96.8412

Auto Physical Damage

Tax Year	Discount Factor (%)
AY+ 0	95.1966
AY+ 1	95.6676
AY+ 2	96.8412

Fidelity, Surety, Financial Guaranty, Mortgage Guaranty

Tax Year	Discount Factor (%)
AY+ 0	84.0469
AY+ 1	86.4207
AY+ 2	87.7821
AY+ 3	89.4142
AY+ 4	91.0835
AY+ 5	92.7170
AY+ 6	93.9699
AY+ 7	95.0086
AY+ 8	96.8412

Other (including Credit, Accident and Health)

Tax Year	Discount Factor (%)
AY+ 0	89.9648
AY+ 1	91.7311
AY+ 2	92.9067
AY+ 3	94.5018
AY+ 4	95.8377
AY+ 5	96.8412

International (Composite)

Tax Year	Discount Factor (%)
AY+ 0	84.7137
AY+ 1	82.4881
AY+ 2	82.2050
AY+ 3	82.2275
AY+ 4	81.2783
AY+ 5	78.4822
AY+ 6	77.4953
AY+ 7	76.9538
AY+ 8	78.5443
AY+ 9	81.0046
AY+10	83.6078
AY+11	86.3851
AY+12	89.3943
AY+13	92.7611
AY+14	96.8412

Reinsurance A

Tax Year	Discount Factor (%)
AY+ 0	77.0244
AY+ 1	80.3308
AY+ 2	82.0405
AY+ 3	83.8941
AY+ 4	86.0620
AY+ 5	88.4270
AY+ 6	91.0715
AY+ 7	93.8805
AY+ 8	96.8412

Reinsurance B (Composite)

Tax Year	Discount Factor (%)
AY+ 0	84.7137
AY+ 1	82.4881
AY+ 2	82.2050
AY+ 3	82.2275
AY+ 4	81.2783
AY+ 5	78.4822
AY+ 6	77.4953
AY+ 7	76.9538
AY+ 8	78.5443
AY+ 9	81.0046
AY+10	83.6078
AY+11	86.3851
AY+12	89.3943
AY+13	92.7611
AY+14	96.8412

Reinsurance C

Tax Year	Discount Factor (%)
AY+ 0	77.0244
AY+ 1	80.3308
AY+ 2	82.0405
AY+ 3	83.8941
AY+ 4	86.0620
AY+ 5	88.4270
AY+ 6	91.0715
AY+ 7	93.8805
AY+ 8	96.8412

Miscellaneous Casualty (Composite)

Tax Year	Discount Factor (%)
AY+ 0	85.0124
AY+ 1	86.9026
AY+ 2	87.8050
AY+ 3	89.0382
AY+ 4	90.2502
AY+ 5	91.6718
AY+ 6	92.9603
AY+ 7	94.5573
AY+ 8	96.8412

Long Lines (Composite)

Tax Year	Discount Factor (%)
AY+ 0	84.7137
AY+ 1	82.4881
AY+ 2	82.2050
AY+ 3	82.2275
AY+ 4	81.2783
AY+ 5	78.4822
AY+ 6	77.4953
AY+ 7	76.9538
AY+ 8	78.5443

Tax Year	Discount Factor (%)
AY+ 9	81.0046
AY+10	83.6078
AY+11	86.3851
AY+12	89.3943
AY+13	92.7611
AY+14	96.8412

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability. (Also Part I, § 42; 1.42–14.)

Rev. Proc. 96–46

SECTION 1. PURPOSE

This revenue procedure publishes the amounts of unused housing credit carryovers allocated to qualified states under § 42(h)(3)(D) of the Internal Revenue Code for calendar year 1996.

SECTION 2. BACKGROUND

Rev. Proc. 92–31, 1992–1 C.B. 775, provides guidance to state housing credit agencies of qualified states on the procedure for requesting an allocation of unused housing credit carryovers under § 42(h)(3)(D). Section 4.06 of Rev. Proc. 92–31 provides that the Internal Revenue Service will publish in the Internal Revenue Bulletin the amount of unused housing credit carryovers allocated to qualified states for a calendar year from a national pool of unused credit authority (the National Pool). This revenue procedure publishes these amounts for calendar year 1996.

SECTION 3. PROCEDURE

.01 The unused housing credit carryover amount allocated from the National Pool by the Secretary to each qualified state for calendar year 1996 is as follows:

Qualified State	*Amount Allocated*
Alabama	$117,431
Alaska	16,867
Arizona	113,423
California	874,843
Colorado	101,760
Connecticut	91,156
Florida	388,365
Hawaii	32,816
Idaho	31,536
Illinois	327,102
Indiana	160,100
Iowa	78,742
Kansas	71,087
Kentucky	106,520
Maine	34,514
Maryland	139,336
Massachusetts	168,144
Michigan	264,309
Minnesota	127,117
Mississippi	74,288
Missouri	146,907
Nebraska	45,174
Nevada	40,554
New Hampshire	31,647
New Jersey	219,998
New Mexico	46,037
New York	505,712
Ohio	309,011
Oregon	85,895
Pennsylvania	335,453
Rhode Island	27,750
South Dakota	20,068
Tennessee	144,040
Utah	53,107
Vermont	16,144
Virginia	182,367
Washington	148,716
Wisconsin	141,451

.02 When certain issues are resolved, qualified states may be entitled to an additional allocation from the 1996 National Pool. If it is determined that qualified states are entitled to an additional allocation from the 1996 National Pool, the Service will publish the additional amount allocated to each qualified state as quickly as feasible to enable the state to allocate the amount before the close of 1996. Unless the Service is notified by a qualified state that it does not wish an additional allocation before these amounts are published, the Service will assume that a qualified state wishes to receive an additional allocation. A qualified state should notify the Service that it does not wish an additional allocation from the 1996 National Pool by writing to the address published in Sec. 4.05 of Rev. Proc. 92–31, in which case the refused additional allocation can be allocated to other qualified states. Any additional amount that a qualified state fails to allocate before the close of 1996 will not be considered in determining whether a state qualifies for the 1997 National Pool.

SECTION 4. EFFECTIVE DATE

This revenue procedure is effective for allocations of housing credit dollar amounts attributable to the National Pool component of a qualified state's housing credit ceiling for calendar year 1996.

26 CFR 601.201: Rulings and determination letters.
(Also Part I, §§ 561, 562, 852; 1.561–1, 1.562–2, 1.852–1, 1.852–3)

Rev. Proc. 96–47

SECTION 1. PURPOSE

This revenue procedure describes conditions under which distributions made to shareholders of a regulated investment company (RIC) may vary and nevertheless be deductible as dividends under § 562 of the Internal Revenue Code.

SECTION 2. BACKGROUND

.01 Section 852(b)(2)(D) allows a RIC a deduction for dividends paid (as defined in § 561 with certain modifications). Section 561 defines the deduction for dividends paid and applies the rules of § 562 to determine which dividends are eligible for the deduction for dividends paid. Section 562(c) provides that the amount of any distribution is not considered a dividend for purposes of computing the dividends paid deduction under § 561 unless the distribution is pro rata, does not prefer any share of stock of a class over any other share of stock of that same class, and does not prefer one class of stock over another class except to the extent that one class is entitled (without reference to waivers of their rights by shareholders) to the preference.

.02 Many RICs have issued groups of shares that represent interests in the same portfolio of securities but have different arrangements for shareholder services or the distribution of shares or both. Because the fees for these arrangements and services may vary, shareholders with equivalent investments in the same fund may receive different distributions. To permit open-end management investment companies to issue these groups of shares, the Securities and Exchange Commission (SEC) has adopted Rule 18f–3, 17 C.F.R. 270.18f–3, under the Investment Company Act of 1940, 15 U.S.C. 80a–1 to –64 (1940 Act).

SECTION 3. SCOPE

This revenue procedure applies to a corporation that meets all of the following requirements:

.01 The corporation is described in § 851(a) and § 851(b)(1).

.02 Groups of shares of the corporation have different arrangements for shareholder services or the distribution of shares or both (Qualified Groups). Expenses related to these arrangements are allocated to the Qualified Group of shares on behalf of which the expenses were incurred. The requirements in this subsection are to be interpreted in a manner consistent with the SEC's interpretation of analogous requirements in the rules under the 1940 Act. Thus, to determine whether groups of shares have different arrangements for shareholder services or the distribution of shares, see Rule 18f–3(a)(1)(i), 17 CFR 270.18f–3(a)(1)(i), and *Exemptions for Open End Management Investment Companies Issuing Multiple Classes of Shares*, Investment Company Act Release No. 20,915, 60 Fed. Reg. 11,876 at 11,878 (Mar. 2, 1995).

.03 Advisory fees and other expenses related to the management of the corporation's assets (including custodial fees and tax-return preparation fees) are allocated to all shares by net asset value, regardless of Qualified Group.

.04 Expenses other than those described in section 3.02 and 3.03 (for example, transfer agency fees) that are incurred on behalf of one or more Qualified Groups in a different amount or at a different rate from the amount or rate at which the expense is incurred on behalf of one or more other Qualified Groups are allocated either by net asset value, regardless of Qualified Group, or on the basis of the amount incurred on behalf of each Qualified Group.

.05 The rights and obligations of the shareholders of each Qualified Group are fixed in the corporation's organizing documents. Except as otherwise provided in this revenue procedure, each Qualified Group is entitled to distributions calculated under those documents in the same manner and at the same time as all other Qualified Groups. For purposes of this calculation, expenses are allocated under those documents to each Qualified Group at the same time as to all other Qualified Groups.

.06 Each Qualified Group separately meets the requirements of § 67(c)(2)(B) (defining the required characteristics of shares of a publicly offered RIC).

SECTION 4. PROCEDURE

If variations in distributions to shareholders of different Qualified Groups exist solely as a result of the allocation of expenses in accordance with the applicable provisions of section 3 of this revenue procedure, those variations do not prevent the distributions from being dividends under § 562.

SECTION 5. EFFECTIVE DATE

This revenue procedure is effective September 6, 1996.

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26 CFR 601.602: Tax forms and instructions.

Rev. Proc. 96–48

CONTENTS

PART A. GENERAL

SECTION 1. PURPOSE
SECTION 2. SCOPE
SECTION 3. NATURE OF CHANGES
SECTION 4. DEFINITIONS
SECTION 5. GENERAL REQUIREMENTS FOR APPROVAL
SECTION 6. HIGHLIGHTS OF PERMITTED CHANGES AND REQUIREMENTS
SECTION 7. APPROVAL
SECTION 8. OFFICE OF MANAGEMENT AND BUDGET (OMB) REQUIREMENTS FOR ALL SUBSTITUTE FORMS
SECTION 9. GENERAL GUIDELINES
SECTION 10. PHYSICAL ASPECTS AND REQUIREMENTS: PAPER
SECTION 11. PHYSICAL ASPECTS AND REQUIREMENTS: PRINTING
SECTION 12. PHYSICAL ASPECTS AND REQUIREMENTS: MARGINS
SECTION 13. EXAMPLES OF APPROVED FORMATS
SECTION 14. SPECIFICATIONS FOR FILING SUBSTITUTE FORMS
SECTION 15. GUIDANCE FROM OTHER REVENUE PROCEDURES
SECTION 16. ORDERING PUBLICATIONS
SECTION 17. ORDERING REPRODUCTION PROOFS
SECTION 18. READER LIST PROGRAM
SECTION 19. INTERNAL REVENUE INFORMATION SYSTEMS BULLETIN BOARD AND THE INTERNET
SECTION 20. FEDERAL TAX FORMS ON CD–ROM
SECTION 21. AGREEMENT

PART B. SPECIFIC

SECTION 1. GENERAL
SECTION 2. CONDITIONS - TAX RETURNS (FORMS 1040, 1040A, 1120, ETC.)
SECTION 3. CHANGES PERMITTED TO GRAPHICS (FORMS 1040A AND 1040)
SECTION 4. CHANGES PERMITTED TO FORM 1040A GRAPHICS
SECTION 5. OTHER CHANGES PROHIBITED
SECTION 6. CHANGES PERMITTED TO THE FORM 1040 GRAPHICS
SECTION 7. OTHER CHANGES PROHIBITED
SECTION 8. ACCEPTABLE FORMATS FOR COMPUTER-GENERATED FORMS AND SCHEDULES
SECTION 9. COMPUTER-GENERATED FORMS NOT SHOWN AS EXHIBITS IN THIS REVENUE PROCEDURE
SECTION 10. INSTRUCTIONS FOR FORMATTING COMPUTER-GENERATED SUBSTITUTES
SECTION 11. ADDITIONAL INSTRUCTIONS FOR ALL FORMS
SECTION 12. FILING SUBSTITUTE FORMS WITH THE SERVICE
SECTION 13. SPECIAL FORM 1040EZ OPTICAL CHARACTER RECOGNITION (OCR) REQUIREMENTS
SECTION 14. COMPUTER GENERATED ALTERNATIVE RETURNS, 1040PC FORMAT RETURN
SECTION 15. SPECIAL FORM 941 REQUIREMENTS - OCR SPECIFICATIONS
SECTION 16. SPECIAL FORM 941 REQUIREMENTS - BLACK AND WHITE SPECIFICATIONS
SECTION 17. PAPER SUBSTITUTES FOR FORM 1042–S
SECTION 18. SPECIFICATIONS FOR FILING SUBSTITUTE SCHEDULES K–1
SECTION 19. PROCEDURES FOR PRINTING INTERNAL REVENUE SERVICE ENVELOPES
SECTION 20. SPECIFICATIONS FOR OCR SCANNABLE APPLICATION FORMS FOR EMPLOYEE PLANS

SECTION 21. PROCEDURE FOR SUBSTITUTE FORM 5471 AND FORM 5472
SECTION 22. FORMS FOR ELECTRONICALLY FILED RETURNS
SECTION 23. FTD MAGNETIC TAPE PAYMENTS
SECTION 24. EFFECT ON OTHER DOCUMENTS

PART C. EXHIBITS

EXHIBIT A–1. SCHEDULE A (Preferred)
EXHIBIT A–2. SCHEDULE A (Acceptable)
EXHIBIT B–1. SCHEDULE B (Preferred)
EXHIBIT B–2. SCHEDULE B (Acceptable)
EXHIBIT CG–A. SCHEDULE A (Computer generated)
EXHIBIT CG–B. SCHEDULE B (Computer generated)
EXHIBIT BW–1. FORM 941 - Acceptable black and white substitute
EXHIBIT BW–2. SCHEDULE B, Form 941 - Acceptable black and white substitute
EXHIBIT L–1. LIST OF FORMS REFERRED TO IN REVENUE PROCEDURE
EXHIBIT L–2. PAYMENT VOUCHER SPECIFICATIONS

PART A. GENERAL

SEC. 1. PURPOSE

The purpose of this revenue procedure is to provide the general requirements and conditions for the development, printing, and approval of all substitute tax forms to be acceptable for filing in lieu of official IRS produced and distributed forms. All IRS tax forms of the types identified in Section 2.03, whether or not specifically mentioned herein by title or form number, are covered by this general revenue procedure. Certain unique, specialized forms require the use of other additional revenue procedures to supplement this publication (see Part A, Sections 15 and 16 for a list of revenue procedures). Persons wanting to submit substitute Forms W–2 should first read Publication 1141, General Rules and Specifications for Private Printing of Substitute Forms W–2 and W–3.

SEC. 2. SCOPE

.01 The Service accepts quality substitute tax forms that are consistent with the official forms they represent, and that do not have an adverse impact on our processing. The IRS Substitute Forms Program administers the formal acceptance and processing of these forms nationwide. While this program deals primarily with paper documents, it also interfaces with other processing and filing media such as magnetic tape, optical character recognition, electronic filing, etc., within a totally integrated tax administration system.

.02 Only those substitute forms that comply fully with the requirements set forth herein are acceptable.

.03 The following forms are covered by this revenue procedure:

1 Tax returns and their related forms and schedules.

2 Applications for permission to file returns electronically and forms submitted as required documentation for electronically-filed returns.

3 Powers of Attorney.

4 Estimated tax payment vouchers.

5 Forms and schedules relating to partnerships, exempt organizations, and employee plans.

.04 The following forms are not covered:

1 Federal Tax Deposit (FTD) coupons.

2 Requests for information or documentation initiated by the Service.

3 Forms used internally by the Service.

4 State tax forms.

5 Forms developed by other agencies (except for Form TD F 90–22.1, Report of Foreign Bank and Financial Accounts).

.05 Exhibit L–1 lists the form numbers mentioned in this document and their titles.

.06 This revenue procedure is updated as required to reflect pertinent tax year form changes and to meet processing and/or legislative requirements.

SEC. 3. NATURE OF CHANGES

.01 Instructions for barcoding Forms 1040A and related schedules and attachments, which appeared in Revenue Procedure 95–46, have not been added to this procedure. While barcodes will appear on the official forms, they are not required on substitute returns.

.02 Statement of Intention for Form 1040 processing deleted.

.03 Payment vouchers for Forms 1040, 941, 940, 940–EZ, 943, 945, and 2290 are required for tax year 1996 forms.

.04 Minor revisions have been made to the addresses for the Substitute W–2 Coordinator and the Employee Plans OCR Forms Coordinator.

.05 References to OMB expiration dates have been deleted. These dates are being phased out as forms are revised.

.06 Revision to preparer's information instructions. Preparer's data will now be preprinted on Page 2 of Form 1040EZ.

.07 Definition of conditional approval modified. Forms will not be accepted for conditional approval (i.e. based on drafts) after the final version has been published.

.08 Requirement to have forms which are filed quarterly approved each quarter has been deleted. Quarterly forms must be approved during the year if the form has been revised.

.09 Assignment of Forms Approval Number changed to assignment of Source Codes.

.10 Non-tax material (e.g., logos, firm names) may not be printed anywhere along the top margin.

.11 Paragraph referencing separate approval numbers for electronically filed returns deleted.

.12 Printing specifications now require that fill-in data (i.e. taxpayer entries) be no smaller than eight points in height.

.13 Form 3975, Tax Practitioner Annual Mailing List Application Update, may only be used to order Package X. Other publications may be ordered by phone.

.14 The reproduction proof and reader list programs are being discontinued as of October 1, 1996. Additional information has been added regarding the IRIS Bulletin Board, the Internet, and tax forms on CD–ROM.

.15 Graphics changes revised for Form 1040, Page 2.

.16 Additional information has been added to the specifications for substitute envelopes.

.17 The section on Form 945 requirements for scanning has been deleted.

.18 Reference added to Form 5471, Schedule J; reference deleted for Form 5471, Schedule P.

.19 The exhibit which lists the forms referenced in this document has been updated.

.20 An exhibit showing the specifications for payment voucher scanlines has been added.

.21 Various editorial changes.

SEC. 4. DEFINITIONS

.01 Substitute Form. A tax form (or related schedule) that differs in any way from the official version and is intended to replace the entire form that is printed and distributed by the Service. This term also covers those approved substitute forms exhibited in this revenue procedure.

.02 Printed (or Preprinted) Form. A form produced using conventional printing processes. Also, a printed form which has been reproduced by photocopying or similar processes.

.03 Preprinted Pin-Fed Form. A printed form that has marginal perforations for use with automated and high-speed printing equipment.

.04 Computer-Prepared Substitute Form. A preprinted form in which the taxpayer's tax entry information has been inserted by a computer, computer-printer or other computer type equipment, such as word-processing equipment.

.05 Computer-Generated Substitute Tax Return or Form. A tax return or form that is entirely designed and printed by the use of a computer printer, such as a laser printer, etc., on plain white paper. This return or form must conform to the physical layout of the corresponding Service form although the typeface may differ. The text should match the text on the officially-printed form as closely as possible; condensed text and abbreviations will be considered on a case-by-case basis. Exception: All jurats (perjury statements) must be reproduced verbatim.

.06 Manually-prepared form. A preprinted reproduced form in which the taxpayer's tax entry information is entered by an individual using a pen, pencil, typewriter, or other non-automated equipment.

.07 Computer-Generated Answer Sheet Format Tax Return. A tax return that contains the taxpayer's significant line entries only, and is formatted three columns per page with tax form headings, a summary, and jurat. This return is printed on plain white paper using a computer printer.

.08 Graphics. Those parts of a printed tax form that are not tax amount entries nor called-for information. Generally, these are line numbers, captions, shadings, instructions, special indicators, borders, rules, and strokes created by typesetting, photographics, photocomposition, etc.

.09 Acceptable Reproduced Form. A legible photocopy of an original form.

.10 Supporting Statement (Supplemental Schedule). A document providing detailed information to support an entry for a line(s) on an official or approved substitute form and filed with (attached to) a tax return. (A supporting statement is not a tax form and does not take the place of an official form, unless specifically permitted elsewhere in this procedure.)

.11 Specific Forms Terms. The following terms are used throughout this revenue procedure in reference to all substitute forms, with the exception of the 1040PC "answer sheet format" tax return.

1 Format. The overall physical arrangement and general layout of a substitute form.

2 Sequence. The same numeric and logical placement order of data, as reflected on the official form version. Sequence is an integral part of the total format requirement.

3 Line Reference (Code). The line numbers, letters or alpha-numerics used to identify each captioned line on the official forms; and printed to the immediate left of each caption or data entry field.

4 Item caption. The textual portion of each line on the form, identifying the specific data elements required.

5 Data Entry Field. All areas designated on a form for the insertion of data, such as dollar amounts, quantities, responses, check-boxes, etc.

SEC. 5. GENERAL REQUIREMENTS FOR APPROVAL

.01 If you plan to change or modify any tax returns or forms per Section 7.01 below, you can, without further approval, generate your own substitutes of the tax forms. See Agreement in Section 21.

.02 If your changes are more extensive, you must get official approval before using substitute forms. These changes include the use of typefaces and sizes other than those found on the offical form and the condensing of line item descriptions to save space.

.03 Schedules

(a) Schedules are considered to be an integral part of a complete tax return when assigned consecutive page numbers and printed contiguously with page one of the return. Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, is an example of this situation, where Schedules A through S have pages numbered as part of the basic return. For a Form 706 to be approved, the entire form including Schedules A through S must be submitted.

(b) However, Schedules 1, 2, and 3 of Form 1040A are examples of schedules that can be separately computer-generated. Although IRS-printed as a continuation of Form 1040A, none of these schedules have page numbers that require them to be filed with Form 1040A, and may, therefore, be separated from Form 1040A and submitted as computer-generated substitute schedules.

.04 The Service is continuing a program to identify and contact tax return preparers, forms developers, and software publishers who use or distribute unapproved forms that do not conform to this revenue procedure, and thus impede processing of the returns.

SEC. 6. HIGHLIGHTS OF PERMITTED CHANGES AND REQUIREMENTS

.01 METHODS OF REPRODUCING INTERNAL REVENUE SERVICE PRINTED TAX FORMS TO MAKE SUCH REPRODUCTIONS SUITABLE FOR USE AS SUBSTITUTE TAX FORMS WITHOUT PRIOR APPROVAL.

1 You can photocopy most tax forms and use them instead of the official ones. The entire substitute form, including entries, must be legible. However, some Service forms should never be reproduced as photocopies, or submitted on carbon copies, for use as substitute forms. These forms are input through OCR scanning equipment and substitutes must meet the specifications found in Part B of this revenue procedure or the appropriate revenue procedure referred to in Part A, Section 16.

(a) Forms W-2, W-2G, W-2AS, W-2GU, W-3, 1096, 1098, 1099-A, 1099-B, 1099-C, 1099-DIV, 1099-G, 1099-INT, 1099-MISC, 1099-OID, 1099-PATR, 1099-R, 1099-S, 5498, 8109, and 8109-B are the major forms that fall in this excluded category.

(b) Most of these forms have provisions for assessment of penalties for submitting non-OCR scannable substitute versions. For further information, see Publication 1179, Specifications for

Paper Document Reporting and Paper Substitutes for Forms 1096, 1098, 1099 Series, 5498, and W–2G (revised annually).

(c) All payment vouchers (Forms 940–V, 940–EZ(V), 941–V, 943–V, 945–V, 1040–V, and 2290–V) must be reproduced. Substitute vouchers must be the same size as the officially printed vouchers. Vouchers that are prepared for printing on a laser printer may include a scanline. See Exhibit L–2 for scanline specifications.

2 You can reproduce any current tax form as cut sheets, snapsets, and marginally-punched, pin-fed forms so long as you use an official Service version as the master copy. Official versions are supplied by the Service, such as those in the taxpayer's tax package, those printed in revenue procedures, and over-the-counter forms available at IRS and other governmental public offices or buildings. Forms are also available on CD–ROM, and online via the IRS bulletin board and the Internet (see Sections 19 and 20).

3 If you reproduce either Form 1040, 1040A or 1040EZ as described in the preceding paragraph, you can adjust the graphics on specified areas to allow for computer-printed or word processor fill-in. Only the areas listed in Part B of this revenue procedure may be adjusted without specific prior approval.

4 You can reproduce a "signature form" as a valid substitute form. Many tax forms (including returns) have a taxpayer signature requirement as part of the form layout. The jurat/perjury statement/signature line areas must be retained and worded exactly as on the official form. The requirement for a signature by itself does not prohibit a tax form from being properly computer-generated.

5 You can computer-generate Answer Sheet Format Tax Returns on plain bond paper using IRS-accepted software for the 1040PC format for return types 1040EZ, 1040, 1040A, and attachments, forms, and schedules.

.02 THINGS YOU CANNOT DO TO INTERNAL REVENUE SERVICE PRINTED TAX FORMS TO MAKE THEM SUITABLE FOR USE AS SUBSTITUTE TAX FORMS.

1 You cannot, without prior Service approval, change any Internal Revenue Service tax forms or use your own (non-approved) versions, unless specifically permitted by this revenue procedure.

2 You cannot adjust any of the graphics on Forms 1040, 1040A and 1040EZ (except in those areas specified in Part B of this revenue procedure) without prior approval from the Service.

3 You cannot use your own preprinted label on tax returns filed with the Service, unless you fully comply with the exception criteria specified in Part A, Section 14.02.

SEC. 7. APPROVAL

.01 Basic Requirements. Preparers who desire to file substitute privately designed and printed tax forms and/or computer-generated and computer-prepared tax forms must develop such substitutes using these guidelines. These substitutes, unless excepted by revenue procedure, must be approved by the Service before being filed. A software developer who wants to market, distribute, or use for its own clientele, a tax preparation package featuring the 1040PC tax return format, must first file an application to participate in the program. Only after successfully fulfilling test requirements will a developer's software package be accepted by the Service to produce 1040PC tax returns.

.02 Requests for Approval

1 The Service cannot grant final approval of your substitute form until the official form has been published. However, the Service usually releases advance proof copies of selected major tax forms that are subject to further changes and OMB approval before their release in final format for printing and distribution to the public. We encourage submission of proposed substitutes of these advance proof forms, and will grant conditional approval based solely on these early proofs. These advance proofs are subject to significant change before forms are finalized. If these advance proofs are used as the basis for your substitute forms, you will be responsible for subsequently updating your final forms to agree with the final official version before use. These revisions need not be submitted for further approval. Conditional approval will not be granted after the final version of an official form is published.

2 Submission of substitute forms must be based on the appropriate revenue procedures. There is a list in Part A, Section 15. Any alteration of forms must be within the limits acceptable to the Service. It is possible that, from one filing period to another, a change in law or a change in internal need (processing, audit, compliance, etc.) may change the allowable limits for the alteration of the official form.

3 When specific approval of any substitute form (other than those specified in 7.02.4 and 7.02.5 below, or forms for which different instructions are published in other revenue procedures) is desired, a sample of the proposed substitute should be forwarded for consideration by letter to the Internal Revenue Service, Attention: Substitute Forms Program Coordinator, T:FP:S, Room 2712, 1111 Constitution Ave. NW, Washington, DC 20224. To expedite multiple forms approval, we prefer that your proposed forms be submitted in separate sets by return. For example, Forms 1040 and their normally related schedules or attachments should be submitted separately from Forms 1120, 1065, 5500 Series, etc., if at all possible. Schedules and forms (e.g., Forms 3468, 4136, etc.) that can be used with more than one type of return (e.g., 1040, 1041, 1120, etc.) should be submitted only once for approval, regardless of the number of different tax returns with which they may be ultimately associated. In addition, all pages of a multipage form or return should be submitted in the same package.

4 The following forms should not be submitted to IRS (or the Social Security Administration, if applicable) for specific approval: W–2, W–3, 1096, 1098, 1099 Series, 5498, and W–2G. If you are uncertain of any specification set forth in the appropriate revenue procedures and want that specification clarified, you may submit a letter citing the specification in question, your interpretation of that specification, and an example of the form to the following addresses:

Forms W–2 and W–3:
Internal Revenue Service
Attn: Substitute Form W–2 Coordinator, CP:CO:SC:A
1111 Constitution Avenue, NW, Room 7238
Washington, DC 20224

Forms 1096, 1098, 1099 Series, 5498, and W–2G:
Internal Revenue Service
Attn: IRP Coordinator, T:S:P:S (Salubria Building)
1111 Constitution Avenue, NW
Washington, DC 20224

5 For Form 1040PC approval, see Part B, Section 14. For approval of

OCR scannable application forms for Employee Plans, see Part B, Section 21.

6 As no Service office except the ones specified in this procedure are authorized to approve substitute forms, unnecessary delay may result if forms are sent elsewhere for approval. All forms submitted to any other office must be forwarded to the appropriate office for formal control, review, and official approval. No IRS office is authorized to allow deviations from this revenue procedure.

7 The Service does not review or approve the logic of specific software programs, nor confirm the calculations entered on forms output from these programs that are submitted for approval. The accuracy of the program itself remains the responsibility of the software package developer, distributor, or user. The Substitute Forms Program is primarily concerned with the prefiling quality review of the final forms output, produced by whatever means, that are expected to be processed by IRS field offices. For the above reasons, it is suggested that you submit forms without including any "taxpayer" information such as names, addresses, monetary amounts, etc.

.03 When to Send Proposed Substitutes. Proposed substitutes which are required to be submitted per this Revenue Procedure should be sent to the address listed in .02 above, as much in advance of the filing period for the form as possible. This is to allow adequate time for analysis and response.

.04 Accompanying Statement. When the sample substitute is submitted, there should be an accompanying statement that lists the form number of each substitute requested and detail those items that deviate from the official form in position, arrangement, appearance, line numbers, additions, deletions, etc. Included with each of the items should be a detailed reason or justification for the change and an approximation of the number of forms expected to be filed.

.05 Approval/Non-Approval Letter. The Service will send either a formal letter of approval/non-approval or, when provided by the originator, a checksheet for the forms included in the package, provided no lengthy explanations are required. Approval letters may contain qualifications for use of the substitutes. Non-approval letters may specify the changes required for approval, but also may require resubmission for approval. Telephone contact is used when possible.

.06 Duration of Approval

1 Most signature tax returns and many of their schedules and related forms have the tax (liability) year printed in the upper right hand corner. Approvals for these forms are usually good for one calendar year (January through December of the year of filing) or, in the case of corporation tax forms (with the exception noted below), for the remainder of the quarters in the calendar year. Quarterly tax forms in the 94X series require approval for any quarter in which the form has been revised.

2 If the preprinted year is the only change made to a form described in 1 above, the form for the upcoming year is not subject to review. Otherwise each new filing season requires a new approval. Limited continued use of a change approved for one tax year may be allowed for the same form in the following tax year. See .07 below for the limitations and for other requirements. Examples of such changes are the use of abbreviated words, revised form spacing, compressed text lines, shortened captions, etc., which do not change the consistency of lines or text on the official forms.

3 Other forms may have expiration dates displayed in the upper right hand corner. Approval of these forms is usually valid through the expiration date. Occasionally, these forms or their instructions will be revised before the expiration date. If substantial change is made to the form, new substitutes must be submitted for approval. If the expiration date changes due to revisions to the instructions, minor editorial changes to the form or to extend the date without revision to the form, it is not subject to review.

.07 Limited Continued Use of an Approved Change

1 If you received written approval of a previous tax year substitute form governed by this revenue procedure and continue to use the approved change on your current tax year substitute form, you may revise your form to include this change and, without additional written approval, use it as a current tax year substitute form, provided you comply with the requirements in this revenue procedure. See exception in 3 below.

2 If you received written approval for a specific change on a specific form last year, such as deleting the vertical lines used to separate dollars and cents on some forms and schedules e.g., Schedules A & B of Form 1040, you may again make the same change on the same form this year if the item changed is present on this year's official form. Thus, the change allowed in last year's approved substitute Schedule A, for example, can be continued in your new substitute for this year. The new substitute does not have to be sent to the IRS and written approval is not required. However, the new substitute must conform to the official current year IRS form in other respects: date, Office of Management and Budget (OMB) approval number, attachment sequence number, Paperwork Reduction Act Notice Statement, arrangement, item caption, line number, line reference, data sequence, etc. It must also comply with this revenue procedure—which may have eliminated, added to, or otherwise changed the guideline(s) which affected the change approved last year. Additionally, you will be bound by the "Agreement" in Section 21.

3 Exception: Those written approvals which state that the approved change or form would not be allowed in any other tax year, or for a temporary, limited, or interim approval pending resolution of a failure to meet one or more Service-prescribed requirements.

4 This authorization for continued use of an approved change is limited to the continuation of design logic from an immediately prior tax year substitute form to a current tax year substitute form.

.08 Requested Copies. Generally, you must send us one copy of each form being submitted for approval. However if you are producing forms for different computer systems (e.g., IBM (or compatible) vs. MacIntosh) or different types of printers (laser vs. dot matrix), and these forms differ significantly in appearance, submit one copy for each type of system or printer.

.09 Responsibility. Following the receipt of initial approval for a substitute forms package, or of a software output program to print substitute forms, it is the responsibility of the originator (designer or distributor) to provide each subsequent client firm or individual with the pertinent Service forms requirements which must be met for continuing acceptability. Examples of this responsibility include the use of prescribed print paper, font size, legibility, state tax data deletion, the legal requirements of the Paperwork Reduction Act Notice for informing all users of substitute forms of the official use and collection re-

quirements stated in the instructions for the official IRS forms, completion of documents, etc.

.10 Source code (formerly) Forms Approval Number. The Substitute Forms Program Coordinator Office, T:FP:S, will assign a unique source code to each firm that submits substitute paper forms for approval. This will be a permanently assigned control number that should be used on every form created by a particular firm.

1 This number should be printed at the bottom left margin area on the first page of every approved substitute paper form.

2 The source code for paper returns consists of three alpha characters.

3 This number should not be used on optically scanned (OCR) forms, except for certain specified Forms 1040–ES.

SEC. 8. OFFICE OF MANAGEMENT AND BUDGET (OMB) REQUIREMENTS FOR ALL SUBSTITUTE FORMS

.01 Legal Requirements of the Paperwork Reduction Act of 1995 ("Act"). Public Law 104–13 requires that: (1) OMB approve all Service tax forms that are subject to the Act; (2) each IRS form contains (in the upper right corner) the OMB number, if any; and, 3) each IRS form (or its instructions) states why IRS is the information, how it will be used, and whether or not the information is required to be furnished. This information must be provided to every user of any official or substitute tax forms.

.02 Application of Act to Substitute Forms.

1 OMB Number Is Required. All substitute forms must contain in the upper right corner (see marginal Printing, Part A, Sec. 13.02.1(c)) the OMB number that is on the official form.

2 Format Required - OMB No. XXXX–XXXX (Preferred) or OMB # XXXX–XXXX.

3 Required Explanation to Users of Substitute Forms. You must also inform the users of your substitute forms of the Service use and collection requirements stated in the instructions for the official Service form.

(a) If you provide your users or customers with the official IRS instructions, page 1 of each form must retain either the Paperwork Reduction Act Notice, or a reference to it as on the official forms (usually in the lower left corner of the forms).

(b) If the Service instructions are not provided to users of your forms, the exact text of the Paperwork Reduction Act Notice must be furnished on the form or separately. This notice reads, in part, "We ask for this information to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to insure that you are complying with these laws and to allow us to figure and collect the right amount of tax. . . ." You must also include a copy of the alternative statement provided to users of your forms with the forms you submit for approval.

.03 Obtaining OMB Number and Notice. The OMB number and Paperwork Reduction Act Notice may be obtained from the official printed form (or its instructions), any format produced by the Service (e.g. CD or BBS download) or directly from the Service.

SEC. 9. GENERAL GUIDELINES

.01 The Official Form is the Standard. Because a substitute form is a variation from the official form, you should know the requirements of the official form for the year of use before you modify it to meet your needs. The Service provides several means of obtaining the most frequently used tax forms. These include the sale of a CD–ROM, and access to an electronic forms bulletin board (See Part A, Section 17–19).

.02 Design. Each form must follow the design of the official form as to format arrangement, item caption, line numbers, line references, and sequence.

.03 State Tax Information Prohibited. State tax information must not appear (be visible) on the federal tax return or associated form or schedule which is filed with the Internal Revenue Service, except where amounts are claimed on or required by the federal return, e.g., line 5, Schedule A (Form 1040). (See Part A, Sec. 14.03 Block Out Methods.)

.04 Federal and State Columns. When a form is designed with both federal and state columns, the federal column must be to the left of the state column and adjacent to the line caption. Again, state tax information must not be on a federal tax form.

.05 Vertical Alignment of Amount Fields.

1 When a form is to be computer-prepared, you may remove the vertical line in the amount field that separates dollars from cents. When a form is to be computer-generated, vertically align the amount entry fields where possible. You must also use one of the ten-character amount formats shown in Part B, Sec. 3.04.

2 If the possibility exists that a form may be manually prepared, the federal column must have a vertical line or some type of indicator in the amount field to separate dollars from cents if the official form has a vertical line. The cents column must be at least 2/10 inch wide.

.06 Attachment Sequence Number. Please note that most individual income tax forms have an "attachment sequence number" located just below the year designation in the upper right corner of the form. The Service uses this number to indicate the order in which forms are to be attached to the tax return so they may be processed in that order. On computer-prepared forms it must be printed in no less than 12-point boldface type and centered below the form's year designation. On computer-generated forms, place the sequence number following the year designation for the tax form and separate with an asterisk. It is not necessary to duplicate the "Attachment Sequence Number" wording, except for the actual number. (See Forms Exhibits at end of this Revenue Procedure.)

.07 Attachment Sequence Numbers Required. The attachment sequence number is required on most IRS forms. Please note that some of the numbers necessarily change each year. The specific sequence numbers used on official IRS forms must be duplicated on the representative substitute form. If a sequence number is not provided on the official form, it is not required on a substitute of that form either.

.08 Paid Preparer's Information and Signature Area. On Forms 1040EZ, 1040A, 1040, and 1120, etc., the "Paid Preparer's Use Only" area may not be rearranged or relocated. You may, however, add three extra lines to the paid preparer's address area without prior approval. This applies to other tax forms as well. Please note that the preparer's area on Form 1040EZ is on the bottom of Page 2. Substitute Forms 1040EZ with the preparer area on Page 1 or in a different location on Page 2 will not be accepted.

.09 Assembly of Forms. If developing software or forms for use by others, please inform your customers/clients that the order in which the forms are arranged may affect the processing of

the package. A return must be arranged in this order: (1) the tax return, (2) Form 1040: schedules and forms in sequence number order; all others (Forms 1120, 1120S, 1065, 1041, etc.): lettered schedules (Schedule D, etc.) in alphabetical order and numbered forms in numerical order (Forms 2220, 4626, etc.), (3) supporting statements in the same sequence as the forms they support, and (4) additional information required or voluntarily submitted. In this way, they are received in the order in which they must be processed. If you do not send them to us in this order, the Service has to delay the return package to disassemble them and place them in this order before processing is continued.

SEC. 10. PHYSICAL ASPECTS AND REQUIREMENTS: PAPER

.01 Paper Content. The paper must be:

1 Chemical wood writing paper that is equal to or better than the quality used for the official form;

2 at least 18 pound (17″ x 22″, 500 sheets) or

3 at least 50 pound offset book (25″ x 38″, 500 sheets).

.02 Paper Prohibited. Carbon-bonded paper is prohibited from use for all substitute forms filed with the Service.

.03 Paper with Chemical Transfer Properties - Limited Use. Chemical transfer paper for all substitute forms may be used only when the following specifications are met.

1 Each ply within the chemical transfer set of forms must be labeled.

2 Only the top ply (ply one and white in color), the one which contains chemical on the back only (coated back), may be filed with the Service. For example, a set containing three plies would be constructed as follows: ply one (coated back), "Federal Return, File with IRS"; ply two (coated front and back), "Taxpayer's copy", and ply three (coated front), "Preparer's copy."

3 The file designation, "Federal Return, File with IRS," for ply one must be printed in the bottom right margin (just below the last line of the form) in 12-point, bold-face type. It is not mandatory, but recommended, that the file designation, "Federal Return, File with IRS," be printed in a contrasting ink for visual emphasis.

4 Carbon Paper. We prefer that you do not attach any carbon paper to any return you file with the Service.

.04 Paper and Ink Color. We prefer that the color and opacity of paper substantially duplicates that of the original form. This means that your substitute must be printed in black ink and may be on white or on the color paper the Service form is printed on. (See Part B for exceptions regarding scannable documents). Forms 1040A and 1040 substitute reproductions may be in black ink without the colored shading. The only exception to this rule is Form 1041–ES, which should always be printed with a very light gray shading in the color screened area. This is necessary to assist us in expeditiously separating this form from the very similar Form 1040–ES.

.05 Page Size. Substitute or reproduced forms and computer prepared/generated substitutes may be the same size as the official form (8″ x 11″, in most cases) or they may be the standard commercial size (8½″ x 11″) exclusive of pin-feed holes. The thickness of the stock cannot be less than .003 inch.

SEC. 11. PHYSICAL ASPECTS AND REQUIREMENTS: PRINTING

.01 Printing Medium. The private printing of all substitute tax forms must be by conventional printing processes, photocopying, computer-graphics, or similar reproduction processes.

.02 Legibility.

1 All forms must have a high standard of legibility, both as to printing and reproduction and as to fill-in matter. Entries of taxpayer data may be no smaller than eight points.

2 The Service reserves the right to reject those with poor legibility. The ink and printing method used must ensure that no part of a form (including text, graphics, data entries, etc.) develops "smears" or similar quality deterioration, including any subsequent copies or reproductions made from an approved master substitute form, either during preparation or during Service processing.

.03 Type Font. Many federal tax forms are printed using "Helvetica" as the basic type font. We request that you use this type font when composing substitute forms.

.04 Print Spacing. Substitute forms should be printed using a 6 lines/inch vertical print option. They should also be printed horizontally in 10 pitch pica (i.e., 10 print characters per inch) or 12 pitch elite (i.e., 12 print positions per inch).

.05 Image Size. The image size of printed substitute forms should be as close as possible to that of the official form. You may omit any text on both computer-prepared and computer-generated forms that is solely instructional.

.06 Title Area Changes. To allow a large top margin for marginal printing and more lines per page (see Sec. 13 below), the title line(s) for all substitute forms (not including the form's year designation and sequence number, when present), may be photographically reduced by 40 percent or reset as one line of type. When reset as one line, the type size may be no smaller than 14-point. You may omit "Department of the Treasury, Internal Revenue Service" and all reference to instructions in the form's title area.

.07 Remove Government Printing Office Symbol. When privately printing substitute tax forms, the Government Printing Office symbol and/or jacket number must be removed. In the same place, using the same type size, print the Employer Identification Number (EIN), the Social Security Number (SSN) of the printer or designer, or the IRS assigned source code. (We prefer this last number be printed in the lower left area of the first page of each form.) Also remove the IRS Catalog Number, if one is present in the bottom center margin, and the Recycle Symbol, if the substitute is not produced on recycled paper.

.08 Printing On One Side of Paper. While it is preferred that both sides of the paper be used for substitute and reproduced forms, resulting in the same page arrangement as that of the official form or schedule, the Service will not object if only one side of the paper is used.

.09 Photocopy Equipment. The Service does not undertake to approve or disapprove the specific equipment or process used in reproducing official forms. Photocopies of forms must be entirely legible and satisfy the conditions stated in this and other revenue procedures.

.10 Reproductions. Reproductions of official forms and substitute forms which do not meet the requirements of this revenue procedure may not be filed instead of the official forms. Illegible photocopies are subject to being returned to the filer for resubmission of legible copies.

.11 Removal of Instructions. You may remove all references to instructions. No

prior approval is needed. One exception is that the statement, "For Paperwork Reduction Act Notice, See Instructions", must be retained or a similar statement provided on each form.

SEC. 12. PHYSICAL ASPECTS AND REQUIREMENTS: MARGINS

.01 Margin Size.

1 The format of a reproduced tax return when printed on the page must have margins on all sides at least as large as the margins on the official form. This allows room for Service employees to make the necessary entries on the form during processing.

2 A one-half to one-quarter inch margin must be maintained across the top, bottom, and both sides (exclusive of any pin-fed holes) of all computer-generated substitutes. The margin area is also used by Service employees to make necessary entries on the form during processing.

3 The marginal, perforated strips containing the pin-fed holes must be removed from all forms prior to filing with the Service.

.02 Marginal Printing.

1 Non-Tax Material Allowed in Limited Areas.

(a) Printing is never allowed in the top margin of the tax return form (i.e., Forms 1040, 1040A, 1040EZ, 1120, 940, 941, 5500 Series, etc.). The Service uses this area to imprint a Document Locator Number and a DPS Unique Submission Identifier for each return.

(b) With the exception of the actual tax return forms (i.e., Forms 1040, 1040A, 1040EZ, 1120, 940, 941, etc.), you may print in the left vertical margin and in the left half of the bottom margin, except for the substitute forms source code, which must be placed in the lower left area of Page 1.

2 Prior Approval Not Required. Prior approval is not required for the marginal printing allowed in 1 above when printed on an official form, on a photocopy of an official form, or on an (unchanged) IRS reproduction proof.

3 Prior Approval Required. The marginal printing allowance in 1 above is also the guide for the preparation of acceptable substitute forms. There is no exception to the requirement that no printing is allowed in the top margin of the tax return form.

SEC. 13. EXAMPLES OF APPROVED FORMATS

.01 Examples. Two sets of exhibits (Exhibits A–1, B–1, A–2 and B–2) are at the end of this revenue procedure. These are examples of how the guidelines in this revenue procedure may be used in some specific cases. Vertical spacing is six (6) lines to the inch. These examples are from a prior year and are not to be used as substitute forms.

.02 No State Tax Information. No state tax information can appear on these forms when filed with the Form 1040. The state column may be present but the state tax information must not be visible when filed with the Service. We prefer that the entire state column be completely blocked out.

.03 BLOCK OUT METHODS. A suggested method to block out state tax information is: (1) place the substitute form in a clear plastic folder, (2) on the folder, place a strip of opaque material the exact width and length of the column you wish to block out, then (3) photocopy the substitute form while still in the folder. The result will be a form with only the federal tax information visible. Another method is to take a black marking pen and, using either vertical or horizontal strokes, cross out the state figures. Carbon interleaved sets may be used where the amounts entered in the state column are filled in with black carbon overprint. This copy may be filed with the return.

.04 Examples of acceptable computer-generated formats are also shown in the Exhibits section of this revenue procedure. The exhibits are for Schedules A and B. Vertical spacing is six (6) lines to the inch. You may also refer to them as examples of how the guidelines in this revenue procedure may be used in specific cases.

1 A combination of upper and lower case print fonts is acceptable in producing the computer-generated forms included in this procedure.

2 This same logic for computer-generated forms can be applied to any Service form that is normally reproducible as a substitute form, with the exception of tax return forms as discussed elsewhere.

SEC. 14. SPECIFICATIONS FOR FILING SUBSTITUTE FORMS

.01 Filing Substitute Forms. To be acceptable for filing, a substitute return or form must print out in a format that will allow the party submitting the return to follow the same instructions as for filing official forms. These instructions are in the taxpayer's tax package, or in the related form instructions. The form must be on the appropriate size paper, be legible, and include a jurat where one appears on the published form.

1 Note to software publishers: The Service has received returns produced by software packages with approved output where either the form heading was altered or the lines were spaced irregularly. This produces an illegible or unrecognizable return or a return with the wrong number of pages. We realize that many of these problems are caused by individual printer differences but they may delay input of return data and, in some cases, generate correspondence to the taxpayer. Therefore, in the instructions to the purchasers of your product, both individual and professional, please stress that their returns will be processed more efficiently if they are properly formatted. This includes:

(a) having the correct form numbers and titles at the top of the return and

(b) submitting the same number of pages as if the form were an official IRS form, with the line items on the proper pages.

.02 Use Preaddressed Internal Revenue Service Label. If you are a practitioner filling out a return for a client or a software publisher who prints instruction manuals, stress the use of the preaddressed label provided in the tax package the Service sent to the taxpayer, when available. The use of this label (or its precisely duplicated label information) is extremely important for the efficient, accurate, and economical processing of a taxpayer's return. Labeled returns indicate that a taxpayer is an established filer and permits us to automatically accelerate processing of those returns. This results in quicker refunds, accurate names/addresses and postal deliveries, and less manual review by IRS functions.

1 If you are producing a software package that generates name and address data onto the tax return, do not under any circumstances program either the Service preprinted check digits or a practitioner-derived Name Control to appear on any return prepared and filed with the Service.

3 If programming to print forms, use only the following label information format for single filers:

000–00–0000
JOHN Q. PUBLIC
310 OAK DRIVE
HOMETOWN, STATE 94000

4 Use only the following information for joint filers:

000–00–0000 000–00–0000
JOHN Q. PUBLIC
MARY I. PUBLIC
310 OAK DRIVE
HOMETOWN, STATE 94000

SEC. 15. GUIDANCE FROM OTHER REVENUE PROCEDURES

.01 Guidance for the substitute tax forms not covered in this revenue procedure and the revenue procedures which govern their use, are as follows:

1 Revenue Procedure 94–79, IRS Publication 1355, Requirements and Conditions for the Reproduction, Private Design, and Printing of Substitute Forms 1040–ES.

2 Revenue Procedures 96–24 and 96–24a, IRS Publication 1141, General Rules and Specifications for Private Printing of Substitute Forms W–2 and W–3.

3 Revenue Procedure 96–42, IRS Publication 1179, Specifications for Paper Document Reporting and Paper Substitutes for Forms 1096, 1098, 1099 Series, 5498, and W–2G.

4 Revenue Procedure 96–11, IRS Publication 1187, Specifications for Filing Form 1042–S, Foreign Person's U.S. Source Income Subject to Withholding, on Magnetic Tape.

5 Revenue Procedure 96–36, IRS Publication 1220, Specifications for Filing Forms 1098, 1099, 5498, and W–2G Magnetically or Electronically.

6 Revenue Procedure 95–18, IRS Publication 1223, Specifications for Private Printing of Substitute Forms W–2c and W–3c.

SEC. 16. ORDERING PUBLICATIONS

.01 In 1996, Form 3975, Tax Practitioner Annual Mailing List Application/Update, which is available in Publication 1045, Information for Tax Practitioners, may be only be used to order Package X, Informational Copies of Tax Forms and Instructions. The revenue procedures listed below may be ordered by calling 1–800–TAX–FORM (1–800–829–3676). Identify the requested document by IRS publication number. The following publications address the filing of substitute forms, as well as documents on magnetic tape:

1 Pub. 1141, the revenue procedure on specifications for private printing for Forms W–2 and W–3.

2 Pub. 1167, the revenue procedure on substitute printed, computer-prepared, and computer-generated tax forms and schedules.

3 Pub. 1179, the revenue procedure on paper substitute information returns (Forms 1096, 1098, 1099 series, 5498, and W–2G).

4 Pub. 1192, Catalog of Reproducible Forms and Instructions.

5 Pub. 1220, the revenue procedure on electronic or magnetic tape and magnetic diskette reporting for information returns (Forms 1098, 1099 series, 5498, and W–2G).

6 Pub. 1223, the revenue procedure on substitute Forms W–2c and W–3c.

7 Pub. 1239, Specifications for Filing Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips, on Magnetic Tape.

8 Pub. 1245, Magnetic Tape Reporting for Forms W–4.

9 Pub. 1345, Handbook for Electronic Filers of Individual Income Tax Returns (Tax Year 1996). (This is an annual publication; tax year is subject to change.)

10 Pub. 1345–A, Handbook for Electronic Filers of Individual Income Tax Returns (Tax Year 1996). This publication, printed in the late fall, supplements Publication 1345.

11 Pub. 1355, the revenue procedure on the requirements for substitute Form 1040–ES.

.02 If you are mailing your order, the address to use is determined by your location. If you are located in:

1 Alaska, Arizona, California, Colorado, Hawaii, Idaho, Kansas, Montana, Nevada, New Mexico, Oklahoma, Oregon, Utah, Washington, Wyoming, Guam, Northern Marianas, or American Samoa, mail your request to:
Western Area Distribution Center
Rancho Cordova, CA 95743–0001

2 Alabama, Arkansas, Illinois, Indiana, Iowa, Kentucky, Louisiana, Michigan, Minnesota, Mississippi, Missouri, Nebraska, North Dakota, Ohio, South Dakota, Tennessee, Texas, or Wisconsin, mail your request to:
Central Area Distribution Center
P.O. Box 8903
Bloomington, IL 61702–8903

3 Connecticut, Delaware, District of Columbia, Florida, Georgia, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, North Carolina, Pennsylvania, Rhode Island, South Carolina, Vermont, Virginia, West Virginia, as well as all foreign countries and Puerto Rico, mail your request to:
Eastern Area Distribution Center
P.O. Box 85074
Richmond, VA 23261–5074

4 Taxpayers in the Virgin Islands should mail their requests to:
V.I. Bureau of Internal Revenue
9601 Estate Thomas
Charlotte Amalie, St. Thomas, VI 00802

SEC. 17. ORDERING REPRODUCTION PROOFS

The reproduction proof program will be discontinued in October 1996. Forms are available on the IRS BBS, the Internet and on CD–ROM. See Sections 19 and 20.

SEC. 18. READER LIST PROGRAM

The reader list program will be discontinued in October 1996. Forms are available on the IRS BBS, the Internet and on CD–ROM. See Sections 19 and 20.

SEC. 19. INTERNAL REVENUE INFORMATION SYSTEMS BULLETIN BOARD AND THE INTERNET

.01 Copies of tax forms and some publications may be downloaded as print files from the Internet or from the Internal Revenue Information Systems (IRIS) Bulletin Board. Forms can be downloaded in several file formats. Those choosing to use the portable document file format (.pdf files) for viewing in Microsoft Windows or on a Macintosh can also download a free copy of the Adobe Acrobat Reader.

.02 Access the Internet via one of the following: World Wide Web - http://www.irs.ustreas.gov, FTP = ftp.irs.ustreas.gov, or Telnet - iris.irs.ustreas.gov. This service is free but time on the Internet is subject to the fees charged by your Internet provider.

.03 IRIS can be reached via FedWorld, an aggregation of federal BBS maintained by the Department of Commerce. IRIS can be reached directly by modem at (703) 321–8020; FedWorld's main number is (703) 321–3339. These are toll calls.

SEC. 20. FEDERAL TAX FORMS ON CD–ROM

.01 The IRS also offers access to current and prior year tax forms and instructions through its Federal Tax Forms CD–ROM. The CD will be issued in two cumulative releases for the 1996 tax year.

.02 The CD will contain over 600 current year tax forms, instructions, and

Taxpayer Information Publications (TIPs). Also included are prior year forms and instructions from 1991 and TIPs from 1994. All necessary software to view the files must be installed from the CD–ROM. Software for Microsoft Windows 3.x and Macintosh System 7.5 and later is included on the disk. The software will also run under Windows 95.

.03 All products are presented in Adobe's Portable Document Format (PDF). A copy of the Adobe Acrobat Reader is on the CD. In addition, the TIPs will be provided in the Standard Generalized Markup Language (SGML).

.04 For system requirements and to order the 1996 Federal Tax Forms CD–ROM (stock number 648–096–00004–6), contact the Government Printing Office's (GPO) Superintendent of Documents:

1 by telephone - (202) 512–1800; select option 1;

2 by fax - (202) 512–2250;

3 through GPO's Federal Bulletin Board - (202) 512–1387; after signon type "/go irs";

4 through GPO's World Wide Web site at http://www.gpo.gov/su_docs;

5 by mail using the order form contained in IRS Publication 1045 (Information for Tax Practitioners); or

6 by mail to Superintendent of Documents, P.O. Box 371954, Pittsburgh, PA 15250–7954.

.05 The cost of the CD is $25 and it will be released in February 1997. Please reference stock number 648–096–00004–6. Those who order before December 2, 1996 will also receive the Janaury early release CD containing tax products issued to that point.

SEC. 21. AGREEMENT

Any person or company who uses substitute forms and makes all or part of the changes specified in this revenue procedure, agrees to the following stipulation: The Service presumes the changes are made in accordance with these procedures and, as such, will be noninterruptive to the processing of the tax return. Should any of the changes prove to be not exactly as described, and as a result become disruptive to the Service during processing of the tax return, the person or company agrees to accept the determination of the Service as to whether or not the form may continue to be used during the filing season, and also agrees to work with the Service in correcting noted deficiencies. Notification of deficiencies may be made by letter, phone contact, or both and may include the return of unacceptable forms for resubmission of acceptable forms.

PART B. SPECIFIC

SEC. 1. GENERAL

The specifications contained in this part of the revenue procedure define specific, detailed requirements for certain forms and conditions. These specifications must be adhered to in producing acceptable substitute forms as defined herein.

SEC. 2. CONDITIONS-TAX RETURNS (FORM 1040, 1040A, 1120, ETC.)

.01 Acceptable Forms.

1 Computer-Generated Versions. Computer-generated versions of a tax return form (e.g., Form 1040, 1040A, 1120, etc., which requires a signature and that establishes tax liability) are permitted under the following conditions:

(a) These substitute returns must be printed on plain white paper.

(b) Substitute returns and forms must conform to the physical layout of the corresponding Service form although the typeface may differ. The text should match the text on the officially-published form as closely as possible; condensed text and abbreviations will be considered on a case-by-case basis. Exception: All jurats (perjury statements) must be reproduced verbatim. No text can be added, deleted, or changed in meaning. It must be readily identifiable as a valid tax return.

(c) Various computer-graphic print media such as laser printing, dot matrix addressable printing, etc., may be used to produce the substitute forms.

(d) The substitute return must be the same exact number of pages, and contain the same line text as the official return.

(e) All computer-generated tax returns MUST be submitted for approval prior to their original use. Should you receive an approval letter for a return and the following year's return has no changes except the preprinted year, the latter return is not subject to approval. Exception: If the approval letter specifies a one-time exception for your return, the next year's return must be approved.

2 Computer Generated Condensed Format Versions. The accepted condensed print format version for individual returns is the 1040PC "answer sheet format" tax return.

.02 Prohibited Forms.

1 Tax returns (e.g., Forms 1040, etc.) CANNOT be computer-generated on lined or color-barred paper, using the basic non-graphic layouts acceptable for all other (non-tax return) substitute forms and schedules.

2 Tax returns that differ from the official IRS forms in a manner that makes them non-standard or unprocessable.

.03 Changes Permitted To The Forms 1040 and 1040A.

1 Certain changes (listed below) are permitted to the graphics of the form without prior approval, but these changes apply only to preprinted forms as described in .01 above.

2 Changes not requiring prior approval are good only for the annual filing period, which is the current Tax Year. Such changes are valid in subsequent years only if the official form does not change.

3 Other Changes Not Listed. All changes not listed here require prior approval from the Service BEFORE the form may be filed with the Service.

SEC. 3. CHANGES PERMITTED TO GRAPHICS (FORMS 1040A AND 1040)

.01 Adjustments

You may make minor vertical and horizontal spacing adjustments to allow for computer or word-processing printing. This includes widening the amount columns or tax entry areas so long as the adjustments do not exceed other provisions stated in revenue procedures. No prior approval is needed for these changes. However, the users of forms with such changes are bound by the "Agreement" in Part A, Section 21.

.02 Name and Address Area.

1 The horizontal rules and instructions within the name and address area may be removed and the entire area left blank; no line or instruction can remain in the area. However, the statement regarding use of the IRS mail label should be retained.

2 The heavy ruled border (when present) that outlines the name and address area must not be removed, relocated, expanded or contracted.

3 Required Format

(a) When the name and address area is left blank, as provided in 1 above, the following format must be used when

printing the taxpayer's name and address. Otherwise, unless the taxpayer's preprinted label is affixed over the information entered in this area, the lines must be filled-in as shown

1st name line (35 characters maximum)

2nd name line (35 characters maximum)

In-care-of name line (35 characters maximum)

City, State (24 char. max.), one blank char., & ZIP (five char.)

(b) When there is no in-care-of name line, the name and address will consist of only three lines (single filer) or four lines (joint filer). Examples of the formats follow:

Example of name and address (joint filer) with no in-care-of name line:

JOHN Z. JONES
MARY I. JONES
1234 ANYWHERE ST., APT 111
ANYTOWN, STATE 12321

Example of name and address (single filer) with in-care-of name line:

JOHN Z. JONES
C/O THOMAS A. JONES
4311 SOMEWHERE AVE.
SAMETOWN, STATE 54345

.03 Social Security Number (SSN) and Employer Identification Number (EIN) Area.

1 The vertical lines separating the format arrangement of the SSN/EIN may be removed.

2 When the vertical lines are removed, the SSN and EIN formats must be 000–00–0000 or 00–0000000, respectively.

.04 Cents Column.

1 You may remove the vertical rule that separates the dollars from the cents.

2 All entries in the amount column should have a decimal point following the whole dollar amounts whether or not the vertical line that separates the dollars from the cents is present.

3 You may omit printing the cents, but all amounts entered on the form must follow a consistent format. You are strongly urged to round off the figures to whole dollar amounts, following the official return instructions. Where several amounts are summed together, the total should be rounded off subsequent to the addition (i.e, indivdual amounts should not be rounded off for computation purposes).

4 When printing money amounts, you must use one of the following ten-character formats: (a) 0,000,000. (b) 000,000.00

5 When there is no entry for a line leave the line blank.

.05 "Paid Preparer's Use Only" Area.

1 On all forms, the paid preparer's information area may not be rearranged or relocated.

2 You may add three lines and remove the horizontal rules in the preparer's address area.

SEC. 4. CHANGES PERMITTED TO FORM 1040A GRAPHICS

No prior approval is needed for the following changes (for use with computer-prepared forms only):

.01 Line 4.

This line may be compressed horizontally (to allow for same line entry for the name of the qualifying child) by using the following caption: "Head of household; child's name" (name field).

.02 Other Lines.

Any line whose caption takes up two or more vertical lines may be compressed to one line by using contractions, etc., and by removing instructional references.

.03 Page 2 (Form 1040A).

All lines must be present and numbered in the order shown on the official form. These lines may also be compressed as in .02 above.

.04 Color Screening.

It is not necessary to duplicate the color-screening used on the official form. A substitute Form 1040A may be printed in black and white only, with no color screening.

SEC. 5. OTHER CHANGES PROHIBITED

No other changes to the Form 1040A graphics are allowed without prior approval, except for the removal of instructions and references to instructions.

SEC. 6. CHANGES PERMITTED TO THE FORM 1040 GRAPHICS

No prior approval is needed for the following changes (for use with computer-prepared forms only):

.01 Line 4.

This line may be compressed horizontally (to allow for a larger entry area for the name of the qualifying child) by using the following caption: "Head of household; child's name" (name field).

.02 Line 6c.

The vertical lines separating columns (1) through (4) may be removed. The captions may be shortened to allow a one-line caption for each column.

.03 Other Lines.

Any other line whose caption takes up two or more vertical lines may be compressed to one line by using contractions, etc., and by removing instructional references.

.04 Line 21 - Other Income.

1 The fill-in portion of this line may be expanded vertically to three lines.

2 The amount entry box must remain a single entry.

.05 Line 38 - Tax

You may change the line caption to read "Tax" and computer-print the words "Total includes tax from" and either "Forms(s) 8814", "Form 4970", or "Form 4972".

.06 Line 42

You may change the caption to read: "Other credits from Form" and computer-print only the form(s) that apply.

.07 Color Screening.

It is not necessary to duplicate the color-screening used on the official form. A substitute Form 1040 may be printed in black and white only, with no color screening.

SEC. 7. OTHER CHANGES PROHIBITED

No other changes to the Form 1040 graphics are permitted without prior approval except for the removal of instructions and references to instructions.

SEC. 8. ACCEPTABLE FORMATS FOR COMPUTER-GENERATED FORMS AND SCHEDULES

.01 Exhibits of acceptable computer-generated formats for the schedules usually attached to the Form 1040 are shown in the Exhibits section of this revenue procedure.

.02 Use of Acceptable Formats. If your computer-generated forms appear exactly like the exhibits, no prior authorization is needed.

SEC. 9. COMPUTER-GENERATED FORMS NOT SHOWN AS EXHIBITS IN THIS REVENUE PROCEDURE

.01 Those desiring to computer-generate forms not shown here may do so, but they must design such forms themselves by following the manner and style of those in the Exhibits section of this revenue procedure, and by taking care to observe other requirements and conditions stated here.

.02 Computer-generated forms so designed do not require prior approval

from the Service. However, the user of such forms is bound by the "Agreement" in Part A, Sec. 21 above. The Service encourages the submission of all proposed forms for review and approval.

.03 If you wish, you may submit any substitute form to the Service for approval consideration, if the proposed form is covered in Part A, Section 2.03.

SEC. 10. INSTRUCTIONS FOR FORMATTING COMPUTER-GENERATED SUBSTITUTES

.01 Format Arrangement

The format of each substitute schedule or form must follow the format of the official schedule or form as to item captions, line references, line numbers, sequence, form arrangement and format, etc. Basically try to make the form look like the official one, with readability and consistency being primary factors. You may use periods and/or other similar special characters to separate the various parts and sections of the form. DO NOT use alpha or numeric characters for these purposes. With the exceptions in .02 below, all line numbers and items must be printed even though an amount is not entered on the line.

.02 Line Numbers.

1 When a line on an official form is designated by a number or a letter, that designation (reference code) must be used on a substitute form.

2 The reference code must be printed to the left of the corresponding captioned line and also immediately preceding the data entry field even if there is no reference code immediately preceding the data entry field on the official form. If an entry field contains multiple lines but shows the line references only one time on the left and right side of the form, do not use more than the same number of line references on the substitute return.

3 In addition, the reference code that is immediately before the data field must either be followed by a period or enclosed in parentheses. There also must be at least two blank spaces between the period or the right parenthesis and the first digit of the data field. (See example below.)

4 A decimal point (i.e., a period) should be used for each money amount regardless of whether the amount is reported in dollars and cents or in whole dollars, or whether or not the vertical line that separates the dollars from the cents is present. The decimal points must be vertically aligned when possible.

Example:

5 STATE & LOCAL INC. TAX.....5. 495.00
6 REAL ESTATE TAXES.....6.
7 PERSONAL PROPERTY TAXES.....7. 198.00

or

5 STATE & LOCAL INC. TAX.....(5) 495.00
6 REAL ESTATE TAXES.....(6)
7 PERSONAL PROPERTY TAXES.....(7) 198.00

.03 Multiple Page Forms.

When submitting multiple page forms, send all pages of the form in the same package.

SEC. 11. ADDITIONAL INSTRUCTIONS FOR ALL FORMS

.01 Internal control numbers and identifying symbols of the computer preparer may be shown on the substitute, if the use of such numbers or symbols is acceptable to the taxpayer and the taxpayer's representative. If shown, such information must not be printed in the top one-half inch clear area of any form or schedule requiring a signature. With the exception of the actual tax return form (i.e., Forms 1040, 1120, 940, 941, 5500 Series, etc.), you may print in the left vertical and bottom left margins. The bottom left margin you may use extends 3½ inches from the left edge of the form. (See Part A, Sec. 12 for more information on this subject.)

.02 Descriptions for captions, lines, etc., appearing on the substitute forms may be limited to one print line by using abbreviations and contractions, and by omitting articles, prepositions, etc. However, sufficient key words must be retained to permit ready identification of the caption, line or item.

1 Explanatory detail and/or intermediate calculations for derivation of final line totals, may be included on the substitute. We prefer that such calculations be submitted in the form of a supporting statement. If intermediate calculations are included on the substitute, the line on which they appear may not be numbered or lettered. Intermediate calculations may not be printed in the right column. This column is reserved for official numbered and lettered lines that correspond to the ones on the official form. If a supporting statement is submitted, intermediate calculations or subtotals may be formatted at the preparer's option.

2 Text prescribed for the official form, which is solely instructional in nature, e.g., "Attach this schedule to Form 1040," "See instructions," etc., may be omitted from the substitute form.

3 Information for more than one schedule or form may not be shown on the same printout page. It is strongly recommended that a substitute form not exceed the same number of pages used for the official form.

(a) Both sides of the paper may be printed for multiple page official forms; but it is unacceptable to intermix single page schedules of forms, except for Schedules A and B which are printed back to back by the Service. For example, Schedule E can be printed on both sides of the paper, because the official form is multiple page, with page two continued on the back. However, for example, do not print Schedule E on the front page and Schedule SE on the back, or Schedule A on the front and Form 8615 on the back, etc. Both pages of a substitute form must match the official form version it represents, except that the back page may be blank if the Service form only contains the instructions thereon.

4 Identify all computer-prepared substitutes clearly; print the form designation one-half inch from the top margin and one and one-half inches from the left margin; print the title centered on the first line of print; and print the taxable year and, where applicable, the sequence number on the same line one-half to one inch from right margin. Include the taxpayer's name and SSN on all forms and attachments. Also print the OMB number as reflected on the official form.

5 The state tax column may be present, but the state tax information must NOT be visible on the copy filed with the Service. When a form is designed with both federal and state columns, the federal column must be to the left of the state column and adjacent to the line caption.

6 Negative (or loss) monetary amount entries should be enclosed in brackets, or signed minus, to assist in the accurate computation and input of form data. On many official forms the Service preprints brackets in selected negative data

fields, and these designations should be retained or inserted on affected substitute forms.

SEC. 12. FILING SUBSTITUTE FORMS WITH THE SERVICE

Instruct the taxpayer to follow the same instructions as for filing official forms, unless filing the forms as a tax preparer. These instructions are in the taxpayer's tax package.

SEC. 13. SPECIAL FORM 1040EZ OPTICAL CHARACTER RECOGNITION/IMAGE CHARACTER RECOGNITION (OCR/ICR) REQUIREMENTS

.01 The Form 1040EZ is designed in OCR/ICR format. IRS has the capability to machine read this form by optical character recognition/image character recognition (OCR/ICR) equipment. Form 1040EZ data may also be filed electronically or on Form 1040PC.

.02 An acceptable substitute OCR/ICR Form 1040EZ must generally be an exact replica of the official OCR/ICR reproduction proof with respect to layout, content and required OCR/ICR characteristics.

.03 The specific paper requirements which must be met for the development of a substitute (privately printed) OCR/ICR Form 1040EZ include the following:

1 Color and quality of paper—Paper must be white, OCR/ICR grade bond, with no fluorescent additives or water marks, and with zero rag content.

2 Reflectivity of paper—Must be 80% or greater.

3 Opacity—The paper opacity ratio must be 80% or more.

4 Paper Weight—Specified paper weight is 20 lb. OCR/ICR bond (.0035″).

5 Dirt—Must not exceed 10 parts per million.

6 Finish (smoothness)—Must be between 90 and 160 units (Sheffield).

7 Porosity—Paper should have a Gurley reading between 15 and 95.

8 Gloss—Paper with shiny or lustrous appearance (glossy) should be avoided.

9 Size—Form trim size must be 8″ x 11″.

.04 The specific ink requirements which must be met for this form include the following:

1 Print Color—The face of the form prints in black and green, the back prints in black only (70% screen).

2 Ink—Green ink used must be highly reflective OCR/ICR type, such as Flint J–27975, or an exact match. Black ink used must be non-reflective.

3 Face Registration—Black to green must be .02″ (plus or minus) both horizontally and vertically.

4 Face Screen—Forms contain a green screened background equal to a 15% tone of 110-line screen. Follow registration marks on repro-proof for screen positioning. Handprinted boxes are included on Page 1 of the reproduction proof and should be printed as a 50% value of the recommended OCR/ICR green ink. Inks used for handprinted boxes must reflect at least 90% of the background on which it is printed as measured in the visible range.

5 Face Margins—Approximately 2/6″ head from top trimmed edge to screen (½″ to black image). 1/6″ outside from trimmed edges to screen.

6 Back Margins—½″ head, 5/16″ foot, and 5/16″ sides.

7 Back Screen—Back copy should be screened for 70% tone value.

.05 Typography

Type must be substantially identical in both size and shape with corresponding type on the official form reproduction proof.

.06 To assure proper alignment and position of hand-printed characters representing return lines 1 through 10 tax data, they must be handprinted (entered) into the preprinted amount field boxes on the form. A #2 lead wooden pencil, or blue, and/or black ink pen (ball point, fountain, or felt-tipped) is recommended as the writing tool which will consistently provide the required stroke width and print contrast on entered characters.

.07 Reading of handprinted characters requires adherence to the following techniques.

1 Enter numeric amount digits carefully and clearly. Fill at least ⅔ of the individual character box height, keeping the character within the box with no overlapping or touching characters. Specific required digit constraints are shown below.

2 When entering "fours", keep the top open.

3 When entering "ones", do not use serifs.

4 When entering "twos", do not add extra loops.

5 All character lines must be connected, with no gaps.

.08 All the general and detailed provisions of this Revenue Procedure apply (in addition to this specific OCR/ICR Section) for the development of substitute OCR/ICR Forms 1040EZ.

SEC. 14. COMPUTER GENERATED ALTERNATIVE RETURNS, FORM 1040PC FORMAT RETURN

.01 The Internal Revenue Service is offering a new approach for filing individual income tax returns. The 1040PC Format Return is an alternative to the conventional preprinted tax return. The 1040PC is an answer sheet return, generated on a personal computer, in three-column format that prints only tax data that is input into the software. Tax returns are filed by tax preparers and taxpayers using commercially available tax preparation software packages that include the 1040PC Format Return print option.

1 1040PC Format Returns are computer-prepared, printed on plain white paper, signed and mailed to the designated processing center and are processed like any other conventionally filed return.

2 Preparers, or taxpayers, must purchase IRS accepted tax preparation software packages that include the 1040PC print option. All that is necessary to participate in 1040PC is a personal computer, accepted software, a printer, and plain white paper. 1040PC is attractive to tax preparers and taxpayers who might not be interested or capable of Electronic Filing.

3 The Direct Deposit option is available to taxpayers filing 1040PC returns. Balance due returns may also be filed using 1040PC. The payment may be forwarded to the Service Center with a separate payment voucher (Form 1040–V).

4 All software used to generate the 1040PC Format Return must be tested and accepted by the Internal Revenue Service. Testing will validate 1040PC returns generated by the software and that the software program is in compliance with validity and consistency checks in the IRS 1040PC Project specifications. Software developers who wish to participate in the 1040PC program must submit Form 9356, Application for Software Developers to Participate in the 1040PC Answer Sheet for Individual Income Tax Returns, to the 1040PC Filing Section.

5 Upon successful completion of software acceptance testing, the software developer will be issued a software acceptance code that will be embedded into the software and print on every

1040PC return generated. This is not the same as the Forms Approval Number which is referenced in Part A, Section 8, or the approval number which is generated for OCR Scannable Application Forms for Employee Plans in Part B, Section 19.

6 The Internal Revenue Service believes that 1040PC will prove beneficial to taxpayers, tax preparers, and the Service. For specific information about the alternative computer generated 1040PC Format Return, refer to Publication 1678, Project 1040PC, Handbook for 1040PC Format Preparers and Publication 1630, Project 1040PC, Specifications for Software Developers. You may also call (202) 283–0180 or write:

Internal Revenue Service
1040PC Filing Office, T:S:P:I
1111 Constitution Ave., NW
Washington, DC 20224

SEC. 15. SPECIAL FORM 941 REQUIREMENTS - OCR SPECIFICATIONS

.01 The official Form 941 and Schedule B (Form 941) are designed in OCR/ICR format. The Service has the capability to machine read these forms by optical character recognition/image character recognition (OCR/ICR) equipment (Scan-optics 9000 Series), if submitted in acceptable OCR/ICR format.

.02 Form 941 and Schedule B (Form 941) may be produced either in OCR/ICR scannable format or as black and white substitute forms which can be recognized by the scanning equipment. The specific criteria in .03 and .04 apply if the substitute form is to be produced for OCR processing. Specification for black and white substitutes are in Section 16.

.03 An acceptable substitute OCR/ICR Form 941 or Schedule B must be an exact replica of the official reproduction proof with respect to layout, content, and required OCR/ICR characteristics.

.04 The specific paper requirements which must be met for the development of substitute (privately printed) forms generally duplicate those specified in Part B, Section 13, with the following exception:

1 Size—Form 941 trim size must be 8½" X 11".

.05 The specific ink requirements which must be met for these forms include the following:

1 Print Color—Black and Red

2 Ink—Red ink must be a highly reflective (not less than 80%) OCR/ICR type ink, such as Sinclair/Valentine J6983 or an exact match. Black ink reflectance must not be greater than 15%.

3 Handprinted Boxes (including the numbers outside the boxes)—These handprinted boxes (for IRS entries and use only) are included on the reproduction proof, and should be printed as a 50% screen value of the recommended OCR/ICR red ink. Inks used for handprinted boxes must be 15% or less when tested using the MacBeth or Kidder testers (see #5 below).

4 Face Margins—Minimum margins require ½" head; center sides; and 5/16" foot.

5 Testers—The following two print testers may be used for Form 941. Any other type tester must first be approved by the IRS.

(a) MacBeth PCM–II

Use "C" scale. The Print Contrast Signal (PCS) must range between .01 minimum to .06 maximum.

(b) Kidder 082 A

Use infrared scale. PCS values must fall in the range of .12 minimum to .21 maximum. White calibration disk must be set at 100%. Sensitivity must be set at "1".

SEC. 16. SPECIAL FORM 941 REQUIREMENTS - BLACK AND WHITE SPECIFICATIONS

Note: This requirement will take effect at a future date. Until written notice is given, either this version or a duplicate of the current Form 941 in black and white is acceptable.

.01 Exhibits BW–1 and BW–2 are exhibits of acceptable black and white substitutes Forms 941 and Schedule B. The general specifications for black and white substitutes are as follows:

(a) No vertical or horizontal rules, except for the IRS internal use boxes in the upper right corner of Form 941 and the signature line.

(b) The ID code ("4141" or "5151") must be printed in OCR–A or Courier font and data fields must be printed in a non-proportional typeface (preferably Courier).

(c) All data positions in the instructions that follow include the margins. Character positions are counted from the left edge based on 10 characters per inch; print lines are counted from the top edge based on six lines per inch.

(d) The boxes labeled "IRS Use" on Form 941 must be displayed as shown on the official form. If possible, use dotted or broken lines. The boxes start in position 17 and cover print lines 19 through 21.

.02 The other checkboxes on Form 941 must not be displayed. The form must be programmed to display non-numeric data at the following locations:

(a) ID Code - starts in line 6, position 19.

(b) Taxpayer identification (entity) data (name, address, etc.) - starts in line 9, position 20.

(c) State Deposit Code - line 11, position 12.

(d) Different address checkbox - line 21, position 13.

(e) Final Return Checkbox - line 23, postion 39.

(f) Seasonal employer checkbox - line 24, position 62.

(g) Social Security and Medicare taxes checkbox - line 35, position 60.

(h) Overpayment boxes (line 16) - line 51, positions 23 and 43.

(i) Semiweekly depositors checkbox - line 53, position 77.

(j) Monthly depositors checkbox - line 54, position 77.

.03 Amount fields - Do not reproduce the dollar signs on lines 6a, 6b, 7, or 9. The decimal point for the first amount on lines 6a, 6b, and 7 must be placed in position 48. The decimal point for amounts in items 2 through 15 (righthand column) must be placed in position 75. The print lines for the amounts are:

Item	*Print Line*	*Item*	*Print Line*
2	26	9	37
3	27	10	39
4	28	11	41
5	30	12	43
6a	31	13	45
6b	32	14	47
7	33	15	49
8	35		

.04 The monthly summary amounts on line 17 must be displayed on print line 58. Decimal points must be displayed in positions 19, 37, 56, and 74 for columns (a) through (d), respectively.

.05 Schedule B (Form 941)

(a) Display the ID Code (5151) on print line 6, position 20. Display the name (positions 9–49), EIN (53–66), and quarter ended (69–78) on print line 9.

(b) The daily amounts appear on the following print lines:

First month - lines 15, 17, 19, 21, 23, 25, and 27
Second month - lines 31, 33, 35, 37, 39, 41, and 43
Third month - lines 47, 49, 51, 53, 55, 57, and 59
Subtotal A - line 28
Subtotal B - line 44
Subtotal C - line 60
Total D - line 61

(b) The body of this form has five columns. The following character positions refer to the placement of a decimal point in the amount. The amounts will the expand two characters to the right for cents and a variable number to the left for dollars.

Column 1 - days 1 through 7 - position 17
Column 2 - days 8 through 14 - position 32
Column 3 - days 15 through 21 - position 46
Column 4 - days 22 through 28 - position 61
Column 5 - days 29 through 31 and totals - position 76
Please do not fill in the area under day 31.

SEC. 17. PAPER SUBSTITUTES FOR FORM 1042-S

.01 Paper substitutes for Form 1042–S, Foreign Person's U.S. Source Income Subject to Withholding, that totally conform to the specifications contained in this procedure may be privately printed without prior approval from the Internal Revenue Service. Proposed substitutes not conforming to these specifications must be submitted for consideration.

1 The request should be submitted by November 15 of the year prior to the year the form is to be used. This is to allow the Service adequate time to respond and the submitter adequate time to make any corrections. These requests should contain a copy of the proposed form, the need for the specific deviation(s), and the number of information returns to be printed.

2 Form 1042–S is subject to annual review and possible change. Withholding agents and form suppliers are cautioned against overstocking supplies of the privately printed substitutes.

3 Copies of the official form for the reporting year may be obtained from most Service offices. The Service provides only cut sheets (no carbon interleaves) of these forms. Continuous fanfold/pin-fed forms are not provided.

.02 Instructions for Withholding Agents

1 Only original copies may be filed with the Service. Carbon copies and reproductions are not acceptable.

2 The term "Recipient's U.S. taxpayer identification number," for an individual means the social security number (SSN) or individual taxpayer identification number (ITIN), consisting of nine digits separated by hyphens as follows: 000–00–0000. For all other recipients, the term means employer identification number (EIN). The EIN consists of nine digits separated by one hyphen as follows: 00–0000000. The taxpayer identification number must be in one of these formats.

3 Withholding agents are requested to type or machine print whenever possible, provide quality data entries on the forms (that is, use black ribbon, insert data in the middle of blocks well separated from other printing and guidelines), and take other measures to guarantee a clear, sharp image. Withholding agents are not required, however, to acquire special equipment solely for the purposes of preparing these forms.

4 On corrected returns, the words CORRECTED RETURN must be typed in all capital letters in the top ¼ inch, right of center margin. All required information must be completed on a corrected return since it replaces and supersedes the information return previously filed.

5 Substitute forms prepared in continuous or strip form must be burst and stripped to conform to the size specified for a single form before they are filed with the Service. The dimensions are found below.

(a) Computer cards are acceptable, provided they meet all requirements regarding layout, content, and size.

.03 Substitute Forms Format Requirements.

1 Privately printed substitute Forms 1042–S must be exact replicas of the official forms with respect to layout and contents. Only the dimensions of the substitute form may differ and the printing of the Government Printing Office symbol must be deleted. The exact dimensions are found below.

2 Line 1 must be present, line 2 may be omitted if it is not needed. If line 2 is omitted, also omit line 3.

3 None of the boxes can be omitted. Each box (a through h) must be present and in the exact order. The box for each payment amount must contain the appropriate caption.

4 Color and Quality of paper.

(a) Paper for Copy A must be white chemical wood bond, or equivalent, 20 pound (basis 17 x 22–500), plus or minus 5 percent; or offset book paper, 50 pound (basis 25 x 38–500). No optical brighteners may be added to the pulp or paper during manufacture. The paper must consist of principally bleached chemical woodpulp or recycled printed paper. It also must be suitably sized to accept ink without feathering.

(b) Copies B, C, D (for Recipient), and E (for Withholding Agent) are provided in the official assembly solely for the convenience of the withholding agent. Withholding agents may choose the format, design, color and quality of the paper used for these copies.

5 Color and Quality of Ink—All printing must be in a high quality non-gloss black ink. Bar codes should be free from picks and voids.

6 Typography—Type must be substantially identical in size and shape to corresponding type on the official form. All rules on the document are either 1 point (0.015 inch) or 3 point (0.045 inch). Vertical rules must be parallel to the left edge of the document; horizontal rules, parallel to the top edge.

7 Dimensions—The official form is 8 inches wide X 5½ inches deep, exclusive of a ½ snap stub on the left side of the form. The snap feature is not required on substitutes.

(a) The width of a substitute Copy A must be a minimum of 7 inches and a maximum of 8 inches, although adherence to the size of the official form is preferred. If the width of the substitute Copy A is reduced from that of the official form, the width of each field on the substitute form must be reduced proportionately. The left margin must be ½ inch and free of all printing other than that shown on the official form.

(b) The depth of a substitute Copy A must be a minimum of 5 ⅙ inches and a maximum of 5½ inches.

8 Carbonized forms or "spot carbons" are not permissible. Interleaved carbons, if used, must be of good quality to preclude smudging and should be black.

9 Other Copies—Copies B, C, and D are required to be furnished for the convenience of payees who are required to send a copy of the form with other

federal and state returns they file. Copy E may be desired as a withholding agent's record/copy.

.04 Additional Instructions

1 Arrangement of Assembly—If all five parts are present, the parts of the assembly shall be arranged from top to bottom as follows: Copy A (Original) "For Internal Revenue Service," Copies B, C, and D "For Recipient," and Copy E "For Withholding Agent."

SEC. 18. SPECIFICATIONS FOR FILING SUBSTITUTE SCHEDULES K-1

Prior approval is NOT required for a substitute Schedule K–1 that accompanies Form 1065 (for partnership), a Form 1120S (for small business corporation), or a Form 1041 (for fiduciary) when the substitute Schedule K–1 meets all of the following requirements.

.01 The Schedule K–1 must contain the payer and recipient's name, address and SSN/EIN.

.02 The Schedule K–1 must contain all line items required for use by the taxpayer.

.03 The line items must be in the same order and arrangement as those on the official form.

.04 The line items must be numbered, titled, and/or captioned exactly as shown on the official form.

.05 Each taxpayer's information must be on a separate sheet of paper. Therefore, all continuously printed substitutes must be separated, by taxpayer, before filing with the Service.

.06 Schedules K–1 for recipients must have instructions for required line items attached.

.07 You may be subject to penalties if you file Schedules K–1 with the Service and furnish Schedules K–1 to partners, shareholders, or beneficiaries that do not conform to the specifications of this revenue procedure.

.08 The amount of each partner's, shareholder's or beneficiary's share of each line item must be shown. The furnishing of a total amount for each line item and a percentage (or decimal equivalent) to be applied to such total amount by the partner, shareholder, or beneficiary does not satisfy the law and the specifications of this revenue procedure.

.09 If you file Schedules K–1 not conforming to the above specifications, IRS may consider these as not processable and return them to you to be filed correctly. You may also be subjected to the penalty as mentioned in .07 above.

SEC. 19. PROCEDURES FOR PRINTING INTERNAL REVENUE SERVICE ENVELOPES

.01 Organizations are now permitted to produce substitute tax return envelopes. Use of substitute return envelopes that comply with the requirements set forth in this section will assist in delivery of mail by the U.S. Postal Service and facilitate internal sorting once the envelopes are received at the Internal Revenue Service Centers. The permanent five digit ZIP codes assigned to the ten service centers are listed below. These ZIP codes must be utilized when mailing returns to the prescribed service center:

ATLANTA GA 39901
KANSAS CITY MO 64999
AUSTIN TX 73301
PHILADELPHIA PA 19255
MEMPHIS TN 37501
ANDOVER MA 05501
CINCINNATI OH 45999
HOLTSVILLE NY 00501
OGDEN UT 84201
FRESNO CA 93888

.02 The sorting of returns by form type is accomplished by the preprinted bar codes on return envelopes that are included in each specific type of form or package mailed to the taxpayer. The 32 bit bar code located to the left of the address on each envelope identifies the type of form that person is filing and assist the Service in consolidating like returns together for processing. Failure to use the envelopes furnished by the Service results in additional processing time and effort, and possibly delays the timely deposit of funds, processing of returns, and issuance of refund checks.

.03 The Internal Revenue Service will not furnish or sell bulk quantities of preprinted tax return envelopes to taxpayers or tax practitioners. A suitable alternative has been developed which will accommodate the sorting needs of both the IRS and the U.S. Postal Service. The new alternative is based on the use of ZIP + 4 or 9 digit ZIP codes for mailing various types of tax returns to the different area service centers. Essentially, the Postal Service will utilize the last four digits to identify and sort the various form types into separate groups for processing. The list of add-on four digits or + 4 portion of the 9 digit ZIP codes with the related form designations is provided below and is to become a permanent part of the five digit service center ZIP codes shown above.

FORM ZIP + FOUR	PACKAGE
XXXXX–0001	Reserved
XXXXX–0002	1040
XXXXX–0005	941
XXXXX–0006	940
XXXXX–0008	943
XXXXX–0011	1065
XXXXX–0012	1120
XXXXX–0013	1120S
XXXXX–0014	1040EZ
XXXXX–0015	1040A
XXXXX–0020	5500–C/R
XXXXX–0024	5500EZ
XXXXX–0027	990
XXXXX–0031	2290
XXXXX–0044	5500

.04 The Reproducible Program that in past years supplied the envelope Reproduction Proofs will be abolished September 30, 1996. The IRS will no longer provide camera copy to practitioners for the production of envelopes. Practitioners must develop their own camera copy.

.05 Use of preparer company names, addresses, and logos is permissible so long as prescribed clear areas are not invaded. The government recommends that the envelope stock have an average opacity not less than 89 percent and contain a minimum of 50 percent waste paper. Use of carbon based ink is essential for effective address and bar code reading. Envelope construction can be of side seam or diagonal seam design. The government recommends that the size of the envelope should be 5¾″ by 9″. Continuous pin-fed construction is not desirable, but is permissible if the glued edge is at the top. This requirement is firm as mail opening equipment is designed to slice or otherwise open the bottom edge of each envelope.

.06 The above procedures or guidelines are written for the user having envelopes preprinted. Many practitioners may not wish to have volumes of the different envelopes with differing ZIP codes/form designations preprinted for reasons of low volume, warehousing, waste, etc. In this case, the practitioner can type or machine print the addresses with the appropriate ZIP codes to accommodate sorting. If the requirements/guidelines outlined in this section cannot be met, then use of only the appropriate five digit service center ZIP code is needed.

SEC. 20. SPECIFICATIONS FOR OCR SCANNABLE APPLICATION FORMS FOR EMPLOYEE PLANS

.01 Forms 4461, 4461–A, 4461–B, 5300, 5303, 5307, 5310, 5310–A, and 6406 are OCR scannable documents submitted to key district offices for employee plans matters. They may be submitted as Computer-generated substitute forms if the requirements of this section are satisfied.

.02 An OCR data sheet must be generated according to the following requirements:

1 Set at least 1″ margin at top, bottom, and both sides.

2 A data element consists of a less than sign, information or at least 5 blank spaces, and a greater than sign (delimiters). All data elements from page one of the application forms in .01 above must be printed on the OCR data sheet, even if no information is entered between the delimiters.

3 Add at least 2 spaces before and after each delimiter.

4 Each data element must start at the left margin.

5 One line for each data field, except employer and plan name fields may be two lines. However, only one set of delimiters may bracket the field, even if the field is on two lines.

6 Each data element must appear on the OCR data sheet in the same sequence as printed on the preprinted form, reading top to bottom and from left to right.

7 Each data field must be sequentially numbered at left commencing with 1. See Notice 90–38 for examples of the acceptable format.

8 The data sheet must be printed on 8½″ X 11″ white nonrecycled paper suitable for use with printing equipment and duplicating machines. A photocopy is not acceptable. Heavyweight bond paper and onion skin paper are not acceptable.

9 Use 10 pitch type in a standard business font (e.g., courier, elite, pica).

10 Add at least two spaces before and after each less than and greater than sign (delimiters).

11 Do not fold or staple the OCR data sheet. It may remain loose, or be paper or spring clipped to the application.

12 At the top of the OCR data sheet add the heading "OCR Data Sheet, File With Application Form, Approval Number (leave nine spaces for approval number)".

.03 The OCR data sheet must be submitted for approval to: EP OCR Forms Coordinator, E:EP:FC, Room 2232, 1111 Constitution Ave., NW, Washington, DC 20224.

.04 The OCR data sheet must be submitted with a complete word-for-word identical copy of the application form except as described in .05 below. This copy may be a photocopy, or a Computer-Generated Substitute Form. Computer-generated substitute forms may be submitted for approval to the address in .03 above. However, except for the OCR data sheet, such approval is not required if the requirements of this Revenue Procedure are satisfied. If approval is requested, leave nine spaces for the approval number above the OMB approval number.

.05 The OCR data sheet replaces one copy of page one of the application which must otherwise be submitted in duplicate. To avoid confusion when generating the OCR data sheet, the following wording should be deleted from the first page of the application, "File page 1 of the form in duplicate" and "Both copies of this page must be signed". If the Procedural Requirements Checklist is being generated, the following line items should be modified as indicated. Item (e) or (f) "Have you submitted page 1 in duplicate?" should be modified to read, "Have you submitted the OCR data sheet?", and item (f) or (g) "Have you signed both copies of page 1 of the application?" should be modified to read, "Have you signed the application?"

.06 Nonscannable EP application forms, e.g., Form(s) 5305 and 5306, may be computer-generated. They need not be submitted for approval if the requirements of this Revenue Procedure are satisfied. If approval is desired, these forms may be submitted to the address in .03 above.

SEC. 21. PROCEDURE FOR SUBSTITUTE FORM 5471 AND FORM 5472

.01 Instructions for Preparing Substitute Forms 5471, Information Return of U.S. Persons With Respect To Certain Foreign Corporations, and their accompanying Schedules J, M, N, and O, and Forms 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged In a U.S. Trade or Business (Under Sections 6038A and 6038C of the Internal Revenue Code).

1 Paper and Computer-Generated Substitutes for Form 5471 and the accompanying Schedules J, M, N, and O, and Form 5472 that totally conform to the specifications contained in this procedure may be privately printed, but must have prior approval and are subject to annual review from the Internal Revenue Service.

2 Copies of the official forms for the reporting year may be obtained from most Service offices. The Service provides only cut sheets of these forms. Continuous fan-folded/pin-fed forms are not provided.

3 The Service will accept QUALITY substitute tax forms that are consistent with the official forms they represent, AND that do not have an adverse impact on our processing. Therefore, only those substitute forms that conform to, and do not deviate from the corresponding official forms, are acceptable.

.02 Computer-Prepared Tax Forms

If the substitute returns and schedules meet the guidelines prescribed herein, the Service will for filing purposes accept computer-prepared Forms 5471 and 5472 filled in by a computer, word processing equipment or similar automated equipment or a combination of computer-prepared/generated and filled in information, filed separately or attached to individual or business income tax returns.

.03 Format Arrangement

1 The substitute must follow the design of the official form as to format, arrangement, item caption, line numbers, line references, and sequence. It must be an exact textual and graphic MIRROR image of the official form for it to be acceptable.

2 The filer must use one of the official ten character amount formats. All entries in the amount column should have a decimal point following the whole dollar amounts whether or not the vertical line that separates the dollars from the cents is present. It must follow a consistent format.

3 The reference code must be printed to the left of the corresponding captioned line and also immediately preceding the data entry field EVEN if there is no reference code preceding the data entry field on the official form. The reference code that is immediately before the data field must either be followed by a period or enclosed in parentheses. There also must be at least two blank spaces between the period or the right parenthesis and the first digit of the data field.

4 The size of the page must be the same as the official form (8½" X 11").

5 The acceptable print is "Helvetica".

6 The spacing of the print must be 6 lines/inch vertical, 10 or 12 print characters per inch horizontally.

7 A ½ to ¼ inch margin must be maintained across the top, bottom, and both sides (exclusive of any pin feed holes).

8 The substitute form must be of the same number of pages as the official one.

9 The preprinted brackets in the money fields should be retained.

10 The filer must COMPLETELY fill in all the specified numbers or referenced lines as they appear on the official form, (not just totals), BEFORE attaching any supporting statement.

11 Supporting statements are NEVER to be used until the required official form they support are first totally filled in (completed). A blank or incomplete form that refers to a supporting statement, in lieu of completing a tax return is unacceptable.

12 Descriptions for captions, lines, etc., appearing in the substitute forms may be limited to one print line by using abbreviations and contractions, and by omitting articles, prepositions, etc. However, sufficient key words must be retained to permit ready identification of the caption, line or item.

13 Text prescribed for the official form, which is solely instructional in nature, e.g., "Attach this schedule to Form 1040", "See instructions," etc., may be omitted from the form.

.04 Filing Instructions

Instructions for filing substitute forms are the same as for filing official forms.

SEC. 22. FORMS FOR ELECTRONICALLY FILED RETURNS

.01 Since the 1986 filing season, the Service has been accepting current processing year electronically filed refund returns. Since tax year 1991, we accept balance due returns that are filed electronically. Electronic filing is a method by which qualified filers transmit tax return information directly to an IRS Service Center over telephone lines, in the format of the official Internal Revenue Service forms.

Anyone wishing to participate in the Electronic Filing Program for individual income tax returns must submit a Form 8633, Application to Participate in the Electronic Filing Program. (**Note:** For Business returns, prospective participants must submit a Form 9041, Application for Electronic/Magnetic Media Filing of Business and Employee Benefit Plan Returns.)

.02 The taxpayer signature does not appear on the electronically transmitted tax return and is obtained by the qualified electronic filer on Form 8453, U. S. Individual Income Tax Declaration for Electronic Filing, for Forms 1040, 1040A and 1040EZ. Form 8453, which serves as a transmittal for the associated non-electronic (paper) documents, such as Forms W–2, W–2G, and 1099–R, is a one-page form and can only be approved through the Substitute Forms Program in that format. For specific information about electronic filing, refer to Publication 1345, Handbook for Electronic Filers of Individual Income Tax Returns. (**NOTE:** For Business returns, the electronic/magnetic media participants must use the official Form 8453–E, F or P, or an approved substitute that duplicates the official form in language, format, content, color and size.)

.03 A participant in the electronic filing program who wants to develop a substitute form should follow the guidelines for preparing substitute forms throughout this publication, and send a sample of the form for approval to the Substitute Forms Coordinator at the address in Part A, Section 7. Forms 8453 prepared using a font where all IRS-approved wording will not fit on a single page will not be accepted as substitute forms. This applies primarily to dot-matrix printers, although forms prepared similarly on laser and inkjet printers will also be rejected. PLEASE NOTE: Use of unapproved forms could result in suspension of the participant from the electronic filing program.

SEC. 23 FTD MAGNETIC TAPE PAYMENTS

.01 REVENUE PROCEDURE 89–48 (IRS PUBLICATION 1315) provides the requirements and instructions for reporting agents who submit Federal Tax Deposits (FTD) payment information on magnetic tape. Magnetic tape submissions for FTD can be made for Forms 940, 941, 942, 943, 720, CT–1, 990–PF, 990–T, 990–C, 1042, 1120, and Schedule A (Form 941) Backup Withholding.

.02 Revenue Procedure 89–49 (Pub. 1374) provides the requirements and instructions for certain banks and fiduciaries to submit quarterly Form 1041–ES payments on magnetic tape through the Federal Tax Deposit (FTD) system.

SEC. 24. EFFECT ON OTHER DOCUMENTS

This revenue procedure supersedes Revenue Procedures 95–16, I.R.B. 1995–8, and 95–46, I.R.B. 95–46.

Exhibit A-1 (Preferred Format)

SCHEDULES A&B (Form 1040)

Department of the Treasury Internal Revenue Service (99)

Schedule A—Itemized Deductions

(Schedule B is on back)

▶ Attach to Form 1040. ▶ See Instructions for Schedules A and B (Form 1040).

OMB No. 1545-0074

1995

Attachment Sequence No. 07

Name(s) shown on Form 1040 | Your social security number

Medical and Dental Expenses		**Caution:** *Do not include expenses reimbursed or paid by others.*			
	1	Medical and dental expenses (see page A-1)	1		
	2	Enter amount from Form 1040, line 32. 2			
	3	Multiply line 2 above by 7.5% (.075)	3		
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-			4
Taxes You Paid (See page A-1.)	5	State and local income taxes	5		
	6	Real estate taxes (see page A-2)	6		
	7	Personal property taxes	7		
	8	Other taxes. List type and amount ▶	8		
	9	Add lines 5 through 8			9
Interest You Paid (See page A-2.)	10	Home mortgage interest and points reported to you on Form 1098	10		
	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-3 and show that person's name, identifying no., and address ▶	11		
Note: Personal interest is not deductible.	12	Points not reported to you on Form 1098. See page A-3 for special rules	12		
	13	Investment interest. If required, attach Form 4952. (See page A-3.)	13		
	14	Add lines 10 through 13			14
Gifts to Charity If you made a gift and got a benefit for it, see page A-3.	15	Gifts by cash or check. If you made any gift of $250 or more, see page A-3	15		
	16	Other than by cash or check. If any gift of $250 or more, see page A-3. If over $500, you **MUST** attach Form 8283	16		
	17	Carryover from prior year	17		
	18	Add lines 15 through 17			18
Casualty and Theft Losses	19	Casualty or theft loss(es). Attach Form 4684. (See page A-4.)			19
Job Expenses and Most Other Miscellaneous Deductions (See page A-5 for expenses to deduct here.)	20	Unreimbursed employee expenses—job travel, union dues, job education, etc. If required, you **MUST** attach Form 2106 or 2106-EZ. (See page A-5.) ▶	20		
	21	Tax preparation fees	21		
	22	Other expenses—investment, safe deposit box, etc. List type and amount ▶	22		
	23	Add lines 20 through 22	23		
	24	Enter amount from Form 1040, line 32. 24			
	25	Multiply line 24 above by 2% (.02)	25		
	26	Subtract line 25 from line 23. If line 25 is more than line 23, enter -0-			26
Other Miscellaneous Deductions	27	Other—from list on page A-5. List type and amount ▶			27
Total Itemized Deductions	28	Is Form 1040, line 32, over $114,700 (over $57,350 if married filing separately)? **NO.** Your deduction is not limited. Add the amounts in the far right column for lines 4 through 27. Also, enter on Form 1040, line 34, the **larger** of this amount or your standard deduction. **YES.** Your deduction may be limited. See page A-5 for the amount to enter.		▶	28

For Paperwork Reduction Act Notice, see Form 1040 instructions. Schedule A (Form 1040) 1995

S582

Exhibit A-2 (Acceptable Format)

SCHEDULES A&B (Form 1040)

Department of the Treasury Internal Revenue Service (99)

Schedule A—Itemized Deductions

(Schedule B is on back)

▶ Attach to Form 1040. ▶ See Instructions for Schedules A and B (Form 1040).

OMB No. 1545-0074

1995

Attachment Sequence No. 07

Name(s) shown on Form 1040 | Your social security number

Medical and Dental Expenses		**Caution:** *Do not include expenses reimbursed or paid by others.*				
	1	Medical and dental expenses (see page A-1)	1			
	2	Enter amount from Form 1040, line 32. 2				
	3	Multiply line 2 above by 7.5% (.075)	3			
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-				4
Taxes You Paid (See page A-1.)	5	State and local income taxes	5			
	6	Real estate taxes (see page A-2)	6			
	7	Personal property taxes	7			
	8	Other taxes. List type and amount ▶	8			
	9	Add lines 5 through 8				9
Interest You Paid (See page A-2.)	10	Home mortgage interest and points reported to you on Form 1098	10			
	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-3 and show that person's name, identifying no., and address ▶	11			
Note: Personal interest is not deductible.	12	Points not reported to you on Form 1098. See page A-3 for special rules	12			
	13	Investment interest. If required, attach Form 4952. (See page A-3.)	13			
	14	Add lines 10 through 13				14
Gifts to Charity If you made a gift and got a benefit for it, see page A-3.	15	Gifts by cash or check. If you made any gift of $250 or more, see page A-3	15			
	16	Other than by cash or check. If any gift of $250 or more, see page A-3. If over $500, you **MUST** attach Form 8283	16			
	17	Carryover from prior year	17			
	18	Add lines 15 through 17				18
Casualty and Theft Losses	19	Casualty or theft loss(es). Attach Form 4684. (See page A-4.)				19
Job Expenses and Most Other Miscellaneous Deductions (See page A-5 for expenses to deduct here.)	20	Unreimbursed employee expenses—job travel, union dues, job education, etc. If required, you **MUST** attach Form 2106 or 2106-EZ. (See page A-5.) ▶	20			
	21	Tax preparation fees	21			
	22	Other expenses—investment, safe deposit box, etc. List type and amount ▶	22			
	23	Add lines 20 through 22	23			
	24	Enter amount from Form 1040, line 32. 24				
	25	Multiply line 24 above by 2% (.02)	25			
	26	Subtract line 25 from line 23. If line 25 is more than line 23, enter -0-				26
Other Miscellaneous Deductions	27	Other—from list on page A-5. List type and amount ▶				27
Total Itemized Deductions	28	Is Form 1040, line 32, over $114,700 (over $57,350 if married filing separately)? **NO.** Your deduction is not limited. Add the amounts in the far right column for lines 4 through 27. Also, enter on Form 1040, line 34, the **larger** of this amount or your standard deduction. **YES.** Your deduction may be limited. See page A-5 for the amount to enter.			▶	28

For Paperwork Reduction Act Notice, see Form 1040 instructions. Schedule A (Form 1040) 1995

S582

Exhibit B-1 (Preferred Format)

Name(s) shown on Form 1040. Do not enter name and social security number if shown on other side. | Your social security number

Schedule B—Interest and Dividend Income

Attachment Sequence No. 08

Part I Interest Income

(See pages 15 and B-1.)

Note: If you received a Form 1099-INT, Form 1099-OID, or substitute statement from a brokerage firm, list the firm's name as the payer and enter the total interest shown on that form.

Note: *If you had over $400 in taxable interest income, you must also complete Part III.*

			Amount
1	List name of payer. If any interest is from a seller-financed mortgage and the buyer used the property as a personal residence, see page B-1 and list this interest first. Also, show that buyer's social security number and address ▶	1	
2	Add the amounts on line 1	2	
3	Excludable interest on series EE U.S. savings bonds issued after 1989 from Form 8815, line 14. You MUST attach Form 8815 to Form 1040	3	
4	Subtract line 3 from line 2. Enter the result here and on Form 1040, line 8a ▶	4	

Part II Dividend Income

(See pages 15 and B-1.)

Note: If you received a Form 1099-DIV or substitute statement from a brokerage firm, list the firm's name as the payer and enter the total dividends shown on that form.

Note: *If you had over $400 in gross dividends and/or other distributions on stock, you must also complete Part III.*

			Amount
5	List name of payer. Include gross dividends and/or other distributions on stock here. Any capital gain distributions and nontaxable distributions will be deducted on lines 7 and 8 ▶	5	
6	Add the amounts on line 5	6	
7	Capital gain distributions. Enter here and on Schedule D*	7	
8	Nontaxable distributions. (See the inst. for Form 1040, line 9.)	8	
9	Add lines 7 and 8	9	
10	Subtract line 9 from line 6. Enter the result here and on Form 1040, line 9 ▶	10	

**If you do not need Schedule D to report any other gains or losses, see the instructions for Form 1040, line 13, on page 16.*

Part III Foreign Accounts and Trusts

(See page B-2.)

If you had over $400 of interest or dividends or had a foreign account or were a grantor of, or a transferor to, a foreign trust, you must complete this part.

		Yes	No
11a	At any time during 1995, did you have an interest in or a signature or other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account? See page B-2 for exceptions and filing requirements for Form TD F 90-22.1		
b	If "Yes," enter the name of the foreign country ▶		
12	Were you the grantor of, or transferor to, a foreign trust that existed during 1995, whether or not you have any beneficial interest in it? If "Yes," you may have to file Form 3520, 3520-A, or 926		

Exhibit B-2 (Acceptable Format)

Name(s) shown on Form 1040. Do not enter name and social security number if shown on other side. | Your social security number

Schedule B—Interest and Dividend Income

Attachment Sequence No. 08

Part I Interest Income

(See pages 15 and B-1.)

Note: If you received a Form 1099-INT, Form 1099-OID, or substitute statement from a brokerage firm, list the firm's name as the payer and enter the total interest shown on that form.

Note: *If you had over $400 in taxable interest income, you must also complete Part III.*

			Amount
1	List name of payer. If any interest is from a seller-financed mortgage and the buyer used the property as a personal residence, see page B-1 and list this interest first. Also, show that buyer's social security number and address ▶	1	
2	Add the amounts on line 1	2	
3	Excludable interest on series EE U.S. savings bonds issued after 1989 from Form 8815, line 14. You MUST attach Form 8815 to Form 1040	3	
4	Subtract line 3 from line 2. Enter the result here and on Form 1040, line 8a ▶	4	

Part II Dividend Income

(See pages 15 and B-1.)

Note: If you received a Form 1099-DIV or substitute statement from a brokerage firm, list the firm's name as the payer and enter the total dividends shown on that form.

Note: *If you had over $400 in gross dividends and/or other distributions on stock, you must also complete Part III.*

			Amount
5	List name of payer. Include gross dividends and/or other distributions on stock here. Any capital gain distributions and nontaxable distributions will be deducted on lines 7 and 8 ▶	5	
6	Add the amounts on line 5	6	
7	Capital gain distributions. Enter here and on Schedule D*	7	
8	Nontaxable distributions. (See the inst. for Form 1040, line 9.)	8	
9	Add lines 7 and 8	9	
10	Subtract line 9 from line 6. Enter the result here and on Form 1040, line 9 ▶	10	

**If you do not need Schedule D to report any other gains or losses, see the instructions for Form 1040, line 13, on page 16.*

Part III Foreign Accounts and Trusts

(See page B-2.)

If you had over $400 of interest or dividends or had a foreign account or were a grantor of, or a transferor to, a foreign trust, you must complete this part.

		Yes	No
11a	At any time during 1995, did you have an interest in or a signature or other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account? See page B-2 for exceptions and filing requirements for Form TD F 90-22.1		
b	If "Yes," enter the name of the foreign country ▶		
12	Were you the grantor of, or transferor to, a foreign trust that existed during 1995, whether or not you have any beneficial interest in it? If "Yes," you may have to file Form 3520, 3520-A, or 926		

S582

Exhibit CG-A (Schedule A)

Schedule A (Form 1040) — ITEMIZED DEDUCTIONS — 1995 * 07 — OMB no. 1545-0074

_____ SSN _____

MEDICAL AND DENTAL EXPENSES*******

1 Medical and dental expenses.....(1) _____
2 Amount from Form 1040, line 32....(2) _____
3 Multiply line 2 by 7.5% (.075).....(3) _____
4 Subtract line 3 from line 1, not less than zero.....(4) _____

TAXES YOU PAID*******

5 State and local income taxes.....(5) _____
6 Real estate taxes.....(6) _____
7 Personal property taxes.....(7) _____
8 Other taxes. List type and amount.
_____.....(8) _____
9 Add lines 5 thru 8.....(9) _____

INTEREST YOU PAID*******

10 Home mortgage interest and points reported to you on Form 1098.....(10) _____
11 Home mtg int not reported on Form 1098. If to seller, person's name, id no., and address:
_____
_____
_____.....(11) _____
12 Points not reported to you on Form 1098....(12) _____
13 Investment interest. Att Form 4952 if req..(13) _____
14 Add lines 10 thru 13.....(14) _____

GIFTS TO CHARITY*******

15 Gifts by cash or check.....(15) _____
16 Other than cash or check. If over $500, you MUST attach Form 8283.....(16) _____
17 Carryover from prior year.....(17) _____
18 Add lines 15 thru 17.....(18) _____

CASUALTY AND THEFT LOSSES*******

19 Casualty or theft loss(es) from Form 4684.....(19) _____

JOB EXPENSES & MOST OTHER MISCELLANEOUS DEDUCTIONS*******

20 Unreim employee exp (Form 2106)_____
_____ _____
_____ _____ ..(20) _____
21 Tax preparation fees.....(21) _____
22 Other expenses:
_____ _____
_____ _____ ..(22) _____
23 Add lines 20 thru 22.....(23) _____
24 Amount from Form 1040, line 32...(24) _____
25 Multiply line 24 by 2% (.02).....(25) _____
26 Subtract line 25 from line 23, not less than zero....(26) _____

OTHER MISCELLANEOUS DEDUCTIONS*******

_____..... _____ (27) _____

TOTAL ITEMIZED DEDUCTIONS*******

28 If Form 1040, line 32 more than $114,700 ($57,350 MFS), see page A-5. Else add right column of lines 4-27....(28) _____

****

D260 For Paperwork Reduction Act Notice, see Form 1040 Instructions.

Exhibit CG-B (Schedule B)

Schedule B (Form 1040) — INTEREST AND DIVIDEND INCOME — 1995 * 08 — OMB no. 1545-0074

_____ SSN _____

****

Part I - Interest Income — Amount

1 _____.....(1) _____

_____..... _____

_____..... _____

_____..... _____

_____..... _____

_____..... _____

_____..... _____

_____..... _____

_____..... _____

_____..... _____

_____..... _____

Less tax-exempt interest.....To Form 1040, line 8b.... _____

2 Add the amounts on line 1.....(2) _____

3 Excludable savings bond interest from Form 8815.....(3) _____

4 Subtract line 3 from line 2.....To Form 1040, line 8a (4) _____

****

Part II - Dividend Income — Amount

5 Dividend income (include capital gain dist, nontaxable dist, etc.)

_____.....(5) _____

_____..... _____

_____..... _____

_____..... _____

_____..... _____

_____..... _____

_____..... _____

_____..... _____

_____..... _____

_____..... _____

_____..... _____

_____..... _____

_____..... _____

6 Add the amounts on line 5.....(6) _____

7 Capital gain distributions.....(7) _____

8 Nontaxable distributions.....(8) _____

9 Add lines 7 and 8.....(9) _____

10 Subtract line 9 from line 6. To Form 1040, line 9...(10) _____

****

Part III - Foreign Accounts and Foreign Trusts

If you had over $400 of interest or dividends OR had a foreign account or were a grantor of, or a transferor to, a foreign trust, must complete:

11a At any time during 1995, did you have an interest in or a signature authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)?.. ___

b If Yes, name of foreign country. _____

12 Were you the grantor of, or transferor to, a foreign trust that existed during 1995, whether or not you have any beneficial interest in it? If Yes, you may have to file Form 3520, 3520-A, or 926.. ___

****

D260 For Paperwork Reduction Act Notice, see Form 1040 Instructions.

EXHIBIT BW-1

Form 941
(Rev. April 1994)
Department of the Treasury
Internal Revenue Service

4141

Employer's Quarterly Federal Tax Return

▶See separate instructions for information on completing this return.
Please type or print.

Enter state code for state in which deposits made. (see page 2 of instructions).

OMB No. 1545-0029

T
FF
FD
FP
I
T

If address is different from prior return, check here

IRS Use

If you do not have to file returns in the future, check here and enter date final wages paid

If you are a seasonal employer, see Seasonal Employers on page 2 and check here (see instructions)

1 Number of employees (except household) employed in the pay period that includes March 12th

2 Total wages and tips subject to withholding, plus other compensation — 2

3 Total income tax withheld from wages, tips, and sick pay — 3

4 Adjustment of withheld income tax for preceding quarters of calendar year — 4

5 Adjusted total of income tax withheld — 5

6a Taxable social security wages — x 12.4% = — 6a

6b Taxable social security tips — x 12.4% = — 6b

7 Taxable Medicare wages and tips — x 2.9% = — 7

8 Total social security and Medicare taxes.
Check here if wages not subject to social security and/or Medicare tax — 8

9 Adjustment of social security and Medicare taxes
Sick Pay $ +/- Fractions of cents $ +/- Other $ = 9

10 Adjusted total of social security and Medicare taxes — 10

11 **Total taxes** (add lines 5 ands 10) — 11

12 Advance earned income credit (EIC) payments made by employees, if any — 12

13 Net Taxes (subtract line 12 from line 11). — 13

14 Total deposits for quarter, including overpayment applied from a prior quarter, — 14

15 **Balance due** (subtract line 14 from line 13). Pay to Internal Revenue Service. — 15

16 Overpayment, if line 14 is more than line 13, enter excess here
and check if to be: Applied to next return OR Refunded.

All filers: If line 13 is less than $500, you need not complete line 17 of Schedule B.
Semiweekly depostiors: Complete Schedule B and check here
Monthly depositors: Complete line 17, columns (a) through (d) and check here

17 **Monthly Summary of Federal Tax Liability**
(a) First month liability (b) Second month liability (c) Third month liability (d) Fourth month liability

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and attachments, and to the best of my knowledge and belief, it is true, correct, and accurate.

Print Your Name and Title ▶

Signature ▶ Date ▶

For Paperwork Reduction Act Notice, see page 1 of separate instructions. Form 941 (Rev. 4-94)

EXHIBIT BW2

SCHEDULE B
(FORM 941)
(Rev. January 1994)
Department of the Treasury
Internal Revenue Service

5151

Employer's Record of Federal Tax Liability

▶See Circular E for more information about employment tax returns.
Attach to form 941 or Form 941-SS.

OMB No. 1545-0029
Expires 1-31-96

Name | Emp. ID | Date

You must complete this schedule if you are required to deposit on a semiweekly basis, or if your tax liabilty on any day is $100,000 or more. Show tax liabilty here, not deposits. (The IRS gets deposit data from FTD coupons.)

A. Daily Tax Liability - First Month of Quarter

1	8	15	22	29
2	9	16	23	30
3	10	17	24	31
4	11	18	25	
5	12	19	26	
6	13	20	27	
7	14	21	28	

A Total tax liability for first month of quarter — A

B. Daily Tax Liability - Second Month of Quarter

1	8	15	22	29
2	9	16	23	30
3	10	17	24	31
4	11	18	25	
5	12	19	26	
6	13	20	27	
7	14	21	28	

B Total tax liability for second month of quarter — B

C. Daily Tax Liability - Third Month of Quarter

1	8	15	22	29
2	9	16	23	30
3	10	17	24	31
4	11	18	25	
5	12	19	26	
6	13	20	27	
7	14	21	28	

C Total tax liability for third month of quarter — C

D Total for quarter (add lines A, B, and C). This should equal line 13 of Form 941. — D

For **Paperwork Reduction Act Notice, see page 2.**

Schedule B (Form 941) (Rev. 1-94)

EXHIBIT L-1 - LIST OF FORMS REFERRED TO IN REVENUE PROCEDURE

FORM	TITLE
706	United States Estate (and Generation-Skipping Transfer) Tax Return
720	Quarterly Federal Excise Tax Return
940	Employer's Annual Federal Unemployment (FUTA) Tax Return
940-EZ	Employer's Annual Federal Unemployment (FUTA) Tax Return
941	Employer's Quarterly Federal Tax Return
941 Sch. B	Employer's Record of Federal Tax Liability
943	Employer's Annual Tax Return for Agricultural Employees
945	Annual Return of Withheld Federal Income Tax
945-A	Annual Record of Federal Tax Liability
990-C	Farmers' Cooperative Association Income Tax Return
990-PF	Return of Private Foundation or Section 4947(a)(1) Trust Treated as a Private Foundation
990-T	Exempt Organization Business Income Tax Return
1040	U.S. Individual Income Tax Return
1040-ES	Estimated Tax for Individuals
1040A	U.S. Individual Income Tax Return
1040EZ	Income Tax Return for Single and Joint Filers with No Dependents
1040PC	1040PC Format U.S. Individual Income Tax Return
1041	U.S. Income Tax Return for Estates and Trusts
1041-ES	Estimated Tax for Estates and Trusts
1042	Annual Withholding Tax Return for U.S. Source Income of Foreign Persons
1042-S	Foreign Person's U.S. Source Income Subject to Withholding
1065	U.S. Partnership Return of Income
1096	Annual Summary and Transmittal of U.S. Information Returns
1098	Mortgage Interest Statement
1099-A	Acquisition or Abandonment of Secured Property
1099-B	Proceeds from Broker and Barter Exchange Transactions
1099-C	Cancellation of Debt
1099-DIV	Dividends and Distributions
1099-G	Certain Government Payments
1099-INT	Interest Income
1099-MISC	Miscellaneous Income
1099-OID	Original Issue Discount
1099-PATR	Taxable Distributions Received from Cooperatives
1099-R	Distributions form Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, Etc.
1099-S	Proceeds from Real Estate Transactions
1120	U.S. Corporation Income Tax Return

EXHIBIT L-1 - LIST OF FORMS REFERRED TO IN REVENUE PROCEDURE (continued)

2290	Heavy Vehicle Use Tax Return
3468	Investment Credit
3975	Tax Practitioner Annual Mailing List Application Update
4136	Credit for Federal Tax Paid on Fuels
4461	Application for Approval of Master or Prototype and Regional Prototype Defined Contribution Plan
4461-A	Application for Approval of Master or Prototype and Regional Prototype Defined Benefit Plan
4461-B	Application for Approval of Master or Prototype Plan, or Regional Prototype Plan Mass Submitter Return Adopting Sponsor
5300	Application for Determination for Employee Benefit Plan
5303	Application for Determination for Collectively Bargained Plan
5305	Individual Retirement Trust Account
5306	Application for Approval of Prototype or Employer Sponsored Individual Retirement Account
5307	Application for Determination for Adopters of Master or Prototype, Regional Prototype or Volume Submitter Plans
5310	Application for Determination for Terminating Plan
5310-A	Notice of Plan Merger or Consolidation, Spinoff, or Transfer of Plan Assets or Liabilities; Notice of Qualified Separate Lines of Business
5498	Individual Retirement Arrangement Information
5500	Annual Return/Report of Employee Benefit Plan (With 100 or more participants)
5500 C/R	Annual Return/Report of Employee Benefit Plan (With fewer than 100 participants)
5500-EZ	Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan
6406	Short Form Application for Determination For Minor Amendment of Employee Benefit Plan
8109	Federal Tax Deposit Coupon
8109-B	Federal Tax Deposit Coupon
8453	U.S. Individual Income Tax Declaration for Electronic Filing
8453-E	Employee Benefit Plan Declaration and Signature for Electronic/Magnetic Media Filing
8453-F	U.S. Income Tax Declaration and Signature for Electronic and Magnetic Media Filing
8453-P	U.S. Partnership Declaration and Signature for Electronic and Magnetic Media Filing
8633	Application to Participate in the Electronic Filing Program
9041	Application for Electronic/Magnetic Media Filing of Business and Employee Benefit Plan Returns

EXHIBIT L-1 - LIST OF FORMS REFERRED TO IN REVENUE PROCEDURE
(continued)

CT-1	Employer's Annual Railroad Retirement Tax Return
W-2	Wage and Tax Statement
W-2G	Certain Gambling Winnings
W-3	Transmittal of Income and Tax Statements

EXHIBIT L-2 - PAYMENT VOUCHER SPECIFICATIONS

NNNNNNNNN AA AAAA NN N NNNN NNN
A B C D E F G

A	Social Security/ Employer Identification Number (SSN/EIN)	9	numeric
B	Check Digit	2	alpha
C	Name Control	4	alphanumeric
D	Master File Tax (MFT) Code	2	numeric (see below)
E	Taxpayer Identification Number (TIN) Type	1	numeric (see below)
F	Tax Period	4	numeric (yymm)
G	Transaction Code	3	numeric

MFT Code - 30 for Form 1040 family; 10 for Form 940 and 940-EZ; 01 for 941; 11 for Form 943; 16 for Form 945; 60 for Form 2290.

TIN Type - 0 for Form 1040 family; 2 for Forms 940, 940-EZ, 941, 943, 945, and 2290.

Voucher size - 8.5" x 3.25". The document scanline must be vertically positioned 1.625" from the bottom of the scanline to the bottom of the voucher. The right most character of the scanline must be placed 3.5" from the right leading edge of the document.

The maximum vertical displacement is .06 inches. The minimum required horizontal clear space between characters is .014 inches. The line to be scanned must have a clear band 0.25 inches in height from top to bottom of the scanline, and from border to border of the document. "Clear band" means no printing except for dropout ink.

26 CFR 601.201: Rulings and determination letters.

Rev. Proc. 96–49

SECTION 1. PURPOSE

This revenue procedure provides a model amendment that will give plan sponsors a streamlined way to amend their plans to comply with the requirements of the Uniformed Services Employment and Reemployment Rights Act of 1994, Pub. L. No. 103–353 ("USERRA"), and § 414(u) of the Internal Revenue Code. The revenue procedure also provides that plan amendments to reflect the provisions of USERRA and § 414(u) generally will not be required to be made before 1998. Section 414(u) was added by § 1704(n) of the Small Business Job Protection Act of 1996, Pub. L. No. 104–188 ("SBJPA"). The model amendment is available for use by sponsors of master or prototype ("M&P"), regional prototype, volume submitter specimen, individually designed, and simplified employee pension ("SEP") plans that have received favorable opinion, notification, advisory, ruling, or determination letters that take into account the requirements of the Tax Reform Act of 1986, Pub. L. No. 99–514 ("TRA '86").

SECTION 2. BACKGROUND AND GENERAL INFORMATION

.01 USERRA, codified at 38 U.S.C. §§ 4301–4333, revised and restated the federal law protecting veterans' reemployment rights. Under USERRA, which is interpreted and enforced by the Veterans' Employment and Training Service of the U.S. Department of Labor, an employee who is absent from a position with an employer because of military service generally is entitled to reemployment with that employer, subject to certain limits and exceptions. USERRA also requires certain other rights and benefits to be provided or made available, including, in certain circumstances, coverage under the employer's health plan. In addition, on reemployment, an employee is entitled to receive certain pension, profit-sharing and similar benefits (under defined benefit or defined contribution plans) that would have been received but for the employee's absence during military service. USERRA sets forth various rules relating to the employee's reemployment and other rights and benefits, including—

- the types of military service covered,
- advance notice of military service to be given to an employer,
- documentation of reemployment eligibility,
- exceptions for dishonorable discharge and employer hardship,
- the position in which an individual must be reemployed, and
- enforcement procedures.

.02 Section 414(u) generally provides that a contribution that is made by an employer or employee to an individual account plan or by an employee to a contributory defined benefit plan, and that is required under USERRA, is taken into account for purposes of the limitations of § 402(g), 402(h), 403(b), 404(a), 404(h), 408, 415 or 457 in the year to which the contribution relates, not the year in which the contribution is made. In addition, § 414(u) provides that a plan is not treated as failing to meet the requirements of § 401(a)(4), 401(a)(26), 401(k)(3), 401(k)(11), 401(k)(12), 401(m), 403(b)(12), 408(k)(3), 408(k)(6), 408(p), 410(b), or 416 because of the contribution (or the right to make the contribution).

.03 Section 414(u) generally provides that an employer maintaining a plan shall be treated as meeting the requirements of USERRA only if an employee reemployed under USERRA is treated as not having incurred a break in service because of the period of military service, the employee's military service is treated as service with the employer for vesting and benefit accrual purposes, the employee is permitted to make additional elective deferrals and employee contributions in an amount not exceeding the maximum amount the employee would have been permitted or required to contribute during the period of military service if the employee had actually been employed by the employer during that period ("make-up contributions"), and the employee is entitled to any accrued benefits that are contingent on employee contributions or elective deferrals to the extent the employee pays the contributions or elective deferrals to the plan. Make-up contributions must be permitted during the period that begins on the date of reemployment and continues for five years or, if less, three times the period of military service. With respect to make-up contributions, the employer must make matching contributions that would have been required if the make-up contributions had actually been made during the period of military service.

.04 Section 414(u) provides that an employee is treated as receiving compensation from the employer during the period of military service equal to the compensation the employee otherwise would have received from the employer during that period, or, if the compensation the employee otherwise would have received is not reasonably certain, the employee's average compensation from the employer during the period immediately preceding the period of military service. For purposes of § 414(u), USERRA is not treated as requiring the crediting of earnings to an employee with respect to any contribution before the contribution is actually made or requiring any allocation of forfeitures to the employee for the period of military service. Section 414(u) also provides that, if a plan provides for the suspension of an employee's obligation to repay a loan for any part of any period of military service, the suspension is not taken into account for purposes of § 72(p), 401(a) or 4975(d)(1).

.05 USERRA provides generally that it is effective with respect to reemployments initiated 60 days or more after the October 13, 1994, enactment date of USERRA, that is, reemployments initiated on or after December 12, 1994. USERRA provides that an employee pension benefit plan has two years from the date of enactment, that is, until October 13, 1996, to come into compliance. Section 1704(n)(3) of SBJPA provides that § 414(u) is effective as of December 12, 1994. The relief provided by § 414(u) extends to plans that are not operated in compliance with the requirements of USERRA specified in § 414(u) until after October 12, 1996, as well as to plans that were operated in compliance with those requirements before October 13, 1996.

.06 Provisions of SBJPA that are unrelated to USERRA changed various qualification requirements for plans. Section 1465 of SBJPA provides that, if a plan amendment is required by certain changes under SBJPA ("SBJPA change"), the amendment is not required to be made before the first day of the first plan year beginning on or after January 1, 1998 (January 1, 2000, for a governmental plan as defined in § 414(d) of the Code), if the plan is operated in accordance with the SBJPA change during the period from the effective date of the SBJPA change to the time the plan amendment is required

and if the plan amendment reflecting the SBJPA change applies retroactively to that period.

.07 Plan amendments to reflect the provisions of USERRA and § 414(u) will not be required to be made before the date plan amendments will be required to be made under § 1465 of SBJPA.

SECTION 3. MODEL AMENDMENT

.01 All plans—Sponsors described in subsection .02 may amend their plans by adopting, word-for-word, the model language in the appendix to this revenue procedure in accordance with the instructions in this revenue procedure. If a sponsor to whom the model language is available pursuant to subsection .02 adopts the model language, neither application to the Service nor a user fee is required. The Service will not issue new opinion, notification, advisory, ruling, or determination letters for plans that are amended solely to add the model language described in this section.

.02 The model language is available only to sponsors of M&P, regional prototype, volume submitter specimen, and individually designed (including volume submitter and SEP) plans that, as of the date of the adoption of the model amendment, have reliance on a favorable opinion, notification, advisory, ruling, or determination letter that takes into account the requirements of TRA '86 under Rev. Proc. 87–50, 1987–2 C.B. 647, as modified; Rev. Proc. 89–9, 1989–1 C.B. 780, as modified; Rev. Proc. 89–13, 1989–1 C.B. 801, as modified; Rev. Proc. 90–20, 1990–1 C.B. 495; Rev. Proc. 91–41, 1991–2 C.B. 697; Rev. Proc. 91–66, 1991–2 C.B. 870; Rev. Proc. 93–39, 1993–2 C.B. 513; or Rev. Proc. 96–6, 1996–1 I.R.B. 151.

.03 M&P, Regional Prototype and Volume Submitter Plans—M&P, regional prototype and volume submitter plan sponsors that use the model language must file Form 8837, Notice of Adoption of Revenue Procedure Model Amendments.

SECTION 4. RELIANCE

An employer entitled to rely on an opinion, notification, ruling, or determination letter will not lose reliance on the letter merely because of this amendment. Plan amendments made in accordance with section 2.07 and section 3 of this revenue procedure will not cause the plan to lose its otherwise applicable extended reliance period under Rev. Procs. 89–9 and 89–13, as modified by Rev. Proc. 93–9, 1993–1 C.B. 474, or section 13 of Rev. Proc. 93–39.

APPENDIX

MODEL AMENDMENTS

AMENDMENT 1

(Note to Sponsor: The following model amendment may be used to amend plans to provide for the requirements of USERRA and § 414(u) of the Code.)

"Notwithstanding any provision of this plan to the contrary, contributions, benefits and service credit with respect to qualified military service will be provided in accordance with § 414(u) of the Internal Revenue Code."

AMENDMENT 2

(Note to Sponsor: The following model amendment may be used to amend plans that provide for loans to participants, if the sponsor chooses to suspend loan repayments during participants' periods of military service.)

"Loan repayments will be suspended under this plan as permitted under § 414(u)(4) of the Internal Revenue Code."

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26 CFR 601.202: Closing agreements.

Rev. Proc. 96–50

SECTION 1. PURPOSE

This revenue procedure modifies Rev. Proc. 95–24, 1995–1 C.B. 694, concerning the Tax Sheltered Annuity Voluntary Correction (TVC) Program by extending the last day for submissions under the TVC Program.

SECTION 2. BACKGROUND

Effective May 1, 1995, the Internal Revenue Service established the TVC Program as an experimental program that is available through October 31, 1996, for 403(b) plans that are not under an Employee Plans or Exempt Organizations examination. The TVC Program generally permits an eligible employer to correct operational defects in the employer's 403(b) plan that are specifically described in Section 7 of Rev. Proc. 95–24 and not excepted from coverage under the program under Section 5 of that revenue procedure. An employer pays a voluntary correction fee based on the number of its employees and a sanction with respect to the corrected defects. Correction must be made for all years of the defects. In general, excise taxes are not waived under the TVC Program, and the employer is still responsible for payment of Federal Insurance Contributions Act (FICA) taxes in appropriate circumstances. At the end of the TVC process, the employer will receive a correction statement setting forth the applicable corrections and conditions.

SECTION 3. EXTENSION OF TVC PROGRAM

Section 3.02 of Rev. Proc. 95–24 provides that the TVC Program will be available through October 31, 1996. In order to continue to evaluate the TVC Program, it will continue to be available through December 31, 1998.

SECTION 4. EXPANSION OF THE PROGRAM

The Service has received comments and inquiries regarding the expansion of the TVC Program to permit the correction of defects not currently covered under Rev. Proc. 95–24. The Service will continue to consider these comments and inquiries and may publish additional guidance in the future.

SECTION 5. EFFECTIVE DATE

This revenue procedure is effective on November 1, 1996.

SECTION 6. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 95–24 is modified.

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.
(Also Part I, § 42; 1.42–14.)

Rev. Proc. 96–51

SECTION 1. PURPOSE

This revenue procedure supplements Rev. Proc. 96–46, 1996–38 I.R.B. 144, by publishing amounts of unused housing credit carryovers allocated to qualified states under § 42(h)(3)(D) of the Internal Revenue Code for calendar year 1996 in addition to those published in Rev. Proc. 96–46. This revenue procedure also publishes the total amounts of unused housing credit carryovers allocated to qualified states under § 42(h)(3)(D) for calendar year 1996.

SECTION 2. BACKGROUND

Rev. Proc. 96–46 published a portion of the unused housing credit carryovers

allocated to qualified states from a national pool of unused credit authority for calendar year 1996 (the 1996 National Pool). Sec. 3.02 of Rev. Proc. 96–46 provides that upon resolution of certain issues, qualified states may be entitled to an additional allocation from the 1996 National Pool. These issues have been resolved and qualified states are entitled to an additional allocation from the 1996 National Pool. This revenue procedure publishes these additional allocation amounts. Because there will be no further allocations to qualified states for the 1996 calendar year, this revenue procedure also publishes the total amounts of unused housing credit carryovers allocated to qualified states from the 1996 National Pool.

SECTION 3. PROCEDURE

.01 The additional amount of unused housing credit carryover allocated to each qualified state from the 1996 National Pool, and the total amount of unused housing credit carryover allocated to each qualified state from the 1996 National Pool is as follows:

Qualified State	*Additional Amount*	*Total Amount*
Alabama	$ 10,322	$ 127,753
Alaska	1,483	18,350
Arizona	9,970	123,392
California	76,898	951,741
Colorado	8,945	110,705
Connecticut	8,013	99,168
Florida	34,137	422,502
Hawaii	2,885	35,701
Idaho	2,772	34,308
Illinois	28,752	355,855
Indiana	14,073	174,173
Iowa	6,921	85,663
Kansas	6,249	77,336
Kentucky	9,363	115,883
Maine	3,034	37,548
Maryland	12,248	151,583
Massachusetts	14,780	182,924
Michigan	23,233	287,542
Minnesota	11,173	138,290
Mississippi	6,530	80,818
Missouri	12,913	159,820
Nebraska	3,971	49,145
Nevada	3,565	44,118
New Hampshire	2,782	34,429
New Jersey	19,338	239,336
New Mexico	4,047	50,084
New York	44,452	550,164
Ohio	27,162	336,172
Oregon	7,550	93,445
Pennsylvania	29,486	364,939
Rhode Island	2,439	30,190
South Dakota	1,764	21,832
Tennessee	12,661	156,701
Utah	4,668	57,775
Vermont	1,419	17,563
Virginia	16,030	198,397
Washington	13,072	161,788
Wisconsin	12,433	153,885

(Note: Amounts are rounded)

.02 Any additional amount of unused housing credit carryover published in this revenue procedure that a qualified state fails to allocate before the close of 1996 will not be considered in determining whether that state qualifies for an allocation of unused housing credit carryover for calendar year 1997.

SECTION 4. EFFECT ON OTHER REVENUE PROCEDURES

This revenue procedure supplements Rev. Proc. 96–46 by increasing the amounts of unused housing credit carryovers allocated to qualified states from the 1996 National Pool.

SECTION 5. EFFECTIVE DATE

This revenue procedure is effective for allocations of housing credit dollar amounts attributable to the National Pool component of a qualified state's housing credit ceiling for calendar year 1996.

26 CFR 301.6109–1: Guidance for qualification as an acceptance agent, and execution of an agreement between an acceptance agent and the Internal Revenue Service relating to the issuance of certain taxpayer identifying numbers.

Rev. Proc. 96–52

CONTENTS

SECTION 1. PURPOSE
SECTION 2. BACKGROUND
SECTION 3. DEFINITIONS
SECTION 4. ACCEPTANCE AGENT
SECTION 5. ACCEPTANCE AGENT AGREEMENT
SECTION 6. CERTIFYING ACCEPTANCE AGENT
SECTION 7. EFFECTIVE DATE
SECTION 8. PAPERWORK REDUCTION ACT

SECTION 1. PURPOSE

This revenue procedure describes the application procedures for becoming an acceptance agent and the requisite agreement that an acceptance agent must execute with the Internal Revenue Service (IRS). Persons may wish to become an acceptance agent for purposes of facilitating the issuance of (1) IRS individual taxpayer identification numbers (ITINs) to alien individuals who are ineligible to obtain social security numbers (SSNs), or (2) employer identification numbers (EINs) to foreign persons.

SECTION 2. BACKGROUND

Section 301.6109–1(d)(3) of the Income Tax Regulations (Regulations) provides general procedures for obtaining an ITIN which require the submission of an application form (Form W–7), together with documentation considered as evidence of the alien individual's identity and alien status. Section 301.6109–1(d)(2) of the Regulations provides general procedures for obtaining an EIN which require the submission of an application form (Form SS–4), together with any supplementary statement as may be required. The regulations require an applicant for an ITIN or an EIN to furnish the information required by the form, the accompanying instructions, and any applicable regulations. An applicant may either submit the application form for an ITIN or an EIN directly to the IRS or, as provided in § 301.6109–1(d)(3)(iv) of the Regulations, apply for an ITIN or an EIN by using an acceptance agent.

SECTION 3. DEFINITIONS

For purposes of this revenue procedure, the terms listed below are defined as follows.

.01 An *acceptance agent* is a person (i.e., an individual or an entity) who, pursuant to a written agreement with the IRS, is authorized to assist alien individuals and other foreign persons in obtaining ITINs or EINs from the IRS. An acceptance agent acting in its capacity as an acceptance agent does not act as an agent of the IRS, nor is it authorized to hold itself out as an agent of the IRS.

.02 An *alien individual* is an individual who is not a citizen or a national of the United States.

.03 A *foreign person* is a nonresident alien individual, a foreign corporation, a foreign partnership, a foreign trust, a foreign estate, or any other person that is not a U.S. person, the U.S. government, or a U.S. state or the District of Columbia.

.04 *Alien status* refers to an individual's status as a non- U.S. citizen or non-U.S. national.

.05 *Identity* refers to the fact of being the same individual as is represented, claimed, or described.

.06 *TIN* (taxpayer identifying number) refers to both ITINs and EINs.

SECTION 4. ACCEPTANCE AGENT

.01 *Role of acceptance agent.* (1) *In general.* The role of an acceptance agent is to facilitate the application process and the issuance of TINs to alien individuals and foreign persons. An acceptance agent performs this duty by forwarding the completed Form W–7 (together with the required documentary evidence) to the IRS, Philadelphia Service Center to obtain ITINs, or by forwarding the completed Form SS–4 (together with any supplementary statement if required) to the IRS, Philadelphia Service Center to obtain EINs, or by calling Tele–TIN: (215) 574– 2400 to obtain EINs.

(2) *Certifying acceptance agent.* In the case of obtaining an ITIN, if permitted under the agreement with the IRS, a person may assume greater responsibility as a certifying acceptance agent. In that case, the acceptance agent may review the documentation required to accompany Form W–7 and certify to the IRS that it has reviewed the required documentation and to the best of its knowledge and belief, the documentation is authentic, complete, and accurate. See section 6 of this revenue procedure for further information.

.02 *Application process for acceptance agent.* (1) *Eligible persons.* Persons eligible to become acceptance agents include, but are not limited to, a financial institution defined in section 265(b)(5) of the Internal Revenue Code (Code) or § 1.165–12(c)(1)(v) of the Regulations, a college or university that is an educational organization defined in § 1.501(c)(3)– 1(d)(3)(i) of the Regulations, a federal agency defined in section 6402(f) of the Code, and persons that provide professional assistance to taxpayers in the preparation of their tax returns. An eligible person may be a U.S. or a foreign person.

(2) *Pre-application conference.* Prior to submitting a formal application, a person interested in becoming an acceptance agent may request a conference with the IRS, which may be held in person or by telephone, to explore informally the benefits and burdens associated with the role of an acceptance agent. Requests for pre-application conferences should be directed to the Assistant Commissioner (International), Foreign Payments Division (telephone: (202) 874–1800, not a toll-free number).

(3) *Written application.* (a) Where to apply. A person may apply to become an acceptance agent by submitting a written request to:

Assistant Commissioner
(International)
Foreign Payments Division CP:IN:-OO:WT
950 L'Enfant Plaza South, SW
Washington, DC 20024
FAX: (202) 874–1984

(b) Content of application. The application shall indicate that the person is requesting permission to execute an agreement with the IRS pursuant to § 301.6109–1(d)(3)(iv) of the Regulations, and in accordance with this revenue procedure. The application shall include the information listed below.

(i) The applicant's complete name, address, and EIN. If the applicant does not have an EIN, a completed Form SS–4 must be included to obtain such number.

(ii) The reason that the applicant wishes to become an acceptance agent, and the type of responsibilities the applicant expects to assume.

(iii) A description of the applicant, including the entity status of the applicant (e.g., bank, university, governmental agency, etc.) and the state (or if

outside the United States, the country) under whose laws the applicant is created or organized.

(iv) A list of the applicant's employees who will be responsible parties for performance under the acceptance agent agreement, including their title and position description.

(v) A list of the offices or branches, if any, intended to be covered by the agreement and their location, including mailing address.

(vi) The business relationship the applicant has with the persons whom it expects to assist in obtaining TINs.

(vii) An estimate of the number of Forms W–7 and/or Forms SS–4 it expects to submit to the IRS per year.

(viii) The name and telephone number of a person the IRS can contact regarding the application.

(4) *IRS review of application.* (a) Request for additional information. Upon review of the application, the IRS may request additional information.

(b) Determination and notification of status. Upon completion of review of the application, including any additional information submitted, the IRS will determine whether the applicant qualifies to become an acceptance agent and will notify the applicant of this determination. If the applicant is approved as an acceptance agent, the IRS will provide instructions to the applicant regarding the procedures for entering into the acceptance agent agreement with the IRS.

SECTION 5. ACCEPTANCE AGENT AGREEMENT

.01 *In general.* An acceptance agent agreement described under § 301.6109–1(d)(3)(iv)(A) of the Regulations is an agreement between the IRS and a person authorized by virtue of the agreement to act as an acceptance agent on behalf of an alien individual or a foreign person with respect to that individual's or person's need to obtain an ITIN or an EIN from the IRS. The Assistant Commissioner (International) shall sign the agreement on behalf of the IRS. If the acceptance agent is a person other than an individual, the agreement must be signed by an authorized representative of the acceptance agent.

.02 *Terms and procedures.* The terms of an acceptance agent agreement may vary depending upon such factors as the nature of the applicant (e.g., bank, university, governmental agency, etc.) and its location (i.e., inside the United States or outside the United States). The acceptance agent agreement will generally contain the following terms and conditions necessary to insure proper administration of the process by which the IRS issues TINs to alien individuals and foreign persons.

(1) *Procedures for providing TIN application forms.* An acceptance agent shall agree to maintain a supply of Form W–7 for obtaining ITINs, and of Form SS–4 for obtaining EINs from the IRS. The acceptance agent may use a substitute form that is approved by the IRS. For example, if the acceptance agent is a financial institution, the Form W–7 or Form SS–4 may be incorporated as part of an account opening package. In addition, an acceptance agent shall agree to send a Form W–7 to any individual client or customer (who is not a U.S. citizen or national) that it knows, or has reason to know, has been issued a temporary tax identification number by the IRS, and to advise the client or customer of the need to replace the temporary tax identification number with an ITIN.

(2) *Procedures for assisting in completion of TIN application forms.* An acceptance agent shall agree to assist in the preparation of the TIN application form. For example, the acceptance agent should make certain that every item included on the application form has been completed and should assist the TIN applicant in understanding the information required by the application form. The acceptance agent should contact the IRS for assistance regarding any questions about the forms, application process, the requirement to have TINs, etc. that it cannot reasonably answer. Questions regarding such matters should be directed to the IRS at (215) 516–ITIN (4846) (not a toll-free number).

(3) *Procedures for IRS communication with acceptance agent.* The applicant's signature on the Form W–7 provides the power of attorney to the acceptance agent, authorizing communication with the IRS regarding that particular application only. The acceptance agent may act as an agent for the applicant regarding any additional communication necessary with the IRS in connection with the application form. However, IRS communication with an acceptance agent in connection with a Form SS–4 application requires that the applicant has furnished a power of attorney (e.g., Form 2848) authorizing such communication.

(4) *Procedures for submitting TIN application forms.* An acceptance agent shall agree to submit promptly the TIN application forms or approved substitute forms (together with the required documentation for ITINs or the supplementary statement, if required, for EINs) to the IRS at the mailing address for the Philadelphia Service Center included on Form W–7 or Form SS–4, or the following street address (for registered or certified mail): 11601 Roosevelt Blvd., D.P. 426, Philadelphia, PA 19255.

(5) *Procedures for collecting and reviewing required documentation for assignment of an ITIN.* A Form W–7 must be accompanied by documentary evidence of alien status and identity. The types of acceptable documentary evidence may vary depending upon such factors as the ITIN applicant's country of citizenship or nationality, the ITIN applicant's residency at the time of the application (i.e., inside or outside the United States), etc. The acceptance agent must review the applicant's documentation in order to determine whether the documentation is of a type which the IRS regards as reliable evidence of alien status and identity. The acceptance agent agreement will specify the various types of documentary evidence that the acceptance agent should accept for submission with Form W–7. Examples of documentary evidence supporting alien status (i.e., non-U.S. citizenship or nationality) include a foreign passport, a foreign birth record, or a current document issued by the Immigration and Naturalization Service (INS) in accordance with that agency's regulations. Examples of documentary evidence supporting identity include a driver's license, identity card, school record, medical record, marriage record, voter registration card, military registration card, passport, or a current document issued by INS in accordance with that agency's regulations. Generally, one piece of documentary evidence should contain a picture or photo identification. Generally, ITIN applicants must submit the required documentation during a personal interview with the acceptance agent. The agreement will generally require that original (or certified copies of original) documentation be submitted to the IRS with Form W–7. All original documents will be returned promptly to the acceptance agent (i.e., no later than 3 business days from receipt of a complete application by the IRS, Philadelphia Service Center). Copies of original documents, if allowed to be submitted

under the acceptance agent agreement, will not be returned to the acceptance agent.

(6) *Procedures for assisting taxpayers with notification procedures in the event of a change of alien status.* When an acceptance agent knows that an individual assigned an ITIN has become eligible to obtain (or has, in fact, obtained) a SSN, such acceptance agent shall agree to inform the individual of the obligation to (1) apply for a SSN, (2) stop using the previously-assigned ITIN upon receipt of the new SSN, and (3) notify the IRS of this change in alien status. The acceptance agent's duty with respect to this matter shall apply only to the situation where the acceptance agent has a continuing business relationship with the individual. An alien individual may become eligible to obtain a SSN if, for example, such individual has become a U.S. citizen or a permanent U.S. resident (i.e., "green card" holder), or is lawfully permitted by INS to work in the United States. The ITIN holder's notification to the IRS should state that the individual either is eligible to have or has a SSN, and should include the individual's name, address, previously-assigned ITIN and new SSN (if available), the current date, and the individual's signature. This information may be provided to the IRS by FAX: (215) 516–3270 or by mail: IRS, Philadelphia Service Center, ATTN: ITIN Unit-D.P. 426, P.O. Box 447, Bensalem, PA 19020. Questions regarding this matter should be directed to (215) 516–ITIN (4846) (not a toll-free number).

(7) *Procedures for IRS verification of compliance with acceptance agent agreement.* The acceptance agent agreement will specify the procedures by which the IRS will verify the acceptance agent's compliance with the agreement. In particular, the procedures must enable the IRS to verify that the acceptance agent has adequate procedures in effect to assist applicants properly. The procedures also must enable the IRS to verify that the acceptance agent is complying with any record retention requirements relating to the issuance of TINs. Verification of compliance with the acceptance agent agreement does not constitute an examination of the books and records of the acceptance agent.

(8) *Procedures regarding termination of acceptance agent agreement.* An acceptance agent agreement generally is not subject to expiration and renewal. Either the acceptance agent or the IRS may terminate an agreement 30 days after delivery of notice of termination to the other party. The decision to terminate is solely at the discretion of the party giving such notice. However, the IRS generally will not give notice of termination unless the acceptance agent willfully fails to comply with procedures required by the agreement or to perform any duty or obligation required in the agreement (including failing to exercise due diligence under the agreement) and such failure constitutes material noncompliance. In addition, the IRS may give notice of termination where the acceptance agent has misrepresented material information given on its application to become an acceptance agent or on a TIN application. Further, notice of termination may be given where the acceptance agent accepts a TIN application with knowledge that material information on the form is false. The acceptance agent may request that the IRS reinstate the acceptance agent agreement by submitting, within 30 days of receipt of the notice of termination, a written explanation of how the acceptance agent proposes to correct the violation and, if appropriate, to modify its procedures to ensure that such violation will not occur in the future. The IRS shall accept or reject the request, or make a counterproposal within 20 days of receipt of the request.

SECTION 6. CERTIFYING ACCEPTANCE AGENT

.01 *General requirements.* A certifying acceptance agent is a person that is authorized under the agreement with the IRS to submit a Form W–7 to the IRS on behalf of an applicant, without having to furnish supporting documentary evidence. Instead, when submitting a Form W–7 to the IRS, a certifying acceptance agent certifies to the IRS that it has reviewed the appropriate documentation evidencing the ITIN applicant's identity and alien status, and that it is maintaining a record of such documentation. In addition, the acceptance agent must certify that to the best of its knowledge and belief, the documentation is authentic, complete, and accurate. As part of the certification, the acceptance agent must describe the documentation upon which it is relying. The certification is not binding on the IRS, which may, in appropriate cases, request to see appropriate documentation before issuing an ITIN.

.02 *Application process.* (1) *Written application.* IRS permission to act as a certifying acceptance agent is conditioned upon the acceptance agent's agreeing to verify documentation supporting the identity and alien status of an ITIN applicant, maintain certain records, and submit certain information to the IRS upon request. As a result, in addition to the information required to be submitted with an application to become an acceptance agent as outlined in section 4.02(3) of this revenue procedure, an applicant to become a certifying acceptance agent must also provide the following information:

(a) If an applicant relies on local know-your-customer practices and procedures for identifying customers or clients, and communicating with customers or clients, then the applicant must provide an explanation of those practices and procedures, including (1) the extent to which they are mandated and verified under local law and regulations applicable at each location intended to be covered by the agreement and (2) the penalties or sanctions that may apply under local law in the event of a failure to comply with such procedures. Supporting documentation must be included.

(b) Information regarding the anticipated reason why customers or clients need to apply for ITINs (e.g., nonresident alien ineligible for SSN, resident alien ineligible for SSN, or U.S. person's dependent ineligible for SSN).

(2) *Pre-application conference.* Prior to submitting a formal application, a person interested in becoming a certifying acceptance agent may request a conference with the IRS, which may be held in person or by telephone. This conference will provide an opportunity to address such matters as the scope of the agreement, corresponding obligations that would arise under the agreement for the applicant, and the nature of documentation, record maintenance, and verification procedures that would arise under the agreement. Requests for pre-application conferences should be directed to the Assistant Commissioner (International), Foreign Payments Division (telephone: (202) 874–1800, not a toll-free number).

.03 *Agreement.* The terms of a certifying acceptance agent agreement may vary from case to case depending upon such factors as local laws and practices, know-your-customer procedures, supervisory controls, and the types of internal controls and recordkeeping procedures in effect in the normal course of business of the certifying acceptance agent.

Generally, the acceptance agent agreement will contain the terms and conditions necessary to insure proper administration of the process by which the IRS issues ITINs to alien individuals as are described in section 5.02 of this revenue procedure. The following terms are in addition to those outlined in section 5 above.

(1) *Procedures for collecting, reviewing, and maintaining a record of required documentation for assignment of an ITIN.* A certifying acceptance agent agreement will describe the procedures by which the acceptance agent will verify the identity and alien status of ITIN applicants and submit a certification to the IRS. To the extent possible, procedures already in place to identify persons for local regulatory purposes or as part of normal course of business will be used to support the representations made by the acceptance agent regarding these matters. To the extent applicable, an acceptance agent may use documentation evidencing citizenship, nationality, residency, or immigration status to support its determination of the alien status of ITIN applicants. The reliability of any documentation should be evaluated by the acceptance agent on the basis of the type of information stated on the document, the source document, if any, used to substantiate the information on the document, the issuance procedures used, and the ease with which the document can be counterfeited. Where the IRS determines that these requirements or practices are not sufficient, it may require that additional procedures and documentation be established.

The acceptance agent will agree that, for purposes of determining its compliance with the acceptance agent agreement, it will maintain a record of the documentation obtained and reviewed pursuant to the obligations set forth in the agreement. If the acceptance agent has a professional or business relationship with the ITIN applicant, the documentation with respect to the ITIN applicant shall be maintained for as long as the ITIN applicant maintains such a relationship with the acceptance agent and for a reasonable period, as prescribed by the IRS in the agreement, from the date such relationship ceases. If the acceptance agent does not have a professional or business relationship with the ITIN applicant, the documentation with respect to the ITIN applicant shall be maintained for three years after presentation.

(2) *Procedures for IRS compliance checks of certifications.* A certifying acceptance agent must also agree to furnish supporting documentary evidence to the IRS upon written request in such manner as the IRS and the acceptance agent will establish. In order to conduct periodic compliance checks, the IRS may rely on sampling techniques and/or verification (by random selection) with ITIN recipients to assure reliability of the acceptance agent's certifications while ensuring the least amount of disruption and burden to the acceptance agent. The acceptance agent agreement will specify the manner in which IRS compliance checks will take place (i.e., either on site or through correspondence). Where the acceptance agent resides outside of the United States, in appropriate cases, assistance may be obtained from the tax authorities of the country where the acceptance agent resides.

SECTION 7. EFFECTIVE DATE

This revenue procedure is effective on the date of publication.

SECTION 8. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1499.

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

The collections of information contained in this revenue procedure are in section 4.02(3), section 5.02(6), and section 6.02(1). This information is required to assist the IRS in issuing TINs to certain alien individuals and foreign persons. In addition, this information will be used to enable the IRS to determine whether persons qualify as acceptance agents. The collection of information is required to obtain an acceptance agent agreement. The likely respondents are state or local governments, business or other for-profit institutions, federal agencies, and nonprofit institutions.

The estimated total annual reporting/recordkeeping burden is 41,006 hours.

The estimated average annual burden per respondent/recordkeeper is 3 hours, 12 minutes. The estimated number of respondents/recordkeepers is 12,825.

The estimated annual frequency of responses is on occasion.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Section 482. — Allocations Between Related Parties

Rev. Proc. 96–53

SECTION 1. PURPOSE

This revenue procedure updates and supersedes Revenue Procedure 91–22, 1991–1 C.B. 526, and informs taxpayers how to secure an advance pricing agreement ("APA") from the Office of the Associate Chief Counsel (International) covering the prospective determination and application of transfer pricing methodologies ("TPMs") for international transactions. An APA is an agreement between the Service and the taxpayer on the TPM to be applied to any apportionment or allocation of income, deductions, credits, or allowances between or among two or more organizations, trades, or businesses owned or controlled, directly or indirectly, by the same interests. The TPM thus represents the application to the taxpayer"s specific facts and circumstances of the best method within the meaning of the income tax regulations under § 482 of the Internal Revenue Code ("the regulations"), as agreed pursuant to negotiations between the Service and the taxpayer.

SEC. 2. OVERVIEW

Under the APA request procedure, the taxpayer proposes a TPM and provides data intended to show that the TPM is the appropriate application of the best method within the meaning of the regulations for determining arm's length results between the taxpayer and specified affiliates with respect to specified intercompany transactions. The Service evaluates the APA request by analyzing the data submitted and any other relevant information. After discussion, if the taxpayer's proposal is acceptable, the parties execute an APA covering the proposed TPM. APAs often involve agreements with foreign competent authorities under income tax conventions.

SEC. 3. PRINCIPLES OF THE APA PROCESS

.01 The APA process is designed to be a flexible problem-solving process, based on cooperative and principled negotiations between taxpayers and the Service.

.02 APAs are intended to reflect agreement between the taxpayer and the Service on the best method, within the meaning of the regulations, for determining arm's length prices, and the proper application of the best method to the taxpayer's specific facts and circumstances (that is, the TPM). In negotiations for APAs involving one or more foreign competent authorities ("bilateral" and "multilateral" APAs), the initial negotiating position of the U.S. competent authority will reflect the Service's opinion, based on consultation with the taxpayer, of the best method within the meaning of the regulations and the appropriate TPM.

.03 The taxpayer must, to the extent feasible, secure relevant pricing data from closely comparable uncontrolled transactions. If this information cannot be obtained, the taxpayer must identify any transactions it believes may be comparable, but for which reliable data is unavailable. Where such transactions cannot be identified, the taxpayer must, to the extent possible, secure relevant pricing data from uncontrolled transactions that are similar, even though not closely comparable, and propose adjustments to account for differences between such uncontrolled transactions and its own operations. The APA process may apply notwithstanding that no comparable uncontrolled transactions can be identified. In such cases, a taxpayer must demonstrate that the proposed TPM otherwise satisfies the requirements of § 482 and this revenue procedure.

.04 The APA Policy Board (the "Policy Board") consists of the Associate Chief Counsel (International), the Assistant Commissioner (International), and the Assistant Commissioner (Examination). The Policy Board establishes Service policy on matters of substantial general importance pertaining to the APA Program.

.05 The APA Program is under the immediate supervision of a Director (the "APA Director") within the Office of the Associate Chief Counsel (International). The APA Director shall, directly or by delegation, take any actions necessary for carrying out the provisions of this revenue procedure.

.06 Application of the TPM to tax years prior to those covered by the APA ("rollback" of the TPM) is an effective means of enhancing voluntary compliance and an effective use of resources in addressing unresolved transfer pricing issues. It is Service policy that, whenever feasible (based, for example, on consistency of facts, law, and available records in the prior years), the TPM should be used for resolving such issues for prior taxable years. As provided in section 8 of this revenue procedure, the taxpayer may request that the Service consider a rollback in connection with a particular request. Taxpayers should recognize that, even absent a request for a rollback, the Service may, under regularly applicable procedures, determine that the TPM agreed to in an APA should be applied to prior years. When applying the TPM to prior years, whether or not at the request of the taxpayer, adjustments may be made to reflect differences in facts, economic conditions, and applicable legal rules.

.07 The filing of an APA request does not put into abeyance any examination or other enforcement proceeding. Service personnel responsible for APAs and for enforcement proceedings involving the taxpayer shall, to the extent feasible, coordinate their activities so as to avoid duplicative information requests to the taxpayer, to enhance the efficiency of Service operations and to reduce overall taxpayer compliance burdens.

.08 Prompt and fair resolution of APA requests and renewals, in keeping with the demands of the multinational economic environment, are central goals of the APA process.

.09 The Service intends that the APA process will retain the flexibility to address the needs of particular taxpayers. To this end, the Service and the taxpayer may, by agreement, adopt special procedures, including simplified procedures, that depart from those set forth in this revenue procedure. Such special procedures might be warranted, for example, in order to meet the needs of small business taxpayers, or in order to facilitate simultaneous negotiation of APAs by the taxpayer, the Service, and foreign competent authorities.

SEC. 4. PREFILING CONFERENCES

.01 Some cases are not suitable for APAs. Even in suitable cases, the extent of information needed and scope of the necessary written request will vary from case to case. Therefore, the taxpayer may request one or more prefiling conferences to explore informally the suitability of an APA and to clarify what data, documentation, and analyses are likely to be necessary in order for the Service to be able to consider a request; the need for an independent expert; potentially applicable TPMs; the possibility of an agreement among competent authorities; and the Service's schedule and method for coordinating and evaluating the request.

.02 To schedule a prefiling conference, the taxpayer or its representative should contact the APA Office with three alternative dates for the prefiling conference. The taxpayer may request a prefiling conference either on the basis that its identity will be made known in connection with the conference, or that it will participate in the conference on an anonymous basis. If the taxpayer chooses to make its identity known in the conference, representatives of the District and of any Appeals or District Counsel Office with responsibility for the taxpayer's returns normally will participate in the prefiling conference. If the taxpayer initially requests a prefiling conference on an anonymous basis, then chooses to identify itself, the conference may be rescheduled to permit necessary personnel to participate. When requesting a prefiling conference on an identified basis, the taxpayer must inform the APA Office whether transactions similar or related to those to be covered by the proposed APA are currently under consideration by Examination, Appeals or Counsel. Taxpayers should, at least one week prior to a prefiling conference, send a brief prefiling submission to the APA Office that confirms the date, time and place of the prefiling conference; lists the persons attending the prefiling conference for the taxpayer; and outlines the issues to be discussed at the prefiling conference. If the prefiling submission is ten pages or less, it may be sent by facsimile; if the prefiling submission exceeds ten pages, seven copies and one original should be delivered pursuant to the instructions contained in section 5.13 of this revenue procedure.

SEC. 5. CONTENT OF APA REQUESTS

.01 *General.*

(1) All materials submitted with the request become part of the Service's file and will not be returned. Therefore, original documents should not be submitted.

(2) The taxpayer must submit copies of any documents relating to the proposed TPM and must ensure that all submitted information is properly labeled, indexed, and referenced in the request. Any previously-submitted documents that the taxpayer wishes to associate with the request must be referenced in the request. If the records or documents to be submitted are too voluminous for transmittal with the request, the taxpayer must describe the contents of such items in the request, certify that the items exist at the time the request is submitted, state where the items are located, state whom the Service can contact to secure the items, and confirm that the items will promptly be made available upon request.

(3) All documents submitted in a foreign language must be accompanied by an English translation.

(4) The user fee should be submitted with the request, unless previously submitted.

.02 *Explanation of the Proposed TPM.*

The taxpayer must provide a detailed explanation and analysis of each proposed TPM based on the principles discussed in sections 3.02 and 3.03 of this revenue procedure. The request should illustrate each proposed TPM by applying it, in a consistent format, to the prior three taxable years' financial and tax data of the parties. When historical data cannot be used to illustrate a TPM (for example, when the TPM applies to a new product or business), the request should include an illustration based on projected or hypothetical data. If coverage of three taxable years is inappropriate for any reason, the taxpayer should provide data for an appropriate date range and explain why this range was chosen.

.03 *General Factual and Legal Items for All Proposed TPMs.*

Unless otherwise agreed in a prefiling conference, each request must include, in addition to any other items specified in this revenue procedure, the following items:

(1) The organizations, trades, businesses, and transactions that will be subject to the APA.

(2) The names, addresses, telephone numbers, and taxpayer identification numbers of the controlled taxpayers that are parties to the requested APA (the parties).

(3) A properly completed Form 2848 for any persons authorized to represent the parties in connection with the request. If the taxpayer or the taxpayer's authorized representative has retained any other person or persons (including, but not limited to, a law firm, accounting firm, or economic consulting firm) to assist the taxpayer in pursuing the APA request, the taxpayer must also provide a separate written authorization for disclosures to such person or persons and their employees during the Service's consideration of the request, pursuant to the instructions in § 301.6103(c)–1 of the Income Tax Regulations.

(4) A brief description of the general history of business operations, worldwide organizational structure, ownership, capitalization, financial arrangements, principal businesses, and the place or places where such businesses are conducted, and major transaction flows of the parties.

(5) Representative financial and tax data of the parties for the last three taxable years, together with other relevant data and documents in support of the proposed TPM. This item includes, but need not be limited to, data contained in Form 5471 (Information Report with Respect to a Foreign Corporation); Form 5472 (Information Report of a Foreign Owned Corporation); income tax returns; financial statements; annual reports; other pertinent U.S. and foreign government filings (for example, customs reports or SEC filings); existing pricing, distribution, or licensing agreements; marketing and financial studies; and company-wide accounting procedures, business segment reports, budgets, projections, business plans, and worldwide product line or business segment profitability reports.

(6) The functional currency of each party and the currency in which payment between parties is made for the transactions that will be covered by the APA.

(7) The taxable year of each party.

(8) A description of significant financial accounting methods employed by the parties that have a direct bearing on the proposed TPM.

(9) An explanation of significant financial and tax accounting differences, if any, between the U.S. and the foreign countries involved that have a bearing on the proposed TPM.

(10) A discussion of any relevant statutory provisions, tax treaties, court decisions, regulations, revenue rulings, or revenue procedures that relate to the proposed TPM.

(11) A statement describing all previous and current issues at the examination, appeals, judicial, or competent authority levels that relate to the proposed TPM, including an explanation of the taxpayer's and the government's positions and any resolution of any such issues. The same information may also be required for similar issues involving foreign tax authorities.

.04 *Specific Factual Items for a Proposed TPM other than a Cost Sharing Arrangement.*

The following information may be appropriate to establish the arm's length basis of the proposed TPM under § 482:

(1) Pertinent measurements of profitability and return on investment (for example, gross profit margin or markup, gross income/total operating expenses, net operating profit margin, or return on assets).

(2) A functional analysis of each party setting forth the economic activities performed, the assets employed, the economic costs incurred, and the risks assumed.

(3) An economic analysis or study of the general industry pricing practices and economic functions performed within the markets and geographical areas to be covered by the APA.

(4) A list of the taxpayer's competitors and a discussion of any uncontrolled transactions, lines of business or types of businesses that may be comparable or similar to those addressed in the request.

(5) A detailed presentation of the research efforts and criteria used to identify and select possible independent comparables and of the application of the criteria to the potential comparables. This presentation should include a list of potential comparables and an explanation of why each was either accepted or rejected.

(6) A detailed explanation of the selection and application of the factors used to adjust the activities of selected independent comparables for purposes of devising the proposed TPM. Examples of possible adjustments include adjustments to accord with product line segregations; for functional differences relating to activities performed, assets employed, risks and costs incurred; for volume or scale differences; and for differing economic and market conditions.

.05 *Specific Factual Items for a Cost Sharing Arrangement.*

The taxpayer must apply the cost sharing regulations under § 482 in developing the cost sharing arrangement proposed in the request. The following illustrates information that may be appropriate to establish that the proposed arrangement is a qualified cost sharing arrangement:

(1) The history of the business operations, the geographic locations, and principal business activities (for example, manufacturing or marketing) of each of the participants.

(2) Documentation of the arrangement and any changes made to it, along with an explanation and the dates thereof.

(3) The participants, their dates of entry, each participant's contribution to the arrangement, each participant's interest in any covered intangibles, and how each participant reasonably anticipates that it will derive benefits from the use of covered intangibles; a statement whether there has been or will be any transfer by any participant of covered intangibles to another taxpayer under common control and, if so, how benefits will be reflected under those circumstances; and evidence of participants' compliance with the reporting requirements under the cost sharing regulations.

(4) The method for calculating each participant's share of intangible development costs and the reason why such method can reasonably be expected to reflect that participant's share of anticipated benefits; and a statement whether and how the participants' shares of intangible development costs will be adjusted to account for changes in economic conditions, the business operations and practices of the participants, and the ongoing development of intangibles under the arrangement.

(5) The scope of the research and development to be undertaken, including the intangible or class of intangibles intended to be developed.

(6) The duration of the arrangement; the conditions under which the arrangement may be modified or terminated; and the consequences of such modification or termination, such as the interest that each participant will receive in any covered intangibles.

(7) The scope of intangible development costs, and which costs are included and which are excluded (for example, costs of technology acquired from third parties; non-product specific development costs; costs associated with abandoned projects; costs associated with specific stages of product development; and relevant labor, material, and overhead costs); a description of any services performed for participants to be included in intangible development costs (for example, contract research) and how those services would be taken into account; and, for a representative period, a breakdown of total costs incurred, and the costs borne by each participant, pursuant to the arrangement.

(8) The basis used for measuring benefits, the projections used to estimate benefits, and why such basis and projections yield the most reliable estimate of reasonably anticipated benefits; a description of any amounts to be received from nonparticipants for the use of covered intangibles (for example, as a royalty pursuant to a license agreement) and how such amounts would be taken into account; and, for a representative period, a comparison of projected and actual benefit shares.

(9) The accounting method used to determine the cost and benefits of the intangible development (including the method used to translate foreign currencies), and to the extent that the accounting method differs materially from U.S. generally accepted accounting principles, an explanation of any material differences.

(10) Prior research, if any, undertaken in the intangible development area; any tangible or intangible property made available for use in the arrangement and any compensation paid for that property (specifying the amount, payor and payee, and how such compensation is determined); and any other information used to establish the value of preexisting and covered intangibles.

(11) Whether and how participants may join or leave the arrangement (or otherwise change their interests in covered intangibles); any adjustments that will be made to the participants' interests in covered intangibles in such cases; any payments that must be made in such cases, and how such payments will be calculated and made; and whether any changes in the participants' interests in covered intangibles have already occurred, any compensation paid for those interests, and any information used to establish the value of such interests.

(12) How cost sharing payments and buy-in or buy-out payments (i.e., payments made when a participant contributes intangibles, or acquires or relinquishes an interest in covered intangibles) made or received have been treated for U.S. income tax purposes.

(13) Representative internal manuals, directives, guidelines, and similar documents prepared for purposes of implementing or operating the cost sharing arrangement (for example, research and development committee meeting minutes, market studies, economic impact analyses, capital expenditure budgets, engineering studies, reports and studies of trends and profitability in the industry, and financial analyses for financing and cash flow purposes).

(14) Each participant's gross and net profitability (historical for five taxable years and projected for two taxable years) with regard to the product area covered by the arrangement.

.06 *Discussion of Collateral Income Tax Issues.*

The taxpayer must discuss any relevant collateral income tax issues (for example, issues relating to foreign tax credits) raised by the proposed TPM under United States law.

.07 *Critical Assumptions.*

The taxpayer must propose and describe a set of critical assumptions. A critical assumption is any fact (whether or not within control of the taxpayer) related to the taxpayer, a third party, an industry, or business and economic conditions, the continued existence of which is material to the taxpayer's proposed TPM. Critical assumptions might include, for example, a particular mode of conducting business operations, a particular corporate or business structure or a range of expected business volume.

.08 *Contents of Annual Report.*

Section 11.01 of this revenue procedure provides that the taxpayer must file an annual report for each taxable year covered by the APA. The taxpayer should propose in the request a list of items to be included in each report. For example, the report should generally include the following items: (a) the application of the TPM to the actual operations for the year; (b) a description of any material lack of conformity with critical assumptions and the reasons therefor (or, if there has been no material lack of conformity with critical assumptions, a statement to that effect); and (c) an analysis of any compensating adjustments to be paid by one entity to the other, and the manner in which the payments are to be made. Other items may be appropriate to the taxpayer's particular circumstances.

.09 *Term.*

(1) The taxpayer must propose an initial term for the APA. For example, the APA could take effect at the beginning of the taxable year during which it was requested or signed, and last for three taxable years. The term should be appropriate to the industry, product, or transaction involved.

(2) The APA request must be filed no later than the time prescribed by law (including extensions) for filing the taxpayer's Federal income tax return for the first taxable year to be covered by the APA. For purposes of the preceding sentence, an APA request will be considered filed on the date payment of the required user fee is made (within the meaning of § 7502(a)), provided that a substantially complete APA request is filed with the Service within 120 days thereafter, subject to extension by the Service based on a showing of substantial unforeseen circumstances.

.10 *Request for Competent Authority Consideration.*

The taxpayer must state whether any of the parties to a request are residents of or conduct activities in a foreign country that has a tax treaty with the United States or in a possession of the United States, and whether the taxpayer proposes an agreement among competent authorities or an agreement described in Rev. Proc. 89–8, 1989–1 C.B. 778 (see section 7 of this revenue procedure for guidelines). For purposes of this revenue procedure, "competent authority" includes the U.S. and foreign competent authorities under income tax treaties to which the U.S. is a party, and also includes the Assistant Commissioner (International) acting with respect to a possession tax agency described in Rev. Proc. 89–8, as well as a designated possession tax official within the meaning of that revenue procedure. If the taxpayer proposes an agreement among competent authorities for the initial term of the APA, the taxpayer's request must include the information described in sections 4.05(a) and (b) and, in a separate document, section 4.05(m), of Rev. Proc. 96–13, 1996–3 I.R.B. 31, or similar information pursuant to a request for relief under Rev. Proc. 89–8.

.11 *Perjury Statement.*

The taxpayer must include in any request for an APA, and any supplemental submission, 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 request contains all the relevant facts relating to the request, and such facts are true, correct, and complete.

The declaration must be signed by the person or persons on whose behalf the request is being made and not by the taxpayer's representative. The person signing for a corporate taxpayer must be an authorized officer of the taxpayer who has personal knowledge of the facts and whose duties are not limited to obtaining letter rulings or determination letters from the Service, or negotiating APAs. The person signing for a trust or a partnership must be a trustee or a partner who has personal knowledge of the facts.

.12 *Signatures.*

The taxpayer or the taxpayer's authorized representative must sign the request. If an authorized representative is to sign, the taxpayer and representative must conform to the rules of Rev. Proc. 96–1, 1996–1 I.R.B. 8 (or its successor).

.13 *Copies and Mailing.*

(1) Requests or other documents containing user fees must be mailed or delivered to

Internal Revenue Service
Attn: CC:DOM:CORP:T
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044,

or may also be hand delivered to the drop box at the 12th Street entrance of 1111 Constitution Avenue, N.W., Washington, DC.

(2) All other communications may either be mailed to

Advance Pricing Agreement Program
Internal Revenue Service
Attn: CC:INTL
Room 3501, 1111 Constitution Ave., NW
Washington, DC 20224

or may be delivered to

Advance Pricing Agreement Program
Internal Revenue Service
Attn: CC:INTL
5th Floor, 950 L'Enfant Plaza, SW
Washington, DC 20024

The taxpayer should provide the original and seven copies of its APA request and of all supplemental materials submitted while the request is pending.

.14 *User Fees.*

(1) The user fee for each separate request for an advance pricing agreement is $25,000 except as provided below in this section 5.14 of this revenue procedure.

(2) The user fee for each separate request for an advance pricing agreement from a taxpayer with gross income (as determined in section 5.14(7) of this revenue procedure) of at least $100,000,000 and less than $1,000,000,000 is $15,000.

(3) The user fee for each separate request for an advance pricing agreement or renewal from a taxpayer with gross income (as determined in section 5.14(7) of this revenue procedure) of less than $100,000,000 is $5,000.

(4) Notwithstanding sections 5.14(1) and (2) of this revenue procedure, if it is apparent on the face of the APA request that the transaction or transactions subject to the request involve tangible property and/or services the total annual value of which is not in excess of $50,000,000, or payments for intangible property (such as royalties) not in excess of $10,000,000 annually, the user fee for each separate request shall not be more than $7,500.

(5) As explained in section 5.14(8) of this revenue procedure, an APA request that involves pricing issues in more than one foreign jurisdiction will normally be considered to constitute multiple bilateral requests. The user fee for the first such request shall be determined under sections 5.14(1), (2), (3), (4), or (6) of this revenue procedure as applicable. The user fee for each subsequent bilateral request, however, shall be not more than $7,500, if such subsequent bilateral request (a) involves the same product line, goods, services, or intangibles, and the same issues, as involved in the first request; (b) covers the same taxable years as covered by the first request; and (c) proposes the same TPM as the first request.

(6) Notwithstanding sections 5.14(1) and (2) of this revenue procedure, the user fee for a request for renewal of an APA, when the material facts, critical assumptions and proposed TPM have not substantially changed, shall not be more than $7,500.

(7) For purposes of sections 5.14(2) and 5.14(3) of this revenue procedure, gross income of a U.S. person (or non-U.S. person filing a federal income tax return with respect to all such person's income) is equal to "total income" as reported on the last federal income tax return for such person (as amended) filed for a full (12 month) taxable year ending before the date the

request was filed, plus "cost of goods sold" as reported on that federal income tax return, plus any income not subject to tax under section 103 for that period; and gross income of all other persons shall be computed on an equivalent basis (that is, gross receipts or economic income plus cost of goods sold) for such person's most recently completed 12-month year. For purposes of sections 5.14(2) and (3) of this revenue procedure, gross income of a taxpayer shall include the gross income (determined pursuant to the preceding sentence) of all organizations, trades or businesses (whether or not incorporated, whether or not resident or organized in the U.S., and whether or not affiliated for tax purposes) owned or controlled directly or indirectly by the same interests controlling the taxpayer.

(8) For purposes of this section 5.14 of this revenue procedure, a separate request constitutes a request for agreement on a transfer pricing methodology or methodologies comprising a closely related set of facts, such that review of the single set of facts will suffice to determine the suitability of all the methodologies involved in the separate request. For example, an APA submission involving the pricing of tangible products and the manufacturing services provided by a parent to a subsidiary with respect to those products usually would constitute one separate request. Similarly, a submission involving separate product lines manufactured in the same location by substantially similar processes usually would constitute one separate request. However, a submission involving product lines manufactured at different locations, or by manufacturing processes that are not substantially similar, usually would constitute more than one request. The fact that an APA submission involves pricing issues related to more than one foreign jurisdiction, and thus requires analyses of separate factual or economic issues, as well as negotiations between the U.S. and more than one foreign competent authority, will normally result in treatment of the submission as more than one request. However, such separate requests may be eligible for reduced user fees under paragraph (5) of this section 5.14 of this revenue procedure.

(9) If an APA request is submitted or processed under paragraphs (2), (3), (4), (5), or (6) of this section 5.14 of this revenue procedure, and it later becomes apparent that the request does not meet the criteria for application of such paragraphs, the Service will request an additional user fee to conform the request to the proper amount under this revenue procedure, as appropriate. The taxpayer may either pay such additional fee and continue the APA process or may withdraw the request. If the taxpayer withdraws the request, the Service may return the user fee to the taxpayer if the Service determines that such action would be appropriate under the circumstances. Except to the extent inconsistent with this revenue procedure, the principles of Rev. Proc. 96–1 (or its successor), including but not limited to section 14 thereof, shall apply to all questions related to user fees in connection with APAs. The APA Team Leader described in section 6.04 of this revenue procedure, prior to the initial meeting with the taxpayer on a filed APA, will make a determination regarding the correctness of the taxpayer's initial payment of user fees and request any necessary corrections.

(10) The chart below summarizes the foregoing user fee provisions:

Taxpayer Gross Income	*Original Request*	*Each Additional Multilateral Request*[1]	*Routine Renewal*[2]	*Small Transactions*[3]
$1 billion or more	$25,000	$7,500	$7,500	$7,500
Less than $1 billion and greater than or equal to $100 million	$15,000	$7,500	$7,500	$7,500
Less than $100 million	$5,000	$5,000	$5,000	$5,000

[1]Only if such additional request involves the same issues, covers the same years, and proposes the same TPM as the first request; see section 5.14(5).
[2]Only if the material facts, critical assumptions, and proposed TPM have not substantially changed; see section 5.14(6).
[3]Regardless of taxpayer size, applies to transactions that involve (i) tangible property or services valued at no more than $50 million annually, or (ii) payments for intangible property not in excess of $10 million annually; see section 5.14(4).

SEC. 6. PROCESSING OF APA REQUESTS

.01 *Initial Contact.*

After receiving a request for an APA, a representative of the APA Program will contact the taxpayer to discuss any questions that the Service may have, or to ask for any additional information or documents believed necessary in order to initiate processing of the request. Additional information and documents must be supplied by the date specified by the Service, as extended for good cause.

.02 *Coordination with Other IRS Offices.*

Upon receipt of a request, the APA Director will coordinate the evaluation of the request with other Service officials, such as the District Director, Regional Director of Appeals and District Counsel. In appropriate cases, such as where a request proposes an agreement between competent authorities, the APA Director will coordinate with the U.S. competent authority.

.03 *Evaluation Process.*

The Office of Associate Chief Counsel (International), in coordination with the appropriate District Director and other appropriate Service officials, will evaluate the taxpayer's APA request by discussing it with the taxpayer, verifying the data supplied, and requesting additional supporting data if necessary. The evaluation of the request will not constitute an examination or inspection of the taxpayer's books and records under § 7605(b) or any other provision of the Code.

.04 *Formation of the APA Team and Designation of Team Leader.*

Within 45 days of receiving the taxpayer's APA request and any required user fees, the APA Director will appoint an APA Team to review the request. The APA Team normally will consist of at least one representative of the Office of Associate Chief Counsel (International), as well as representatives of the appropriate District and District Counsel and, when appropriate, Appeals and the U.S. competent authority. The APA Director will appoint a Team Leader to oversee the APA Team's activities. Whenever reasonably feasible, if a prefiling conference has been held with the taxpayer,

the Team Leader will be appointed from among the IRS representatives at the prefiling conference.

.05 *Negotiation and Drafting.*

(1) The APA Team shall arrange with the taxpayer for an initial meeting to take place within 60 days of receiving the taxpayer's APA request and required user fee. In connection with the initial meeting, the APA Team and the taxpayer shall agree on a Case Plan and Schedule, to which everyone involved in the APA–both government and taxpayer personnel–will be expected to adhere. The Case Plan and Schedule should list each question raised by the initial Service review of the APA request and should include a schedule for seeking to resolve each. The Case Plan and Schedule generally should reflect agreement between the APA Team and the taxpayer on the scope and nature of any additional information that will be required to resolve these questions in order to negotiate an APA. Firm dates should be agreed upon for case milestones, including: (a) submission of any necessary additional information by the taxpayer; (b) evaluation of the information by the government; (c) negotiation of a recommended agreement or competent authority negotiating position; and (d) presentation of the recommended agreement or competent authority negotiating position in writing to the Associate Chief Counsel (International).

(2) The time scheduled for completion of the case milestones will depend to some extent on the scope and complexity of the particular case. In the case of bilateral or multilateral requests, the Service will seek to work with the competent authority of the treaty partner or U.S. possession involved to minimize the time needed for competent authority resolution.

(3) To minimize delays caused by the need to coordinate different parties' schedules on short notice, the time and place of meetings required for any steps in the case should be determined in the Case Plan and Schedule.

(4) Failures by either the taxpayer or the APA Team to meet case milestones will be addressed promptly, normally in a meeting or telephone conference involving the APA Director, members of the Service APA Team, and the taxpayer. If a taxpayer has failed to meet one of the case milestones, the APA Director will assist the taxpayer in remedying any difficulties and will propose a course of action to ensure that milestones can be met. Substantial and consistent failure by the taxpayer to comply with the Case Plan and Schedule will be treated by the Service as a withdrawal of the APA request. In this event, if the taxpayer wishes to continue to pursue the APA, the taxpayer will be required to refile the request and pay a new user fee. If the Service fails to meet a case milestone, the APA Director, the Service APA Team, and supervisors in the District and Region, as appropriate, shall work together promptly to remedy the situation.

(5) In some circumstances, development of the case after agreement on the Case Plan and Schedule will suggest, to both the APA Team and the taxpayer, that some milestone dates should be adjusted. To preserve flexibility, the APA Team and the taxpayer may amend the Case Plan and Schedule by mutual agreement, consistent with the need to maintain progress toward completion of the case as expeditiously as feasible.

(6) The function of the APA Team is to negotiate and recommend an agreement, and if applicable to recommend in consultation with the taxpayer a competent authority negotiating position, to the Associate Chief Counsel (International). Negotiations between taxpayers and the APA Team should be documented by means agreed between the parties. The District Director with responsibility for the taxpayer's returns shall be provided an opportunity to review and comment on the draft APA in the case of a unilateral APA, and the proposed initial US competent authority negotiating position in the case of a bilateral or multilateral APA. Signature of an APA by the Associate Chief Counsel (International) and the taxpayer will constitute agreement to the APA.

.06 *Withdrawing the Request.*

The taxpayer may withdraw the request at any time before the execution of the APA. Pursuant to the principles of Rev. Proc. 96–1 (or its successors), including but not limited to section 14.09 thereof, the user fee generally will not be refunded if the taxpayer withdraws its request for an APA.

.07 *Rejecting the Request.*

The Service may decline either to accept any APA request or to execute any APA, as requested, after a request has been accepted. If the Service declines to execute an APA after the request has been initiated, the Service normally will retain the user fee, although the fee may be returned if the Service determines that such action would be appropriate under the circumstances. If the Service proposes to reject an APA request, the taxpayer will be granted one conference of right. Other conferences may be granted at the Service's discretion.

SEC. 7. COMPETENT AUTHORITY CONSIDERATION

.01 When any of the parties to a request are entitled to seek relief under the mutual agreement provision of a tax treaty between a foreign country and the United States, or under Rev. Proc. 89–8, the competent authorities may enter into agreements concerning the APA. Requests similar to APA requests that are initiated through treaty partners or possession tax agencies and submitted to the U.S. competent authority will be processed under this revenue procedure and Rev. Proc. 96–13, as appropriate. In order to provide timely clarification of factual issues, minimize the potential for miscommunication, and assist in development of a multiple party agreement on a timely basis, the Service will generally initiate coordination among the taxpayer, the Service, and the competent authorities of treaty partners at the earliest possible stage of consideration of an APA request including, where possible, the prefiling stage. In this manner, the U.S. and foreign competent authorities can develop a joint understanding of the case which should facilitate negotiation and resolution of competent authority issues. The taxpayer should remain available throughout consideration of the request to assist the Service in reaching agreement with the foreign competent authority. Final agreement to the negotiated APA will be sought among the taxpayer, the Service, and the foreign competent authority. As a general matter, the taxpayer is encouraged to submit APA requests and related correspondence simultaneously to the Service and to foreign competent authorities involved in the requests.

.02 The purpose of the competent authority agreement is to avoid double taxation. If such an agreement is not acceptable to the taxpayer, the taxpayer may withdraw the APA request (see section 6.06 of this revenue procedure). If the competent authorities are unable to reach an agreement or the taxpayer does not accept the competent authority agreement, the Service will attempt to negotiate a unilateral APA with the taxpayer (see section 7.07 of this revenue procedure).

.03 The taxpayer must cooperate with the Service and the U.S. competent authority, pursuant to the standards set forth in Rev. Proc. 96–13 and any other applicable revenue procedures. Any information received or prepared by the Service, including information furnished by the taxpayer or the related foreign entity, will be subject to the restrictions on disclosure of tax related information provided by U.S. law and the applicable income tax convention.

.04 It may be necessary to request sensitive confidential data (such as trade secrets) which, if disclosed, could harm the taxpayer's competitive position. In such cases, the parties will attempt to negotiate a mechanism to permit verification by a foreign competent authority without disclosing such information.

.05 When the competent authorities enter into an agreement covering an APA, the Service will, to the extent practicable, agree to a mutual exchange of information with the foreign competent authority concerning any subsequent modifications, cancellation, revocation, requests to renew, evaluation of annual reports, or examination of the taxpayer's compliance with the terms and conditions of the APA. Bilateral APAs may provide for simultaneous filing of the annual report with the Service and with the foreign tax administration.

.06 The U.S. competent authority will seek to persuade the foreign competent authority to use APA data only on terms similar to those described in sections 10.04 and 10.05 of this revenue procedure.

.07 To minimize taxpayer and governmental uncertainty and administrative cost, bilateral or multilateral APAs generally are preferable to unilateral APAs when competent authority procedures are available with respect to the foreign country or countries involved. In appropriate circumstances, however, the Service may execute an APA with a taxpayer without reaching a competent authority agreement. The taxpayer must show sufficient justification for a unilateral APA. When a unilateral APA request involves taxpayers operating in a country that is a treaty partner, the Service may notify the treaty partner of the filing of the request and provide the treaty partner with other information related to the request, under normal rules governing the exchange of information under income tax treaties. In some circumstances, procedures agreed upon with particular foreign competent authorities, or the requirements of proper relations with treaty partners, may preclude unilateral APAs.

.08 Section 7.05 of Rev. Proc. 96–13 provides in part that, if a taxpayer reaches a settlement on an issue with Counsel pursuant to a written agreement, the U.S. competent authority will endeavor only to obtain a correlative adjustment from a treaty country and will not undertake any actions that would otherwise change such agreement. The restrictions imposed under section 7.05 of Rev. Proc. 96–13 with respect to the discretion of the U.S. competent authority to negotiate correlative relief will not apply to a unilateral APA. However, a unilateral APA may hinder the ability of the U.S. competent authority to reach a mutual agreement which will provide relief from double taxation, particularly when a contemporaneous bilateral or multilateral APA request would have been both effective and practical (within the meaning of § 1.901–2(e)(5)(i)) to obtain consistent treatment of the APA matters in a treaty country. (If there is a settlement with respect to taxable years prior to the first year subject to a unilateral APA based on rollback of such APA's TPM (as discussed in sections 3.06 and 8 of this revenue procedure), section 7.05 of Rev. Proc. 96–13 will apply to such rollback years in the regular manner.)

SEC. 8. ROLLBACKS

.01 The taxpayer may indicate in its APA request, or at any time prior to the completion of APA negotiations, that it desires for the Service to consider using the TPM of the APA to resolve transfer pricing issues for years prior to the earliest year covered by the APA. In general, the principles set forth in section 3.06 of this revenue procedure will govern the Service's consideration of this request (the "rollback request"). When a rollback request is made after submission of the APA request, the taxpayer must provide the request to the APA Director at the address indicated in section 5.13(2) of this revenue procedure.

.02 If a rollback request is submitted in connection with a bilateral or multilateral APA, the rollback request will be deemed to constitute an application for accelerated competent authority consideration as described in section 7.06 of Rev. Proc. 96–13. The Office of Associate Chief Counsel (International), the District Director, and the U.S. competent authority will coordinate consideration of the request. The taxpayer's request must include all information required for accelerated competent authority consideration under Rev. Proc. 96–13, subject to the rules set forth therein. The taxpayer's request can pertain to any years prior to the first year to be covered under the requested APA, except that, in order to facilitate effective competent authority negotiations, the Service may require that, if accelerated competent authority consideration is to be granted, it will apply to one or more specified years. In exercising their regular discretion over the conduct of accelerated competent authority consideration, Service officials shall seek to implement the policy concerning APA rollbacks stated in section 3.06 of this revenue procedure.

.03 If a rollback request is submitted in connection with a bilateral or multilateral APA and involves a taxable year that is under the jurisdiction of Appeals, the rollback request will be deemed to constitute an application for simultaneous Appeals and competent authority consideration as described in section 8 of Rev. Proc. 96–13 and will be subject to the rules set forth therein. The Office of Associate Chief Counsel (International), the Regional Director of Appeals, and the U.S. competent authority will coordinate consideration of the request. In exercising their regular discretion over the conduct of simultaneous Appeals and competent authority consideration, Service officials shall seek to implement the policy concerning APA rollbacks stated in section 3.06 of this revenue procedure.

.04 Subject to the policy set forth in section 3.06 of this revenue procedure, the determination whether a rollback shall be granted with respect to a taxable year is within the discretion of the Service official with jurisdiction over the taxable year subject to the rollback — typically, either the District Director, the Regional Director of Appeals, the Assistant Commissioner (International) (for matters subject to competent authority negotiations), or the District Counsel (for matters under litigation). Except to the extent inconsistent with this revenue procedure, normal procedures for resolving tax issues, including but not limited to closing agreements and other settlement documents and Forms 870 and 870AD, shall be used to implement APA rollbacks.

SEC. 9. INDEPENDENT EXPERT OPINION

.01 The taxpayer may be required to provide at its own expense an independent expert, acceptable to both the taxpayer and the Service (and, in a bilateral or multilateral proceeding, the foreign competent authority or authorities) to review and opine on the proposed TPM. The taxpayer may suggest in its APA request whether an independent expert is needed, or the Service (or, if applicable, the foreign competent authority) may determine that an independent expert is needed for the evaluation of the taxpayer's request.

.02 For purposes of this revenue procedure, an expert is any person who, by agreement between the taxpayer and the Service (and, if involved, the foreign competent authority), possesses expert education or experience in a field of study, industry or geographic area that is relevant to the subject matter of the taxpayer's APA request.

.03 For purposes of this revenue procedure, an expert is independent if the expert has not participated to any material extent in the development of the request and has not in the past assisted either the Service or the taxpayer in matters substantially related to the request.

.04 If an expert is necessary, the expert will critically analyze the taxpayer's proposed TPM and render a written opinion. The opinion will address any questions and concerns raised by the Service or the taxpayer (and, if involved, the foreign competent authority); conclude whether the proposed TPM or a revised version fairly supports and produces an arm's length approach; and provide the basis for this opinion. However, the expert's opinion will not be binding on any of the parties. The taxpayer and the Service (and, if involved, the foreign competent authority) will have access to the expert's report and supporting documentation. The Service and the taxpayer shall both be kept fully informed of any communications between the other party and the independent expert, and receive copies of all information provided by such other party to the expert.

.05 If an independent expert is necessary, the taxpayer must provide a waiver under § 6103(c) to the Service for purposes of discussing returns or return information with the expert. The taxpayer must also ensure that the expert is familiar with the provisions of this revenue procedure and that any opinion rendered by the expert complies with those provisions.

SEC. 10. LEGAL EFFECT

.01 An APA is a binding agreement between the taxpayer and the Service.

.02 If the taxpayer complies with the terms and conditions of the APA, the Service will regard the results of applying the TPM as satisfying the arm's length standard, and, except as provided in this revenue procedure, will not contest the application of the TPM to the subject matter of the APA. The taxpayer remains otherwise subject to U.S. income tax laws and is entitled to any benefits otherwise available under U.S. income tax laws.

.03 Except to the extent provided by regulations, an APA shall have no legal effect except with respect to the taxpayer, taxable years and transactions to which the APA specifically relates.

.04 Except as otherwise provided by written agreement, regulations, or this revenue procedure, neither the APA nor any non-factual oral or written representations or submissions made in conjunction therewith may be introduced by the taxpayer or the Service as evidence in any judicial or administrative proceeding in relation to any tax year, transaction, or person not covered by the APA. However, taxpayers should recognize that the preceding sentence does not preclude rollback of the APA TPM, nor the discovery, use, or admissibility of non-factual material otherwise discoverable or obtained other than in the APA process merely because the same or similar material was also included in the APA or representations or submissions made in connection with the APA or presented during the APA process.

.05 Except as otherwise provided by written agreement or regulations, if an APA is not executed or if an executed APA is later revoked or canceled, neither the APA or the proposal to use a particular TPM, nor any non-factual oral or written representations or submissions made during the APA process, may be introduced by the taxpayer or the Service as an admission by the other party in any administrative or judicial proceeding for the taxable years for which the APA was requested or executed. However, taxpayers should recognize that the preceding sentence does not preclude the discovery, use, or admissibility of non- factual material otherwise discoverable or obtained other than in the APA process merely because the same or similar material was also included in the APA or representations or submissions made in connection with the APA or presented during the APA process.

SEC. 11. ADMINISTERING THE APA

.01 Annual Reports.

(1) For each taxable year covered by the APA, the taxpayer must file a timely and complete annual report describing the taxpayer's actual operations for the year and demonstrating good faith compliance with the terms and conditions of the APA. The report must include all items called for by the APA, must describe any pending or contemplated requests to renew, modify or cancel the APA, and must describe any compensating adjustments made pursuant to section 11.02 of this revenue procedure.

(2) The taxpayer shall file an original and four copies of each report, no later than 90 days after the time prescribed by law (including extensions) for filing the taxpayer's Federal income tax return for the year covered by the report, or by such other date as is specified in the APA, with the APA Director at the address indicated in section 5.13(2) of this revenue procedure. The taxpayer may also be required to file a copy of the annual report with the treaty partner or partners with respect to a bilateral or multilateral APA. The report must comply with sections 5.11 and 5.12 of this revenue procedure.

(3) The Service will contact the taxpayer regarding an annual report only if it is necessary to clarify or complete the information contained in the annual report. Additional information must be supplied by the date specified by the Service, as extended for good cause. Any contact between the taxpayer and the Service for the purpose of clarifying the information contained in the annual report will not constitute an examination, or the commencement of any examination, of the taxpayer for purposes of § 7605(b) or any other provision of the Code.

.02 *Compensating Adjustments.*

(1) If the results of applying the TPM differ from those contemplated by the APA, the APA may permit the taxpayer and its related foreign entity to make a compensating adjustment. For example, if the APA provides for a range of expected operating results, and the actual operating results are outside that range (but within any limits specified in the APA), the APA may permit the

parties to make a compensating adjustment to bring the results to an agreed upon point within the described range. Such compensating adjustment should be reflected on the taxpayer's timely filed (with extensions) federal income tax return; if the taxpayer is not able to make such adjustments in its original return, the required compensating adjustment must in any event be made and paid within 90 days of the date prescribed for filing such return (with extensions), and reflected on an amended return filed within such period and the timely filed annual report required by section 11.01 of this revenue procedure. To the extent the APA covers years for which federal income tax returns were filed before the APA was executed, the taxpayer must make any required compensating adjustments in an amended return or returns filed within, and pay such compensating adjustments within, 90 days of entering into such APA.

(2) The taxable income and earnings and profits of both the taxpayer and its related foreign entity for a taxable year covered by an APA will include all income generated as a result of the TPM as increased or decreased by any compensating adjustment for that year. A compensating adjustment will be deemed to have been made as of the last day of the taxable year to which it applies. For all U.S. income tax purposes, after taking into consideration any compensating adjustment, the adjusted figures will be used. Provided that the taxpayer has made a good faith effort to comply with the TPM in such manner as to avoid the need for compensating adjustments, and payments of compensating adjustments are made within the time specified in section 11.02(1) of this revenue procedure, (i) the compensating adjustment will not be taken into account in the computation of any required estimated tax installments for such year, (ii) the taxpayer will not be subject to the failure to pay penalties under § § 6651 and 6655 by reason of the compensating adjustment, and (iii) no interest will accrue on any receivable or payable established to settle such compensating adjustment. A compensating adjustment may, however, be taken into account for purposes of redetermining any foreign tax credits in accordance with § 901. Subject, where applicable, to agreement between competent authorities, the taxpayer or the related foreign entity may employ any method that accords with section 4 of Rev. Proc. 65–17, 1965–1 C.B. 833 (as modified), or any successor, for paying compensating adjustments, including checks, wire transfers, offsets through intercompany accounts, or recharacterized dividends. All actions taken with respect to such compensating adjustments must be documented and disclosed in the annual report.

(3) A "subsequent compensating adjustment" arises when the taxpayer or the Service makes normal and routine adjustments (for example, correction of computational errors) to the determination and computation of the taxpayer's TPM during the taxable year or years under the APA, as determined in accordance with the TPM. The generally applicable Code rules relating to assessment, collection and refund of tax and the principles of Rev. Proc. 65–17 (as modified), or any successor, apply to any resulting change in Federal income tax liability because of a subsequent compensating adjustment.

(4) When an agreement between competent authorities is sought as part of the APA request, the principles stated in this section will be discussed with the appropriate foreign competent authority to seek to ensure substantially identical treatment of the taxpayer's related foreign entity.

(5) The Service and the taxpayer may agree in an APA to modify the foregoing provisions relating to compensating adjustments.

.03 *Examination.*

(1) If the District Director examines a tax year covered by an APA, the examination of matters covered by the APA will be limited to the factors in section 11.03(2) of this revenue procedure. The District Director will not re-evaluate the TPM itself.

(2) The District Director may require the taxpayer to establish that (a) the taxpayer has complied in good faith with the terms and conditions of the APA; (b) the material representations in the APA and the annual reports remain valid and accurately describe the taxpayer's operations; (c) the supporting data and computations used in applying the TPM were correct in all material respects; (d) the critical assumptions underlying the APA remain valid; and (e) the taxpayer has consistently applied the TPM and met the critical assumptions.

(3) If the District Director determines that any requirement in section 11.03(2) of this revenue procedure has not been satisfied, the issue will be submitted to the Associate Chief Counsel (International) for resolution. The Associate Chief Counsel (International) will decide either to continue to apply the APA; revoke the APA (see section 11.05 of this revenue procedure); cancel the APA (see section 11.06); or revise the APA (see section 11.07).

(4) The District Director may, without securing the consent of the Associate Chief Counsel (International), propose normal and routine audit adjustments, which are not related to interpretation of the TPM, to the determination and computation of the operating results of the taxpayer's TPM during the taxable year or years under examination (as determined in accordance with the TPM) without affecting the continued validity or applicability of the APA. If the taxpayer agrees with the proposed adjustments, they will be given effect through payment of additional compensating adjustments. If the taxpayer does not agree, the taxpayer may contest the proposed adjustments through normal administrative and judicial proceedings. Any changes to compensating adjustments previously made by the taxpayer, in respect of the taxable year or years under examination, that arise as a result of the audit adjustments made by the District Director will be made within ninety days of a final determination of the audit adjustments. Any compensating adjustments and changes to compensating adjustments described in this section 11.03(4) will be treated as subsequent compensating adjustments for purposes of section 11.02 of this revenue procedure.

.04 *Record Retention.*

(1) The taxpayer must maintain books and records sufficient to enable the Service to examine the taxpayer's compliance with the APA. The APA may specify the books and records that are necessary to fulfill this objective and may specify that compliance with the applicable provisions of the APA will constitute compliance with the provisions of §§ 6038A and 6038C with respect to transactions covered by the APA.

(2) Upon examination, information requested by the Service must be made available to the Service upon written request within 30 days, and translations must be provided within 30 days of a request for translation of specific documents, both as extended for good cause. The fact that a foreign jurisdiction may impose a penalty upon the taxpayer or other person for disclosing the material

will not constitute reasonable cause for noncompliance with the Service's request.

.05 *Revoking the APA.*

(1) The Associate Chief Counsel (International) may revoke the APA if there has been fraud or malfeasance (as defined in § 7121) or disregard (as defined in § 6662(b)(1) and (c)) by the taxpayer in connection with the APA, including but not limited to fraud, malfeasance or disregard involving any of the following: the material facts set forth in the request or subsequent submissions (including the annual report), or lack of good faith compliance with the terms and conditions of the APA. Material facts are those that, if known by the Service, could reasonably have resulted in a significantly different APA (or no APA at all). The Associate Chief Counsel (International) is not required to revoke the APA and may require the taxpayer to continue to abide by it.

(2) If the APA is revoked for any reason, the revocation may be retroactive to the first day of the first taxable year for which the APA was effective.

(3) If the APA is revoked for any reason, the Service may determine deficiencies in income taxes and additions thereto in accordance with applicable provisions of the Code. In addition, (a) relief under Rev. Proc. 65–17 may be denied; (b) if the Service determines that the taxpayer may avail itself of the relief under Rev. Proc. 65–17, interest on any account receivable established under section 4.03 of that revenue procedure may be determined not to be subject to mutual agreement or correlative relief; (c) the revocation of the APA may be treated as an "egregious case" under Rev. Rul. 80–231, 1980–2 C.B. 219, with the result that the taxpayer may be denied a foreign tax credit in accordance with that ruling; and (d) the unilateral relief provisions of Rev. Proc. 96–14, 1996–3 I.R.B. 41, may not be available. When an APA has been the subject of negotiation with a foreign competent authority, the Service will seek to coordinate any action concerning revocation of the APA with the foreign competent authority.

.06 *Cancelling the APA.*

(1) The Associate Chief Counsel (International) may cancel the APA if the District Director, with the concurrence of the Associate Chief Counsel (International), determines that there was a misrepresentation, mistake as to a material fact, failure to state a material fact, or lack of good faith compliance with the terms and conditions of the APA (but not fraud, malfeasance or disregard) in connection with the request for the APA, or in any subsequent submissions (including the annual report). Material facts are those that, if known by the Service, would have resulted in a significantly different APA (or no APA at all).

(2) The Associate Chief Counsel (International) may waive cancellation if the taxpayer can show good faith and reasonable cause to the satisfaction of the Associate Chief Counsel (International), and if the taxpayer agrees to make any adjustment proposed by the Associate Chief Counsel (International) to correct for the misrepresentation, mistake as to a material fact, failure to state a material fact, or noncompliance. The Associate Chief Counsel (International) is not required to cancel the APA and may require the taxpayer to continue to abide by it.

(3) If the APA is cancelled under section 11.06(1) of this revenue procedure, the cancellation will be effective as of the beginning of the year in respect of which the misrepresentation, mistake as to a material fact, failure to state a material fact, or noncompliance occurs. If, however, the cancellation results from a change in law or treaty, as provided in section 11.07(1) of this revenue procedure, the cancellation normally will be effective as of the effective date of the change in law or treaty.

(4) If the APA is cancelled for any reason, then as of the effective date of the cancellation the APA will cease to be of any further force and effect with respect to the taxpayer and the Service for U.S. income tax purposes. After the effective date of the cancellation, the tax treatment of the transactions covered by the APA will be subject to all U.S. tax rules (including treaty rules) that otherwise apply. When an APA has been the subject of negotiation with a foreign competent authority, the Service will seek to coordinate any action concerning cancellation of the APA with the foreign competent authority.

.07 *Revising the APA.*

(1) If a critical assumption has not been met, or there has been a change in law or treaty as described in section 11.09 of this revenue procedure, the APA may be revised by agreement of the parties. If such agreement cannot be achieved, the APA will be cancelled.

(2) If a critical assumption has not been met, the taxpayer must notify the APA Director, including with the notification supporting documentation and a statement whether a revision appears appropriate. The taxpayer shall file the notification at any time prior to the last date permitted for filing the annual report for the year in which the failure to meet a critical assumption occurred. In providing the notification, the taxpayer must follow the procedures contained in sections 5.11 through 5.13 of this revenue procedure.

(3) If a critical assumption has not been met, the taxpayer and the Service will discuss how to revise the APA. If the taxpayer and the Service cannot execute a revised agreement, the APA will be cancelled as of the beginning of the taxable year in which the failure to meet a critical assumption occurred. If the Service and the taxpayer can agree on a revised APA, the effective date of the revised APA will be stated in the new APA.

(4) If the Service and the taxpayer agree to revise an APA that has been subject to competent authority agreement, the revised APA will be submitted to the U.S. competent authority in order to seek the consent of the foreign competent authority to the revised APA. If the foreign competent authority refuses to accept the revised APA, or if the competent authorities cannot agree on a revised APA agreeable to all parties, the taxpayer and the Service may: (a) agree to continue to apply the existing APA, (b) agree to apply the revised APA or agree to further revision thereof, or (c) agree to cancel the APA as of an agreed date. If such agreement cannot be achieved, the APA will be cancelled pursuant to section 11.07(1) of this revenue procedure.

.08 *Renewing the APA.*

A taxpayer may request renewal by following the form and procedures that apply to initial APA requests. The taxpayer must submit the user fee as required under section 5.14 of this revenue procedure, and must provide appropriate supporting documentation with the request. Unless otherwise agreed by the Service, the taxpayer should file the request to renew no later than nine months before the expiration of the initial term or any renewal term.

.09 *Change in Law or Treaty.*

If there is a change in any applicable U.S. law or treaty that changes the Federal income tax treatment of any

matter covered by the APA, the new law or treaty provision supersedes the APA to the extent the APA is inconsistent therewith. The parties may revise the APA under section 11.07 of this revenue procedure to reconcile it with the new law or treaty provision.

SEC. 12. DISCLOSURE

The information received or generated by the Service during the APA process relates directly to the existence and amount of tax liability of the taxpayer under the Internal Revenue Code. Therefore, the APA and such information are subject to the confidentiality requirements of § 6103. In addition, the APA and such information may be confidential pursuant to the provisions of income tax conventions, or other rules applicable to communications with foreign governments.

SEC. 13. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 91–22, 1991–1 C.B. 526, is superseded. Rev. Proc. 96–13 is modified. Rev. Proc. 96–1 is modified.

SEC. 14. EFFECTIVE DATE

This revenue procedure will apply to all APA requests, including requests for renewal, received on or after December 31, 1996, except that (i) section 7.08 shall apply to all such APA requests and APA requests that have been filed on or after the effective date of Rev. Proc. 96–13, (ii) section 8.02 and/or section 8.03 may at the taxpayer's request apply to an APA request filed prior to such date and with respect to which an APA has not been concluded, and (iii) any provision of section 5.14 may apply to a request filed prior to such date and with respect to which an APA has not been concluded, if the taxpayer demonstrates that such application is necessary to avoid unfairness to the taxpayer.

SEC. 15. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1503.

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

The collections of information in this revenue procedure are in sections 4.02, 5, 8.02, 9, 11.01, 11.02(1), 11.04, 11.07, and 11.08. This information is required to provide the Service sufficient information to evaluate and process the APA request or request for renewal of an existing APA, or to determine whether the taxpayer is in compliance with the terms and conditions of an APA. This information will be used to evaluate the proposed TPM, and the taxpayer's compliance with the terms and conditions of any APA to which it is a party. The collections of information are required to obtain an APA. The likely respondents are business or other for-profit institutions.

The estimated total annual reporting and/or recordkeeping burden is 5,250 hours.

The estimated average burden for an APA prefiling conference is 10 hours; the estimated average burden for an APA request is 50 hours; and the estimated average burden for preparation of an annual report by a party to an APA is 15 hours. The estimated number of respondents and/or recordkeepers is 160.

The estimated annual frequency of responses is one request or report per year per applicant or party to an APA, except that a taxpayer requesting an APA may also request a prefiling conference.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally tax returns and tax return information are confidential, as required by § 6103.

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26 CFR 2056A: Qualified domestic trust.

Rev. Proc. 96–54

SEC. 1. PURPOSE

This revenue procedure provides sample paragraphs that may be used to satisfy the governing instrument requirements contained in §§ 20.2056A–2(d)(1)(i) and (d)(1)(ii) of the Estate Tax Regulations for a qualified domestic trust (QDOT) as described in § 2056A-(a) of the Internal Revenue Code.

SEC. 2. BACKGROUND

Section 2056A(a)(2) authorizes the Internal Revenue Service to promulgate regulations that will ensure the collection of the additional estate tax imposed under § 2056A(b)(1)(A) and (B). Final regulations were issued pursuant to this authorization on December 9, 1996.

Under § 20.2056A–2(d)(1)(i), if the fair market value of the assets passing to the QDOT is in excess of $2 million, either: (A) at least one Trustee must be a United States bank described in § 581, or a U.S. Branch of a foreign bank; (B) the trustee must furnish a bond in favor of the Internal Revenue Service in an amount equal to 65 percent of the fair market value of the trust corpus; or (C) the trustee must furnish an irrevocable letter of credit in an amount equal to 65 percent of the fair market value of the trust corpus. The regulations provide detailed descriptions of the required terms of the bond and letter of credit and sample forms for each.

Under § 20.2056A–2(d)(1)(i), the QDOT may alternate among the arrangements provided in paragraphs (d)(1)(i)(A), (B), and (C), provided that at any given time at least one of the arrangements is in effect.

Under § 20.2056A–2(d)(1)(ii), if the fair market value of the QDOT assets is $2 million or less, the QDOT must provide that the trustee will either satisfy the requirements listed above, or limit the fair market value of real property that is held by the trust and situated outside the United States to 35 percent of the value of the trust at the close of the taxable year. A special look-through rule applies for interests in corporations or partnerships that own real property. In addition, an executor may elect to exclude up to $600,000 in value of a principal residence passing to the QDOT in determining if the $2 million threshold has been exceeded.

This revenue procedure contains sample trust language that, if adopted in the trust instrument, will be recognized as meeting the requirements of § 20.2056A–2(d)(1)(i)(A), (B), and (C), and (d)(1)(ii).

SEC. 3. SCOPE AND OBJECTIVE

The sample trust language contained in section 4 of this revenue procedure meets all of the requirements under § 20.2056A–2(d)(1)(i)(A), (B), and (C), and (d)(1)(ii). If the trust instrument expressly adopts language that is the same in all material respects to the sample paragraphs provided herein, and otherwise meets the requirements of a qualified domestic trust under § 2056A(a) and § 20.2056A–2, the Service will recognize the trust as satisfy-

ing the applicable requirements of § 2056A(a) and the corresponding regulations.

SEC. 4. SAMPLE QUALIFIED DOMESTIC TRUST LANGUAGE THAT MAY BE USED TO SATISFY THE "GOVERNING INSTRUMENT" REQUIREMENTS OF § 20.2056A–2(d)(1)(i) and (ii).

My trustee shall comply with the requirements for security arrangements for qualified domestic trusts as set forth in Treas. Reg. § 20.2056A–2(d)(1)(i) or (ii), summarized as follows:

(a) *Trust in Excess of $2 Million.* If the fair market value of the assets passing to the trust (determined without reduction for any indebtedness thereon) exceeds $2 million on the relevant valuation date, then my Trustee must at all times during the term of the Trust either satisfy the U.S. Bank as Trustee requirement (see Treas. Reg. § 20.2056A–2(d)-(1)(i)(A)), or furnish a bond that satisfies the requirements of Treas. Reg. § 20.2056A– 2(d)(1)(i)(B), or furnish an irrevocable letter of credit that satisfies the requirements of Treas. Reg. § 20.2056A–2(d)(1)(i)(C), (hereinafter referred to as the U.S. Bank, Bond, or Letter of Credit Requirement). My Trustee may alternate between any of the security arrangements described in the preceding sentence provided that, at all times during the term of the trust, one of the arrangements is operative.

If my Trustee elects to furnish a bond or letter of credit as security, then in the event the Internal Revenue Service draws on the instrument in accordance with its terms, neither my U.S. Trustee nor any other person will seek a return of any part of the remittance until after April 15th of the calendar year following the year in which the bond or letter of credit is drawn upon.

(b) *Trust of $2 Million or Less.* If the fair market value of the assets passing to the trust (determined without reduction for any indebtedness) is $2 million or less on the relevant valuation date, then my Trustee must comply with either the U.S. Bank, Bond, or Letter of Credit Requirement only if more than 35% of the fair market value of the trust assets, determined annually on the last day of the taxable year of the trust, consists of real property located outside the United States. For purposes of determining whether more than 35% of the trust assets consist of foreign real property, Treas. Reg. § 20.2056A–2(d)(1)-(ii)(B) applies.

(c) *Determination of Value.* For purposes of determining whether the fair market value of the trust assets exceeds $2 million, my Trustee is authorized to make the election under Treas. Reg. § 20.2056A–2(d)(1)(iv)(A) with respect to real property used as my spouse's personal residence.

(d) *Amount of Bond or Letter of Credit.* For purposes of determining the amount of the bond or letter of credit, my Trustee is authorized to make the election under Treas. Reg. § 20.2056A–2(d)(1)(iv)(B) with respect to real property used as my spouse's personal residence.

(e) *Annual Statements.* My Trustee is directed to file any annual statements required under Treas Reg. § 20.2056A–2(d)(3).

(f) *General Conduct.* Notwithstanding anything contained herein to the contrary, my U.S. Trustee is hereby authorized to enter into alternative plans or arrangements with the Internal Revenue Service pursuant to Treas. Reg. § 20.2056A–2(d)(4) to assure collection of the deferred estate tax, in lieu of the provisions contained herein.

(g) *References to Regulations.* All references to "Treas. Reg." in this document shall be references to regulations published under 26 CFR as in effect on the date of execution of this document, or, in the event that any such regulation is amended or superseded thereafter, to the regulation (or any successor regulation) as so amended.

(h) *Dollar Values.* The use of the dollar sign ($) shall indicate amounts stated in U.S. dollars.

SEC. 5. APPLICATION

The Service will recognize a trust as meeting all of the requirements of § 20.2056A–2(d)(1)(i) and (ii) if the trust contains language that is the same in all material respects to the paragraphs provided in section 4, and the trust operates in a manner consistent with the terms of the trust instrument.

* * * * *

SEC. 7. EFFECTIVE DATE

This revenue procedure is effective for trusts for which qualified domestic trust elections are made after December 9, 1996, the date of publication of this revenue procedure in the Internal Revenue Bulletin.

26 CFR 601.201: Rulings and determination letters.

Rev. Proc. 96–55

SECTION 1. PURPOSE

.01 This revenue procedure provides a model amendment for sponsors of certain master and prototype ("M&P"), regional prototype, volume submitter specimen, and individually designed profit-sharing or stock bonus plans in order to assist these plan sponsors in amending their plans to comply with Rev. Rul. 94–76, 1994–2 C.B. 46.

.02 This revenue procedure also extends, until June 30, 1997, the time period to adopt corrective plan amendments provided for in Rev. Rul. 94–76.

SECTION 2. BACKGROUND AND GENERAL INFORMATION

.01 Section 401(a) of the Internal Revenue Code provides that a trust created or organized in the United States and forming a part of a qualified stock bonus, pension, or profit-sharing plan of an employer constitutes a qualified trust only if the various requirements set out in § 401(a) are met.

.02 Section 1.401–1(b)(1)(i) of the Income Tax Regulations provides the definition of a pension plan for purposes of § 401(a). This section provides, in part, that a pension plan is a plan established and maintained by an employer primarily to provide for the payment of definitely determinable benefits to employees over a period of years, usually for life, after retirement. This section also provides that a pension plan may provide for the payment of a pension due to disability, and may also provide for incidental death benefits.

.03 Rev. Rul. 56–693, 1956–2 C.B. 282, as modified by Rev. Rul. 60–323, 1960–2 C.B. 148, provides that, pursuant to the definition of a pension plan in § 1.401–1(b) of the regulations, a pension plan fails to meet the requirements of § 401(a) if it permits an employee to withdraw any part of the employee's accrued benefit (other than a benefit attributable to voluntary employee contributions) prior to certain distributable events; i.e., retirement, death, disability, severance of employment, or termination of the plan.

.04 Rev. Rul. 94–76 provides that, to satisfy § 401(a), benefits attributable to

assets and liabilities transferred, within the meaning of § 414(l), from a money purchase pension plan to a profit-sharing or stock bonus plan must remain subject to the restrictions on distributions from pension plans set forth in Rev. Rul. 56–693 based upon § 1.401–1(b) of the regulations.

.05 Rev. Rul. 94–76 provides that, in order to remain qualified under § 401(a), profit-sharing or stock bonus plans that accept transfers of assets and liabilities from money purchase pension plans and permit distributions prior to retirement, death, disability, severance of employment, or termination of the plan, must be amended to provide that on or after a transfer of assets and liabilities from a money purchase pension plan to the profit-sharing or stock bonus plan, the account balances (including the post-transfer earnings thereon) attributable to the transferred assets and liabilities will be distributed only on or after the occurrence of one of these events on or after which distributions are permitted from a pension plan.

.06 Rev. Rul. 94–76 provides that certain profit-sharing plans or stock bonus plans are permitted to be amended to eliminate an optional form of benefit provided for in the plan prior to December 12, 1994, solely with respect to benefits attributable to assets and liabilities that are transferred (within the meaning of § 414(l)) from a money purchase pension plan (other than any portion of those assets and liabilities attributable to voluntary employee contributions), to the extent that the optional form permits distribution of those benefits prior to the employee's retirement, death, disability, or severance of employment, and prior to plan termination. The plan amendment eliminating the optional form of benefit must be adopted by the last day of the first plan year beginning on or after December 12, 1994, and must be made effective not later than the first day of that plan year, or, if later, 90 days after December 12, 1994.

.07 With respect to certain plans, employers are entitled to extended reliance pursuant to Rev. Proc. 89–9, 1989–1 C.B. 780, Rev. Proc. 89–13, 1989–1 C.B. 801 (both as modified by Rev. Proc. 93–9, 1993–1 C.B. 474), or Rev. Proc. 93–39, 1993–2 C.B. 513 (relating to master or prototype plans, regional prototype plans, and individually designed plans). Except in certain limited circumstances, plans that are entitled to this extended reliance generally are not required to be amended until 1999 to comply with administrative guidance of general applicability (e.g., revenue rulings). Accordingly, for a profit-sharing or stock bonus plan entitled to extended reliance, if no transfer of assets and liabilities to the plan from a money purchase pension plan occurred or occurs after the date of the plan's most recent determination letter and prior to the date that the amendment required by Rev. Rul. 94–76 is adopted and if the amendment is made effective within certain time limits specified in Rev. Rul. 94–76, there is an extended period for amending the plan.

SECTION 3. MODEL AMENDMENT

.01 All plans—Sponsors described in subsection .02 may amend their plans by adopting the model language in the appendix to this revenue procedure on a word-for-word basis, in accordance with the instructions in this revenue procedure. If a sponsor to whom the model language is available pursuant to subsection .02 adopts the model language, neither application to the Service nor a user fee is required. The Service will not issue new opinion, notification, advisory, or determination letters for plans that are amended solely to add the model language described in this section.

.02 The model language is available only to sponsors of M&P, regional prototype, volume submitter specimen, and individually designed plans (including volume submitter plans) that 1) are eligible for the relief from failure to be qualified under § 401(a) provided in Rev. Rul. 94–76 and 2) as of the date of the adoption of the model amendment have reliance on a favorable opinion, notification, or determination letter that takes into account the requirements of the Tax Reform Act of 1986, Pub. L. No. 99–514 ("TRA '86") under Rev. Proc. 89–9, 1989–1 C.B. 780, as modified; Rev. Proc. 89–13, 1989–1 C.B. 801, as modified; Rev. Proc. 90–20, 1990–1 C.B. 495; Rev. Proc. 91–41, 1991–2 C.B. 697; Rev. Proc. 91–66, 1991–2 C.B. 870; Rev. Proc. 93–39, 1993–2 C.B. 513; or Rev. Proc. 96–6, 1996–1 I.R.B. 151. Condition 2) in the preceding sentence does not apply to plans 1) that (a) have received a favorable determination, opinion, or notification letter that considered TEFRA, DEFRA, and REA, and (b) have been submitted within the plan's § 401(b) remedial amendment period for a determination, opinion, or notification letter that considers TRA '86 (TRA '86 remedial amendment period) but have not yet received the letter or 2) for which the TRA '86 remedial amendment period has not yet expired, such as adopters of master and prototype plans, regional prototype plans, and volume submitter plans, described in section 3 of Rev. Proc. 95–12, 1995–1 C.B. 508; governmental plans described in Announcement 95–48, 1995–23 I.R.B. 13; and plans maintained by tax-exempt organizations, including non-electing church plans, described in Announcement 95–48.

.03 M&P, Regional Prototype and Volume Submitter Plans—M&P, regional prototype and volume submitter plan sponsors that use the model language must file Form 8837, Notice of Adoption of Revenue Procedure Model Amendments.

SECTION 4. EXTENSION OF TIME TO ADOPT AMENDMENT

The time period for adopting a plan amendment eliminating an optional form of benefit pursuant to Rev. Rul. 94–76 is extended to June 30, 1997, for profit-sharing or stock bonus plans that otherwise were required, under that revenue ruling, to be amended to eliminate any optional form of benefit before that date.

SECTION 5. RELIANCE

An employer entitled to rely on an opinion, notification, or determination letter will not lose reliance on the letter merely because of this amendment. Plans that are amended in accordance with section 3 of this revenue procedure will not cause the plan to lose its otherwise applicable extended reliance period under Rev. Procs. 89–9 and 89–13, as modified by Rev. Proc. 93–9, or section 13 of Rev. Proc. 93–39.

APPENDIX
MODEL LANGUAGE

(Note to Sponsor: The following model amendment may be used to amend a profit-sharing or stock bonus plan to eliminate an optional form of benefit provided for in the plan on or before December 12, 1994, solely with respect to benefits attributable to assets and liabilities that have been transferred, within the meaning of § 414(l), from a money purchase pension plan (other than any portion of those assets and liabilities attributable to voluntary employee contributions) to the extent that the optional form permits distribution of those ben-

efits prior to the employee's retirement, death, disability or severance from employment, and prior to plan termination.)

This amendment is effective _____ _____. (For plans, other than those entitled to extended reliance as described in Rev. Rul. 94–76, insert a date not later than the first day of the first plan year beginning on or after December 12, 1994, or, if later, 90 days after December 12, 1994. For plans entitled to extended reliance, see Rev. Rul. 94–76 for the permissible effective date.)

Notwithstanding any provision of this plan to the contrary, to the extent that any optional form of benefit under this plan permits a distribution prior to the employee's retirement, death, disability, or severance from employment, and prior to plan termination, the optional form of benefit is not available with respect to benefits attributable to assets (including the post-transfer earnings thereon) and liabilities that are transferred, within the meaning of § 414(l) of the Internal Revenue Code, to this plan from a money purchase pension plan qualified under § 401(a) of the Internal Revenue Code (other than any portion of those assets and liabilities attributable to voluntary employee contributions).

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26 CFR 601.201: Rulings and determinations letters.

Rev. Proc. 96–56

Section 1. PURPOSE

This revenue procedure amplifies Rev. Proc. 96–3, 1996–1 I.R.B. 82, which sets forth areas of the Internal Revenue Code ("Code") under the jurisdiction of the Associate Chief Counsel (Employee Benefits and Exempt Organizations) in which the Internal Revenue Service will not issue advance rulings.

Section 2. BACKGROUND

Rev. Proc. 96–3, section 5, lists specific areas in which rulings or determination letters will not be issued because the areas are under extensive study. This revenue procedure adds a subparagraph for certain rulings involving § 457 nonqualified deferred compensation plans of state and local government and tax-exempt entities. The Small Business Job Protection Act of 1996, P.L. 104–188 ("SBJPA") has substantially changed the requirements for state and local government plans that meet the requirements of § 457(b) by mandating that all assets and income of these plans be held in trust for the exclusive benefit of the participants and their beneficiaries. The SBJPA has also added other provisions which are now available for use in all plans that meet the requirements of § 457(b).

Section 3. PROCEDURE

Rev. Proc. 96–3 is amplified by adding to section 5 the following: Section 457. Deferred Compensation Plans of State and Local Government and Tax-Exempt Organizations. The tax effect of provisions under the Small Business Job Protection Act affecting plans described in § 457. Taxpayers may, however, still receive advance rulings on § 457 plans based on the law in effect prior to enactment of the Small Business Job Protection Act.

Section 4. EFFECTIVE DATE

This revenue procedure applies to all ruling requests, including any pending in the National Office before December 16, 1996. In pending cases, taxpayers may withdraw their ruling request from consideration and obtain a refund of their user fee. If the ruling request is not withdrawn, the ruling will analyze the taxpayer's plan under the law in effect before the enactment of the SBJPA.

Section 5. EFFECTS ON OTHER REVENUE PROCEDURES

Rev. Proc. 96–3 is amplified.

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26 CFR 601.602: Forms and instructions. (Also Part I, §§ 6011, 6051, 6071, 6081; 301.6011–2T, 31.6051–1, 31.6071(a)–1, 31.6081 (a)–1)

Rev. Proc. 96–57

SECTION 1. PURPOSE

.01 This revenue procedure provides automatic extensions of time for (1) furnishing Form W–2, Wage and Tax Statement, to employees and (2) filing Form W–2, with the Social Security Administration (SSA) as provided in §§ 31.6051–1(d)(2)(ii) and 31.6081(a)–1(a)(3)(ii) of the Employment Tax Regulations. These automatic extensions also apply to Form 499R–2/W–2PR, Withholding Statement; Form W–2VI, U.S. Virgin Island Wage and Tax Statement; Form W–2GU, Guam Wage and Tax Statement; and Form W–2AS, American Samoa Wage and Tax Statement, These automatic extensions are only available to "Qualified Employers," as defined below.

SECTION 2. BACKGROUND

.01 Section 6011(a) of the Internal Revenue Code provides that any person made liable for any tax, or for the collection of the tax, must make a return or statement according to the forms or regulations prescribed by the Secretary.

.02 Section 31.6011(a)–1 prescribes Form 941 as the form to use for persons required to make a quarterly return under the Federal Insurance Contributions Act.

.03 Section 31.6011(a)–4 prescribes Form 941 as the form to use for persons required to make a quarterly return of income tax withheld from wages.

.04 Section 31.6011(a)–6 provides that an employer who ceases to pay wages reportable on Form 941 shall file a final Form 941.

.05 Section 31.6071(a)–1 provides that Form 941 generally must be filed on or before the last day of the first calendar month following the quarter for which it is made.

.06 Section 6051(a) provides that (1) every person required to deduct and withhold income tax, or who would have been required to deduct and withhold if the employee had claimed no more than 1 withholding exemption, or (2) every employer engaged in a trade or business who pays remuneration for services performed by an employee, must furnish a written statement to an employee regarding the remuneration paid to the employee during the calendar year. Section 31.6051–1(a) provides that the statement is Form W–2. Form W–2 must be furnished to the employee on or before January 31 of the following calendar year. If the employee's employment is terminated before the close of the calendar year, however, and the employee requests the Form W–2 in writing, the Form W–2 must be furnished to the employee within 30 days of the later of the written request from the employee or the last payment of wages, provided such 30-day period ends before January 31.

.07 Section 31.6051–1(d)(1)(ii) provides that, effective January 1, 1997, an employer who is required to file a final Form 941 must furnish Forms W–2 to its employees on or before the date required for filing the final Form 941. If the final Form 941 is a monthly return, as described in § 31.6011(a)–5, the Forms W–2 must be furnished on or before the last day of the month in which the final Form 941 is required to be filed.

.08 Section 31.6071(a)–1(a)(3)(ii) provides that, effective January 1, 1997, an employer who is required to file a final Form 941 must file Forms W–2 on or before the last day of the second calendar month following the period for which the final Form 941 is filed.

.09 Section 301.6011–2T(b)(2) of the temporary Regulations on Procedure and Administration provides that if an employer is required to file 250 or more Forms W–2, Forms 499R–2/W–2PR, Forms W–2VI, Forms W–2GU, or Forms W–2AS in a calendar year, the employer must file these forms on magnetic media. The 250 return threshold applies separately to each type of form. Employers who file less than 250 of these forms in a calendar year may file their forms on magnetic media with SSA, but are not required to do so.

.10 SSA prepares the magnetic media specifications (Specifications) for filing Forms W–2 and updates them annually. SSA updates the Specifications generally by July of the year to which they apply, and prints them in Technical Information Bulletin–4 (TIB–4). Employers may obtain the Specifications by contacting their Magnetic Media Coordinator (call 1–800–SSA–1213 for the number of the local coordinator). Employers using a personal computer and a modem can download the TIB–4 from either of two electronic bulletin board systems: SSA–BBS (410–965–1133) or IRP–BBS(IRS) (304–264–7070). Employers can generally obtain the Specifications by either of these methods in July of the current year.

.11 SSA mails the TIB–4 to those employers who filed on magnetic media in the prior year. SSA mails the TIB–4 early in the fourth quarter of each year to allow employers sufficient time to update their payroll systems for preparing the current year Forms W–2, which generally are due the last day of February following the year in which the wages were paid.

.12 SSA also prepares the magnetic media specifications for Forms 499R–2/W–2PR, Forms W–2VI, Forms W–2GU, and Forms W–2AS. These specifications, which are published in TIB–5 (Forms 499R–2/W–2PR); TIB–6 (Form W–2VI); and TIB–7 (Forms W–2GU and Forms W–2AS), are available early in the fourth quarter of the year to which they apply.

.13 Section 31.6051–1(d)(2)(ii) provides that the Commissioner may publish procedures for automatic extensions of time to furnish Forms W–2 to employees where the employer is required to furnish Forms W–2 on an expedited basis.

.14 Section 31.6081(a)–1(a)(3)(ii) provides that the Commissioner may publish procedures for automatic extensions of time to file Forms W–2 with SSA where the employer is required to file Forms W–2 on an expedited basis.

.15 Automatic extensions are appropriate for those employers who are required to (1) furnish Forms W–2 to employees and file Forms W–2 with SSA on an expedited basis, and (2) file Forms W–2 on magnetic media before the current Specifications are available. They are also appropriate for those employers who have filed on magnetic media in the prior year, even though not required to do so. While use of magnetic media does not apply to Forms W–2 furnished to employees, an extended due date for the employee copy of Forms W–2 is granted to allow the employer to prepare all the Forms W–2 at approximately the same time.

SECTION 3. SCOPE

.01 *Qualified Employers.* The automatic extensions of time are available to "Qualified Employers." A "Qualified Employer" is an employer who:

1) is required to furnish Forms W–2 to its employees on an expedited basis under § 31.6051–1(d)(1)(ii) and file Forms W–2 with SSA on an expedited basis under § 31.6071(a)–1(a)(3)(ii), and

2) is either required to file the expedited Forms W–2 with SSA on magnetic media, or filed Forms W–2 on magnetic media in the year prior to the year that expedited Forms W–2 are required (whether or not the employer was required to file on magnetic media in the prior year).

.02 *Application to returns filed by employers for employees in Guam, U.S. Virgin Islands, American Samoa and Puerto Rico.* Wage and tax statements filed by employers for employees in Guam, U.S. Virgin Islands, American Samoa and Puerto Rico (Form W–2GU, Form W–2VI, Form W–2AS and Form 499R–2/W–2PR, respectively) are treated in the same manner as Forms W–2.

SECTION 4. AUTOMATIC EXTENSION PERIOD

.01 Qualified Employers must furnish Forms W–2 to the employees on or before the later of the expedited due date under § 31.6051–1(d)(1)(ii) or October 31 of the year in which they file their final Form 941.

.02 This automatic extension of time to furnish Forms W–2 to employees does not relieve an employer of its obligation to furnish a Form W–2 within 30 days to any employee who makes such a request in writing under § 6051.

.03 Qualified Employers must file Forms W–2 on or before the later of the expedited due date under § 31.6071(a)–1(a)(3)(ii) or November 30 of the year in which they file their final Form 941.

.04 These automatic extension periods remain in effect until new automatic extension periods are published by the Commissioner.

SECTION 5. DISCRETIONARY EXTENSIONS

.01 Qualified Employers may request additional extensions of time to furnish Forms W–2 to employees and file Forms W–2 with SSA. Additional extensions of time are discretionary and should be requested from the Director, Martinsburg Computing Center. See §§ 31.6051–1(d)(2)(i), 31.6081(a)–1(a)(3)(i) and Form 8809.

.02 Employers who do not meet the definition of a "Qualified Employer" may request an extension of time to furnish Forms W–2 to employees and file Forms W–2 with SSA. These extensions of time are discretionary and should be requested from the Director, Martinsburg Computing Center. See §§ 31.6051–1(d)(2)(i), 31.6081(a)–1(a)(3)(i) and Form 8809.

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective January 1, 1997.

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26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.
(Also Part I, § 6662.)

Rev. Proc. 96–58

SEC. 1. PURPOSE

.01 This revenue procedure updates Rev. Proc. 95–55, 1995–2 C.B. 457, and identifies circumstances under which the disclosure on a taxpayer's return of a position with respect to an item is adequate for the purpose of reducing the understatement of income tax under § 6662(d) of the Internal Revenue Code (relating to the substantial understatement aspect of the accuracy-related pen-

alty), and for the purpose of avoiding the preparer penalty under § 6694(a) (relating to understatements due to unrealistic positions). This revenue procedure does not apply with respect to any other penalty provision (including the negligence or disregard provisions of the § 6662 accuracy-related penalty).

.02 This revenue procedure applies to any return filed on 1996 tax forms for a taxable year beginning in 1996, and to any return filed on 1996 tax forms in 1997 for short taxable years beginning in 1997.

SEC. 2. CHANGES FROM REV. PROC. 95–55

Editorial changes only have been made in this revenue procedure.

SEC. 3. BACKGROUND

.01 If § 6662 applies to any portion of an underpayment of tax required to be shown on a return, an amount equal to 20 percent of the portion of the underpayment to which the section applies is added to the tax. (The penalty rate is 40 percent in the case of certain gross valuation misstatements.) Under § 6662(b)(2), § 6662 applies to the portion of an underpayment that is attributable to a substantial understatement of income tax.

.02 Section 6662(d)(1) provides that there is a substantial understatement of income tax if the amount of the understatement exceeds the greater of 10 percent of the amount of tax required to be shown on the return for the taxable year or $5,000 ($10,000 in the case of a corporation other than an S corporation or a personal holding company). Section 6662(d)(2) defines an understatement as the excess of the amount of tax required to be shown on the return for the taxable year over the amount of the tax that is shown on the return reduced by any rebate (within the meaning of § 6211(b)(2)).

.03 In the case of an item not attributable to a tax shelter, § 6662(d)(2)-(B)(ii) provides that the amount of the understatement is reduced by the portion of the understatement attributable to any item with respect to which the relevant facts affecting the item's tax treatment are adequately disclosed on the return or on a statement attached to the return, and there is a reasonable basis for the tax treatment of such item by the taxpayer.

.04 In general, this revenue procedure provides guidance in determining when disclosure is adequate for purposes of § 6662(d). For purposes of this revenue procedure, the taxpayer must furnish all required information in accordance with the applicable forms .and instructions, and the money amounts entered on these forms must be verifiable. Guidance under § 6662(d) for returns filed in 1994, 1995, and 1996 is provided in Rev. Proc. 94–36, 1994–1 C.B. 682; Rev. Proc. 94–74, 1994–2 C.B. 823; and Rev. Proc. 95–55, 1995–2 C.B. 457, respectively.

SEC. 4. PROCEDURE

.01 Additional disclosure of facts relevant to, or positions taken with respect to, issues involving any of the items set forth below is unnecessary for purposes of reducing any understatement of income tax under § 6662(d) provided that the forms and attachments are completed in a clear manner and in accordance with their instructions. The money amounts entered on the forms must be verifiable, and the information on the return must be disclosed in the manner described below. For purposes of this revenue procedure, a number is verifiable if, on audit, the taxpayer can demonstrate the origin of the number (even if that number is not ultimately accepted by the Internal Revenue Service) and the taxpayer can show good faith in entering that number on the applicable form.

(1) Form 1040, Schedule A, Itemized Deductions:

(a) Medical and Dental Expenses: Complete lines 1 through 4, supplying all required information.

(b) Taxes: Complete lines 5 through 9, supplying all required information. Line 8 must list each type of tax and the amount paid.

(c) Interest Expense: Complete lines 10 through 14, supplying all required information. This section 4.01(1)(c) does not apply to (i) amounts disallowed under § 163(d) unless Form 4952, Investment Interest Expense Deduction, is completed, or (ii) amounts disallowed under § 265.

(d) Contributions: Complete lines 15 through 18, supplying all required information. Merely entering the amount of the donation on Schedule A, however, will not constitute adequate disclosure if the taxpayer receives a substantial benefit from the donation shown. If a contribution of property other than cash is made and the amount claimed as a deduction exceeds $500, a properly completed Form 8283, Noncash Charitable Contributions, must be attached to the return. This section 4.01(1)(d) will not apply to any contribution of $250 or more unless the contemporaneous written acknowledgement requirement of § 170(f)(8) is satisfied.

(e) Casualty and Theft Losses: Complete Form 4684, Casualties and Thefts, and attach to the return. Each item or article for which a casualty or theft loss is claimed must be listed on Form 4684.

(2) Certain Trade or Business Expenses (including, for purposes of this section 4.01(2), the following six expenses as they relate to the rental of property):

(a) Casualty and Theft Losses: The procedure outlined in section 4.01(1)(e) above must be followed.

(b) Legal Expenses: The amount claimed must be stated. This section 4.01(2)(b) does not apply, however, to amounts properly characterized as capital expenditures, personal expenses, or nondeductible lobbying or political expenditures, including amounts that are required to be (or that are) amortized over a period of years.

(c) Specific Bad Debt Charge-off: The amount written off must be stated.

(d) Reasonableness of Officers' Compensation: Form 1120, Schedule E, Compensation of Officers, must be completed when required by its instructions. The time devoted to business must be expressed as a percentage as opposed to "part" or "as needed." This section 4.01(2)(d) does not apply to "golden parachute" payments, as defined under § 280G. This section 4.01(2)(d) will not apply to the extent that remuneration paid or incurred exceeds the $1 million employee remuneration limitation, if applicable.

(e) Repair Expenses: The amount claimed must be stated. This section 4.01(2)(e) does not apply, however, to any repair expenses properly characterized as capital expenditures or personal expenses.

(f) Taxes (other than foreign taxes): The amount claimed must be stated.

(3) Form 1120, Schedule M–1, Reconciliation of Income (Loss) per Books With Income per Return, provided:

(a) The amount of the deviation from the financial books and records is

not the result of a computation that includes the netting of items; and

(b) The information provided reasonably may be expected to apprise the Internal Revenue Service of the nature of the potential controversy concerning the tax treatment of the item.

(4) Foreign Tax Items:

(a) International Boycott Transactions: Transactions disclosed on Form 5713, International Boycott Report.

(b) Intercompany Transactions: Transactions and amounts shown on Schedule M (Form 5471), Transactions Between Controlled Foreign Corporation and Shareholders or Other Related Persons, lines 19 and 20, and Form 5472, Part IV, Monetary Transactions Between Reporting Corporations and Foreign Related Party, lines 7 and 18.

(5) Other:

(a) Moving Expenses: Complete Form 3903, Moving Expenses, or Form 3903–F, Foreign Moving Expenses, and attach to the return.

(b) Sale or Exchange of Your Main Home: Complete Form 2119, Sale of Your Home, and attach to the return.

(c) Employee Business Expenses: Complete Form 2106, Employee Business Expenses, or Form 2106–EZ, Unreimbursed Employee Business Expenses, and attach to the return. This section 4.01(5)(c) does not apply to club dues, or to travel expenses for any non-employee accompanying the taxpayer on a trip.

(d) Fuels Credit: Complete Form 4136, Credit for Federal Tax Paid on Fuels, and attach to the return.

(e) Investment Credit: Complete Form 3468, Investment Credit, and attach to the return.

SEC. 5. EFFECTIVE DATE

.01 This revenue procedure applies to any return filed on 1996 tax forms for a taxable year beginning in 1996, and to any return filed on 1996 tax forms in 1997 for short taxable years beginning in 1997.

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26 CFR 601.602: Tax forms and instructions.
(Also Part I, §§ 1, 32, 59, 63, 68, 132, 135, 151, 170, 512, 513, 877, 4001, 4003, 6012, 6013, 6033, 6039F, 7430; 1.1–1, 1.32–2, 1.63–1, 1.151–4, 1.170–1, 1.6012–1, 1.6013–1)

Rev. Proc. 96–59

Table of Contents

SECTION 1. PURPOSE
SECTION 2. CHANGES MADE FROM PRECEDING YEAR
SECTION 3. 1997 ADJUSTED ITEMS

		Code Section
.01	Tax Rate Tables	1(a)–(e)
.02	Unearned Income of Minor Children Taxed as if Parent's Income ("Kiddie Tax")	1(g)
.03	Earned Income Tax Credit	32
.04	Alternative Minimum Tax Exemption for "Kiddie Tax" Reported on Parent's Return	59(j)
.05	Standard Deduction	63
.06	Overall Limitation on Itemized Deductions	68
.07	Qualified Transportation Fringe	132(f)
.08	Income from United States Savings Bonds for Taxpayers Who Pay Qualified Higher Education Expenses	135
.09	Personal Exemption	151
.10	Treatment of Dues Paid to Agricultural or Horticultural Organizations	512(d)
.11	Insubstantial Benefit Limitations for Contributions Associated with Charitable Fund-Raising Campaigns	513(h)
.12	Expatriation to Avoid Tax	877
.13	Luxury Automobile Excise Tax	4001 & 4003
.14	Reporting Exception for Certain Exempt Organizations with Nondeductible Lobbying Expenditures	6033(e)(3)
.15	Notice of Large Gifts Received from Foreign Persons	6039F
.16	Attorney Fee Awards	7430

SECTION 4. COMPUTATION OF INFLATION ADJUSTMENTS
SECTION 5. 1997 INFLATION ADJUSTMENT FACTORS
SECTION 6. EFFECT ON OTHER DOCUMENTS
SECTION 7. EFFECTIVE DATE
SECTION 8. DRAFTING INFORMATION

SECTION 1. PURPOSE

This revenue procedure sets forth inflation adjusted items for 1997.

SECTION 2. CHANGES MADE FROM PRECEDING YEAR

.01 Amounts used to determine eligibility for the elective method under § 1(g)(7) to report the "kiddie tax" on the parent's tax return, and to make computations under this method, are adjusted for inflation for tax years beginning in 1997. See section 3.02 of this revenue procedure.

.02 The amount of investment income that causes an individual to be denied the earned income tax credit under § 32(i) is adjusted for inflation for tax years beginning in 1997. See section 3.03(2) of this revenue procedure.

.03 A limited exemption from the alternative minimum tax under § 59(j) for a child subject to the "kiddie tax" is adjusted for inflation for tax years beginning in 1997. See section 3.04 of this revenue procedure.

.04 The maximum amount of annual dues that can be paid to certain agricultural or horticultural organizations under § 512(d)(1) without any portion being treated as unrelated trade or business income by reason of any benefits or privileges available to members is adjusted for inflation for tax years beginning in 1997. See section 3.10 of this revenue procedure.

.05 The amounts used under § 877 to determine whether a principal purpose of expatriation is to avoid tax are adjusted for inflation for calendar year 1997. See section 3.12 of this revenue procedure.

.06 The amount of gifts in a taxable year from foreign person(s), which triggers a reporting requirement for a United States person under § 6039F, is adjusted for inflation for tax years beginning in 1997. See section 3.15 of this revenue procedure.

.07 The hourly limit on attorney fees that may be awarded under § 7430, in a judgment or settlement of an administrative or judicial proceeding concerning the determination, collection, or refund of tax, interest, or penalty under the Code, is adjusted for inflation for tax years beginning in 1997. See section 3.16 of this revenue procedure.

SECTION 3. 1997 ADJUSTED ITEMS

.01 *Tax Rate Tables.* The following adjusted tax rate tables are prescribed in lieu of the tables in subsections (a), (b), (c), (d), and (e) of § 1 of the Code with respect to tax years beginning in 1997.

TABLE 1—Section 1(a).—MARRIED INDIVIDUALS FILING JOINT RETURNS AND SURVIVING SPOUSES

If Taxable Income Is:	The Tax Is:
Not Over $41,200	15% of the taxable income
Over $41,200 but not over $99,600	$6,180 plus 28% of the excess over $41,200
Over $99,600 but not over $151,750	$22,532 plus 31% of the excess over $99,600
Over $151,750 but not over $271,050	$38,698.50 plus 36% of the excess over $151,750
Over $271,050	$81,646.50 plus 39.6% of the excess over $271,050

TABLE 2—Section 1(b).—HEADS OF HOUSEHOLDS

If Taxable Income Is:	The Tax Is:
Not Over $33,050	15% of the taxable income
Over $33,050 but not over $85,350	$4,957.50 plus 28% of the excess over $33,050
Over $85,350 but not over $138,200	$19,601.50 plus 31% of the excess over $85,350
Over $138,200 but not over $271,050	$35,985 plus 36% of the excess over $138,200
Over $271,050	$83,811 plus 39.6% of the excess over $271,050

TABLE 3—Section 1(c).—UNMARRIED INDIVIDUALS (OTHER THAN SURVIVING SPOUSES AND HEADS OF HOUSEHOLDS)

If Taxable Income Is:	The Tax Is:
Not Over $24,650	15% of the taxable income
Over $24,650 but not over $59,750	$3,697.50 plus 28% of the excess over $24,650
Over $59,750 but not over $124,650	$13,525.50 plus 31% of the excess over $59,750
Over $124,650 but not over $271,050	$33,644.50 plus 36% of the excess over $124,650
Over $271,050	$86,348.50 plus 39.6% of the excess over $271,050

TABLE 4—Section 1(d).—MARRIED INDIVIDUALS FILING SEPARATE RETURNS

If Taxable Income Is:	The Tax Is:
Not Over $20,600	15% of the taxable income
Over $20,600 but not over $49,800	$3,090 plus 28% of the excess over $20,600
Over $49,800 but not over $75,875	$11,266 plus 31% of the excess over $49,800
Over $75,875 but not over $135,525	$19,349.25 plus 36% of the excess over $75,875
Over $135,525	$40,823.25 plus 39.6% of the excess over $135,525

TABLE 5—Section 1(e).—ESTATES AND TRUSTS

If Taxable Income Is:	The Tax Is:
Not Over $1,650	15% of the taxable income
Over $1,650 but not over $3,900	$247.50 plus 28% of the excess over $1,650
Over $3,900 but not over $5,950	$877.50 plus 31% of the excess over $3,900
Over $5,950 but not over $8,100	$1,513 plus 36% of the excess over $5,950
Over $8,100	$2,287 plus 39.6% of the excess over $8,100

.02 *Unearned Income of Minor Children Taxed as if Parent's Income (the "Kiddie Tax").*

(1) *Reporting on Child's Return.*

(a) Section 1(g) provides that the tax on the net unearned income of a child under the age of 14 is computed at the marginal rate of the child's parent. Under § 1(g)(4)(A)(ii), net unearned income generally equals unearned income less the sum of (I) the amount in effect for the tax year under § 63(c)(5)(A), plus (II) the greater of the amount described in (I) or certain itemized deductions.

(b) The amount in effect for tax years beginning in 1997 under § 63(c)(5)(A) is $650. See section 3.05(2) below. Accordingly, for tax years beginning in 1997, net unearned income will generally equal unearned income less the greater of $1,300 or $650 plus certain itemized deductions.

(2) *Election to Report on Parent's Return.*

(a) Section 1(g)(7)(A) provides that if a child's gross income from interest and dividends is more than the amount described in § 1(g)(4)(A)(ii)(I) and less than ten times that amount, and certain other conditions are met, a parent may elect to include a child's gross income in the parent's gross income for the taxable year. Under § 1(g)(7)(B), the "kiddie tax" is determined by (I) including the portion of a child's gross income in the parent's gross income to the extent that the child's gross income exceeds twice the amount described in § 1(g)(4)(A)(ii)(I), and (II) adding to the tax on that income the lesser of 15 percent of either the amount described in § 1(g)(4)(A)(ii)(I) or the excess of the child's gross income over such amount.

(b) The amount in effect for tax years beginning in 1997 under § 1(g)(4)(A)(ii)(I), which is also the amount under § 63(c)(5)(A) (see section 3.02(1)(b) above), is $650. Accordingly, for tax years beginning in 1997, to qualify to make the parent's election, the child's gross income from interest and dividends must be more than $650 and less than $6,500 pursuant to § 1(g)(7)(A). Under § 1(g)(7)(B), the "kiddie tax" is imposed on the parent by (I) including a child's gross income in excess of $1,300 in the parent's gross income, and (II) adding to the tax on that income the lesser of either $97.50 (or $98 if the taxpayer elects to round on the return) or 15 percent of the excess of the child's gross income over $650.

.03 *Earned Income Tax Credit.*

(1) *Amount of credit; phaseout income levels.*

(a) Section 32(a)(1) provides an earned income tax credit amount for certain taxpayers with one child, two or more children, or no children. For tax years beginning in 1997, the "maximum amount of the credit" is calculated by multiplying the "earned income amount" by the "credit percentage" as follows:

Type of Taxpayer	*Credit Percentage*	*Earned Income Amount*	*Maximum Amount of the Credit*
1 child	34	$6,500	$2,210
2 or more children	40	$9,140	$3,656
No children	7.65	$4,340	$ 332

(b) Section 32(a)(2) provides for the phaseout of the earned income tax credit. The amount of the reduction in the maximum amount of the credit caused by the phaseout is calculated by multiplying the "phaseout percentage" by the amount by which the taxpayer's adjusted gross income (or, if greater, earned income) exceeds the "threshold phaseout amount." For tax years beginning in 1997, the "phaseout percentages," the "threshold phaseout amounts," and the "completed phaseout amounts" are as follows:

Type of Taxpayer	*Phaseout Percentage*	*Threshold Phaseout Amount*	*Completed Phaseout Amount*
1 child	15.98	$11,930	$25,760
2 or more children	21.06	$11,930	$29,290
No children	7.65	$ 5,430	$ 9,770

(c) The Internal Revenue Service will prescribe tables showing the amount of the earned income tax credit for each type of taxpayer.

(2) *Excessive investment income.*

(a) Under § 32(i), the earned income tax credit is denied if the aggregate amount of certain investment income for the taxable year exceeds $2,200 (the "disqualified income limitation").

(b) For tax years beginning in 1997, the "disqualified income limitation" is $2,250.

.04 *Alternative Minimum Tax Exemption for "Kiddie Tax" Reported on Parent's Return.*

(1) Section 59(j) provides that for a child to whom § 1(g) applies, the exemption amount for purposes of the alternative minimum tax under § 55 shall not exceed the sum of (A) such child's earned income for the taxable year, plus (B) twice the amount in effect for the taxable year under § 63(c)(5)(A) (or, if greater, the child's share of the unused parental minimum tax exemption).

(2) The amount in effect for tax years beginning in 1997 under § 63(c)(5)(A) is $650. See section 3.05(2) below. Accordingly, for tax years beginning in 1997, twice the amount in effect for the taxable year under § 63(c)(5)(A) is $1,300.

.05 *Standard Deduction.*

(1) The following adjusted standard deduction amounts are prescribed in lieu of the amounts set forth in § 63(c)(2) with respect to tax years beginning in 1997.

Filing Status	*Standard Deduction*
MARRIED INDIVIDUALS FILING JOINT RETURNS AND SURVIVING SPOUSES (§ 1(a))	$6,900
HEADS OF HOUSEHOLDS (§ 1(b))	$6,050
UNMARRIED INDIVIDUALS (OTHER THAN SURVIVING SPOUSES AND HEADS OF HOUSEHOLDS) (§ 1(c))	$4,150
MARRIED INDIVIDUALS FILING SEPARATE RETURNS (§ 1(d))	$3,450

(2) Under § 63(c)(5)(A) for tax years beginning in 1997, the standard deduction for an individual who may be claimed as a dependent by another taxpayer for a tax year beginning in the calendar year in which the individual's tax year begins, cannot exceed the greater of (A) $650 or (B) the amount of the individual's earned income.

(3) Under § 63(f) for tax years beginning in 1997, the additional standard deduction amounts for the aged and for the blind are $800 for each. These amounts are each increased to $1,000 if the individual is also unmarried and not a surviving spouse.

.06 *Overall Limitation on Itemized Deductions.*

(1) Section 68 provides that the amount of itemized deductions otherwise allowable for the tax year shall be reduced by the lesser of (1) 3 percent of the excess of adjusted gross income over the "applicable amount," or (2) 80 percent of the amount of certain itemized deductions otherwise allowable for the tax year.

(2) The "applicable amount" for tax years beginning in 1997 is $121,200 ($60,600 in the case of a separate return filed by a married individual within the meaning of § 7703).

.07 *Qualified Transportation Fringe.*

(1) Section 132(f) provides an exclusion from gross income for certain employer-provided transportation referred to as a "qualified transportation fringe." A "qualified transportation fringe" means any of the following: transportation in a commuter highway vehicle between the employee's residence and place of employment, any transit pass, and qualified parking. Section 132(f)(2)(A) limits the exclusion for the aggregate of the transportation in a commuter highway vehicle and the transit pass to $60 per month (the "$60 vehicle/transit" limitation). Section 132(f)(2)(B) limits the exclusion for qualified parking to $155 per month (the "$155 parking" limitation).

(2) For tax years beginning in 1997, the "$60 vehicle/transit" limitation is $65 and the "$155 parking" limitation is $170.

.08 *Income from United States Savings Bonds for Taxpayers Who Pay Qualified Higher Education Expenses.*

(1) Section 135 provides an exclusion of income from the redemption of United States savings bonds for taxpayers who pay qualified higher education expenses. Section 135(b)(2) provides for the phaseout of the exclusion. The amount of the reduction in the exclusion caused by the phaseout is calculated by multiplying the amount otherwise excludable by a fraction. The numerator of the fraction is the excess of the taxpayer's modified adjusted gross income over the threshold amount ($60,000 for joint returns or $40,000 for others) and the denominator is $30,000 for joint returns or $15,000 for others.

(2) For tax years beginning in 1997, the amounts of modified adjusted gross income above which the phaseout of the exclusion begins ("threshold phaseout amounts"), and the amounts at which the benefit is completely phased out ("completed phaseout amounts"), are as follows:

Filing Status	*Threshold Phaseout Amount*	*Completed Phaseout Amount*
Code § 1(a)	$76,250	$106,250
Others	$50,850	$ 65,850

.09 *Personal Exemption.*

(1) Section 151(b) generally allows a taxpayer an exemption for himself or herself. Section 151(c) generally allows a taxpayer additional exemptions for dependents as defined in § 152. The personal exemption for tax years beginning in 1997 is $2,650.

(2) Section 151(d)(3) provides for the phaseout of the tax benefit of the personal exemptions allowed by § 151. The reduction in the amount of personal exemptions caused by the phaseout is

calculated by reducing the total amount of the personal exemptions by 2 percent for each $2,500 increment (or portion thereof) of adjusted gross income in excess of a threshold phaseout amount. For tax years beginning in 1997, the "threshold phaseout amounts" and the "completed phaseout amounts" are as follows:

Filing Status	*Threshold Phaseout Amount*	*Completed Phaseout Amount After*
Code § 1(a)	$181,800	$304,300
Code § 1(b)	$151,500	$274,000
Code § 1(c)	$121,200	$243,700
Code § 1(d)	$ 90,900	$152,150

.10 *Treatment of Dues Paid to Agricultural or Horticultural Organizations.*

(1) Section 512(d)(1) provides that no portion of annual dues required by an agricultural or horticultural organization described in § 501(c)(5) is treated as derived from an unrelated trade or business by reason of any benefits or privileges to which members are entitled if the amount of required annual dues from each member does not exceed $100 (the "$100 amount").

(2) For tax years beginning in 1997, the "$100 amount" is $106.

.11 *Insubstantial Benefit Limitations for Contributions Associated with Charitable Fund-Raising Campaigns.*

(1) Section 513(h)(1)(A) provides that, in the case of certain exempt organizations, the term "unrelated business income" does not include activities relating to the distribution of "low cost articles" (as defined in § 513(h)(2)) if the distribution of such articles is incidental to the solicitation of charitable contributions.

(2) Section 3 of Rev. Proc. 90–12, 1990–1 C.B. 471, as amplified by Rev. Proc. 92–49, 1992–1 C.B. 987, and as modified by Rev. Proc. 92–102, 1992–2 C.B. 579, provides guidelines for determining the deductible amount of contributions under § 170 when contributors receive something in return for their contributions. The guidelines provide that insubstantial benefits received by a contributor (in the context of a charitable fund-raising campaign) are disregarded, which makes the contribution fully deductible under § 170. The guidelines further provide the following three alternative limitations on what are insubstantial benefits:

(a) The fair market value of all the benefits received is not more than 2-percent of the contribution, or $50 (the "$50 benefit" limitation), whichever is less;

(b) The contribution is $25 (the "$25 payment" limitation) or more, and the only benefits received by the donor in return during the calendar year have a cost, in the aggregate, of not more than a "low cost article" under § 513(h)(2); or

(c) In connection with a request for a charitable contribution, the charity mails or otherwise distributes free, unordered items to patrons, and the cost of such items (in the aggregate) distributed to any single patron in a calendar year is not more than a "low cost article" under § 513(h)(2).

(3) For tax years beginning in 1997, the "$50 benefit" limitation is $69, the "$25 payment" limitation is $34.50, and the "low cost article" limitation is $6.90.

.12 *Expatriation to Avoid Tax.*

(1) Under § 877(a)(1), an individual who loses United States citizenship may be subject to taxation under § 877(b) if a principal purpose of such loss is the avoidance of tax. Under § 877(a)(2), an individual is treated as having the avoidance of tax as a principal purpose of such loss if (A) the average annual net income tax (as defined in § 38(c)(1)) of such individual for a period of 5 taxable years ending before the date of the loss of United States citizenship is greater than $100,000 (the "$100,000 amount") or (B) the net worth of the individual as of such date is $500,000 or more (the "$500,000 amount").

(2) For calendar year 1997, the "$100,000 amount" is $106,000 and the "$500,000 amount" is $528,000.

.13 *Luxury Automobile Excise Tax.*

(1) Section 4001(a) imposes an excise tax on the first retail sale of any passenger vehicle to the extent the price exceeds $30,000 (the "$30,000 amount"). Section 4003(a) imposes an excise tax on the installation of parts or accessories on a passenger vehicle within six months of the date after the vehicle was first placed in service, to the extent the price of all parts and accessories, including installation, and the price of the vehicle exceed the "$30,000 amount."

(2) For calendar year 1997, the "$30,000 amount" is $36,000.

.14 *Reporting Exception for Certain Exempt Organizations with Nondeductible Lobbying Expenditures.*

(1) Section 6033(e)(1)(A) provides that certain exempt organizations that pay or incur nondeductible lobbying expenditures must include the total of those expenditures on their annual returns and must notify their members with a reasonable estimate of the portion of dues allocated to those expenditures. Section 6033(e)(3) provides that § 6033(e)(1)(A) shall not apply to an organization that establishes to the satisfaction of the Secretary that substantially all of its dues are nondeductible without regard to the lobbying expenditure restrictions. Section 4.02 of Rev. Proc. 95–35, 1995–2 C.B. 391, provides that § 501(c)(4) social welfare organizations and § 501(c)(5) agricultural and horticultural organizations are treated as satisfying § 6033(e)(3) if either (1) more than 90 percent of all annual dues are received from persons, families, or entities who each pay $50 or less (the "$50 exception" amount), or (2) more than 90 percent of all annual dues are received from certain exempt entities.

(2) For tax years beginning in 1997, the "$50 exception" amount is $53.

.15 *Notice of Large Gifts Received from Foreign Persons.*

(1) Section 6039F requires that a United States person report information on gifts from foreign persons if the aggregate of such gifts from all such persons exceeds $10,000 (the "$10,000 amount") in a taxable year.

(2) For tax years beginning in 1997, the "$10,000 amount" is $10,276.

.16 *Attorney Fee Awards.*

(1) Under § 7430, attorney fees may be awarded in a judgment or settlement of an administrative or judicial proceeding concerning the determination, collection, or refund of tax, interest, or penalty under the Code. The attorney fees are subject to an hourly limit of $110 (the "$110 amount") pursuant to § 7430(c)(1).

(2) For calendar year 1997, the "$110 amount" is $110.

SECTION 4. COMPUTATION OF INFLATION ADJUSTMENTS

.01 *Tax Rate Tables.*

(1) Section 1(f)(1) provides that not later than December 15 of each calendar year, the Secretary shall prescribe inflation-adjusted tax rate tables that apply in lieu of the tax rate tables in § 1 with respect to tax years beginning in the succeeding calendar year.

(2) Under § 1(f)(3), the inflation adjustment for a calendar year is the percentage (if any) by which the Consumer Price Index (CPI) for the preceding calendar year exceeds the CPI for the calendar year 1992. However, § 1(f)(7)(B) provides that in prescribing the inflation adjustments for the 36 percent and 39.6 percent tax rate brackets, the preceding calendar year's CPI is compared with the CPI for the calendar year 1993. For purposes of computing the inflation adjustment, § 1(f)(4) defines the CPI as the average of the 12 monthly CPIs for the 12-month period ending on August 31 of such calendar year. Under § 1(f)(5), the CPI is that for all-urban consumers published by the Department of Labor.

(3) Section 1(f)(2)(A) provides that the inflation adjustment is reflected in the tax rate tables by increasing the minimum and maximum dollar amounts for each rate bracket. Under § 1(f)(6), an adjusted bracket amount is "rounded down" to the nearest multiple of $50 ($25 in the case of married individuals filing separately).

.02 *Kiddie Tax.*

(1) *Reporting on Child's Return.* Section 1(g)(4) uses the limitation on the standard deduction for certain dependents under § 63(c)(5)(A) in computing the "kiddie tax." That limitation is adjusted for inflation under § 63(c)(4). The inflation adjustment computation under § 63(c)(4) is described below in section 4.05.

(2) *Election To Report on Parent's Return.* Section 1(g)(7) uses an amount described in § 1(g)(4) in computing the "kiddie tax." Section 1(g)(4) uses the limitation on the standard deduction for certain dependents under § 63(c)(5)(A), and is adjusted, as described above in section 4.02(1).

.03 *Earned Income Tax Credit.*

(1) *Amount of credit; phaseout income levels.*

(a) Section 32(j) provides that the "earned income amounts" and "phaseout amounts," which limit the earned income tax credit, are adjusted for inflation under the method described in § 1(f)(3), except that the preceding calendar year's CPI is compared with the CPI for the calendar year 1995. Under § 32(j)(2)(A), the adjusted amount is rounded to the nearest multiple of $10.

(b) Under § 32(b)(2), the base amounts of the "earned income amounts" and "phaseout amounts" are $6,330 and $11,610 for a taxpayer with one child, $8,890 and $11,610 for a taxpayer with two or more children, and $4,220 and $5,280 for a taxpayer with no children.

(2) *Excessive Investment Income.*

(a) Section 32(j) provides that the "disqualified income limitation" is adjusted for inflation under the method described in § 1(f)(3), except that the preceding calendar year's CPI is compared with the CPI for the calendar year 1995. Under § 32(j)(2)(B), the "disqualified income limitation" is "rounded down" to the next lowest multiple of $50.

(b) Under § 32(i), the base amount of the "disqualified income limitation" is $2,200.

.04 *Alternative Minimum Tax Exemption for "Kiddie Tax" Reported on Parent's Return.* Section 59(j) uses the limitation on the standard deduction for certain dependents under § 63(c)(5)(A) in computing the alternative minimum tax on income subject to the "kiddie tax." The limitation on the standard deduction is adjusted for inflation under § 63(c)(4). The inflation adjustment computation under § 63(c)(4) is described below in section 4.05.

.05 *Standard Deduction.*

(1) Under § 63(c)(4), the standard deduction amounts (including the limitation for certain dependents and the additional standard deduction amounts for the aged and for the blind) are adjusted for inflation under the method described in § 1(f)(3), except that the preceding calendar year's CPI is compared with the CPI for the calendar year 1987. Under § 1(f)(6), an adjusted amount is "rounded down" to the nearest multiple of $50 ($25 in the case of the basic standard deduction for married individuals filing separately).

(2) Under § 63(c)(2), the base amounts of the basic standard deduction are $5,000 for married individuals filing joint returns and surviving spouses; $4,400 for heads of households; $3,000 for unmarried individuals (other than surviving spouses and heads of households); and $2,500 for married individuals filing separate returns. Under § 63(c)(5)(A), the base amount of the limited standard deduction for an individual who may be claimed as a dependent by another taxpayer is $500. Under § 63(f), the base amounts of the additional standard deduction for the aged and for the blind are $600 for each, except that these amounts are increased to $750 if the individual is unmarried and not a surviving spouse.

.06 *Overall Limitation on Itemized Deductions.*

(1) Section 68(b)(2) provides that the "applicable amount" for the overall limitation on itemized deductions is adjusted for inflation under the method described in § 1(f)(3), except that the preceding calendar year's CPI is compared with the CPI for the calendar year 1990. Under § 1(f)(6), the adjusted "applicable amount" is "rounded down" to the nearest multiple of $50 ($25 in the case of married individuals filing separately).

(2) Under § 68(b)(1), the base amount of the "applicable amount" is $100,000 ($50,000 in the case of a separate return by a married individual within the meaning of § 7703).

.07 *Qualified Transportation Fringe.* Section 132(f)(6) provides that the limitation on the amount of the exclusion from gross income for a qualified transportation fringe is adjusted for inflation under the method described in § 1(f)(3). See section 4.01 above. Under § 132(f)(6)(B), an increased amount that is not a multiple of $5 is "rounded down" to the next lowest multiple of $5.

.08 *Income from United States Savings Bonds for Taxpayers Who Pay Qualified Higher Education Expenses.* Section 135(b)(2)(B) provides that the dollar amount at which the phaseout of the exclusion (of income from the redemption of United States savings bonds for taxpayers who pay qualified higher education expenses) begins is adjusted for inflation under the method described in § 1(f)(3). The preceding calendar year's CPI is compared with the CPI for the calendar year 1989. The adjusted dollar amount is rounded to the nearest multiple of $50 (if the adjusted figure is a multiple of $25, it is increased to the next highest multiple of $50) under § 135(b)(2)(C).

.09 *Personal Exemption.*

(1) Exemption amount.

(a) Section 151(d)(4)(A) provides that the personal exemption amount is adjusted for inflation under the method described in § 1(f)(3), except that the preceding calendar year's CPI is compared with the CPI for the calendar year 1988. The adjusted exemption is "rounded down" to the nearest multiple of $50 under § 1(f)(6).

(b) Under § 151(d)(1), the base amount of the personal exemption is $2,000.

(2) *Phaseout amounts.*

(a) Section 151(d)(4)(B) provides that the "threshold amounts" at which the phaseout of the tax benefit of the personal exemptions begins are adjusted for inflation under the method described in § 1(f)(3), except that the preceding calendar year's CPI is compared with the CPI for the calendar year 1990. Under § 1(f)(6), an adjusted "threshold amount" is "rounded down" to the nearest multiple of $50 ($25 in the case of married individuals filing separately).

(b) Under § 151(d)(3)(C), the base amounts of the "threshold amounts" are $150,000 for Code § 1(a) taxpayers; $125,000 for Code § 1(b) taxpayers; $100,000 for Code § 1(c) taxpayers; and $75,000 for Code § 1(d) taxpayers.

.10 *Treatment of Dues Paid to Agricultural or Horticultural Organizations.* Section 512(d)(2) provides that the "$100 amount" is adjusted for inflation under the method described in § 1(f)(3), except that the preceding calendar year's CPI is compared with the CPI for the calendar year 1994.

.11 *Insubstantial Benefit Limitations for Contributions Associated with Charitable Fund-Raising Campaigns.*

(1) *Section 513(h).*

(a) Section 513(h)(1)(C) provides that the maximum cost of a "low cost article" is adjusted for inflation under the method described in § 1(f)(3), except that the preceding calendar year's CPI is compared with the CPI for the calendar year 1987.

(b) Under § 513(h)(2)(A), the base amount of the "low cost article" is $5.

(2) *Rev. Proc. 90–12.* Rev. Proc. 90–12 provides for the adjustment of the "low cost article" and the "$25 payment" limitations in that revenue procedure as provided under § 513(h)(2)(C). The "$50 benefit" limitation in that revenue procedure is adjusted in the same manner.

.12 *Expatriation to Avoid Tax.* Section 877(a)(2) provides that the "$100,000 amount" and the "$500,000 amount" are adjusted for inflation under the method described in § 1(f)(3), except that the preceding calendar year's CPI is compared with the CPI for the calendar year 1994. Under § 877(a)(2), the adjusted "$100,000 amount" and "$500,000 amount" are rounded to the nearest multiple of $1,000.

.13 *Luxury Automobile Excise Tax.* Section 4001(e)(1) provides that the "$30,000 amount" threshold for the excise tax on a luxury automobile in §§ 4001(a) and 4003(a) is adjusted for inflation under the method described in § 1(f)(3), except that the preceding calendar year's CPI is compared with the CPI for the calendar year 1990. Under § 4001(e)(2), the adjusted "$30,000 amount" is "rounded down" to the nearest multiple of $2,000.

.14 *Reporting Exception for Certain Exempt Organizations with Nondeductible Lobbying Expenditures.* Section 5.05 of Rev. Proc. 95–35 provides that the "$50 exception" amount is adjusted for inflation under the method described in § 1(f)(3), except that the preceding calendar year's CPI is compared with the CPI for the calendar year 1994. The adjusted "$50 exception" amount is rounded up to the next highest dollar.

.15 *Notice of Large Gifts Received from Foreign Persons.* Section 6039F(d) provides that the "$10,000 amount" is adjusted for inflation under the method described in § 1(f)(3), except that the preceding calendar year's CPI is compared with the CPI for the calendar year 1995.

.16 *Attorney Fee Awards.* Section 7430(c)(1)(B) provides that the "$110 amount" is adjusted for inflation under the method described in § 1(f)(3), except that the preceding calendar year's CPI is compared with the CPI for the calendar year 1995. The adjusted "$110 amount" is rounded to the nearest multiple of $10 under § 7430(c)(1)(B).

SECTION 5. 1997 INFLATION ADJUSTMENT FACTORS

.01 *1995 Base Year Adjustments.* The CPI for 1996 is 155.2416666667 and the CPI for 1995 is 151.0750000000. This results in an inflation adjustment factor of 1.0275801202. This factor applies to the earned income tax credit, the reporting of large gifts from foreign persons for tax years beginning in 1997, and the awarding of attorney fees for calendar year 1997.

.02 *1994 Base Year Adjustments.* The CPI for 1996 is 155.2416666667 and the CPI for 1994 is 146.9000000000. This results in an inflation adjustment factor of 1.0567846608. This factor applies to the treatment of dues paid to agricultural or horticultural organizations, the amounts used to determine whether a principal purpose of expatriation is to avoid tax, and the reporting exception for certain exempt organizations with nondeductible lobbying expenditures for tax years beginning in 1997.

.03 1993 Base Year Adjustments. The CPI for 1996 is 155.2416666667 and the CPI for 1993 is 143.1750000000. This results in an inflation adjustment factor of 1.0842791456. This factor applies to the 36 percent and 39.6 percent brackets of the tax rate tables for tax years beginning in 1997.

.04 *1992 Base Year Adjustments.* The CPI for 1996 is 155.2416666667 and the CPI for 1992 is 138.9250000000. This results in an inflation adjustment factor of 1.1174494631. This factor applies to the 15 percent, 28 percent, and 31 percent brackets of the tax rate tables, and to the qualified transportation fringe limitations for tax years beginning in 1997.

.05 *1990 base year adjustments.* The CPI for 1996 is 155.2416666667 and the CPI for 1990 is 128.0583333333. This results in an inflation adjustment factor of 1.2122730526. This factor applies to the phaseout of personal exemptions, to the limitation on itemized deductions, and to the luxury automobile excise tax threshold for tax years beginning in 1997.

.06 *1989 base year adjustments.* The CPI for 1996 is 155.2416666667 and the CPI for 1989 is 122.1500000000. This results in an inflation adjustment factor of 1.2709100832. This factor applies to the qualified higher education expense exclusion for tax years beginning in 1997.

.07 *1988 Base Year Adjustments.* The CPI for 1996 is 155.2416666667 and the CPI for 1988 is 116.6166666667. This results in an inflation adjustment factor of 1.3312133772. This factor applies to the personal exemption for tax years beginning in 1997.

.08 *1987 Base Year Adjustments.* The CPI for 1996 is 155.2416666667 and the CPI for 1987 is 111.9833333333. This results in an inflation adjustment factor of 1.3862926031. This factor applies to the "kiddie tax" (including the election to report on the parent's return) and the limitation on the alternative minimum tax exemption for "kiddie tax" reported on a parent's return, the standard deduction amounts, and the insubstantial benefit limitations for charitable contributions for tax years beginning in 1997.

SECTION 6. EFFECT ON OTHER DOCUMENTS

.01 *Rev. Proc. 95–53.* Rev. Proc. 95–53, 1995–2 C.B. 445, is amplified and modified as follows:

(1) *Kiddie Tax.* For tax years beginning in 1996, the amount in effect under § 1(g)(4)(A)(ii)(I) for purposes of the election to report on a parent's return is the same as that provided in section 3.02(b) of this revenue procedure for tax years beginning in 1997.

(2) *Alternative Minimum Tax Exemption for "Kiddie Tax" Reported on Parent's Return.* For tax years beginning in 1996, the amount in effect under § 63(c)(5)(A) is the same as that provided in section 3.04 of this revenue procedure for tax years beginning in 1997.

(3) *Income from United States Savings Bonds for Taxpayers Who Pay Qualified Higher Education Expenses.* For tax years beginning in 1996, the amounts of modified adjusted gross income above which the § 135 exclusion begins to phase out and the amounts at which the phaseout is complete, are as follows:

Filing Status	*Threshold Phaseout Amount*	*Completed Phaseout Amount*
Code § 1(a)	$74,200	$104,200
Others	$49,450	$ 64,450

(4) *Treatment of Dues Paid to Agricultural or Horticultural Organizations.* For tax years beginning in 1996, no portion of annual dues required by an agricultural or horticultural organization described in § 501(c)(5) is treated as derived from an unrelated trade or business by reason of any benefits or privileges to which members are entitled if the amount of required annual dues from each member does not exceed $103.

.02 *Rev. Proc. 94–72.* Rev. Proc. 94–72, 1994–2 C.B. 811, is modified as follows: For tax years beginning in 1995, the amounts of modified adjusted gross income above which the § 135 exclusion begins to phase out and the amounts at which the phaseout is complete, are as follows:

Filing Status	*Threshold Phaseout Amount*	*Completed Phaseout Amount*
Code § 1(a)	$72,150	$102,150
Others	$48,100	$ 63,100

.03 *Rev. Proc. 93–49.* Rev. Proc. 93–49, 1993–2 C.B. 581, is modified as follows: For tax years beginning in 1994, the amounts of modified adjusted gross income above which the § 135 exclusion begins to phase out and the amounts at which the phaseout is complete, are as follows:

Filing Status	*Threshold Phaseout Amount*	*Completed Phaseout Amount*
Code § 1(a)	$70,350	$100,350
Others	$46,900	$ 61,900

.04 *Rev. Proc. 92–102.* Rev. Proc. 92–102, 1992–2 C.B. 579, is modified as follows: For tax years beginning in 1993, the amounts of modified adjusted gross income above which the § 135 exclusion begins to phase out and the amounts at which the phaseout is complete, are as follows:

Filing Status	*Threshold Phaseout Amount*	*Completed Phaseout Amount*
Code § 1(a)	$68,250	$98,250
Others	$45,500	$60,500

SECTION 7. EFFECTIVE DATE

.01 *General Rule.* Except as provided in sections 6 and 7.02, this revenue procedure applies to tax years beginning in 1997.

.02 *Calendar Year Rule.* This revenue procedure applies to transactions or events occurring in calendar year 1997 for purposes of section 3.12 (the expatriation tax), section 3.13 (the excise tax on luxury automobiles), and section 3.16 (the hourly limit on attorney fee awards).

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26 CFR 601.602: Forms and instructions.
(Also Part I, §§ 6011, 6051, 6071; 31.6011(a)–4, 31.6051–1, 31.6071(a)–1.

Rev. Proc. 96–60

SECTION 1. PURPOSE

.01 This revenue procedure modifies and supersedes Rev. Proc. 84–77, 1984–2 C.B. 753. This revenue procedure explains both the standard procedure and an alternate procedure for preparing and filing Form W–2, Wage and Tax Statement; Form W–3, Transmittal of Income and Tax Statements; Form 941, Employer's Quarterly Federal Tax Return; Form W–4, Employee's Withholding Allowance Certificate; and Form W–5, Earned Income Credit Advance Payment Certificate in certain acquisitions. This revenue procedure applies when an employer (successor) acquires substantially all the property (1) used in a trade or business of another employer (predecessor), or (2) used in a separate unit of a trade or business of a predecessor, and in connection with, or immediately after the acquisition (but during the same calendar year) the successor employs individuals who immediately prior to the acquisition were employed in the trade or business of the predecessor. (The term "trade or business," for purposes of this revenue procedure, may include the activity of a nonprofit organization or of a federal or state agency.)

.02 This revenue procedure does not apply to the situation described in Rev. Rul. 62–60, 1962–1 C.B. 186, which relates to the absorption of one corporation by another in a statutory merger or consolidation, where the resultant entity is regarded as the same taxpayer and the same employer as the absorbed corporation.

SECTION 2. CHANGES

.01 Section 4.01, which provided the time frame for a predecessor to furnish Forms W–2 under the standard procedure, has been modified to explain that the predecessor must furnish Forms W–2 to its former employees, and file Forms W–2 and W–3 with the Social Security Administration (SSA) on an expedited basis, if the predecessor has ceased to pay wages and is required to file a final Form 941.

.02 Section 5.01, which provided the alternate procedure for furnishing Forms W–2, has been modified to provide that the expedited furnishing and filing requirements do not apply to the successor.

.03 Section 5.02, which provided the alternate procedure for the predecessor to submit Form 941, has been modified to provide that if the predecessor is required to file a final Form 941, the predecessor must both furnish Forms W–2 to its employees who are not acquired by the successor and file Forms W–2 and W–3 with SSA on an expedited basis.

.04 Section 5.06 has been added to provide procedures for transferring electronically filed Forms W–4 from the predecessor to the successor.

SECTION 3. BACKGROUND

.01 Section 6011(a) of the Internal Revenue Code provides that any person made liable for any tax, or for the collection of the tax, must make a return or statement according to the forms or regulations prescribed by the Secretary.

.02 Section 31.6011(a)–1 of the Employment Tax Regulations prescribes Form 941 as the form to use for persons

required to make a quarterly return under the Federal Insurance Contributions Act.

.03 Section 31.6011(a)–4 prescribes Form 941 as the form to use for persons required to make a quarterly return of income tax withheld from wages.

.04 Section 31.6011(a)–6 provides that an employer who ceases to pay wages reportable on Form 941 shall file a final Form 941.

.05 Section 31.6071(a)–1 provides that the Form 941 generally must be filed on or before the last day of the first calendar month following the quarter for which it is made.

.06 Section 6051(a) provides that (1) every person required to deduct and withhold income tax, or who would have been required to deduct and withhold if the employee had claimed no more than 1 withholding exemption, or (2) every employer engaged in a trade or business who pays remuneration for services performed by an employee, must furnish a written statement to an employee regarding the remuneration paid to the employee during the calendar year. Section 31.6051–1(a) provides that the statement is Form W–2. Form W–2 must be furnished to the employee on or before January 31 of the following calendar year. If the employee's employment is terminated before the close of the calendar year, however, and the employee requests the Form W–2 in writing, the Form W–2 must be furnished to the employee within 30 days of the later of the written request from the employee or the last payment of wages, provided such 30-day period ends before January 31.

.07 Section 31.6051–1(d)(1)(ii) provides that, effective January 1, 1997, an employer who is required to file a final Form 941 must furnish Forms W–2 to its employees on or before the date required for filing the final Form 941. If the final Form 941 is a monthly return as described in § 31.6011(a)–5, the Forms W–2 must be furnished on or before the last day of the month in which the final Form 941 is required to be filed.

.08 Section 31.6071(a)–1(a)(3)(ii) provides that, effective January 1, 1997, an employer who is required to file a final Form 941 must file Forms W–2 and W–3 on or before the last day of the second calendar month following the period for which the final Form 941 is filed.

.09 Section 31.3402(f)(5)–1(c) provides that an employer may establish a system for its employees to file Form W–4 electronically.

SECTION 4. STANDARD PROCEDURE

.01 *In general.* Under the standard procedure, the predecessor performs all the reporting duties for the wages and other compensation it pays. These duties include the filing of quarterly Forms 941 and the furnishing and filing of Forms W–2 and W–3. In connection with the successor's acquisition of property and hiring of employees from the predecessor, as described in section 1.01, the predecessor may cease to pay any wages required to be reported on Form 941 (for example, the predecessor may go out of business). In that case, the predecessor must file the Form 941 for the quarter of the acquisition as a final Form 941. If the predecessor does not cease to pay any wages required to be reported on Form 941, (for example, the predecessor remains in business) a final Form 941 is not required. Instead, the predecessor would file its quarterly Form 941 for the quarter of the acquisition. The successor, under the standard procedure, performs all the reporting duties for the wages and other compensation it pays.

.02 *Forms W–2.*

(1) *In general.* If, under the circumstances described in section 1.01, the predecessor is not required to file a final Form 941, the predecessor and successor both must furnish Forms W–2 to their respective employees no later than January 31 of the following calendar year. If an employee requests the Form W–2 earlier, however, the Form W–2 must be furnished within 30 days of the written request, or within 30 days after the final payment of wages to the employee, whichever is later, provided the 30 day period ends before January 31. The predecessor and successor must file Forms W–2 and W–3 for their respective employees with SSA no later than the last day of February of the following calendar year.

(2) *Expedited Forms W–2.* If, under the circumstances described in section 1.01, the predecessor is required to file a final Form 941, the predecessor must furnish Forms W–2 to its former employees on an expedited basis. The Forms W–2 are due on or before the date required for filing the final Form 941. If the predecessor is required to file Form 941 on a monthly basis, the Forms W–2 are due on or before the last day of the month in which the final Form 941 is required to be filed. The predecessor must also file Forms W–2 and W–3 with SSA on an expedited basis. The Forms W–2 and W–3 are due on or before the last day of the second calendar month following the period for which the final Form 941 is required to be filed.

.03 *Forms W–4.* The predecessor must keep on file the Forms W–4 provided by its former employees. The transferred employees must provide the successor with new Forms W–4 as the successor now becomes responsible for deducting and withholding tax from wages paid to the transferred employees.

.04 *Forms W–5.* The predecessor must also keep on file the Forms W–5 provided by its former employees. The transferred employees must provide the successor with new Forms W–5 for the current year.

SECTION 5. ALTERNATE PROCEDURE

.01 *In general.* If, in connection with the circumstances described in section 1.01, the predecessor and successor so agree, the predecessor will be relieved from furnishing Forms W–2 to any employees who will be employed in the same calendar year by the successor (acquired employees). In such circumstances the acquired employees presumably will be paid wages by the successor in the same calendar year and the Forms W–2 furnished to the acquired employees by the successor for the year will include wages paid, and taxes withheld, by both the predecessor and the successor. The predecessor will also be relieved from filing Forms W–2 with SSA for the acquired employees. The predecessor's entire Form W–2 reporting obligations for the acquired employees will be assumed by the successor. The predecessor remains responsible for the Form W–2 reporting obligations for those employees who are not employed by the successor.

.02 *Forms W–2.*

(1) *In general.* If, under the circumstances described in section 1.01, the predecessor is not required to file a final Form 941, the predecessor must furnish Forms W–2 to employees who are not employed by the successor by January 31 of the following calendar year. Forms W–2 and W–3 filed by the predecessor with SSA for employees

who are not employed by the successor are due the last day of February of the following calendar year. If the successor assumes the predecessor's obligation to furnish Forms W–2 to the acquired employees for a calendar year, the successor must assume the predecessor's entire Form W–2 reporting obligation. Thus, Forms W–2 furnished by the successor to the acquired employees must include the wages paid and the taxes withheld by both the predecessor and the successor. The successor must include on the Forms W–2 any amount reportable by the predecessor, including "Other compensation" or uncollected employee tax on tips, if applicable. Forms W–2 must be furnished by the successor to its employees (both the acquired employees and any other employees of the successor) by January 31 of the following calendar year. Forms W–2 and W–3 must be filed by the successor with SSA by the last day of February of the following calendar year.

(2) *Expedited Forms W–2.* If, under the circumstances described in section 1.01, the predecessor is required to file a final Form 941, the predecessor must furnish Forms W–2 to the employees who are not employed by the successor on an expedited basis. Forms W–2 and W–3 filed with SSA by the predecessor must also be filed on an expedited basis. The successor is not required to either furnish Forms W–2 to the acquired employees or to file the Forms W–2 and W–3 with SSA on an expedited basis.

.03 *Form 941 filed by predecessor.* To the extent the wages paid and the taxes withheld by the predecessor are to be included in the Forms W–2 furnished to the acquired employees by the successor, there will be a difference between the amounts shown on the predecessor's Form W–3 and its Form 941. When the predecessor files its Form 941, it should attach a statement explaining the discrepancy and include the name, address, and identification number of the successor and a reference to this revenue procedure. This Form 941 cannot be filed electronically. See Rev. Proc. 96–19, 1996–4 I.R.B. 80, section 3.03.

.04 *Form 941 filed by successor.* There will be a corresponding difference between the amounts shown on the successor's Form W–3 and its Form 941. When the successor files its Form 941, it should also attach a statement to its Form 941 explaining the discrepancy, and include the name, address, and identification number of the predecessor and a reference to this revenue procedure. This Form 941 cannot be filed electronically. See Rev. Proc. 96–19, 1996–4 I.R.B. 80, section 3.03. For instructions relating to annual wage limitations, see § 31.3121(a)(1)–1.

.05 *Forms W–4.* The predecessor must transfer to the successor all current Forms W–4 that were provided to the predecessor by the acquired employees. The successor must keep the transferred Forms W–4 on file and deduct and withhold from the wages it pays to the acquired employees according to the information supplied on those forms until an employee submits a revised form. The successor employer must submit to the Service, in accordance with § 31.3402(f)(2)–1(g), copies of the Forms W–4 received by the predecessor during the current calendar quarter and the preceding calendar quarter.

.06 *Transfer of Forms W–4 furnished electronically.* If the predecessor and successor both maintain an electronic system for use by employees in filing Forms W–4, and the systems are compatible, the predecessor may electronically transfer the Forms W–4 of the acquired employees to the successor. The successor may also choose to acquire and maintain the predecessor's system. If these options do not apply, the transferred employees must provide the successor with a new Form W–4, either electronically or on paper, as prescribed by the successor.

.07 *Forms W–5.* The predecessor must transfer to the successor all Forms W–5 for the current year that were provided to the predecessor by the acquired employees.

SECTION 6. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 84–77 is modified and superseded.

SECTION 7. EFFECTIVE DATE

This revenue procedure is effective January 1, 1997.

SECTION 8. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1510.

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

The collections of information in this revenue procedure are in sections 5.03 and 5.04. This information is required to explain the discrepancy between the amounts reported on Forms 941 and W–3 filed by both the predecessor and successor who use the Alternate Procedure. This information will be used to assist the IRS in reconciling Forms 941 and W–3. The collections of information are required to use the Alternate Procedure. The likely respondents are business or other for-profit institutions.

The estimated total annual reporting burden is 110,700 hours.

The estimated annual burden per respondent is 12 minutes. The estimated number of respondents is 553,500.

The estimated annual frequency of responses is on occasion.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

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26 CFR 601.602: Tax forms and instructions. (Also Part I, Sections 6012, 6061; 1.6012–5, 1.6061–1.)

Rev. Proc. 96–61

CONTENTS

SECTION 1 PURPOSE
SECTION 2 BACKGROUND AND CHANGES
SECTION 3 ELECTRONIC FILING PARTICIPANTS—DEFINITIONS
SECTION 4 ACCEPTANCE IN THE ELECTRONIC FILING PROGRAM
SECTION 5 RESPONSIBILITIES OF AN ELECTRONIC FILER
SECTION 6 PENALTIES
SECTION 7 FORM 8453, U.S. INDIVIDUAL INCOME TAX DECLARATION FOR ELECTRONIC FILING
SECTION 8 INFORMATION AN ELECTRONIC FILER MUST PROVIDE TO THE TAXPAYER
SECTION 9 DIRECT DEPOSIT OF REFUNDS
SECTION 10 REFUND ANTICIPATION LOANS
SECTION 11 BALANCE DUE RETURNS

SECTION 12 ADVERTISING STANDARDS FOR ELECTRONIC FILERS AND FINANCIAL INSTITUTIONS
SECTION 13 MONITORING AND SUSPENSION OF AN ELECTRONIC FILER
SECTION 14 ADMINISTRATIVE REVIEW PROCESS FOR DENIAL OF PARTICIPATION IN THE ELECTRONIC FILING PROGRAM
SECTION 15 ADMINISTRATIVE REVIEW PROCESS FOR SUSPENSION FROM THE ELECTRONIC FILING PROGRAM
SECTION 16 VITA AND TCE SPONSORED ELECTRONIC FILING
SECTION 17 EMPLOYER SPONSORED ELECTRONIC FILING
SECTION 18 EFFECT ON OTHER DOCUMENTS
SECTION 19 EFFECTIVE DATE
SECTION 20 INTERNAL REVENUE SERVICE OFFICE CONTACT
SECTION 21 PAPERWORK REDUCTION ACT

SECTION 1. PURPOSE

This revenue procedure informs those who participate in the 1997 Electronic Filing Program for Form 1040 and Form 1040A, U.S. Individual Income Tax Return, and Form 1040EZ, Income Tax Return for Single and Joint Filers With No Dependents, of their obligations to the Internal Revenue Service, taxpayers, and other participants. This revenue procedure updates Rev. Proc. 95–49, 1995–2 C.B. 419.

SECTION 2. BACKGROUND AND CHANGES

.01 Section 1.6012–5 of the Income Tax Regulations provides that the Commissioner may authorize the use, at the option of a person required to make a return, of a composite return in lieu of any form specified in 26 CFR Part 1 (Income Tax), subject to the conditions, limitations, and special rules governing the preparation, execution, filing, and correction thereof as the Commissioner may deem appropriate.

.02 For purposes of this revenue procedure, an electronically filed Form 1040, Form 1040A, or Form 1040EZ is a composite return consisting of electronically transmitted data and certain paper documents. The nonelectronic portion of the return consists of Form 8453, U.S. Individual Income Tax Declaration for Electronic Filing, and other paper documents that cannot be electronically transmitted. Form 8453 must be received by the Service before any electronically filed return is complete (see section 5.08 of this revenue procedure). An electronically filed return must contain the same information that a return filed completely on paper contains. See section 7 of this revenue procedure for procedures for completing Form 8453.

.03 The Service will periodically issue a publication that lists the forms and schedules associated with a Form 1040 that can be electronically transmitted.

.04 A Form 1040, a Form 1040A, or a Form 1040EZ cannot be electronically filed after October 15, 1997, notwithstanding the fact that the taxpayer has been granted an extension to file a return beyond that date.

.05 An amended tax return cannot be electronically filed. A taxpayer must file an amended tax return on paper in accordance with the instructions for Form 1040X, Amended U.S. Individual Income Tax Return.

.06 A tax return that has a foreign address for the taxpayer cannot be electronically filed. Army/Air Force (APO) and Fleet (FPO) post offices are not considered foreign addresses.

.07 A tax return for a decedent cannot be electronically filed. The decedent's spouse or personal representative must file a paper tax return for the decedent.

.08 This revenue procedure updates Rev. Proc. 95–49, which applied to the Electronic Filing Program for the 1996 filing season. The updates include changes in the Electronic Filing Program for the 1997 filing season, clarifications of prior Electronic Filing Program statements, and additional guidance derived from other Service documents that relate to the Electronic Filing Program. Some of the updates are:

(1) in certain circumstances, a letter may be submitted in lieu of a revised Form 8633 (section 4.04);

(2) the application period to submit a new application for an applicant that purchases an Electronic Filer on or after November 1, 1996, is 30 days after the date of the purchase (section 4.05(2));

(3) the time period to submit a revised Form 8633 is extended to 30 days (section 4.06);

(4) a Principal for a firm or organization is defined (section 4.10);

(5) certain Responsible Officials may be listed on a maximum of ten or twenty Forms 8633 (sections 4.12);

(6) an Electronic Filer's foreign location no longer has to have an APO or FPO address and additional information is required on Form 8633 for a foreign location (section 4.14);

(7) a nonparticipating ERO may be dropped from the Electronic Filing Program (section 4.16);

(8) a fee for the electronic transmission of a tax return may not be computed using any amount from the return (section 5.05);

(9) the time period for an Electronic Filer to notify the Service that it is discontinuing its participation in the Electronic Filing Program is extended to 30 days (section 5.07);

(10) the duties of a Transmitter are clarified (section 5.16);

(11) an ERO must advise taxpayers that refund information is available on TeleTax (section 8.05);

(12) information an Electronic Filer must provide regarding a taxpayer's address of record is clarified (section 8.06);

(13) the effect of suspending a Principal or a Responsible Official, on entities that listed the Principal or Responsible Official on their Forms 8633, is clarified (section 13.02);

(14) the two-year periods for denial and suspension are modified and clarified (sections 13.10 and 13.11);

(15) the time and method to respond to a proposed letter of denial and a denial letter are clarified (sections 14.03 and 14.06); and

(16) the time and method to respond to a proposed suspension letter and a suspension letter are clarified (sections 15.02 and 15.05).

SECTION 3. ELECTRONIC FILING PARTICIPANTS—DEFINITIONS

.01 After acceptance into the Electronic Filing Program, as described in section 4 of this revenue procedure, a participant is referred to as an "Electronic Filer."

.02 An Electronic Filer is categorized as follows:

(1) ELECTRONIC RETURN ORIGINATOR. An "Electronic Return Originator" (ERO) is: (a) an "Electronic Return Preparer" who prepares tax returns, including Forms 8453, for taxpayers who intend to have their returns electronically filed; and/or (b) an "Electronic Return Collector" who accepts completed tax returns, including Forms 8453, from taxpayers who intend to have their returns electronically filed.

(2) SERVICE BUREAU. A "Service Bureau" receives tax return information on any media from an ERO,

formats the return information, and either forwards the return information to a Transmitter or sends back the return information to the ERO. A Service Bureau may or may not process Forms 8453 and send them to the appropriate service center.

(3) SOFTWARE DEVELOPER. A "Software Developer" develops software for the purposes of (a) formatting returns according to the Service's electronic return specifications; and/or (b) transmitting electronic returns directly to the Service. A Software Developer may also sell its software.

(4) TRANSMITTER. A "Transmitter" transmits the electronic portion of a return directly to the IRS Data Communications Subsystem. An entity that provides a "bump-up" service is a Transmitter. A bump-up service provider increases the transmission rate or line speed of formatted or reformatted information that is being sent to the Service via a public switched telephone network. For example, a bump-up service provider may increase the transmission rate or line speed of information from 4800 bits per second (BPS) to 9600 BPS. Service specifications for electronic filing require an asynchronous speed of 300 BPS to 38,400 BPS or a bisynchronous speed of 4800 BPS to 19,200 BPS.

.03 The Electronic Filer categories are not mutually exclusive. For example, an ERO can, at the same time, be considered a Transmitter, Software Developer, or Service Bureau depending on the function(s) performed.

.04 An electronic filing controlled office: (1) is an office in which an Electronic Filer has an ownership interest; (2) uses hardware, software, and transmission services supplied by an Electronic Filer; (3) receives income tax returns for electronic filing; and (4) has direct contact with taxpayers. At a minimum, direct contact includes verifying dollar amounts, routing transit numbers, and depositor account numbers on Forms 8453. A controlled office may or may not be open all year.

.05 An Electronic Filer may have a drop-off collection point(s). The activity at a drop-off collection point is limited solely to receiving a return or return information that a taxpayer wants to have electronically filed and collecting a fee for electronically filing that return. No returns may be prepared at the drop-off collection point. An Electronic Filer need not have an ownership interest in the drop-off collection point.

SECTION 4. ACCEPTANCE IN THE ELECTRONIC FILING PROGRAM

.01 Except as provided in sections 4.02 through 4.04 of this revenue procedure, an Electronic Filer that has actively participated in the 1996 Electronic Filing Program does not have to reapply to participate in the 1997 Electronic Filing Program. However, an Electronic Filer that intends to function as a Transmitter or a Software Developer in the 1997 Electronic Filing Program must first successfully complete the testing described in section 4.08 of this revenue procedure. In addition, section 4.15 of this revenue procedure provides for the Service's issuance of credentials necessary for participation in the 1997 Electronic Filing Program.

.02 Applicants and Electronic Filers must file a new Form 8633, Application to Participate in the Electronic Filing Program, with completed fingerprint cards for the appropriate individuals if:

(1) the applicant has never actively participated in the Electronic Filing Program;

(2) the applicant is an Electronic Filer that has actively participated in the Electronic Filing Program and wants to operate an electronic filing business at a new location;

(3) the applicant has previously been denied participation in the Electronic Filing Program; or

(4) the applicant has been suspended from the Electronic Filing Program.

.03 To participate in the 1997 Electronic Filing Program, an Electronic Filer in the 1996 Electronic Filing Program must submit a revised Form 8633, signed by all Principals and the Responsible Official, with completed fingerprint cards for the appropriate individuals if:

(1) the Electronic Filer functioned solely as a Software Developer during the 1996 Electronic Filing Program and intends to function as an ERO, Service Bureau, or Transmitter during the 1997 Electronic Filing Program;

(2) there is an additional principal, such as a partner or a corporate officer, that must be listed on Form 8633, line 8 (formerly line 1k(1)), "Principals of Your Firm or Organization";

(3) there is a "Principal" listed on Form 8633, line 8, that should be deleted; or

(4) the "Responsible Official" on Form 8633, line 9 (formerly line 1k(2)), changes.

.04 To participate in the 1997 Electronic Filing Program, an Electronic Filer in the 1996 Electronic Filing Program must submit either a revised Form 8633, or a letter containing the same information contained in a revised Form 8633, if there is any revision to the following information:

(1) the Firm name or Doing Business As (DBA) name;

(2) the business or mailing address;

(3) the contact representative or the alternate contact representative's name or telephone number;

(4) the Electronic Filer's form of organization, as described on Form 8633, line 1k;

(5) the electronic functions performed by an Electronic Filer, other than an Electronic Filer that functions solely as a Software Developer; or

(6) the number or location(s) of drop-off collection points.

A Form 8633 or letter submitted under this section should only include the information requested on lines 1a through 1i of Form 8633 and the information being revised. A Principal or a Responsible Official must sign the Form 8633 or the letter.

.05 Applicants described in section 4.02 of this revenue procedure must submit new applications within the following time periods:

(1) except as provided in section 4.05(2) of this revenue procedure, the application period begins on August 1, 1996, and ends on December 2, 1996; and

(2) if an applicant purchases an Electronic Filer on or after November 1, 1996, a new application must be submitted within 30 days after the date of the purchase.

.06 Revised applications described in sections 4.03 and 4.04 of this revenue procedure must be submitted within 30 days of the change(s) reflected on the revised Form 8633 or in the letter.

.07 Applicants and Electronic Filers described in sections 4.02 through 4.04 of this revenue procedure must file Form 8633 (or a letter containing the same information as provided in section 4.04 of this revenue procedure) with the service center that accepts electronically filed returns from the applicant's state.

.08 Applicants and Electronic Filers described in sections 4.01 through 4.03 of this revenue procedure that intend to function as a Transmitter or a Software Developer in the 1997 Electronic Filing Program must first successfully com-

plete the necessary testing at the appropriate service center(s).

.09 Each individual listed as a Principal or a Responsible Official must:

(1) be a United States citizen or an alien lawfully admitted for permanent residence as described in 8 U.S.C. § 1101(a)(20) (1994);

(2) have attained the age of 21 as of the date of application;

(3) submit with Form 8633 one standard fingerprint card with a full set of fingerprints taken by a law enforcement agency, except as provided in section 4.10 of this revenue procedure;

(4) pass a suitability check that includes a credit check and a fingerprint check; and

(5) if applying to be an ERO, meet state and local licensing and/or bonding requirements in connection with the preparation of tax returns and the collection of prepared returns that taxpayers intend to have electronically filed. However, if the state and local licensing and/or bonding requirements apply to a business entity, the individual(s) must demonstrate that the business entity meets the requirements.

.10 A Principal for a firm or organization includes the following:

(1) Sole Proprietorship. The sole proprietor is the Principal for a sole proprietorship.

(2) Partnership. Each partner who has a five percent (5%) or more interest in the partnership is a Principal of the partnership. If no partner has at least a 5% or more interest in the partnership, the Principal is an individual authorized to act for the partnership in legal and/or tax matters (at least one such individual must be listed on Form 8633).

(3) Corporation. The President, Vice-President, Secretary, and Treasurer of the corporation are each a Principal of the corporation.

(4) Other. The Principal for a for-profit entity that is not a sole proprietorship, partnership, or corporation, is an individual authorized to act for the entity in legal and/or tax matters (at least one such individual must be listed on Form 8633).

.11 A Responsible Official is the individual who oversees the daily operations of an Electronic Filer's office. As set forth in section 4.12 of this revenue procedure, a Responsible Official may be responsible for more than one office.

.12 A Responsible Official is categorized as follows:

(1) TIER I RESPONSIBLE OFFICIAL. A "Tier I Responsible Official" is a Responsible Official who does not meet the definition of a "Tier II Responsible Official." A Tier I Responsible Official should be able to physically visit on a daily basis each office for which he or she is listed as a Responsible Official. A Tier I Responsible Official may be listed on a maximum of ten applications (Forms 8633).

(2) TIER II RESPONSIBLE OFFICIAL. A "Tier II Responsible Official" is an individual who has participated in the Electronic Filing Program as a Responsible Official during at least the two most recent filing seasons and who has never been suspended from participation in the Electronic Filing Program. A Tier II Responsible Official should be able to physically visit on a daily basis any office for which he or she is listed as a Responsible Official. A Tier II Responsible Official may be listed on a maximum of twenty applications (Forms 8633).

.13 An individual may choose to submit evidence of the individual's professional status in lieu of one standard fingerprint card if the individual is:

(1) an attorney in good standing of the bar of the highest court of any State, possession, territory, Commonwealth, or the District of Columbia, and is not currently under suspension or disbarment from practice before the Service;

(2) a certified public accountant who is duly qualified to practice as a certified public accountant in any State, possession, territory, Commonwealth, or the District of Columbia and is not currently under suspension or disbarment from practice before the Service;

(3) an enrolled agent pursuant to part 10 of 31 C.F.R. Subtitle A;

(4) an officer of a publicly held corporation; or

(5) a banking official who is bonded and has been fingerprinted within the last two years.

.14 If an Electronic Filer has a foreign location, the following information is required on any new or revised Form 8633:

(1) the complete name of the contact representative at the foreign location;

(2) the complete mailing address for the foreign location (including city, country, and postal code);

(3) the complete business address for the foreign location (including city, country, and postal code);

(4) the complete local telephone number for the foreign location (include international access code, country code, and city code); and

(5) the information on lines 1m, 1n, 1p, and 1q of Form 8633 for the stateside contact representative. The stateside contact representative will receive all Service correspondence for the foreign location relating to the Electronic Filing Program.

.15 The Service will issue credentials to eligible applicants for the 1997 Electronic Filing Program, as well as Electronic Filers that do not have to reapply pursuant to section 4.01, 4.03, or 4.04 of this revenue procedure (provided they have first satisfactorily completed the testing described in section 4.08 of this revenue procedure if they intend to function as a Transmitter or Software Developer). No one may participate in the Electronic Filing Program for the 1997 filing season without the following credentials:

(1) a letter of acceptance into the Electronic Filing Program for the 1997 filing season;

(2) an Electronic Filing Identification Number (EFIN);

(3) if appropriate, an Electronic Transmitter Identification Number (ETIN);

(4) if appropriate, a Service Bureau Identification Number (SBIN); and

(5) if appropriate, a Collection Point Identification Number (CPIN).

.16 An ERO may not receive a letter of acceptance to participate in the 1997 Electronic Filing Program if the Service did not receive and accept during the 1996 filing season any electronically filed returns containing the ERO's EFIN. In addition, an ERO may be dropped from the 1997 Electronic Filing Program if the Service does not receive and accept prior to April 15, 1997, any electronically filed returns containing the ERO's EFIN. In either case, the Service will notify the ERO that it has been dropped from the Electronic Filing Program and explain what steps the ERO needs to take for future participation in the program.

.17 If an Electronic Filer is a Software Developer that performs no other function in the Electronic Filing Program but software development, no Principal or Responsible Official needs to pass a suitability check.

.18 If an Electronic Filer will have a drop-off collection point(s) (as defined in section 3.05 of this revenue procedure) for the 1997 filing season, an

Electronic Filer must submit a Form 8633 that lists each drop-off collection point. By listing a drop-off collection site on Form 8633, an Electronic Filer becomes a "parent" in relation to a listed drop-off collection point.

.19 The following reasons, which apply to any firm, organization, Principal, or Responsible Official listed on Form 8633, may result in the rejection of an application to participate in the 1997 Electronic Filing Program (this list is not all-inclusive):

(1) conviction of any criminal offense under the revenue laws of the United States, or of any offense involving dishonesty or breach of trust;

(2) failure to file timely and accurate tax returns, including returns indicating that no tax is due;

(3) failure to timely pay any tax liabilities;

(4) assessment of tax penalties;

(5) suspension/disbarment from practice before the Service;

(6) other facts or conduct of a disreputable nature that would reflect adversely on the Electronic Filing Program;

(7) misrepresentation on an application;

(8) suspension or rejection from the program in a prior year;

(9) unethical practices in return preparation;

(10) stockpiling returns prior to official acceptance into the Electronic Filing Program (see section 5.14 of this revenue procedure);

(11) knowingly and directly or indirectly employing or accepting assistance from any firm, organization, or individual that is prohibited from applying to participate in the Electronic Filing Program (see section 13.10 of this revenue procedure) or that is suspended from participating in the Electronic Filing Program (see section 13.11 of this revenue procedure). This includes any individual whose actions resulted in the rejection or suspension of a corporation or a partnership from the Electronic Filing Program; or

(12) knowingly and directly or indirectly accepting employment as an associate, correspondent, or as a subagent from, or sharing fees with, any firm, organization, or individual that is prohibited from applying to participate in the Electronic Filing Program (see section 13.10 of this revenue procedure) or that is suspended from participating in the Electronic Filing Program (see section 13.11 of this revenue procedure). This includes any individual whose actions resulted in the rejection or suspension of a corporation or a partnership from the Electronic Filing Program.

SECTION 5. RESPONSIBILITIES OF AN ELECTRONIC FILER

.01 To ensure that complete returns are accurately and efficiently filed, an Electronic Filer must comply with all the publications and notices of the Service. Currently, these publications and notices include:

(1) Handbook for Electronic Filers of Individual Income Tax Returns, Publication 1345, and Handbook for Electronic Filers of Individual Income Tax Returns (Supplement), Publication 1345A;

(2) Electronic Return File Specifications and Record Layouts for Individual Income Tax Returns, Publication 1346;

(3) Test Package for Electronic Filing of Individual Income Tax Returns, Publication 1436; and

(4) Postings to the Electronic Filing System Bulletin Board (EFS Bulletin Board).

.02 An Electronic Filer must maintain a high degree of integrity, compliance, and accuracy.

.03 An Electronic Filer may only accept returns for electronic filing directly from taxpayers, from drop-off collection sites accurately identified on its own Form 8633 (see section 4.18 of this revenue procedure), or from another Electronic Filer.

.04 If the taxpayer's address on a Form W–2, Wage and Tax Statement, Form W–2G, Statement for Recipients of Certain Gambling Winnings, Form 1099–R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., Form 1040, Schedule C, Profit or Loss From Business (Sole Proprietorship), or Form 1040, Schedule C–EZ, Profit or Loss From Business—Short Version, or any other tax form is different than the taxpayer's address in the entity section of the electronic portion of the taxpayer's Form 1040, the ERO or the Service Bureau must input for transmission to the Service those addresses that differ from the taxpayer's address on the electronic portion of the taxpayer's Form 1040.

.05 If an Electronic Filer charges a fee for the electronic transmission of a tax return, the fee may not be based on a percentage of the refund amount or any other amount from the tax return. An Electronic Filer may not charge a separate fee for Direct Deposit. See section 9 of this revenue procedure.

.06 An Electronic Filer must submit a revised Form 8633 to the appropriate service center within 30 days of when any of the conditions or changes described in section 4.03 or 4.04 of this revenue procedure occur. See section 4.06 of this revenue procedure.

.07 An Electronic Filer must notify the service center where the Electronic Filer filed its Form 8633 within 30 days of discontinuing its participation in the Electronic Filing Program. This does not preclude reapplication in the future.

.08 An Electronic Filer must ensure that an electronic return is filed on or before the due date of the return. A tax return is not considered filed until the electronic portion of the tax return has been acknowledged by the Service as accepted for processing and a completed and signed Form 8453 has been received by the Service. However, if the electronic portion of a return is successfully transmitted on or shortly before the due date and the Electronic Filer complies with section 7.01 of this revenue procedure, the return will be deemed timely filed. If the electronic portion of a return is initially transmitted on or shortly before the due date and is ultimately rejected, but the Electronic Filer and the taxpayer comply with section 5.13 of this revenue procedure, the return will be deemed timely filed. In the case of a balance due return, see section 11 of this revenue procedure for instructions on how to make a timely payment of tax.

.09 An Electronic Filer that functions as an ERO must:

(1) comply with the procedures for completing and securing Forms 8453 described in section 7 of this revenue procedure;

(2) comply with the procedures described in section 11 of this revenue procedure for handling a balance due return;

(3) while returns are being filed, retain and, if requested, make available to the Service the following material at the business address from which a return was accepted for electronic filing:

(a) a copy of the signed Form 8453 and paper copies of Forms W–2, W–2G, and 1099–R;

(b) a complete copy of the electronic portion of the return (may be retained on magnetic media) that can be

readily and accurately converted into an electronic transmission that the Service can process; and

(c) the acknowledgement file received from the Service or from a third party Transmitter; and

(4) retain until the end of the calendar year in which a return was filed, and, if requested, make available to the Service the materials described in section 5.09(3) of this revenue procedure at either the business address from which a return was electronically filed or from the contact representative named on Form 8633.

.10 An ERO who is the paid preparer of an electronic tax return must also retain for the prescribed amount of time the materials described in § 1.6107–1(b) that are required to be kept by an income tax return preparer.

.11 An ERO must identify the paid preparer (if any) in the appropriate field of the electronic return, in addition to ensuring that the paid preparer signed Form 8453. If Form 8453 is not signed by the paid preparer, the ERO must attach a copy of the Form 1040EZ signed by the paid preparer below the taxpayer's signature or pages one and two of Form 1040A or Form 1040 that includes the paid preparer's signature. These copies must be marked "COPY-DO NOT PROCESS" to prevent duplicate filings.

.12 An ERO must ensure against the unauthorized use of its EFIN and, if applicable, the CPIN(s) issued to its drop-off collection point(s). An ERO must not transfer its EFIN or the CPIN(s) of its drop-off collection point(s) by sale, merger, loan, gift, or otherwise to another entity.

.13 If the electronic portion of a taxpayer's return is acknowledged as rejected by the Service, and the reason for the rejection cannot be rectified by the actions described in section 6.02(3), the ERO, within 24 hours of receiving the rejection, must take all reasonable steps to tell the taxpayer that the taxpayer's return has not been filed. When the ERO advises the taxpayer that the taxpayer's return has not been filed, the ERO must provide the taxpayer with the reject code(s), an explanation of the reject code(s), and the sequence number of each reject code(s). If the taxpayer chooses not to have the previously rejected return retransmitted or if the return cannot be accepted for processing, the taxpayer must file a paper return by the later of:

(1) the due date of the return; or

(2) within ten calendar days after the Service's acknowledgement that the return is rejected or notification that the return cannot be retransmitted with an explanation of why the return is being filed after the due date.

.14 An ERO is responsible for ensuring that stockpiling does not occur at its office(s) or drop-off collection point(s). Stockpiling means collecting returns from taxpayers or from another Electronic Filer prior to official acceptance into the Electronic Filing Program, or, after official acceptance into the Electronic Filing Program, waiting more than three calendar days to transmit a return to the Service after receiving the information necessary for an electronic transmission of a tax return.

.15 An Electronic Filer who functions as a Service Bureau must:

(1) deliver all electronic returns to a Transmitter or to the ERO who gave the electronic returns to the Service Bureau within three calendar days of receipt;

(2) retrieve the acknowledgement file from the Transmitter within one calendar day of receipt by the Transmitter;

(3) initiate the communication of the acknowledgement file to the ERO (whether related or not) within one work day of retrieving the acknowledgement file;

(4) if the Service Bureau processes Forms 8453, send back to the ERO any return and Form 8453 that needs correction, unless the correction is described in section 6.02(3);

(5) accept tax return information only from Electronic Filers;

(6) include its SBIN and the ERO's EFIN with all return information the Service Bureau forwards to a Transmitter or sends back to an ERO;

(7) retain each acknowledgement file received from a Transmitter until the end of the calendar year in which the electronic return was filed;

(8) if requested, serve as a contact point between its client EROs and the Service;

(9) if requested, provide the Service with a list of each client ERO; and

(10) ensure against the unauthorized use of its SBIN. A Service Bureau must not transfer its SBIN by sale, merger, loan, gift, or otherwise to another entity.

.16 An Electronic Filer who functions as a Transmitter must:

(1) transmit all electronic returns within three calendar days of receipt;

(2) retrieve the acknowledgement file within two work days of transmission;

(3) match the acknowledgement file to the original transmission file and initiate the communication of the acknowledgement file to the ERO or the Service Bureau (whether or not the ERO or the Service Bureau are related to the Transmitter) within two work days of retrieving the acknowledgement file;

(4) retain an acknowledgement file received from the Service until the end of the calendar year in which the electronic return was filed;

(5) immediately contact the appropriate service center's Electronic Filing Unit for further instructions if an acknowledgement of acceptance for processing has not been received by the Transmitter within two work days of transmission or if a Transmitter receives an acknowledgement for a return that was not transmitted on the designated transmission;

(6) promptly correct any transmission error that causes an electronic transmission to be rejected;

(7) contact the appropriate service center's Electronic Filing Unit for assistance if a return has been rejected after three transmission attempts;

(8) ensure the security of all transmitted data;

(9) ensure against the unauthorized use of its EFIN or ETIN. A Transmitter must not transfer its EFIN or ETIN by sale, merger, loan, gift, or otherwise to another entity; and

(10) not use software that has a Service assigned production password built into the software.

.17 A Transmitter who provides transmission services to other unrelated Electronic Filers must only accept electronic returns for transmission to the IRS Data Communications Subsystem from accepted Electronic Filers. A Transmitter must include the ERO's EFIN and if applicable, the CPIN on each return that the Transmitter accepts from an ERO. In addition, a Transmitter must also include a Service Bureau's SBIN if a Service Bureau formats the return information.

.18 An Electronic Filer who functions as a Software Developer must:

(1) promptly correct any software error which causes an electronic return to be rejected;

(2) promptly distribute any software correction;

(3) ensure that any software package that will be used to transmit any returns from multiple Electronic Filers has the capability of combining returns from these Electronic Filers into one Service transmission file taking into account the sorting requirements of the Declaration Control Number (DCN);

(4) ensure that no other entity uses the Software Developer's EFIN or ETIN. A Software Developer must not transfer by sale, merger, loan, gift, or otherwise its EFIN or ETIN to another entity; and

(5) not incorporate into its software a Service assigned production password.

.19 An Electronic Filer with a drop-off collection point is the ERO for that drop-off collection point. The ERO must clearly display its name at each drop-off collection point. The Service will hold the ERO responsible for any violation of the advertising standards described in section 12 or any other violation of this revenue procedure that occurs at a drop-off collection point listed on the ERO's Form 8633. The ERO must also serve as the contact point between the Service and the drop-off collection point for all correspondence including problem resolution and report evaluation.

.20 In addition to the specific responsibilities described in this section, an Electronic Filer must meet all the requirements in this revenue procedure to keep the privilege of participating in the Electronic Filing Program.

SECTION 6. PENALTIES

.01 Penalties for Disclosure or Use of Information.

(1) An Electronic Filer, except a Software Developer, is a tax return preparer (Preparer) under the definition of § 301.7216–1(b) of the Regulations on Procedure and Administration. A Preparer is subject to a criminal penalty for disclosure or use of tax return information, as described in § 301.7216–1(a). In general, that regulation provides that any preparer who discloses or uses any tax return information for a purpose other than preparing, assisting in preparing, or obtaining or providing services in connection with the preparation of a tax return is guilty of a misdemeanor. In addition, § 6713 of the Internal Revenue Code provides for civil penalties that may be assessed against a preparer who makes an unauthorized disclosure or use of tax return information.

(2) Under § 301.7216–2(h), disclosure of tax return information among accepted Electronic Filers for the purpose of preparing a return is permissible. For example, it is permissible for an ERO to pass on tax return information to a Service Bureau and/or a Transmitter for the purpose of having an electronic return formatted and transmitted to the Service. However, if the tax return information is disclosed or used in any other way, a Service Bureau and/or a Transmitter may be guilty of a misdemeanor as described in section 6.01(1) of this revenue procedure.

.02 Other Preparer Penalties.

(1) Preparer penalties may be asserted against an individual or firm who meets the definition of an income tax return preparer under § 7701(a)(36) and § 301.7701–15. Examples of preparer penalties that may be asserted under appropriate circumstances include, but are not limited to, those set forth in §§ 6694, 6695, and 6713.

(2) Under § 301.7701–15(d), Electronic Return Collectors, Service Bureaus, Transmitters, and Software Developers are not income tax return preparers for the purpose of assessing most preparer penalties as long as their services are limited to "typing, reproduction, or other mechanical assistance in the preparation of a return or claim for refund."

(3) If an Electronic Return Collector, Service Bureau, Transmitter, or Software Developer alters the return information in a nonsubstantive way, this alteration will be considered to come under the "mechanical assistance" exception described in § 301.7701–15(d)(1). A nonsubstantive change is a correction or change limited to a transposition error, misplaced entry, spelling error, or arithmetic correction that falls within the following tolerances:

(a) the Total Tax amount, Withholding amount, Refund amount, or Amount Owed shown on Form 8453 differs from the corresponding amount on the electronic portion of the tax return by no more than $7;

(b) the Total Income amount shown on Form 8453 differs from the corresponding amount on the electronic portion of the tax return by no more than $25; or

(c) dropping cents and rounding to whole dollars.

(4) If an Electronic Return Collector, Service Bureau, or Transmitter alters the return information in a substantive way, rather than having the taxpayer alter the return, the Electronic Return Collector, Service Bureau, or Transmitter will be considered to be an income tax return preparer for purposes of § 7701(a)(36).

(5) If an Electronic Return Collector, Service Bureau, or Transmitter, or the product of a Software Developer, goes beyond mechanical assistance, any of these parties may be held liable for income tax return preparer penalties. Rev. Rul. 85–189, 1985–2 C.B. 341, describes a situation where a Software Developer was determined to be an income tax return preparer and subject to certain preparer penalties.

.03 In addition to the above specified provisions, the Service reserves the right to assert all appropriate preparer, nonpreparer, and disclosure penalties against an Electronic Filer as warranted under the circumstances.

SECTION 7. FORM 8453, U.S. INDIVIDUAL INCOME TAX DECLARATION FOR ELECTRONIC FILING

.01 Procedures for Completing Form 8453.

(1) Form 8453 must be completed in accordance with the instructions for Form 8453.

(2) The taxpayer(s)'s name, address, social security number(s), tax return information, and direct deposit of refund information in the electronic transmission must be identical to the information on the Form 8453 that the taxpayer(s) signed and provided for submission to the Service.

(3) An Electronic Filer, a financial institution, or any other entity associated with the electronic filing of a taxpayer's return must not put its address in the section reserved for the taxpayer's address on Form 8453 or anywhere in the electronic portion of a return.

(4) After the return has been prepared and before the return is electronically transmitted, the taxpayer must verify the information on the electronic portion of the return and on Form 8453, and must sign Form 8453. The taxpayer may verify the information on the electronic portion of the return by viewing this information on a computer display terminal. Both spouses' signatures are required on a joint return prior to the electronic transmission of the tax return.

(5) An Electronic Filer must submit the taxpayer's Form 8453 to the appropriate service center within one

work day after the Electronic Filer receives acknowledgment that the electronic portion of the taxpayer's return has been accepted for processing.

(6) If an Electronic Filer functions as an ERO, the Electronic Filer must sign the ERO's Declaration on Form 8453.

(7) If the ERO is also the paid preparer, the ERO must check the "Paid Preparer" box and sign the ERO Declaration on Form 8453.

.02 Corrections to Form 8453.

(1) A new Form 8453 is not required for a nonsubstantive change. A nonsubstantive change is limited to a correction that does not exceed the tolerances, described in section 7.02(2) of this revenue procedure for arithmetic errors, a transposition error, a misplaced entry, or a spelling error. The incorrect nonsubstantive information must be neatly lined through on the Form 8453 and the correct data entered next to the lined-through entry. Also, the individual making the correction must initial the correction.

(2) The tolerances for section 7.02(1) of this revenue procedure are:

(a) the "Total Income" does not differ from the amount on the electronic tax return by more than $25; or

(b) the "Total Tax", the "Federal income tax withheld", the "Refund", or the "Amount you owe" does not differ from the amount on the electronic portion of the tax return by more than $7.

(3) If the ERO makes a substantive change to the electronic portion of the return after Form 8453 has been signed by the taxpayer, but before it is transmitted, the ERO must have all the necessary parties described above sign a new Form 8453 that reflects the corrections before the return is transmitted.

(4) Dropping cents or rounding to whole dollars does not constitute a substantive change or alteration to the return unless the amount differs by more than the above tolerances. All rounding should be accomplished in accordance with the instructions in the Form 1040 tax package.

.03 If the Service determines that a Form 8453 is missing, the ERO must provide the Service with a replacement. The ERO must also provide a copy of the Form(s) W–2, W–2G, 1099R, and all other attachments to Form 8453.

.04 If a substitute Form 8453 is used, it must be approved by the Service prior to use. See Rev. Proc. 96–48, 1996–39 I.R.B. 10.

SECTION 8. INFORMATION AN ELECTRONIC FILER MUST PROVIDE TO THE TAXPAYER

.01 The ERO must furnish the taxpayer with a complete paper copy of the taxpayer's return. A complete copy of a taxpayer's return includes: (1) Form 8453 and other paper documents that cannot be electronically transmitted, and (2) a printout of the electronic portion of the return. See section 2.02 of this revenue procedure. The electronic portion of the return can be contained on a replica of an official form or on an unofficial form. However, on an unofficial form, data entries must be referenced to the line numbers on an official form.

.02 The ERO must advise the taxpayer to retain a complete copy of the return and any supporting material.

.03 The ERO must advise the taxpayer that an amended return, if needed, must be filed as a paper return and mailed to the service center that would handle the taxpayer's paper return.

.04 The ERO must, upon request, provide the taxpayer with the Declaration Control Number and the date the electronic portion of the taxpayer's return was acknowledged as accepted for processing by the Service.

.05 The ERO must advise taxpayers that they can call the local IRS TeleTax number to inquire about the status of their tax refund. The ERO should also advise taxpayers to wait at least three weeks from the acceptance date of the electronic return before calling the TeleTax number.

.06 If a taxpayer chooses to use an address other than his or her home address on the return, the Electronic Filer must inform the taxpayer that the address on the electronic portion of the return, once processed by the Service, will be used to update the taxpayer's address of record. The Internal Revenue Service uses the taxpayer's address of record for various notices that are required to be sent to a taxpayer's "last known address" under the Internal Revenue Code, and for refunds of overpayments of tax (unless otherwise specifically directed by the taxpayer, such as by Direct Deposit).

SECTION 9. DIRECT DEPOSIT OF REFUNDS

.01 The Service will ordinarily process a request for Direct Deposit but reserves the right to issue a paper refund check.

.02 The Service does not guarantee a specific date by which a refund will be directly deposited into the taxpayer's financial institution account.

.03 Neither the Service nor Financial Management Service (FMS) is responsible for the misapplication of a Direct Deposit that is caused by error, negligence, or malfeasance on the part of the taxpayer, Electronic Filer, financial institution, or any of their agents.

.04 An ERO must:

(1) advise taxpayers of the option to receive their refund by paper check or direct deposit;

(2) not charge a separate fee for a Direct Deposit;

(3) accept any Direct Deposit election to any eligible financial institution designated by the taxpayer;

(4) ensure that the taxpayer is eligible to choose Direct Deposit;

(5) verify that the taxpayer has entered the Direct Deposit information requested on Part II of Form 8453 correctly and that the information entered is the information transmitted with the electronic portion of the return;

(6) caution the taxpayer that once an electronic return has been accepted for processing by the Service:

(a) the Direct Deposit election cannot be rescinded;

(b) the Routing Transit Number (RTN) of the financial institution cannot be changed; and

(c) the taxpayer's account number cannot be changed; and

(7) advise the taxpayer that refund information is available by calling the local IRS TeleTax number. See section 8.05 of this revenue procedure.

SECTION 10. REFUND ANTICIPATION LOANS

.01 A Refund Anticipation Loan (RAL) is money borrowed by a taxpayer that is based on a taxpayer's anticipated income tax refund. The Service has no involvement in RALs. A RAL is a contract between the taxpayer and the lender.

.02 Any entity that is involved in the Electronic Filing Program, including a financial institution that accepts direct deposits of income tax refunds, has an obligation to every taxpayer who applies for a RAL to clearly explain to the taxpayer that a RAL is in fact a loan, and not a substitute for or a quicker way of receiving an income tax refund. An Electronic Filer must advise the taxpayer that if a Direct Deposit is not

timely, the taxpayer may be liable to the lender for additional interest on the RAL.

.03 An Electronic Filer may assist a taxpayer in applying for a RAL.

.04 An Electronic Filer may charge a flat fee to assist a taxpayer in applying for a RAL. The fee must be identical for all of the Electronic Filer's customers and must not be related to the amount of the refund or a RAL. The Electronic Filer must not accept a fee from a financial institution for any service connected with a RAL that is contingent upon the amount of the refund or a RAL.

.05 The Service has no responsibility for the payment of any fees associated with the preparation of a return, the electronic transmission of a return, or a RAL.

.06 An Electronic Filer may disclose tax information to the lending financial institution in connection with an application for a RAL only with the taxpayer's written consent as specified in § 301.7216–3(b).

.07 An Electronic Filer that is also the return preparer, and the financial institution or other lender that makes an RAL, may not be related taxpayers within the meaning of § 267 or § 707.

.08 Section 6695(f) imposes a $500 penalty on a return preparer who endorses or negotiates a refund check issued to any taxpayer other than the return preparer. However, a bank, as defined in § 581, may accept the full amount of a refund check as a deposit in the taxpayer's account for the benefit of the taxpayer. Section 1.6695–1(f) clarifies § 6695 of the Code by explaining that the prohibition on a return preparer negotiating a refund check is limited to a refund check for a return that the return preparer prepared. A preparer that is also a financial institution, but has not made a loan to the taxpayer on the basis of the taxpayer's anticipated refund, may (1) cash a refund check and remit all of the cash to the taxpayer or accept a refund check for deposit in full to a taxpayer's account, provided the bank does not initially endorse or negotiate the check; or (2) endorse a refund check for deposit in full to a taxpayer's account pursuant to a written authorization of the taxpayer. A preparer bank may also subsequently endorse or negotiate a refund check as part of the check-clearing process through the financial system after initial endorsement. Any income tax return preparer that violates this provision may be suspended from the Electronic Filing Program.

SECTION 11. BALANCE DUE RETURNS

.01 All service centers that accept electronically filed returns will accept electronically filed balance due returns.

.02 The Electronic Filer must furnish Form 1040–V, Electronic Payment Voucher, to a taxpayer who electronically files a balance due return.

.03 To expedite the crediting of a tax payment, a taxpayer who electronically files a balance due return should mail his or her tax payment with either Form 1040–V or the scannable payment voucher that is included in some tax packages. Each of these options has specific mailing instructions.

.04 A taxpayer who electronically files a balance due return must make a full and timely payment of any tax that is due. Failure to make full payment of any tax that is due on or before April 15, 1997, will result in the imposition of interest and may result in the imposition of penalties.

SECTION 12. ADVERTISING STANDARDS FOR ELECTRONIC FILERS AND FINANCIAL INSTITUTIONS

.01 An Electronic Filer shall comply with the advertising and solicitation provisions of 31 C.F.R. Part 10 (Treasury Department Circular No. 230). This circular prohibits the use or participation in the use of any form of public communication containing a false, fraudulent, misleading, deceptive, unduly influencing, coercive, or unfair statement or claim. In addition, advertising must not imply a special relationship with the Service, FMS, or the Treasury Department. Any claims concerning faster refunds by virtue of electronic filing must be consistent with the language in official Service publications.

.02 An Electronic Filer must adhere to all relevant federal, state, and local consumer protection laws that relate to advertising and soliciting.

.03 An Electronic Filer must not use the Service's name, "Internal Revenue Service" or "IRS", within a firm's name.

.04 An Electronic Filer must not use improper or misleading advertising in relation to the Electronic Filing Program (including the time frames for refunds and RALs).

.05 Use of Direct Deposit name and logo.

(1) The name "Direct Deposit" will be used with initial capital letters or all capital letters.

(2) The logo/graphic for Direct Deposit will be used whenever feasible in advertising copy.

(3) The color or size of the Direct Deposit logo/graphic may be changed when used in advertising pieces.

.06 Advertising materials shall not carry the FMS, IRS, or other Treasury Seals.

.07 Advertising for a cooperative electronic return project (public/private sector) must clearly state the names of all cooperating parties.

.08 In advertising the availability of a RAL, an Electronic Filer and a financial institution must clearly (and, if applicable, in easily readable print) refer to or describe the funds being advanced as a loan, not a refund; that is, it must be made clear in the advertising that the taxpayer is borrowing against the anticipated refund and not obtaining the refund itself from the financial institution.

.09 If an Electronic Filer uses radio or television broadcasting to advertise, the broadcast must be pre-recorded. The Electronic Filer must keep a copy of the pre-recorded advertisement for a period of at least 36 months from the date of the last transmission or use.

.10 If an Electronic Filer uses direct mail or fax communications to advertise, the Electronic Filer must retain a copy of the actual mailing or fax, along with a list or other description of the firms, organizations, or individuals to whom the communication was mailed, faxed, or otherwise distributed for a period of at least 36 months from the date of the last mailing, fax, or distribution.

.11 Acceptance to participate in the Electronic Filing Program does not imply endorsement by the Service or FMS of the software or quality of services provided.

SECTION 13. MONITORING AND SUSPENSION OF AN ELECTRONIC FILER

.01 The Service will monitor an Electronic Filer for conformity with this revenue procedure. The Service can immediately suspend, without notice, an Electronic Filer from the Electronic Filing Program. However, in most circumstances, a suspension from participation in the Electronic Filing Program is effective as of the date of the letter

informing the Electronic Filer of the suspension. Before suspending an Electronic Filer, the Service may issue a warning letter that describes specific corrective action for deviations from this revenue procedure.

.02 If a Principal or Responsible Official is suspended from the Electronic Filing Program, every entity that listed the suspended Principal or Responsible Official on its Form 8633 may also be suspended.

.03 The Service will monitor the timely receipt of Forms 8453, as well as their overall legibility.

.04 The Service will monitor the quality of an Electronic Filer's transmissions throughout the filing season. The Service will also monitor electronic returns and tabulate rejections, errors, and other defects. If quality deteriorates, the Electronic Filer will receive a warning from the Service.

.05 The Service will monitor drop-off collection points and advise a parent of any Electronic Filing Program violations the Service has encountered with a parent's drop-off collection point. If a parent fails to correct a drop-off collection point problem, the parent will be required to eliminate that drop-off collection point. Failure to take corrective action or eliminate a drop-off collection point will cause the Service to suspend the parent. If the Service initiates suspension action, it will apply to all returns filed by the parent.

.06 The Service will monitor complaints about an Electronic Filer and issue a warning or suspension letter as appropriate.

.07 The Service reserves the right to suspend the electronic filing privilege of any Electronic Filer that violates any provision of this revenue procedure. Generally, the Service will advise a suspended Electronic Filer concerning the requirements for reacceptance into the Electronic Filing Program. The following reasons may lead to a warning letter and/or suspension of an Electronic Filer from the Electronic Filing Program (this list is not all-inclusive):

(1) the reasons listed in section 4.19 of this revenue procedure;

(2) deterioration in the format of individual transmissions;

(3) unacceptable cumulative error or rejection rate;

(4) untimely received, illegible, incomplete, missing, or unapproved substitute Forms 8453;

(5) stockpiling returns at any time while participating in the Electronic Filing Program;

(6) failure on the part of a Transmitter to retrieve acknowledgement files within two work days of transmission by the Service;

(7) failure on the part of a Transmitter to initiate the communication of acknowledgement files to clients within two work days of receipt of the acknowledgement files from the Service;

(8) significant complaints about an Electronic Filer's performance in the Electronic Filing Program;

(9) failure on the part of an Electronic Filer to ensure that no other entity uses the Electronic Filer's EFIN and/or ETIN;

(10) having more than one EFIN for the same business entity at the same location (the business entity is generally the entity that reports on its return the income derived from electronic filing), unless the Service has issued more than one EFIN to a business entity. For example, the Service may issue more than one EFIN to accommodate high volumes of returns;

(11) failure on the part of a Transmitter to include a Service Bureau's SBIN in the transmission of a return submitted by a Service Bureau;

(12) failure on the part of an ERO to include a drop-off collection point's CPIN as part of a return collected from a drop-off collection point;

(13) failure on the part of an Electronic Filer to cooperate with the Service's efforts to monitor Electronic Filers and investigate electronic filing abuse;

(14) failure on the part of an Electronic Filer to properly use the standard/non-standard W–2 indicator;

(15) failure on the part of an Electronic Filer to properly use the refund anticipation loan (RAL) indicator;

(16) failure on the part of a Service Bureau or a Transmitter to include the ERO's EFIN as part of a return that the ERO submits to the Service Bureau or the Transmitter;

(17) violation of the advertising standards described in section 12 of this revenue procedure;

(18) failure to maintain and make available records as described in section 5.09(4) of this revenue procedure;

(19) accepting a tax return for electronic filing either directly or indirectly from a firm, organization, or individual (other than the taxpayer who is submitting his or her return) that is not in the Electronic Filing Program;

(20) submitting the electronic portion of a return with information that is not identical to the information on Form 8453;

(21) failure to timely pay any applicable fees, as implemented by subsequent guidance; or

(22) failure to timely submit a revised Form 8633 notifying the Service of changes described in section 4.03 or 4.04 of this revenue procedure.

.08 The Service may list in the Internal Revenue Bulletin, district office listings, district office newsletters, and the EFS Bulletin Board the name and owner(s) of any entity suspended from the Electronic Filing Program and the effective date of the suspension.

.09 A district director may warn Electronic Filers who are using the services of a rejected or a suspended Electronic Filer that sections 4.19(11) and (12) of this revenue procedure prohibit a business relationship with a rejected or a suspended Electronic Filer. However, in appropriate circumstances, the Service may immediately suspend the Electronic Filer.

.10 If an application for participation in the Electronic Filing Program is denied, the applicant is ineligible to submit a new application for two years from the application date of the denied application.

.11 If an Electronic Filer is suspended from participating in the Electronic Filing Program, the period of suspension includes the remainder of the calendar year in which the suspension occurs plus the next two calendar years. A suspended participant may submit a new application for the application period immediately preceding the end of the suspension.

SECTION 14. ADMINISTRATIVE REVIEW PROCESS FOR DENIAL OF PARTICIPATION IN THE ELECTRONIC FILING PROGRAM

.01 An applicant that has been denied participation in the Electronic Filing Program has the right to an administrative review. During the administrative review process, the denial of participation remains in effect.

.02 In response to the submission of a Form 8633, the appropriate district office will either (1) accept an applicant into the Electronic Filing Program, or (2) issue a proposed letter of denial that explains to the applicant why the district

office proposes to reject the application to participate in the Electronic Filing Program.

.03 An applicant that receives a proposed letter of denial may mail or deliver, within 30 calendar days of the date of the proposed letter of denial, a written response to the district office that issued the proposed letter of denial. The applicant's response must address the district office's explanation for proposing the denial to participate.

.04 Upon receipt of an applicant's written response, the district office will reconsider its proposed letter of denial. The district office may (1) withdraw its proposed letter of denial and admit the applicant into the Electronic Filing Program, or (2) finalize its proposed letter of denial and issue it to the applicant.

.05 If an applicant receives a final letter from the district office that denies the applicant participation in the Electronic Filing Program, the applicant is entitled to an appeal, in writing, to the Director of Practice.

.06 The appeal must be mailed or delivered to the district office that issued the denial letter within 30 calendar days of the date of the denial letter. An applicant's written appeal must contain a detailed explanation, with supporting documentation, of why the denial should be reversed. In addition, the applicant must include a copy of the applicant's Form 8633 and a copy of the denial letter.

.07 The district office whose denial is being appealed will, upon receipt of a written appeal to the Director of Practice, forward to the Director of Practice its file on the applicant and the material described in section 14.06 of this revenue procedure that the applicant has submitted to the district office. The district office will forward to the Director of Practice these materials within 15 calendar days of receipt of the applicant's written appeal to the Director of Practice.

.08 Failure to respond within the 30-day periods described in sections 14.03 and 14.06 of this revenue procedure irrevocably terminates an applicant's right to an administrative review or appeal.

SECTION 15. ADMINISTRATIVE REVIEW PROCESS FOR SUSPENSION FROM THE ELECTRONIC FILING PROGRAM

.01 An Electronic Filer that has been suspended from participation in the Electronic Filing Program has the right to an administrative review. During the administrative review process, the suspension remains in effect.

.02 If an Electronic Filer receives a proposed suspension letter, the Electronic Filer may mail or deliver, within 30 calendar days of the date of the proposed suspension letter, a detailed written explanation, with supporting documentation, of why the proposed suspension letter should be withdrawn. This written response should be sent to the district office or service center that issued the proposed suspension letter.

.03 Upon receipt of the Electronic Filer's written response, the district office or service center will reconsider its proposed suspension of the Electronic Filer. The district office or service center will either withdraw its proposed suspension letter and reinstate the Electronic Filer or issue a suspension letter to the Electronic Filer.

.04 If an Electronic Filer receives a suspension letter from a district office or a service center, the Electronic Filer is entitled to an appeal, in writing, to the Director of Practice.

.05 The appeal must be mailed or delivered to the district office or service center that issued the suspension letter within 30 calendar days of the date of the suspension letter. The Electronic Filer's written appeal must contain detailed reasons, with supporting documentation, for reversal of the suspension. In addition, the Electronic Filer must include a copy of its Form 8633 and a copy of the suspension letter.

.06 The district office or service center whose decision to suspend is being appealed will, upon receipt of a written appeal to the Director of Practice, forward to the Director of Practice its file on the Electronic Filer and the material described in section 15.05 of this revenue procedure that the Electronic Filer has submitted to the district office or the service center. The district office or the service center will forward to the Director of Practice these materials within 15 calendar days of the receipt of the Electronic Filer's written request for appeal to the Director of Practice.

.07 Failure to appeal within the 30-day period described in section 15.05 of this revenue procedure irrevocably terminates an Electronic Filer's right to an appeal.

SECTION 16. VITA AND TCE SPONSORED ELECTRONIC FILING

.01 This revenue procedure applies to VITA (Volunteer Income Tax Assistance) and TCE (Tax Counselling for the Elderly) sponsors subject to the exceptions and restrictions described in this section.

.02 For purposes of this section, the District Director may be represented by an individual designated by the District Director such as a District Office Electronic Filing Coordinator (DOEFC) or a Taxpayer Education Coordinator.

.03 To be accepted in, or to continue participation in, the Electronic Filing Program, a VITA or TCE sponsor must:

(1) have obtained the District Director's permission (and, in the case of a TCE sponsor, the permission of the Service office that is funding the TCE program) to provide electronic filing; and

(2) have a manual or electronic quality review system for each return to be electronically filed.

.04 The District Director will advise the VITA and TCE sponsor how to submit or transmit returns. Some of the options available to the District Director are:

(1) having the VITA or TCE sponsor submit returns on paper, magnetic disk, or in an electronic transmission to the DOEFC or other locally designated office;

(2) having the VITA or TCE sponsor directly transmit returns to the appropriate service center; or

(3) having the VITA or TCE sponsor use a third party Transmitter.

.05 A VITA or TCE sponsor is not required to manually sign Form 8453 as ERO. However, if the VITA or TCE sponsor chooses not to manually sign Form 8453, the VITA or TCE sponsor must otherwise furnish on Form 8453 its VITA or TCE acronym and, if operating from multiple sites, a site designation number.

.06 A VITA or TCE sponsor can only accept a return for electronic filing that is (1) prepared at the VITA or TCE site by a VITA or TCE volunteer, (2) prepared by a taxpayer that meets the criteria for VITA or TCE assistance, or (3) prepared by a paid preparer that meets the criteria for VITA or TCE assistance.

.07 Only returns and accompanying forms and schedules included in a district, VITA, or TCE training course may

be accepted for electronic filing by a VITA or TCE sponsor.

.08 A VITA or TCE sponsor and a District Director may enter into an agreement that provides for the retention of copies of tax returns and Forms 8453 by a District Director. This information must be retained by either the VITA or TCE sponsor or a District Director. This information must not be given to a third party, including a third party Transmitter.

.09 A District Director is responsible for ensuring that Form 8453 is sent to the appropriate Service office or service center. However, a District Director may delegate to the VITA or TCE sponsor the responsibility for mailing Form 8453 to the appropriate office or service center.

.10 A VITA or TCE sponsor may collect a fee only if it is directly related to defraying the actual cost of electronically transmitting a tax return. A VITA or TCE sponsor may also collect this fee on behalf of a third party Transmitter who electronically transmitted a VITA or TCE return.

.11 Before a VITA or TCE sponsor may collect a fee for electronically filing a tax return, the VITA or TCE sponsor must ensure that the taxpayer understands that:

(1) the fee is not for the preparation of the return; and

(2) the VITA or TCE service is offered without regard to either the electronic filing of a return or the collection of a fee.

SECTION 17. EMPLOYER SPONSORED ELECTRONIC FILING

.01 This revenue procedure applies to an employer who chooses to offer electronic filing as an employee benefit to (1) business owners and spouses, (2) employees and spouses, and/or (3) dependents of business owners and employees, subject to the exceptions and restrictions described in this section.

.02 For purposes of this section, the District Director may be represented by an individual designated by the District Director.

.03 An employer may choose to electronically transmit returns or may arrange to have tax returns electronically transmitted through a third party. If an employer chooses to transmit returns from more than one location, the employer must submit a properly completed Form 8633 for each location.

.04 An employer may offer electronic filing as an employee benefit whether the employer chooses to transmit tax returns or contracts with a third party to transmit the tax returns.

.05 If an employer contracts with a third party to transmit tax returns, the employer may collect from participating employees a fee that is directly related to defraying the actual cost of electronically transmitting a tax return.

.06 An employer is not required to manually sign Form 8453 as ERO. However, if the employer chooses not to manually sign Form 8453, the employer must otherwise furnish on Form 8453 its name, address, and the designation "Employee Benefit," and if operating from multiple sites, a site designation number.

.07 An employer and a District Director may enter into an agreement that provides for the retention of copies of tax returns including Forms 8453. In the absence of such an agreement, this information must be retained by the employer. This information is not to be given to a third party, including a third party Transmitter.

SECTION 18. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 95–49, 1995–2 C.B. 419, is superseded.

SECTION 19. EFFECTIVE DATE

This revenue procedure is effective December 30, 1996.

SECTION 20. INTERNAL REVENUE SERVICE OFFICE CONTACT

All questions regarding this revenue procedure should be directed to the Internal Revenue Service. The telephone number for this purpose is (202) 283–1010 (not a toll-free number).

SECTION 21. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1512.

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

The collections of information in this revenue procedure are in sections 5, 8, 9, and 12. This information is required to implement the Electronic Filing Program and to enable taxpayers to file their individual income tax returns electronically. The information will be used to ensure that taxpayers receive accurate and essential information regarding the filing of their electronic returns and to identify the persons involved in the filing of electronic returns. The collections of information are required to retain the benefit of participating in the Electronic Filing Program. The likely respondents are business or other for-profit institutions.

The estimated total annual reporting and recordkeeping burden is 1,146,272 hours.

The estimated annual burden per respondent/recordkeeper varies from six (6) minutes to 15.5 hours, depending on individual circumstances, with an estimated average of 15.28 hours (or approximately six (6) minutes per electronically filed return). The estimated number of respondents and recordkeepers is 75,000.

The estimated annual frequency of responses is on occasion.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. § 6103.

26 CFR 601.602: Tax forms and instructions. (Also Part I, Sections 6012, 6061; 1.6012–5, 1.6061–1.)

Rev. Proc. 96–62

CONTENTS

SECTION 1 PURPOSE
SECTION 2 BACKGROUND AND CHANGES
SECTION 3 ON-LINE FILING PARTICIPANTS—DEFINITIONS
SECTION 4 ACCEPTANCE IN THE ON-LINE FILING PROGRAM
SECTION 5 RESPONSIBILITIES OF AN ON-LINE FILER
SECTION 6 PENALTIES
SECTION 7 FORM 8453–OL, U.S. INDIVIDUAL TAX DECLARATION FOR ON-LINE FILING
SECTION 8 INFORMATION AN ON-LINE FILER MUST PROVIDE TO THE TAXPAYER
SECTION 9 DIRECT DEPOSIT OF REFUNDS
SECTION 10 BALANCE DUE RETURNS

SECTION 11 ADVERTISING STANDARDS FOR ON-LINE FILERS
SECTION 12 MONITORING AND SUSPENSION OF AN ON-LINE FILER
SECTION 13 ADMINISTRATIVE REVIEW PROCESS FOR DENIAL OF PARTICIPATION IN THE ON-LINE FILING PROGRAM
SECTION 14 ADMINISTRATIVE REVIEW PROCESS FOR SUSPENSION FROM THE ON-LINE FILING PROGRAM
SECTION 15 EFFECT ON OTHER DOCUMENTS
SECTION 16 EFFECTIVE DATE
SECTION 17 INTERNAL REVENUE SERVICE OFFICE CONTACT
SECTION 18 PAPERWORK REDUCTION ACT

SECTION 1. PURPOSE

This revenue procedure informs those who participate in the 1997 On-Line Filing Program for Form 1040 and Form 1040A, U.S. Individual Income Tax Return, and Form 1040EZ, Income Tax Return for Single and Joint Filers With No Dependents, of their obligations to the Internal Revenue Service, taxpayers, and other participants. This revenue procedure updates Rev. Proc. 96–20, 1996–4 I.R.B. 88.

SECTION 2. BACKGROUND AND CHANGES

.01 During the 1996 federal income tax filing season, all returns filed through the On-Line Filing Program were filed at the Austin Service Center. For the 1997 federal income tax filing season, the program is being expanded to allow returns filed through the On-Line Filing Program to be filed at all service centers that process electronic returns.

.02 Section 1.6012–5 of the Income Tax Regulations provides that the Commissioner may authorize the use, at the option of a person required to make a return, of a composite return in lieu of any form specified in 26 C.F.R. Part 1 (Income Tax), subject to the conditions, limitations, and special rules governing the preparation, execution, filing, and correction thereof as the Commissioner may deem appropriate.

.03 For purposes of this revenue procedure, an on-line electronically filed Form 1040, Form 1040A, or Form 1040EZ is a composite return consisting of electronically transmitted data and certain paper documents. The non-electronic portion of the return consists of Form 8453–OL, U.S. Individual Income Tax Declaration for On-Line Filing, and other paper documents that cannot be electronically transmitted. Form 8453–OL must be received by the Service before an on-line electronically filed return is complete (See section 5.07 of this revenue procedure). An on-line electronically filed return must contain the same information that a return filed completely on paper contains. See section 7 of this revenue procedure for procedures for completing Form 8453–OL.

.04 The Service will periodically issue a publication that lists the forms and schedules associated with a Form 1040 that can be electronically transmitted.

.05 A Form 1040, a Form 1040A, or a Form 1040EZ cannot be electronically filed after October 15, 1997, notwithstanding the fact that the taxpayer has been granted an extension to file a return beyond that date.

.06 An amended tax return cannot be electronically filed. A taxpayer must file an amended tax return on paper in accordance with the instructions for Form 1040X, Amended U.S. Individual Income Tax Return.

.07 A tax return that has a foreign address for the taxpayer cannot be electronically filed. Army/Air Force (APO) and Fleet (FPO) post offices are not considered foreign addresses.

.08 A tax return for a decedent cannot be electronically filed. The decedent's spouse or personal representative must file a paper tax return for the decedent.

.09 This revenue procedure updates Rev. Proc. 96–20, which applied to the On-Line Filing Program for the 1996 filing season. The updates include changes in the On-Line Filing Program for the 1997 filing season, clarifications of prior On-Line Filing Program statements, and additional guidance derived from other Service documents that relate to the On-Line Filing Program. Some of the updates are:

(1) in certain circumstances, a letter may be submitted in lieu of a revised Form 8633 (section 4.04);

(2) the time period to submit a revised Form 8633 is extended to 30 days (section 4.05);

(3) a fee for the electronic transmission of a tax return may not be computed using any amount from the return (section 5.04);

(4) a revised Form 8633 must be filed with the IRS Headquarters On-Line Filing Analyst (section 5.05);

(5) the time period for an On-Line Filer to notify the Service that it is discontinuing its participation in the On-Line Filing Program is extended to 30 days (section 5.06);

(6) a Software Developer must ensure that its software package cannot be used to transmit more than three electronic returns (section 5.10(3));

(7) a Software Developer must ensure that its software package contains a Form 8453–OL format that can be printed and used by a taxpayer to file with the Service (section 5.10(4));

(8) a Software Developer must ensure that its software package contains a consent to disclosure statement (section 5.10(5));

(9) a Software Developer must provide software and accompanying documentation to the IRS Headquarters On-Line Filing Analyst once the software has been successfully tested (section 5.10(6));

(10) a Transmitter must transmit electronic returns to the appropriate service center based on the state code in the taxpayer's return address (section 5.11(3));

(11) a Transmitter must enter the letter "O" in Field #15 (Transmission Type Code) when transmitting the electronic portion of an on-line electronically filed return to the Service (section 5.13);

(12) a Transmitter must not combine the electronic portion of an on-line electronically filed return with the electronic portion of any other return within the same transmission to the Service (section 5.14);

(13) a Transmitter must provide a taxpayer with the appropriate service center's address for mailing the Form 8453–OL (section 5.15(5));

(14) a Software Developer that performs a function in the On-line Filing Program other than software development is a tax return preparer under the definition of § 301.7216–1(a) of the Regulations on Procedure and Administration (section 6.01(1));

(15) a taxpayer will mail Form 8453–OL to the appropriate service center (section 7.01);

(16) the effect of suspending a Principal or a Responsible Official, on entities that listed the Principal or Responsible Official on their Forms 8633, is clarified (section 12.02);

(17) the two-year periods for denial and suspension are modified and clarified (sections 12.09 and 12.10);

(18) the time and method to respond to a proposed letter of denial and a denial letter are clarified (sections 13.03 and 13.06); and

(19) the time and method to respond to a proposed suspension letter and a suspension letter are clarified (sections 14.02 and 14.05).

SECTION 3. ON-LINE FILING PARTICIPANTS—DEFINITIONS

.01 After acceptance into the On-Line Filing Program, as described in section 4 of this revenue procedure, a participant is referred to as an "On-Line Filer."

.02 An On-Line Filer is categorized as follows:

(1) ON-LINE SERVICE PROVIDER. An "On-Line Service Provider" is an on-line information service organization that provides paying subscribers dial-up access to a variety of data bases. For purposes of the On-Line Filing Program, an On-Line Service Provider must also have:

(a) an established subscriber or client base to whom the On-Line Service Provider offers services on a continuing basis and about which the On-Line Service Provider maintains certain minimum information identifying the subscriber. Such information could include the subscriber's name, account number, or credit card or demand deposit account number;

(b) a port capacity of at least 1,000 lines or the ability to simultaneously service 1,000 customers;

(c) a network of personal computers that are linked by modems;

(d) access to a broad spectrum of information and/or entertainment services; and

(e) a client base that has the ability to communicate using electronic mail.

(2) SOFTWARE DEVELOPER. A "Software Developer" develops software for the purposes of (a) formatting returns according to the Service's electronic return specifications; and/or (b) transmitting electronic returns directly to the Service. A Software Developer may also sell its software.

(3) TRANSMITTER. A "Transmitter" transmits the electronic portion of a return directly to the IRS Data Communications Subsystem. An entity that provides a "bump-up" service is a Transmitter. A "bump-up" service provider increases the transmission rate or line speed of formatted or reformatted information that is being sent to the Service via a public switched telephone network. For example, a bump-up service provider may increase the transmission rate or line speed of information from 4800 bits per second (BPS) to 9600 BPS. Service specifications for electronic filing require an asynchronous speed of 300 BPS to 38,400 BPS or a bisynchronous speed of 4800 BPS to 19,200 BPS.

.03 The On-Line Filer categories are not mutually exclusive. For example, an On-line Service Provider can, at the same time, be considered a Transmitter or Software Developer depending on the function(s) performed.

SECTION 4. ACCEPTANCE IN THE ON-LINE FILING PROGRAM

.01 The Service will review and process applications received on or before December 2, 1996, for acceptance into the 1997 On-Line Filing Program.

.02 Applicants and On-Line Filers are required to submit a new Form 8633 designated for the On-Line Filing Program (hereinafter "Form 8633"), with fingerprint cards for appropriate individuals, to the IRS Headquarters On-Line Filing Analyst (see section 17 of this revenue procedure) if:

(1) the applicant has never participated in the On-Line Filing Program;

(2) the On-Line Filer intends to function as an On-Line Service Provider or a Transmitter during the 1997 On-Line Filing Program;

(3) the applicant has previously been denied participation in the On-Line Filing Program; or

(4) the applicant has been suspended from the On-Line Filing Program.

.03 An On-Line Filer must submit a revised Form 8633, signed by all Principals and the Responsible Official, with completed fingerprint cards for the appropriate individuals if:

(1) there is an additional Principal, such as a partner or corporate officer, that must be listed on Form 8633, line 8 (formerly line 1k(1)), "Principals of Your Firm or Organization";

(2) there is a "Principal" listed on Form 8633, line 1k(1), that should be deleted; or

(3) the "Responsible Official" on Form 8633, line 9 (formerly line 1k(2)) changes.

.04 An On-Line Filer must submit either a revised Form 8633 or a letter containing the same information contained in a revised Form 8633 if there is any change to the following:

(1) the Firm name or Doing Business As (DBA) name;

(2) the business or mailing address;

(3) the contact representative or the alternate contact representative's name or telephone number; or

(4) the On-Line Filer's form of organization, as described on Form 8633, line 1k;

A Form 8633 or letter submitted under this section needs to include only the information requested on lines 1a through 1i of Form 8633 and the information being revised and must be submitted within 30 days of the change(s). A Principal or Responsible Official must sign the Form 8633 or the letter.

.05 Revised applications described in section 4.03 or 4.04 of this revenue procedure must be submitted to the IRS Headquarters On-Line Filing Analyst within 30 days of the change(s).

.06 Applicants and On-Line Filers that intend to function as a Transmitter or a Software Developer in the 1997 On-Line Filing Program must first successfully complete the necessary testing at the appropriate service center(s).

.07 Each individual listed as a Principal or a Responsible Official must:

(1) be a United States citizen or an alien lawfully admitted for permanent residence as described in 8 U.S.C. § 1101(a)(20) (1994);

(2) have attained the age of 21 as of the date of application;

(3) submit with Form 8633 one standard fingerprint card with a full set of fingerprints taken by a law enforcement agency, except as provided in subsection 4.08 of this revenue procedure; and

(4) pass a suitability check that includes a credit check and a fingerprint check.

.08 An individual may choose to submit evidence of the individual's professional status in lieu of one standard fingerprint card if the individual is:

(1) an attorney in good standing of the bar of the highest court of any State, possession, territory, Commonwealth, or the District of Columbia, and is not currently under suspension or disbarment from practice before the Service;

(2) a certified public accountant who is duly qualified to practice as a certified public accountant in any State, possession, territory, Commonwealth, or

the District of Columbia, and is not currently under suspension or disbarment from practice before the Service;

(3) an enrolled agent pursuant to part 10 of 31 C.F.R. Subtitle A;

(4) an officer of a publicly held corporation; or

(5) a banking official who is bonded and has been fingerprinted within the last two years.

.09 The Service will issue credentials for the 1997 On-Line Filing Program to eligible applicants and On-Line Filers (provided they have first satisfactorily completed the testing described in section 4.06 of this revenue procedure). No one may participate in the On-Line Filing Program for the 1997 filing season without the following credentials:

(1) a letter of acceptance into the On-Line Program for the 1997 filing season;

(2) an Electronic Filing Identification Number (EFIN) for each applicable service center; and

(3) if appropriate, an Electronic Transmitter Identification Number (ETIN) for each applicable service center.

.10 If an On-Line Filer is a Software Developer that performs no other function in the On-Line Filing Program but software development, no Principal or Responsible Official needs to pass a suitability check.

.11 The following reasons, which apply to any firm, organization, Principal, or Responsible Official listed on Form 8633, may result in the rejection of an application to participate in the 1997 On-Line Filing Program (this list is not all-inclusive):

(1) conviction of any criminal offense under the revenue laws of the United States, or of any offense involving dishonesty or breach of trust;

(2) failure to file timely and accurate tax returns, including returns indicating that no tax is due;

(3) failure to timely pay any tax liabilities;

(4) assessment of tax penalties;

(5) suspension/disbarment from practice before the Service;

(6) other facts or conduct of a disreputable nature that would reflect adversely on the On-Line Filing Program;

(7) misrepresentation on an application;

(8) suspension or rejection from either the Electronic Filing Program or the On-Line Filing Program in a prior year;

(9) unethical practices in return preparation;

(10) stockpiling returns prior to official acceptance into the On-Line Filing Program (see section 5.20 of this revenue procedure);

(11) knowingly and directly or indirectly employing or accepting assistance from any firm, organization, or individual that is prohibited from applying to participate in the Electronic Filing Program or the On-Line Filing Program, or that is suspended from participating in the Electronic Filing Program or the On-Line Filing Program. This includes any individual whose actions resulted in the rejection or suspension of a corporation or a partnership from the Electronic Filing Program or the On-Line Filing Program; or

(12) knowingly and directly or indirectly accepting employment as an associate, correspondent, or as a subagent from, or sharing fees with, any firm, organization, or individual that is prohibited from applying to participate in the Electronic Filing Program or the On-Line Filing Program, or that is suspended from participating in the Electronic Filing Program or the On-Line Filing Program. This includes any individual whose actions resulted in the rejection or suspension of a corporation or a partnership from the Electronic Filing Program or the On-Line Filing Program.

SECTION 5. RESPONSIBILITIES OF AN ON-LINE FILER

.01 To ensure that complete returns are accurately and efficiently filed, an On-Line Filer must comply with all the publications and notices of the Service. Currently, these publications and notices include:

(1) Handbook for Electronic Filers of Individual Income Tax Returns, Publication 1345 and Handbook for Electronic Filers of Individual Income Tax Returns (Supplement), Publication 1345A;

(2) Electronic Return File Specifications and Record Layouts for Individual Income Tax Returns, Publication 1346;

(3) Test Package for Electronic Filing of Individual Income Tax Returns, Publication 1436; and

(4) Postings to the Electronic Filing System Bulletin Board (EFS Bulletin Board).

.02 An On-Line Filer must maintain a high degree of integrity, compliance, and accuracy.

.03 An On-Line Filer may only accept returns for on-line electronic filing directly from taxpayers or from another On-Line Filer.

.04 If an On-Line Filer charges a fee for the electronic transmission of a tax return, the fee may not be based on a percentage of the refund amount or any other amount from the tax return.

.05 An On-Line Filer must submit a revised Form 8633 to the IRS Headquarters On-Line Filing Analyst within 30 days of when any of the conditions or changes described in section 4.03 or 4.04 of this revenue procedure occur.

.06 An On-Line Filer must notify the IRS Headquarters On-Line Filing Analyst within 30 days of discontinuing its participation in the On-Line Filing Program. This does not preclude reapplication in the future.

.07 An On-Line Filer must ensure that an on-line electronic return is filed on or before the due date of the return. A tax return is not considered filed until the electronic portion of the tax return has been acknowledged by the Service as accepted for processing and a completed and signed Form 8453–OL has been received by the Service. However, if the electronic portion of a return is successfully transmitted on or shortly before the due date and the taxpayer complies with section 7.01 of this revenue procedure, the return will be deemed timely filed. If the electronic portion of a return is initially transmitted on or shortly before the due date and is ultimately rejected, but the taxpayer complies with section 5.17 of this revenue procedure, the return will be deemed timely filed. In the case of a balance due return, see section 10 of this revenue procedure for instructions on how to make a timely payment of tax.

.08 An On-Line Filer must ensure that no other entity uses its EFIN or ETIN. An On-Line Filer must not transfer its EFIN or ETIN by sale, loan, gift, or otherwise to another entity.

.09 An On-Line Filer that functions as an On-Line Service Provider must:

(1) provide assistance to a subscriber in transmitting the electronic portion of a tax return;

(2) ensure that no more than three tax returns are filed electronically by one subscriber;

(3) not provide to a subscriber software that has a Service-assigned production password built into the software;

(4) immediately deliver to a subscriber the information provided by a Transmitter under section 5.16 or 5.17 of this revenue procedure; and

(5) if requested, inform a subscriber that information regarding a refund can be obtained by using the IRS TeleTax system or contacting the appropriate service center's customer service department.

.10 An On-Line Filer that functions as a Software Developer must:

(1) promptly correct any software error which causes an electronic return to be rejected;

(2) promptly distribute any software correction;

(3) ensure that its software package cannot be used to transmit more than three electronic returns;

(4) ensure that its software package contains a Form 8453–OL format that can be printed and used by a taxpayer to file with the Service;

(5) ensure that its software package contains a consent to disclosure statement;

(6) provide software and accompanying documentation provided to a purchaser of its software (a demonstration package is sufficient to satisfy this requirement) to the IRS Headquarters On-Line Filing Analyst, once the software has been successfully tested for the 1997 filing season (see section 4.06 of this revenue procedure); and

(7) not incorporate into its software a Service-assigned production password.

.11 An On-Line Filer that functions as a Transmitter must:

(1) assign (as prescribed in Publication 1345) a Declaration Control Number (DCN) to the electronic portion of each return received from a taxpayer;

(2) include the assigned DCN in the transmission of the electronic portion of a return;

(3) transmit all electronic returns within three calendar days of receipt to the appropriate service center based on the state code in the taxpayer's return address;

(4) retrieve the acknowledgement file within two work days of transmission;

(5) match the acknowledgement file to the original transmission file and notify the taxpayer of the status of a transmitted return as prescribed in section 5.18 of this revenue procedure;

(6) retain, until the end of the calendar year in which a return was filed, an acknowledgement file received from the Service;

(7) retain, until the end of the calendar year in which a return was filed, a complete copy of the electronic portion of the return (may be retained on magnetic media) that can be readily and accurately converted into an electronic transmission that the Service can process;

(8) immediately contact the Electronic Filing Unit at the appropriate service center for further instructions if an acknowledgement of acceptance for processing has not been received by the Transmitter within two work days of transmission or if the Transmitter receives an acknowledgement for a return that was not transmitted on the designated transmission;

(9) promptly correct any transmission error that causes an electronic transmission to be rejected;

(10) contact the Electronic Filing Unit at the appropriate service center for assistance if a return has been rejected after three transmission attempts;

(11) ensure the security of all transmitted data;

(12) ensure that it does not transmit or accept for transmission more than three electronic returns originating from one software package;

(13) ensure that the electronic portion of a return contains a completed consent to disclosure statement; and

(14) ensure that it does not use software that has a Service-assigned production password built into the software.

.12 A Transmitter must include an On-Line Service Provider's EFIN on each return that the Transmitter accepts from an On-Line Service Provider.

.13 A Transmitter must enter the letter "O" in Field #15 (Transmission Type Code) when transmitting the electronic portion of an on-line electronically filed return to the Service. See Part II, Section 1, page 4, of Publication 1346.

.14 A Transmitter must ensure that it does not combine the electronic portion of an on-line electronically filed return with the electronic portion of any other return within the same transmission to the Service.

.15 If the electronic portion of a taxpayer's return is acknowledged as accepted by the Service, the Transmitter must notify the taxpayer, as prescribed in section 5.18 of this revenue procedure, of the following:

(1) the date the transmission was accepted;

(2) the DCN;

(3) where to put the DCN on Form 8453–OL;

(4) the requirement to properly complete and timely submit a Form 8453–OL with accompanying paper documents within one work day;

(5) the appropriate service center's address to which Form 8453–OL with accompanying paper documents must be sent;

(6) that a Form 8453–OL must be received by the Service before an on-line electronically filed return is complete; and

(7) the taxpayer's failure to timely submit a Form 8453–OL with accompanying paper documents could result in the Service not allowing the taxpayer to file a tax return through the On-Line Filing Program in the future.

.16 If the electronic portion of a taxpayer's return is acknowledged as rejected by the Service, the Transmitter must notify the taxpayer, as prescribed in section 5.18 of this revenue procedure, of the following:

(1) that the electronic portion of the return submitted by the taxpayer has not been accepted for processing;

(2) the date of the rejection;

(3) what the reject code means;

(4) what steps the taxpayer needs to take to correct the error that caused the rejection; and

(5) the information contained in section 5.17 of this revenue procedure.

.17 If the taxpayer chooses not to have the rejected return retransmitted or if the return cannot be accepted for processing, the taxpayer, in order to file a timely return, must file a paper return by the later of:

(1) the due date of the return; or

(2) within ten calendar days of the Service's acknowledgment that the return is rejected or notification that the return cannot be retransmitted, with an explanation of why the return is being filed after the due date.

.18 A Transmitter that transmits a return of a taxpayer who is a subscriber of an On-Line Service Provider must notify the taxpayer by sending an electronic transmission to the On-Line Service Provider within two work days of retrieving the acknowledgement file. A Transmitter that transmits a return of a

taxpayer who is not a subscriber of an On-Line Service Provider must notify the taxpayer by:

(1) sending an electronic transmission to the taxpayer within two work days of retrieving the acknowledgement file; or

(2) mailing a written notification to the taxpayer within one work day of retrieving the acknowledgement file.

.19 A Transmitter must, if requested, make available to the Service all items required by this section to be retained until the end of the calendar year in which a return was filed. The Transmitter must make this material available either at the business address of the Transmitter or from the contact representative named on Form 8633.

.20 A Transmitter is responsible for ensuring that stockpiling does not occur. Stockpiling means collecting returns from taxpayers prior to official acceptance into the On-Line Filing Program, or, after official acceptance into the On-Line Filing Program, waiting more than three calendar days to transmit a return to the Service after receiving the information necessary for an electronic transmission of a tax return.

.21 An On-Line Filer may not offer, nor in any way participate in or facilitate, a Refund Anticipation Loan (RAL) in connection with any return filed under the On-Line Filing Program. A RAL is money borrowed by a taxpayer that is based on a taxpayer's anticipated income tax refund.

.22 An On-Line Filer may not charge a separate fee for a Direct Deposit. See section 9 of this revenue procedure.

.23 In addition to the specific responsibilities described in this section, an On-Line Filer must meet all the requirements in this revenue procedure to keep the privilege of participating in the On-Line Filing Program.

SECTION 6. PENALTIES

.01 *Penalties for Disclosure or Use of Information.*

(1) An On-Line Filer, except a Software Developer that performs no other function in the On-Line Filing Program but software development, is a tax return preparer (Preparer) under the definition of § 301.7216–1(b) of the Regulations on Procedure and Administration. A Preparer is subject to a criminal penalty for disclosure or use of tax return information, as described in § 301.7216–1(a). In general, that regulation provides that any preparer who discloses or uses any tax return information for a purpose other than preparing, assisting in preparing, or obtaining or providing services in connection with the preparation of a tax return is guilty of a misdemeanor. In addition, § 6713 of the Internal Revenue Code provides for civil penalties that may be assessed against a preparer who makes an unauthorized disclosure or use of tax return information.

(2) Under § 301.7216–2(h), disclosure of tax return information among accepted On-Line Filers for the purpose of preparing a return is permissible. For example, it is permissible for an On-Line Service Provider to pass on tax return information to a Transmitter for the purpose of having an on-line electronic return formatted and transmitted to the Service. However, if the tax return information is disclosed or used in any other way, an On-Line Filer may be guilty of a misdemeanor as described in section 6.01(1) of this revenue procedure.

.02 *Other Preparer Penalties.*

(1) Preparer penalties may be asserted against an individual or firm who meets the definition of an income tax return preparer under § 7701(a)(36) and § 301.7701–15. Examples of preparer penalties that may be asserted under appropriate circumstances include, but are not limited to, those set forth in §§ 6694, 6695, and 6713.

(2) Under § 301.7701–15(d), an On-Line Filer is not an income tax return preparer for the purpose of assessing most preparer penalties as long as the On-Line Filer's services are limited to "typing, reproduction, or other mechanical assistance in the preparation of a return or claim for refund."

(3) If an On-Line Filer alters the return information in a nonsubstantive way, this alteration will be considered to come under the "mechanical assistance" exception described in § 301.7701–15(d)(1). A nonsubstantive change is a correction or change limited to a transposition error, misplaced entry, spelling error, or arithmetic correction that falls within the following tolerances:

(a) the Total Tax amount, Withholding amount, Refund amount, or Amount Owed shown on Form 8453–OL differs from the corresponding amount on the electronic portion of the tax return by no more than $7;

(b) the Total Income amount shown on Form 8453–OL differs from the corresponding amount on the electronic portion of the tax return by no more than $25; or

(c) dropping cents and rounding to whole dollars.

(4) If an On-Line Filer alters the return information in a substantive way, rather than having the taxpayer alter the return, the On-Line Filer will be considered to be an income tax return preparer for purposes of § 7701(a)(36).

(5) If an On-Line Filer goes beyond mechanical assistance, the On-Line Filer may be held liable for income tax return preparer penalties. Rev. Rul. 85–189, 1985–2 C.B. 341, describes a situation where a Software Developer was determined to be an income tax return preparer and subject to certain preparer penalties.

.03 In addition to the above specified provisions, the Service reserves the right to assert all appropriate preparer, nonpreparer, and disclosure penalties against an On-Line Filer as warranted under the circumstances.

SECTION 7. FORM 8453–OL, U.S. INDIVIDUAL INCOME TAX DECLARATION FOR ON-LINE FILING

.01 Procedures for Completing Form 8453–OL.

(1) Form 8453–OL must be completed by the taxpayer in accordance with the instructions for Form 8453–OL.

(2) The taxpayer(s)'s name, address, social security number(s), tax return information, and direct deposit of refund information in the electronic transmission must be identical to the information on the Form 8453–OL that the taxpayer(s) signs and will mail to the appropriate service center.

(3) If the electronic portion of a return was filed as a joint return, both spouses' signatures are required on Form 8453–OL.

(4) The taxpayer's Form 8453–OL must be sent to the address of the appropriate service center within one work day after the taxpayer is provided notification that the electronic portion of the taxpayer's return has been accepted for processing.

.02 If the Service determines that a Form 8453–OL is missing, the taxpayer must provide the Service with a replacement. A taxpayer must also provide a copy of any Form W–2, Wage and Tax Statement, Form W–2G, Certain Gambling Winnings, Form 1099–R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs,

Insurance Contracts, etc., and all other attachments to Form 8453–OL.

.03 If a substitute Form 8453–OL is used, it must be approved by the Service prior to use. See Rev. Proc. 96–48, 1996–39 I.R.B. 10.

SECTION 8. INFORMATION AN ON-LINE FILER MUST PROVIDE TO THE TAXPAYER

.01 The Transmitter must advise a taxpayer to retain a complete copy of the return and any supporting material.

.02 The Transmitter must advise the taxpayer that an amended return, if needed, must be filed as a paper return and mailed to the service center that would handle the taxpayer's paper return.

.03 The Transmitter must give the taxpayer the Declaration Control Number (DCN) for the taxpayer's Form 8453–OL and instructions to the taxpayer for entering the DCN on Form 8453–OL.

.04 If a taxpayer inquires about the status of a refund, the Transmitter, or On-Line Service Provider if the taxpayer is a subscriber, must advise the taxpayer to use the IRS TeleTax system or contact the appropriate service center's customer service department. The Transmitter or On-Line Service Provider should also advise the taxpayer to wait at least three weeks from the acceptance date of the electronic return before making an inquiry regarding the status of a refund.

.05 The Transmitter must inform the taxpayer that the address on the electronic portion of the return, once processed, will be used to update the taxpayer's address of record. The Internal Revenue Service uses the taxpayer's address of record for various notices that are required to be sent to a taxpayer's "last known address" under the Internal Revenue Code and for refunds of overpayments of tax (unless otherwise specifically directed by the taxpayer, such as by Direct Deposit).

SECTION 9. DIRECT DEPOSIT OF REFUNDS

.01 The Service will ordinarily process a request for Direct Deposit but reserves the right to issue a paper refund check.

.02 The Service does not guarantee a specific date by which a refund will be directly deposited into the taxpayer's financial institution account.

.03 Neither the Service nor Financial Management Service (FMS) is responsible for the misapplication of a Direct Deposit that is caused by error, negligence, or malfeasance on the part of the taxpayer, On-Line Filer, financial institution, or any of their agents.

SECTION 10. BALANCE DUE RETURNS

.01 An electronically filed balance due return is transmitted to the appropriate service center in the same manner that a refund or zero balance return is filed. A balance due return is not complete unless and until the Service receives Form 8453–OL completed and signed by the taxpayer.

.02 The Transmitter must furnish Form 1040–V, Electronic Payment Voucher, to a taxpayer who electronically files a balance due return.

.03 To expedite the crediting of a tax payment, a taxpayer who electronically files a balance due return should mail his or her tax payment with either Form 1040–V or the scannable payment voucher that is included in some tax packages. Each of these options has specific mailing instructions.

.04 A taxpayer who electronically files a balance due return must make a full and timely payment of any tax that is due. Failure to make full payment of any tax that is due on or before April 15, 1997, will result in the imposition of interest and may result in the imposition of penalties.

SECTION 11. ADVERTISING STANDARDS FOR ON-LINE FILERS

.01 An On-Line Filer shall comply with the advertising and solicitation provisions of 31 C.F.R. Part 10 (Treasury Department Circular No. 230). This circular prohibits the use or participation in the use of any form of public communication containing a false, fraudulent, misleading, deceptive, unduly influencing, coercive, or unfair statement or claim. In addition, advertising must not imply a special relationship with the Service, FMS, or the Treasury Department. Any claims concerning faster refunds by virtue of electronic filing must be consistent with the language in official Service publications.

.02 An On-Line Filer must adhere to all relevant federal, state, and local consumer protection laws that relate to advertising and soliciting.

.03 An On-Line Filer must not use the Service's name, "Internal Revenue Service" or "IRS", within a firm's name.

.04 An On-Line Filer must not use improper or misleading advertising in relation to the On-Line Filing Program (including the time frames for refunds).

.05 Use of Direct Deposit name and logo.

(1) The name "Direct Deposit" will be used with initial capital letters or all capital letters.

(2) The logo/graphic for Direct Deposit will be used whenever feasible in advertising copy.

(3) The color or size of the Direct Deposit logo/graphic may be changed when used in advertising pieces.

.06 Advertising materials shall not carry the FMS, IRS, or other Treasury Seals.

.07 Advertising for a cooperative electronic return project (public/private sector) must clearly state the names of all cooperating parties.

.08 If an On-Line Filer uses radio or television broadcasting to advertise, the broadcast must be pre-recorded. The On-Line Filer must keep a copy of the pre-recorded advertisement for a period of at least 36 months from the date of the last transmission or use.

.09 If an On-Line Filer uses direct mail or fax communications to advertise, the On-Line Filer must retain a copy of the actual mailing or fax, along with a list or other description of firms, organization, or individuals to whom the communication was mailed, faxed, or otherwise distributed for a period of at least 36 months from the date of the last mailing, fax, or distribution.

.10 Acceptance to participate in the On-Line Filing Program does not imply endorsement by the Service or FMS of the software or quality of services provided.

SECTION 12. MONITORING AND SUSPENSION OF AN ON-LINE FILER

.01 The Service will monitor an On-Line Filer for conformity with this revenue procedure. The Service can immediately suspend, without notice, an On-Line Filer from the On-Line Filing Program. However, in most circumstances, a suspension from participation in the On-Line Filing Program is effective as of the date of the letter informing the On-Line Filer of the suspension. Before suspending an On-Line Filer, the Service may issue a warning letter that

describes specific corrective action for deviations from this revenue procedure.

.02 If a Principal or Responsible Official is suspended from the On-Line Filing Program, every entity that listed the suspended Principal or Responsible Official on its Form 8633 may also be suspended.

.03 The Service will monitor the timely receipt of Forms 8453–OL.

.04 The Service will monitor the quality of an On-Line Filer's transmissions throughout the filing season. The Service will also monitor electronic returns and tabulate rejections, errors, and other defects. If quality deteriorates, the On-Line Filer will receive a warning from the Service.

.05 The Service will monitor complaints about an On-Line Filer and issue a warning or suspension letter as appropriate.

.06 The Service reserves the right to suspend the electronic filing privilege of any On-Line Filer that violates any provision of this revenue procedure. Generally, the Service will advise a suspended On-Line Filer concerning the requirements for reacceptance into the On-Line Filing Program. The following reasons may lead to a warning letter and/or suspension of an On-Line Filer from the On-Line Filing Program (this list is not all-inclusive):

(1) the reasons listed in section 4.11 of this revenue procedure;

(2) deterioration in the format of individual transmissions;

(3) unacceptable cumulative error or rejection rate;

(4) stockpiling returns at any time while participating in the On-Line Filing Program;

(5) failure on the part of a Transmitter to retrieve acknowledgement files within two work days of transmission by the Service;

(6) failure on the part of a Transmitter to notify the taxpayer, as prescribed in section 5.18 of this revenue procedure, of the status of a transmitted return within two work days of receipt of the acknowledgement files from the Service;

(7) failure on the part of an On-Line Service Provider to ensure that no more than three tax returns are filed electronically by one subscriber;

(8) failure on the part of a Transmitter to ensure that it does not transmit or accept for transmission more than three electronic returns originating from one software package;

(9) significant complaints about an On-Line Filer;

(10) failure on the part of an On-Line Filer to ensure that no other entity uses its EFIN and/or ETIN;

(11) having more than one EFIN for the same business entity at the same location (the business entity is generally the entity that reports on its return the income derived from electronic filing), unless the Service has issued more than one EFIN to a business entity.

(12) failure on the part of an On-Line Filer to cooperate with the Service's efforts to investigate electronic filing abuse;

(13) violation of the advertising standards described in section 11 of this revenue procedure;

(14) failure to maintain and make available records as described in section 5.19 of this revenue procedure;

(15) failure to supply a taxpayer with an accurate DCN;

(16) failure to give effective instructions to a taxpayer concerning the entry of the DCN on Form 8453–OL;

(17) failure to timely pay any applicable fees, as implemented by subsequent guidance; or

(18) failure to timely submit a revised Form 8633 or a letter containing the same information contained in a revised Form 8633 notifying the Service of changes described in section 4.03 or 4.04 of this revenue procedure.

.08 The Service may list in the Internal Revenue Bulletin, district office listings, district office newsletters, and on the EFS Bulletin Board the name and owner(s) of any entity suspended from the On-Line Filing Program and the effective date of the suspension.

.09 If an application for participation in the On-Line Filing Program is denied, the applicant is ineligible to submit a new application for two years from the application date of the denied application.

.10 If a participant is suspended from participating in the On-Line Filing Program, the period of suspension includes the remainder of the calendar year in which the suspension occurs plus the next two calendar years. A suspended participant may submit a new application for the application period immediately preceding the end of the suspension.

SECTION 13. ADMINISTRATIVE REVIEW PROCESS FOR DENIAL OF PARTICIPATION IN THE ON-LINE FILING PROGRAM

.01 An applicant that has been denied participation in the On-Line Filing Program has the right to an administrative review. During the administrative review process, the denial of participation remains in effect.

.02 In response to the submission of a Form 8633, the appropriate district office will either (1) accept an applicant into the On-Line Filing Program, or (2) issue a proposed letter of denial that explains to the applicant why the district office proposes to reject the application to participate in the On-Line Filing Program.

.03 An applicant who receives a proposed letter of denial may mail or deliver, within 30 calendar days of the date of the proposed letter of denial, a written response to the district office that issued the proposed letter of denial. The applicant's response must address the district office's explanation for proposing the denial to participate.

.04 Upon receipt of an applicant's written response, the district office will reconsider its proposed letter of denial. The district office may (1) withdraw its proposed letter of denial and admit the applicant into the On-Line Filing Program, or (2) finalize its proposed letter of denial and issue it to the applicant.

.05 If an applicant receives a final letter from the district office that denies the applicant participation in the On-Line Filing Program, the applicant is entitled to an appeal, in writing, to the Director of Practice.

.06 The appeal must be mailed or delivered to the district office that issued the denial letter within 30 calendar days of the date of the denial letter. An applicant's written appeal must contain a detailed explanation, with supporting documentation, of why the denial should be reversed. In addition, the applicant must include a copy of the applicant's Form 8633 and a copy of the denial letter.

.07 The district office whose denial is being appealed will, upon receipt of a written appeal to the Director of Practice, forward to the Director of Practice its file on the applicant and the material described in section 13.06 of this revenue procedure that the applicant has submitted to the district office. The district office will forward to the Director of Practice these materials within 15

calendar days of receipt of the applicant's written appeal to the Director of Practice.

.08 Failure to respond within the 30-day periods described in sections 13.03 and 13.06 of this revenue procedure irrevocably terminates an applicant's right to an administrative review or appeal.

SECTION. 14. ADMINISTRATIVE REVIEW PROCESS FOR SUSPENSION FROM THE ON-LINE FILING PROGRAM

.01 An On-Line Filer that has been suspended from participation in the On-Line Filing Program has the right to an administrative review. During the administrative review process, the suspension remains in effect.

.02 If an On-Line Filer receives a proposed suspension letter, the On-Line Filer may mail or deliver, within 30 calendar days of the date of the proposed suspension letter, a detailed written explanation, with supporting documentation, of why the proposed suspension letter should be withdrawn. This written response should be sent to the district office or service center that issued the proposed suspension letter.

.03 Upon receipt of the On-Line Filer's written response, the district office or service center will reconsider its proposed suspension of the On-Line Filer. The district office or service center will either withdraw its proposed suspension letter and reinstate the On-Line Filer or issue a suspension letter to the On-Line Filer.

.04 If the On-Line Filer receives a suspension letter from a district office or a service center, the On-Line Filer is entitled to an appeal, in writing, to the Director of Practice.

.05 The appeal must be mailed or delivered to the district office or service center that issued the suspension letter within 30 calendar days of the date of the suspension letter. The On-Line Filer's written appeal must contain detailed reasons, with supporting documentation, for reversal of the suspension. In addition, the On-Line Filer must include a copy of its Form 8633 and a copy of the suspension letter.

.06 The district office or service center whose decision to suspend is being appealed will, upon receipt of a written appeal to the Director of Practice, forward to the Director of Practice its file on the On-Line Filer and the material described in section 14.05 of this revenue procedure that the On-Line Filer has submitted to the district office or the service center. The district office or the service center will forward to the Director of Practice these materials within 15 calendar days of the receipt of an On-Line Filer's written request for appeal.

.05 Failure to appeal within the 30-day period described in section 14.05 of this revenue procedure irrevocably terminates an On-Line Filer's right to an appeal.

SECTION 15. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 96–20, 1996–4 I.R.B. 88, is superseded.

SECTION 16. EFFECTIVE DATE

This revenue procedure is effective December 30, 1996.

SECTION 17. INTERNAL REVENUE SERVICE OFFICE CONTACT

All questions regarding the electronic filing aspects of the On-Line Filing Program should be directed to the Electronic Filing Office. The telephone number for this purpose is (202) 283–1010 (not a toll-free number). All questions regarding the on-line aspects of this program should be directed to the IRS Headquarters On-Line Filing Analyst. The telephone number for this purpose is (202) 283–0265 (not a toll-free number).

SECTION 18. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1513.

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

The collections of information in this revenue procedure are in sections 5, 8, and 11 of the revenue procedure. This information is required by the IRS to implement the On-Line Filing Program and to enable taxpayers to file their individual income tax returns electronically through the On-Line Filing Program. The information will be used to ensure that taxpayers receive accurate and essential information regarding the filing of their return through the On-Line Filing Program and to identify the persons involved in the filing of a return through the On-Line Filing Program. The collections of information are required to retain the benefit of participating in the On-Line Filing Program. The likely respondents are business or other for-profit institutions.

The estimated total annual reporting and recordkeeping burden is 5,919 hours.

The estimated annual burden per respondent/recordkeeper varies from eight (8) minutes to 455 hours, depending on individual circumstances, with an estimated average of 423 hours (or approximately two (2) minutes per on-line electronically filed return). The estimated number of respondents and recordkeepers is 14.

The estimated annual frequency of responses is on occasion.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. § 6103.

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.
(Also Part I, Sections 62, 162, 274, 1016; 1.62–2, 1.162–17, 1.274–5T, 1.274(d)–1, 1.1016–3.)

Rev. Proc. 96–63

SEC. 1. PURPOSE

This revenue procedure updates Rev. Proc. 95–54, 1995–2 C.B. 450, by providing optional standard mileage rates for employees, self-employed individuals, or other taxpayers to use in computing the deductible costs paid or incurred on or after January 1, 1997, of operating a passenger automobile for business, charitable, medical, or moving expense purposes. This revenue procedure also provides rules under which the amount of ordinary and necessary expenses of local travel or transportation away from home that are paid or incurred by an employee will be deemed substantiated under § 1.274–5T of the temporary Income Tax Regulations when a payor (the employer, its agent, or a third party) provides a mileage allowance under a reimbursement or other expense allowance arrangement to pay for such expenses. Use of a method of substantiation described in this revenue procedure is not mandatory and a taxpayer may

use actual allowable expenses if the taxpayer maintains adequate records or other sufficient evidence for proper substantiation.

SEC. 2. SUMMARY OF STANDARD MILEAGE RATES

Business (Sec. 5 below)
31.5 cents per mile
Rural Mail Carrier (Sec. 6 below)
47.25 cents per mile
Charitable (Sec. 7 below)
12 cents per mile
Medical and Moving (Sec. 7 below)
10 cents per mile

SEC. 3. BACKGROUND

.01 Section 162(a) of the Internal Revenue Code allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Under that provision, an employee or self-employed individual may deduct the cost of operating a passenger automobile to the extent that it is used in a trade or business. However, under § 262, no portion of the cost of operating a passenger automobile that is attributable to personal use is deductible.

.02 Section 274(d) provides, in part, that no deduction shall be allowed under § 162 with respect to any listed property (as defined in § 280F(d)(4) to include passenger automobiles and any other property used as a means of transportation) unless the taxpayer complies with certain substantiation requirements. The section further provides that regulations may prescribe that some or all of the substantiation requirements do not apply to an expense that does not exceed an amount prescribed by such regulations.

.03 Section 1.274(d)–1 in part, grants the Commissioner the authority to prescribe rules relating to mileage allowances for ordinary and necessary expenses of local travel and transportation away from home. Pursuant to this grant of authority, the Commissioner may prescribe rules under which such allowances, if in accordance with reasonable business practice, will be regarded as (1) equivalent to substantiation, by adequate records or other sufficient evidence, of the amount of such travel and transportation expenses for purposes of § 1.274–5T(c), and (2) satisfying the requirements of an adequate accounting to the employer of the amount of such expenses for purposes of § 1.274–5T(f).

.04 Section 62(a)(2)(A) allows an employee, in determining adjusted gross income, a deduction for the expenses allowed by Part VI (§ 161 and following), subchapter B, chapter 1 of the Code, paid or incurred by the employee in connection with the performance of services as an employee under a reimbursement or other expense allowance arrangement with a payor.

.05 Section 62(c) provides that an arrangement will not be treated as a reimbursement or other expense allowance arrangement for purposes of § 62(a)(2)(A) if it—

(1) does not require the employee to substantiate the expenses covered by the arrangement to the payor, or

(2) provides the employee with the right to retain any amount in excess of the substantiated expenses covered under the arrangement. Section 62(c) further provides that the substantiation requirements described therein shall not apply to any expense to the extent that, under the grant of regulatory authority prescribed in § 274(d), the Commissioner has provided that substantiation is not required for such expense.

.06 Under § 1.62–2(c)(1) a reimbursement or other expense allowance arrangement satisfies the requirements of § 62(c) if it meets the requirements of business connection, substantiation, and returning amounts in excess of expenses as specified in the regulations. Section 1.62–2(e)(2) specifically provides that substantiation of certain business expenses in accordance with rules prescribed under the authority of § 1.274(d)–1 will be treated as substantiation of the amount of such expenses for purposes of § 1.62–2. Under § 1.62–2(f)(2), the Commissioner may prescribe rules under which an arrangement providing mileage allowances will be treated as satisfying the requirement of returning amounts in excess of expenses, even though the arrangement does not require the employee to return the portion of such an allowance that relates to miles of travel substantiated and that exceeds the amount of the employee's expenses deemed substantiated pursuant to rules prescribed under § 274(d), provided the allowance is reasonably calculated not to exceed the amount of the employee's expenses or anticipated expenses and the employee is required to return any portion of such an allowance that relates to miles of travel not substantiated.

.07 Section 1.62–2(h)(2)(i)(B) provides that if a payor pays a mileage allowance under an arrangement that meets the requirements of § 1.62–2(c)(1), the portion, if any, of the allowance that relates to miles of travel substantiated in accordance with § 1.62–2(e), that exceeds the amount of the employee's expenses deemed substantiated for such travel pursuant to rules prescribed under §§ 274(d) and 1.274(d)–1, and that the employee is not required to return, is subject to withholding and payment of employment taxes. See §§ 31.3121(a)–3, 31.3231(e)–3, 31.3306(b)–2, and 31.3401(a)–4. Because the employee is not required to return this excess portion, the reasonable period of time provisions of § 1.62–2(g) (relating to the return of excess amounts) do not apply to this excess portion.

.08 Under § 1.62–2(h)(2)(i)(B)(4), the Commissioner may, in his or her discretion, prescribe special rules regarding the timing of withholding and payment of employment taxes on mileage allowances.

SEC. 4. DEFINITIONS

.01 *Standard mileage rate.* The term "standard mileage rate" means the applicable amount provided by the Service for optional use by employees or self-employed individuals in computing the deductible costs of operating passenger automobiles owned by them (including vans, pickups, or panel trucks) for business purposes, or by taxpayers in computing the deductible costs of operating passenger automobiles for charitable, medical, or moving expense purposes.

.02 *Transportation expenses.* The term "transportation expenses" means the expenses of operating a passenger automobile for local travel or transportation away from home.

.03 *Mileage allowance.* The term "mileage allowance" means a payment under a reimbursement or other expense allowance arrangement that meets the requirements specified in § 1.62–2(c)(1) and that is

(1) paid with respect to the ordinary and necessary business expenses incurred, or which the payor reasonably anticipates will be incurred, by an employee for transportation expenses in connection with the performance of services as an employee of the employer,

(2) reasonably calculated not to exceed the amount of the expenses or the anticipated expenses, and

(3) paid at the applicable standard mileage rate, a flat rate or stated sched-

ule, or in accordance with any other Service-specified rate or schedule.

.04 *Flat rate or stated schedule.* A mileage allowance is paid at a flat rate or stated schedule if it is provided on a uniform and objective basis with respect to the expenses described in section 4.03. Such allowance may be paid periodically at a fixed rate, at a cents-per-mile rate, at a variable rate based on a stated schedule, at a rate that combines any of these rates, or on any other basis that is consistently applied and in accordance with reasonable business practice. Thus, for example, a periodic payment at a fixed rate to cover the fixed costs (including depreciation, insurance, registration and license fees, and personal property taxes) of driving an automobile in connection with the performance of services as an employee of the employer, coupled with a periodic payment at a cents-per-mile rate to cover the operating costs (including gasoline and all taxes thereon, oil, tires, and routine maintenance and repairs) of using an automobile for such purposes, is an allowance paid at a flat rate or stated schedule. Likewise, a periodic payment at a variable rate based on a stated schedule for different locales to cover the costs of driving an automobile in connection with the performance of services as an employee is an allowance paid at a flat rate or stated schedule.

SEC. 5. BUSINESS STANDARD MILEAGE RATE

.01 *In general.* The standard mileage rate for transportation expenses paid or incurred on or after January 1, 1997, is 31.5 cents per mile for all miles of use for business purposes. This business standard mileage rate will be adjusted annually (to the extent warranted) by the Service, and any such adjustment will be applied prospectively.

.02 *Use of the business standard mileage rate.* A taxpayer may, on a yearly basis, deduct an amount equal to either the business standard mileage rate times the number of business miles traveled or the actual costs (both operating and fixed) paid or incurred by the taxpayer that are allocable to traveling those business miles.

.03 *Business standard mileage rate in lieu of operating and fixed costs.* A deduction computed using the standard mileage rate for business miles is in lieu of operating and fixed costs of the automobile allocable to business purposes. Such items as depreciation, maintenance and repairs, tires, gasoline (including all taxes thereon), oil, insurance, and registration fees are included in operating and fixed costs.

.04 *Parking fees, tolls, interest, and taxes.* Parking fees and tolls attributable to use of the automobile for business purposes may be deducted as separate items. Likewise, interest relating to the purchase of the automobile as well as state and local taxes (other than those included in the cost of gasoline) may be deducted as separate items, but only to the extent that the interest or taxes are allowable deductions under § 163 or 164 respectively. If the automobile is operated less than 100 percent for business purposes, an allocation is required to determine the business and nonbusiness portion of the taxes and interest deduction allowable. However, § 163-(h)(2)(A) expressly provides that interest is nondeductible personal interest when it is paid or accrued on indebtedness properly allocable to the trade or business of performing services as an employee. Section 164 also expressly provides that state and local taxes that are paid or accrued by a taxpayer in connection with an acquisition or disposition of property will be treated as part of the cost of the acquired property or as a reduction in the amount realized on the disposition of such property.

.05 *Depreciation.*

For automobiles placed in service for business purposes, and for which the business standard mileage rate has been used for any year, depreciation will be considered to have been allowed at the rate of 11 cents a mile for 1989, 1990, and 1991; 11.5 cents a mile for 1992 and 1993; and 12 cents a mile for 1994, 1995, 1996, and 1997, for those years in which the business standard mileage rate was used. If actual costs were used for one or more of those years, the rates above will not apply to any year in which such costs were used. The depreciation described above will reduce the basis of the automobile (but not below zero) in determining adjusted basis as required by § 1016.

.06 *Limitations.*

(1) The business standard mileage rate may not be used to compute the deductible expenses of (a) vehicles used for hire, such as taxicabs, (b) two or more automobiles used simultaneously (such as in fleet operations), or (c) any vehicle that is leased, rather than owned, by the taxpayer.

(2) The business standard mileage rate may not be used if (a) the automobile has previously been depreciated using a method other than straight-line for its estimated useful life, (b) a § 179 deduction has been claimed, or (c) the taxpayer has used the Accelerated Cost Recovery System (ACRS) under former § 168 or the Modified Accelerated Cost Recovery System (MACRS) under current § 168. By using the business standard mileage rate, the taxpayer has elected to exclude the automobile from MACRS pursuant to § 168(f)(1). If, after using the business standard mileage rate, the taxpayer uses actual costs, the taxpayer must use straight-line depreciation for the automobile's remaining estimated useful life (subject to the applicable depreciation deduction limitations under § 280F for any passenger automobile).

SEC. 6. RURAL MAIL CARRIER SPECIAL MILEAGE RATE

.01 *Special mileage rate.* For taxable years beginning after December 31, 1987, § 6008 of the Technical and Miscellaneous Revenue Act of 1988, 1988–3 C.B. 347, 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 business standard mileage rate, and is 47.25 cents per mile for transportation expenses paid or incurred on or after January 1, 1997 (150 percent of the business standard mileage rate of 31.5 cents per mile). The special mileage rate applies to all business use of an automobile while performing qualifying services. It will be adjusted annually (to the extent warranted) by the Service to reflect changes in the business standard mileage rate, and any such adjustment will be applied prospectively.

.02 *Depreciation.* In determining the adjusted basis of an automobile used to perform qualifying services, depreciation will be computed as provided in section 5.05, except as provided in section 6.03.

.03 *Special depreciation rules.* 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. For this purpose, claiming depreciation means the deduction of any

amount under § 167, 168, or 179 (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 mileage 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.

.04 *Rural mail carrier special mileage rate in lieu of operating and fixed costs.* The rules provided under section 5.03 also apply to use of the special mileage rate.

.05 *Parking fees, tolls, interest, and taxes.* The rules provided under section 5.04 also apply to the use of the special mileage rate.

SEC. 7. CHARITABLE, MEDICAL, AND MOVING STANDARD MILEAGE RATE

.01 *Charitable.* Section 170(i) provides a standard mileage rate of 12 cents per mile for purposes of computing the charitable deduction for use of a passenger automobile in connection with rendering gratuitous services to a charitable organization under § 170.

.02 *Medical and moving.* The standard mileage rate is 10 cents per mile for use of a passenger automobile (a) to obtain medical care described in § 213, or (b) as part of a move for which the expenses are deductible under § 217. The standard mileage rates for medical and moving transportation expenses will be adjusted annually (to the extent warranted) by the Service, and any such adjustment will be applied prospectively.

.03 *Charitable, medical, or moving expense standard mileage rate in lieu of operating expenses.* A deduction computed using the applicable standard mileage rate for charitable, medical, or moving expense miles is in lieu of operating expenses (including gasoline and oil) of the automobile allocable to such purposes. Costs for such items as depreciation, maintenance and repairs, tires, insurance, and registration fees are not deductible, and are not included in such standard mileage rates.

.04 *Parking fees, tolls, interest, and taxes.* Parking fees and tolls attributable to the use of the automobile for charitable, medical, or moving expense purposes may be deducted as separate items. Likewise, interest relating to the purchase of the automobile as well as state and local taxes (other than those included in the cost of gasoline) may be deducted as separate items, but only to the extent that the interest and taxes are allowable deductions under § 163 or 164, respectively.

SEC. 8. FIXED AND VARIABLE RATE ALLOWANCE

.01 *In general.*

(1) The ordinary and necessary expenses paid or incurred by an employee in driving an automobile in connection with the performance of services as an employee of the employer will be deemed substantiated (in an amount determined under section 9) when a payor reimburses such expenses with a mileage allowance using a flat rate or stated schedule that combines periodic fixed and variable rate payments that meet all the requirements of this section (a FAVR allowance).

(2) The amount of a FAVR allowance must be based on data that (a) is derived from the base locality, (b) reflects retail prices paid by consumers, and (c) is reasonable and statistically defensible in approximating the actual expenses of employees receiving the allowance.

.02 *Definitions.*

(1) *FAVR allowance.* A FAVR allowance includes periodic fixed payments and periodic variable payments. A payor may maintain more than one FAVR allowance. A FAVR allowance that uses the same payor, standard automobile (or an automobile of the same make and model that is comparably equipped), retention period, and business use percentage is considered one FAVR allowance, even though other features of the allowance may vary. A FAVR allowance also includes any optional high mileage payments; however, such optional high mileage payments are included in the employee's gross income, are reported as wages or other compensation on the employee's Form W–2, and are subject to withholding and payment of employment taxes when paid. See section 9.05. An optional high mileage payment covers the additional depreciation for a standard automobile attributable to business miles driven and substantiated by the employee for a calendar year in excess of the annual business mileage for that year. If an employee is covered by the FAVR allowance for less than the entire calendar year, the annual business mileage may be prorated on a monthly basis for purposes of the preceding sentence.

(2) *Periodic fixed payment.* A periodic fixed payment covers the projected fixed costs (including depreciation, insurance, registration and license fees, and personal property taxes) of driving a standard automobile in connection with the performance of services as an employee of the employer in a base locality, and must be paid at least quarterly. A periodic fixed payment may be computed by (a) dividing the total projected fixed costs for the standard automobile for all years of the retention period, determined at the beginning of the retention period, by the number of periodic fixed payments in the retention period, and (b) multiplying the resulting amount by the business use percentage.

(3) *Periodic variable payment.* A periodic variable payment covers the projected operating costs (including gasoline and all taxes thereon, oil, tires, and routine maintenance and repairs) of driving a standard automobile in connection with the performance of services as an employee of the employer in a base locality, and must be paid at least quarterly. The rate of a periodic variable payment for a computation period may be computed by dividing the total projected operating costs for the standard automobile for the computation period, determined at the beginning of the computation period, by the computation period mileage. A computation period can be any period of a year or less. Computation period mileage is the total mileage (business and personal) a payor reasonably projects a standard automobile will be driven during a computation period and equals the retention mileage divided by the number of computation periods in the retention period. For each business mile substantiated by the employee for the computation period, the periodic variable payment must be paid at a rate that does not exceed the rate for that computation period.

(4) *Base locality.* A base locality is the particular geographic locality or region of the United States in which the costs of driving an automobile in connection with the performance of services as an employee of the employer are generally paid or incurred by the employee. Thus, for purposes of determining the amount of fixed costs, the base locality is generally the geographic locality or region in which the employee resides. For purposes of determining the amount of operating costs, the base

locality is generally the geographic locality or region in which the employee drives the automobile in connection with the performance of services as an employee of the employer.

(5) *Standard automobile.* A standard automobile is the passenger automobile selected by the payor on which a specific FAVR allowance is based.

(6) *Standard automobile cost.* The standard automobile cost for a calendar year may not exceed 95 percent of the sum of (a) the retail dealer invoice cost of the standard automobile in the base locality, and (b) state and local sales or use taxes applicable on the purchase of such an automobile. Further, the standard automobile cost may not exceed $26,500.

(7) *Annual mileage.* Annual mileage is the total mileage (business and personal) a payor reasonably projects a standard automobile will be driven during a calendar year. Annual mileage equals the annual business mileage divided by the business use percentage.

(8) *Annual business mileage.* Annual business mileage is the mileage a payor reasonably projects a standard automobile will be driven by an employee in connection with the performance of services as an employee of the employer during the calendar year, but may not be less than 6,250 miles for a calendar year. Annual business mileage equals the annual mileage multiplied by the business use percentage.

(9) *Business use percentage.* A business use percentage is determined by dividing the annual business mileage by the annual mileage. The business use percentage may not exceed 75 percent. In lieu of demonstrating the reasonableness of the business use percentage based on records of total mileage and business mileage driven by the employees annually, a payor may use a business use percentage that is less than or equal to the following percentages for a FAVR allowance that is paid for the following annual business mileage:

Annual business mileage	*Business use percentage*
6,250 or more but less than 10,000	45 percent
10,000 or more but less than 15,000	55 percent
15,000 or more but less than 20,000	65 percent
20,000 or more	75 percent

(10) *Retention period.* A retention period is the period in calendar years selected by the payor during which the payor expects an employee to drive a standard automobile in connection with the performance of services as an employee of the employer before the automobile is replaced. Such period may not be less than two calendar years.

(11) *Retention mileage.* Retention mileage is the annual mileage multiplied by the number of calendar years in the retention period.

(12) *Residual value.* The residual value of a standard automobile is the projected amount for which it could be sold at the end of the retention period after being driven the retention mileage. The Service will accept the following safe harbor residual values for a standard automobile computed as a percentage of the standard automobile cost:

Retention period	*Residual value*
2-year	70 percent
3-year	60 percent
4-year	50 percent

.03 *FAVR allowance in lieu of operating and fixed costs.*

(1) Except as provided in section 8.03(2), a deduction computed using a FAVR allowance is in lieu of all the operating and fixed costs paid or incurred by an employee in driving the automobile in connection with the performance of services as an employee of the employer.

(2) Parking fees and tolls attributable to an employee driving the standard automobile in connection with the performance of services as an employee of the employer are not included in fixed and operating costs and may be deducted as separate items. Similarly, interest relating to the purchase of the standard automobile may be deducted as a separate item, but only to the extent that the interest is an allowable deduction under § 163.

.04 *Depreciation.*

(1) A FAVR allowance may not be paid with respect to an automobile for which the employee has claimed (a) depreciation using a method other than straight-line for its estimated useful life, (b) a § 179 deduction has been claimed, or (c) the taxpayer has used the Accelerated Cost Recovery System (ACRS) under former § 168 or the Modified Accelerated Cost Recovery System (MACRS) under current § 168. If an employee uses actual costs for an automobile that has been covered by a FAVR allowance, the employee must use straight-line depreciation for the automobile's remaining estimated useful life (subject to the applicable depreciation deduction limitations under § 280F for any passenger automobile).

(2) The total amount of the depreciation component for the retention period taken into account in computing the periodic fixed payments for that retention period may not exceed the excess of the standard automobile cost over the residual value of the standard automobile. In addition, the total amount of such depreciation component may not exceed the sum of the annual § 280F limitations on depreciation (in effect at the beginning of the retention period) that apply to the standard automobile during the retention period.

(3) The depreciation included in each periodic fixed payment portion of a FAVR allowance paid with respect to an automobile will reduce the basis of the automobile (but not below zero) in determining adjusted basis as required by § 1016. See section 8.07(2) for the requirement that the employer report the depreciation component of a periodic fixed payment to the employee.

.05 *FAVR allowance limitations.*

(1) A FAVR allowance may be paid only to an employee who substantiates to the payor for a calendar year at least 5,000 miles driven in connection with the performance of services as an employee of the employer or, if greater, 80 percent of the annual business mileage of that FAVR allowance. If the employee is covered by the FAVR allowance for less than the entire calendar year, these limits may be prorated on a monthly basis.

(2) A FAVR allowance may not be paid to a control employee (as defined in § 1.61–21(f)(5) and (6), excluding the $100,000 limitation in paragraph (f)(5)(iii)).

(3) At no time during a calendar year may a majority of the employees covered by a FAVR allowance be management employees.

(4) At all times during a calendar year at least 10 employees of an employer must be covered by one or more FAVR allowances.

(5) A FAVR allowance may be paid only with respect to an automobile (a) owned by the employee receiving the payment, (b) the cost of which, when new, is at least 90 percent of the

standard automobile cost taken into account for purposes of determining the FAVR allowance for the first calendar year the employee receives the allowance with respect to that automobile, and (c) the model year of which does not differ from the current calendar year by more than the number of years in the retention period.

(6) The insurance cost component of a FAVR allowance must be based on the rates charged in the base locality for insurance coverage on the standard automobile during the current calendar year without taking into account such rate-increasing factors as poor driving records or young drivers.

(7) A FAVR allowance may be paid only to an employee whose insurance coverage limits on the automobile with respect to which the FAVR allowance is paid are at least equal to the insurance coverage limits used to compute the periodic fixed payment under that FAVR allowance.

.06 *Employee reporting.* Within 30 days after an employee's automobile is initially covered by a FAVR allowance, or is again covered by a FAVR allowance if such coverage has lapsed, the employee by written declaration must provide the payor with the following information: (a) the make, model, and year of the automobile owned by the employee, (b) written proof of the insurance coverage limits on the automobile, (c) the odometer reading of the automobile, (d) the purchase price of the automobile, and (e) whether the employee has claimed depreciation with respect to the automobile using any of the depreciation methods prohibited by section 8.04(1). The information described in (a), (b), and (c) of the preceding sentence also must be supplied by the employee to the payor within 30 days after the beginning of each calendar year that the employee's automobile is covered by a FAVR allowance.

.07 *Payor recordkeeping and reporting.*

(1) The payor or its agent must maintain written records setting forth (a) the statistical data and projections on which the FAVR allowance payments are based, and (b) the information provided by the employees pursuant to section 8.06.

(2) Within 30 days of the end of each calendar year, the employer must provide each employee covered by a FAVR allowance during that year with a statement listing the amount of depreciation included in each periodic fixed payment portion of the FAVR allowance paid during that calendar year and explaining that by receiving a FAVR allowance the employee has elected to exclude the automobile from MACRS pursuant to § 168(f)(1).

.08 *Failure to meet section 8 requirements.* If an employee receives a mileage allowance that fails to meet one or more of the requirements of section 8, the employee may not be treated as covered by any FAVR allowance of the payor during the period of such failure. Nevertheless, the expenses to which that mileage allowance relates may be deemed substantiated using the method described in sections 5, 9.01(1), and 9.02 to the extent the requirements of those sections are met.

SEC. 9. APPLICATION

.01 If a payor pays a mileage allowance in lieu of reimbursing actual transportation expenses incurred or to be incurred by an employee, the amount of the expenses that is deemed substantiated to the payor is either:

(1) for any mileage allowance other than a FAVR allowance, the lesser of the amount paid under the mileage allowance or the applicable standard mileage rate in section 5.01 or 6.01 multiplied by the number of business miles substantiated by the employee; or

(2) for a FAVR allowance, the amount paid under the FAVR allowance less the sum of (a) any periodic variable rate payment that relates to miles in excess of the business miles substantiated by the employee and that the employee fails to return to the payor although required to do so, (b) any portion of a periodic fixed payment that relates to a period during which the employee is treated as not covered by the FAVR allowance and that the employee fails to return to the payor although required to do so, and (c) any optional high mileage payments.

.02 If the amount of transportation expenses is deemed substantiated under the rules provided in section 9.01, and the employee actually substantiates to the payor the elements of time, place (or use), and business purpose of the transportation expenses in accordance with paragraphs (b)(2) (travel away from home), (b)(6) (listed property, which includes passenger automobiles and any other property used as a means of transportation), and (c) of § 1.274–5T, the employee is deemed to satisfy the adequate accounting requirements of § 1.274–5T(f), as well as the requirement to substantiate by adequate records or other sufficient evidence for purposes of § 1.274–5T(c). See § 1.62–2(e)(1) for the rule that an arrangement must require business expenses to be substantiated to the payor within a reasonable period of time.

.03 An arrangement providing mileage allowances will be treated as satisfying the requirement of § 1.62–2(f)(2) with respect to returning amounts in excess of expenses as follows:

(1) For a mileage allowance other than a FAVR allowance, the requirement to return excess amounts will be treated as satisfied if the employee is required to return within a reasonable period of time (as defined in § 1.62–2(g)) any portion of such an allowance that relates to miles of travel not substantiated by the employee, even though the arrangement does not require the employee to return the portion of such an allowance that relates to the miles of travel substantiated and that exceeds the amount of the employee's expenses deemed substantiated. For example, assume a payor provides an employee an advance mileage allowance of $70 based on an anticipated 200 business miles at 35 cents per mile (at a time when the applicable business standard mileage rate is 31.5 cents per mile), and the employee substantiates 120 business miles. The requirement to return excess amounts will be treated as satisfied if the employee is required to return the portion of the allowance that relates to the 80 unsubstantiated business miles ($28) even though the employee is not required to return the portion of the allowance ($4.20) that exceeds the amount of the employee's expenses deemed substantiated under section 9.01 ($37.80) for the 120 substantiated business miles. However, the $4.20 excess portion of the allowance is treated as paid under a nonaccountable plan as discussed in section 9.05.

(2) For a FAVR allowance, the requirement to return excess amounts will be treated as satisfied if the employee is required to return within a reasonable period of time (as defined in § 1.62–2(g)), (a) the portion (if any) of the periodic variable payment received that relates to miles in excess of the business miles substantiated by the employee, and (b) the portion (if any) of a periodic fixed payment that relates to a period during which the employee was not covered by the FAVR allowance.

.04 An employee is not required to include in gross income the portion of a mileage allowance received from a payor that is less than or equal to the amount deemed substantiated under section 9.01, provided the employee substantiates in accordance with section 9.02. See § 1.274–5T(f)(2)(i). In addition, such portion of the allowance is treated as paid under an accountable plan, is not reported as wages or other compensation on the employee's Form W–2, and is exempt from the withholding and payment of employment taxes. See §§ 1.62–2(c)(2) and (c)(4).

.05 An employee is required to include in gross income only the portion of a mileage allowance received from a payor that exceeds the amount deemed substantiated under section 9.01, provided the employee substantiates in accordance with section 9.02. See § 1.274–5T(f)(2)(ii). In addition, the excess portion of the allowance is treated as paid under a nonaccountable plan, is reported as wages or other compensation on the employee's Form W–2, and is subject to withholding and payment of employment taxes. See §§ 1.62–2(c)(3)(ii), (c)(5), and (h)(2)(i)(B).

.06 If the amount of the expenses deemed substantiated under the rules provided in section 9.01 is less than the amount of the employee's business transportation expenses, the employee may claim an itemized deduction for the amount by which the business transportation expenses exceed the amount that is deemed substantiated, provided the employee substantiates all the business transportation expenses, includes on Form 2106, Employee Business Expenses, the deemed substantiated portion of the mileage allowance received from the payor, and includes in gross income the portion (if any) of the mileage allowance received from the payor that exceeds the amount deemed substantiated. See § 1.274–5T(f)(2)(iii). However, for purposes of claiming this itemized deduction, substantiation of the amount of the expenses is not required if the employee is claiming a deduction that is equal to or less than the applicable standard mileage rate multiplied by the number of business miles substantiated by the employee minus the amount deemed substantiated under section 9.01. The itemized deduction is subject to the 2-percent floor on miscellaneous itemized deductions provided in § 67.

.07 An employee may deduct an amount computed pursuant to section 5.01 or 6.01 only as an itemized deduction. This itemized deduction is subject to the 2-percent floor on miscellaneous itemized deductions provided in § 67.

.08 A self-employed individual may deduct an amount computed pursuant to section 5.01 in determining adjusted gross income under § 62(a)(1).

.09 If a payor's reimbursement or other expense allowance arrangement evidences a pattern of abuse of the rules of § 62(c) and the regulations thereunder, all payments under the arrangement will be treated as made under a nonaccountable plan. Thus, such payments are included in the employee's gross income, are reported as wages or other compensation on the employee's Form W–2, and are subject to withholding and payment of employment taxes. See §§ 1.62–2(c)(3), (c)(5), and (h)(2).

SEC. 10. WITHHOLDING AND PAYMENT OF EMPLOYMENT TAXES.

.01 The portion of a mileage allowance (other than a FAVR allowance), if any, that relates to the miles of business travel substantiated and that exceeds the amount deemed substantiated for those miles under section 9.01(1) is subject to withholding and payment of employment taxes. See § 1.62–2(h)(2)(i)(B).

(1) In the case of a mileage allowance paid as a reimbursement, the excess described in this section 10.01 is subject to withholding and payment of employment taxes in the payroll period in which the payor reimburses the expenses for the business miles substantiated. See § 1.62–2(h)(2)(i)(B)(*2*).

(2) In the case of a mileage allowance paid as an advance, the excess described in this section 10.01 is subject to withholding and payment of employment taxes no later than the first payroll period following the payroll period in which the business miles with respect to which the advance was paid are substantiated. See § 1.62–2(h)(2)(i)(B)(*3*). If some or all of the business miles with respect to which the advance was paid are not substantiated within a reasonable period of time and the employee does not return the portion of the allowance that relates to those miles within a reasonable period of time, the portion of the allowance that relates to those miles is subject to withholding and payment of employment taxes no later than the first payroll period following the end of the reasonable period. See § 1.62–2(h)(2)(i)(A).

(3) In the case of a mileage allowance that is not computed on the basis of a fixed amount per mile of travel (e.g., a mileage allowance that combines periodic fixed and variable rate payments, but that does not satisfy the requirements of section 8), the payor must compute the amount, if any, that exceeds the amount deemed substantiated under section 9.01(1) periodically (no less frequently than quarterly) by comparing the total mileage allowance paid for the period to the applicable standard mileage rate in section 5.01 or 6.01 multiplied by the number of business miles substantiated by the employee for the period. Any excess is subject to withholding and payment of employment taxes no later than the first payroll period following the payroll period in which the excess is computed. See § 1.62–2(h)(2)(i)(B)(*4*).

(4) For example, assume an employer pays its employees a mileage allowance at a rate of 35 cents per mile (when the business standard mileage rate is 31.5 cents per mile). The employer does not require the return of the portion of the allowance (3.5 cents) that exceeds the business standard mileage rate for the business miles substantiated. In June, the employer advances an employee $175 for 500 miles to be traveled during the month. In July, the employee substantiates to the employer 400 business miles traveled in June and returns $35 to the employer for the 100 business miles not traveled. The amount deemed substantiated for the 400 miles traveled is $126 and the employee is not required to return the remaining $14. No later than the first payroll period following the payroll period in which the 400 business miles traveled are substantiated, the employer must withhold and pay employment taxes on $14.

.02 The portion of a FAVR allowance, if any, that exceeds the amount deemed substantiated for those miles under section 9.01(2) is subject to withholding and payment of employment taxes. See § 1.62–2(h)(2)(i)(B).

(1) Any periodic variable rate payment that relates to miles in excess of the business miles substantiated by the employee and that the employee fails to return within a reasonable period, or any portion of a periodic fixed payment that relates to a period during which the employee is treated as not covered by the FAVR allowance and that the employee fails to return within a reasonable period, is subject to withholding and payment of employment taxes no

later than the first payroll period following the end of the reasonable period. See § 1.62–2(h)(2)(i)(A).

(2) Any optional high mileage payment is subject to withholding and payment of employment taxes when paid.

SEC. 11. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 95–54, 1995–2 C.B. 450, is hereby superseded for mileage allowances paid to an employee on or after January 1, 1997, with respect to transportation expenses paid or incurred on or after January 1, 1997, and, for purposes of computing the amount allowable as a deduction, for transportation expenses paid or incurred on or after January 1, 1997.

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26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.
(Also Part I, §§ 62, 162, 267, 274; 1.62–2, 1.162–17, 1.267(a)–1, 1.274–5T, 1.274(d)–1.)

Rev. Proc. 96–64

SECTION 1. PURPOSE

This revenue procedure updates Rev. Proc. 96–28, 1996–1 C.B. 686, by providing rules under which the amount of ordinary and necessary business expenses of an employee for lodging, meal, and incidental expenses or for meal and incidental expenses incurred while traveling away from home will be deemed substantiated under § 1.274–5T of the temporary Income Tax Regulations when a payor (the employer, its agent, or a third party) provides a per diem allowance under a reimbursement or other expense allowance arrangement to pay for such expenses. This revenue procedure also provides an optional method for employees and self-employed individuals to use in computing the deductible costs of business meal and incidental expenses paid or incurred while traveling away from home. Use of a method described in this revenue procedure is not mandatory and a taxpayer may use actual allowable expenses if the taxpayer maintains adequate records or other sufficient evidence for proper substantiation. This revenue procedure does not provide rules under which the amount of an employee's lodging expenses will be deemed substantiated when a payor provides an allowance to pay for those expenses but not meal and incidental expenses.

SECTION 2. BACKGROUND AND CHANGES

.01 Section 162(a) of the Internal Revenue Code allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Under that provision, an employee or self-employed individual may deduct expenses paid or incurred while traveling away from home in pursuit of a trade or business. However, under § 262, no portion of such travel expenses that is attributable to personal, living, or family expenses is deductible.

.02 Section 274(d) provides, in part, that no deduction shall be allowed under § 162 for any traveling expense (including meals and lodging while away from home) unless the taxpayer complies with certain substantiation requirements. The section further provides that regulations may prescribe that some or all of the substantiation requirements do not apply to an expense that does not exceed an amount prescribed by such regulations.

.03 Section 1.274(d)–1(a) of the regulations, in part, grants the Commissioner the authority to prescribe rules relating to reimbursement arrangements or per diem allowances for ordinary and necessary expenses paid or incurred while traveling away from home. Pursuant to this grant of authority, the Commissioner may prescribe rules under which such arrangements or allowances, if in accordance with reasonable business practice, will be regarded (1) as equivalent to substantiation, by adequate records or other sufficient evidence, of the amount of such travel expenses for purposes of § 1.274–5T(c), and (2) as satisfying the requirements of an adequate accounting to the employer of the amount of such travel expenses for purposes of § 1.274–5T(f).

.04 Section 1.274–5T(j) grants the Commissioner the authority to establish a method under which a taxpayer may elect to use a specified amount for meals paid or incurred while traveling away from home in lieu of substantiating the actual cost of meals.

.05 For purposes of determining adjusted gross income, § 62(a)(2)(A) allows an employee a deduction for expenses allowed by Part VI (§ 161 and following), subchapter B, chapter 1 of the Code, paid or incurred by the employee in connection with the performance of services as an employee under a reimbursement or other expense allowance arrangement with a payor.

.06 Section 62(c) provides that an arrangement will not be treated as a reimbursement or other expense allowance arrangement for purposes of § 62(a)(2)(A) if it—

(1) does not require the employee to substantiate the expenses covered by the arrangement to the payor, or

(2) provides the employee with the right to retain any amount in excess of the substantiated expenses covered under the arrangement.

Section 62(c) further provides that the substantiation requirements described therein shall not apply to any expense to the extent that, under the grant of regulatory authority prescribed in § 274(d), the Commissioner has provided that substantiation is not required for such expense.

.07 Under § 1.62–2(c)(1) a reimbursement or other expense allowance arrangement satisfies the requirements of § 62(c) if it meets the requirements of business connection, substantiation, and returning amounts in excess of expenses as specified in the regulations. Section 1.62–2(e)(2) specifically provides that substantiation of certain business expenses in accordance with rules prescribed under the authority of § 1.274(d)–1(a) or 1.274–5T(j) will be treated as substantiation of the amount of such expenses for purposes of § 1.62–2. Under § 1.62–2(f)(2), the Commissioner may prescribe rules under which an arrangement providing per diem allowances will be treated as satisfying the requirement of returning amounts in excess of expenses, even though the arrangement does not require the employee to return the portion of such an allowance that relates to days of travel substantiated and that exceeds the amount of the employee's expenses deemed substantiated pursuant to rules prescribed under § 274(d), provided the allowance is reasonably calculated not to exceed the amount of the employee's expenses or anticipated expenses and the employee is required to return any portion of such an allowance that relates to days of travel not substantiated.

.08 Section 1.62–2(h)(2)(i)(B) provides that if a payor pays a per diem allowance that meets the requirements of § 1.62–2(c)(1), the portion, if any, of the allowance that relates to days of travel substantiated in accordance with § 1.62–2(e), that exceeds the amount of the employee's expenses deemed substantiated for such travel pursuant to rules prescribed under § 274(d) and § 1.274(d)–1(a) or § 1.274–5T(j), and

that the employee is not required to return, is subject to withholding and payment of employment taxes. See §§ 31.3121(a)–3, 31.3231(e)–3, 31.3306(b)–2, and 31.3401(a)–4. Because the employee is not required to return this excess portion, the reasonable period of time provisions of § 1.62–2(g) (relating to the return of excess amounts) do not apply to this portion.

.09 Under § 1.62–2(h)(2)(i)(B)(4), the Commissioner may, in his or her discretion, prescribe special rules regarding the timing of withholding and payment of employment taxes on per diem allowances.

.10 Section 5.04 contains a description of changes to the high-cost localities for purposes of section 5.

.11 Changes to sections 3.01(3), 4.02, and 6.02 clarify that the amount of an employee's expenses of traveling away from home may be deemed substantiated under the revenue procedure if a payor pays a per diem amount for the employee's lodging, meal, and incidental expenses that is equal to *or less than* the amount of the Federal per diem for the locality of travel for the day (or part of the day).

.12 Changes to sections 1, 3.01(1), 6.01, and 6.06 clarify that the revenue procedure does not provide rules under which the amount of an employee's lodging expenses will be deemed substantiated when a payor provides an allowance to pay for those expenses but not meal and incidental expenses.

SECTION 3. DEFINITIONS

.01 *Per diem allowance.* The term "per diem allowance" means a payment under a reimbursement or other expense allowance arrangement that meets the requirements specified in § 1.62–2(c)(1) and that is

(1) paid with respect to ordinary and necessary business expenses incurred, or which the payor reasonably anticipates will be incurred, by an employee for lodging, meal, and incidental expenses or for meal and incidental expenses for travel away from home in connection with the performance of services as an employee of the employer,

(2) reasonably calculated not to exceed the amount of the expenses or the anticipated expenses, and

(3) paid at or below the applicable Federal per diem rate, a flat rate or stated schedule, or in accordance with any other Service-specified rate or schedule.

.02 *Federal per diem rate.*

(1) *General rule.* The Federal per diem rate is equal to the sum of the Federal lodging expense rate and the Federal meal and incidental expense (M&IE) rate for the locality of travel. Each of these rates for a particular locality in the continental United States ("CONUS") is set forth in Appendix A of 41 C.F.R., Chapter 301, as amended. See 41 C.F.R. Part 301–7 (1996), as amended, for specific rules regarding these Federal rates. Each of these rates is established by the Secretary of Defense for a particular nonforeign locality outside the continental United States ("OCONUS") (including Alaska, Hawaii, Puerto Rico, the Northern Mariana Islands, and the possessions of the United States), and by the Secretary of State for a particular foreign OCONUS locality. Each of these OCONUS rates is published in the Per Diem Supplement to the Standardized Regulations (Government Civilians, Foreign Areas). See, e.g., Maximum Travel Per Diem Allowances for Foreign Areas, PD Supplement 382, issued March 1, 1996.

(2) *Locality of travel.* The term "locality of travel" means the locality where an employee traveling away from home in connection with the performance of services as an employee of the employer stops for sleep or rest.

(3) *Incidental expenses.* The term "incidental expenses" includes, but is not limited to, expenses for laundry, cleaning and pressing of clothing, and fees and tips for services, such as for porters and baggage carriers. The term "incidental expenses" does not include taxicab fares or the costs of telegrams or telephone calls.

.03 *Flat rate or stated schedule.*

(1) In general. Except as provided in section 3.03(2), an allowance is paid at a flat rate or stated schedule if it is provided on a uniform and objective basis with respect to the expenses described in section 3.01. Such allowance may be paid with respect to the number of days away from home in connection with the performance of services as an employee or on any other basis that is consistently applied and in accordance with reasonable business practice. Thus, for example, an hourly payment to cover meal and incidental expenses paid to a pilot or flight attendant who is traveling away from home in connection with the performance of services as an employee is an allowance paid at a flat rate or stated schedule. Likewise, a payment based on the number of miles traveled (*e.g.*, cents per mile) to cover meal and incidental expenses paid to an over-the-road truck driver who is traveling away from home in connection with the performance of services as an employee is an allowance paid at a flat rate or stated schedule.

(2) *Limitation.* For purposes of this revenue procedure, an allowance that is computed on a basis similar to that used in computing the employee's wages or other compensation (e.g., the number of hours worked, miles traveled, or pieces produced) does not meet the business connection requirement of § 1.62–2(d), is not a per diem allowance, and is not paid at a flat rate or stated schedule, unless, as of December 12, 1989, (a) the allowance was identified by the payor either by making a separate payment or by specifically identifying the amount of the allowance, or (b) an allowance computed on that basis was commonly used in the industry in which the employee is employed. See § 1.62–2(d)(3)(ii).

SECTION 4. PER DIEM SUBSTANTIATION METHOD

.01 *Per diem allowance.* If a payor pays a per diem allowance in lieu of reimbursing actual expenses for lodging, meal, and incidental expenses incurred or to be incurred by an employee for travel away from home, the amount of the expenses that is deemed substantiated for each calendar day (or part of the calendar day, see section 6.04) is equal to the lesser of the per diem allowance for such day or the amount computed at the Federal per diem rate for the locality of travel for such day (or part of such day, see section 6.04).

.02 *Meals only per diem allowance.* If a payor pays a per diem allowance only for meal and incidental expenses in lieu of reimbursing actual expenses for meal and incidental expenses incurred or to be incurred by an employee for travel away from home, the amount of the expenses that is deemed substantiated for each calendar day (or part of the calendar day, see section 6.04) is equal to the lesser of the per diem allowance for such day or the amount computed at the Federal M&IE rate for the locality of travel for such day (or part of such day, see section 6.04). A per diem allowance is treated as paid only for meal and incidental expenses if (1) the payor pays the employee for actual expenses for lodging based on receipts submitted to the payor, (2) the payor provides the lodging in kind, (3) the

payor pays the actual expenses for lodging directly to the provider of the lodging, (4) the payor does not have a reasonable belief that lodging expenses were or will be incurred by the employee, or (5) the allowance is computed on a basis similar to that used in computing the employee's wages or other compensation (e.g., the number of hours worked, miles traveled, or pieces produced).

.03 *Optional method for meals only deduction.* In lieu of using actual expenses, employees and self-employed individuals, in computing the amount allowable as a deduction for ordinary and necessary meal and incidental expenses paid or incurred for travel away from home, may use an amount computed at the Federal M&IE rate for the locality of travel for each calendar day (or part thereof, see section 6.04) the employee or self-employed individual is away from home. Such amount will be deemed substantiated for purposes of paragraphs (b)(2) (travel away from home) and (c) of § 1.274–5T, provided the employee or self-employed individual substantiates the elements of time, place, and business purpose of the travel expenses in accordance with those regulations.

.04 *Special rules for transportation industry.*

(1) *In general.* This section 4.04 applies to (a) a payor that pays a per diem allowance only for meal and incidental expenses for travel away from home as described in section 4.02 to an employee in the transportation industry, or (b) an employee or self-employed individual in the transportation industry who computes the amount allowable as a deduction for meal and incidental expenses for travel away from home in accordance with section 4.03.

(2) *Rates.* A taxpayer described in section 4.04(1) may treat $36 as the Federal M&IE rate for any locality of travel in CONUS, and/or $40 as the Federal M&IE rate for any locality of travel OCONUS. A payor that uses either (or both) of these special rates with respect to an employee must use the special rate(s) for all amounts subject to section 4.02 paid to that employee for travel away from home within CONUS and/or OCONUS, as the case may be, during the calendar year. Similarly, an employee or self-employed individual that uses either (or both) of these special rates must use the special rate(s) for all amounts computed pursuant to section 4.03 for travel away from home within CONUS and/or OCONUS, as the case may be, during the calendar year.

(3) *Periodic rule.* A payor described in section 4.04(1) may compute the amount of the employee's expenses that is deemed substantiated under section 4.02 periodically (not less frequently than monthly), rather than daily, by comparing the total per diem allowance paid for the period to the sum of the amounts computed at the Federal M&IE rate(s) for the localities of travel for the days (or partial days, see section 6.04) the employee is away from home during the period. For example, assume an employee in the transportation industry travels away from home within CONUS on 17 days (including partial days under section 6.04) during a calendar month and receives a per diem allowance only for meal and incidental expenses from a payor that uses the special rule under section 4.04(2). The amount deemed substantiated under section 4.02 is equal to the lesser of the total per diem allowance paid for the month or $612 (17 days at $36 per day).

(4) *Transportation industry defined.* For purposes of this section 4.04, an employee or self-employed individual is "in the transportation industry" only if the employee's or individual's work (a) is of the type that directly involves moving people or goods by airplane, barge, bus, ship, train, or truck, and (b) regularly requires travel away from home which, during any single trip away from home, usually involves travel to localities with differing Federal M&IE rates. For purposes of the preceding sentence, a payor must determine that an employee or a group of employees is "in the transportation industry" by using a method that is consistently applied and in accordance with reasonable business practice.

SECTION 5. HIGH-LOW SUBSTANTIATION METHOD

.01 *General rule.* If a payor pays a per diem allowance in lieu of reimbursing actual expenses for lodging, meal, and incidental expenses incurred or to be incurred by an employee for travel away from home and the payor uses the high-low substantiation method described in this section 5 for travel within CONUS, the amount of the expenses that is deemed substantiated for each calendar day (or part of the calendar day, see section 6.04) is equal to the lesser of the per diem allowance for such day or the amount computed at the rate set forth in section 5.02 for the locality of travel for such day (or part of such day, see section 6.04). This high-low substantiation method may be used in lieu of the per diem substantiation method provided in section 4.01, but may not be used in lieu of the meals only substantiation method provided in section 4.02 or 4.03.

.02 *Specific high-low rates.* The per diem rate set forth in this section 5.02 is $166 for travel to any "high-cost locality" specified in section 5.03, or $109 for travel to any other locality within CONUS. Whichever per diem rate applies, it is applied as if it were the Federal per diem rate for the locality of travel. For purposes of applying the high-low substantiation method, the Federal M&IE rate shall be treated as $40 for a high-cost locality and $32 for any other locality within CONUS.

.03 *High-cost localities.* The following localities have a Federal per diem rate of $138 or more for all or part of the calendar year, and are high-cost localities for all of the calendar year or the portion of the calendar year specified in parenthesis under the key city name:

Key city	*County and other defined location*
Arizona	
Grand Canyon	All points in the Grand Canyon National Park and Kaibab National Forest within Coconino County
Phoenix/Scottsdale (October 1–May 14)	Maricopa

Key city	*County and other defined location*
California	
Gualala/Point Arena	Mendocino
Los Angeles	Los Angeles, Kern, Orange, and Ventura Counties; Edwards Air Force Base; Naval Weapons Center and Ordnance Test Station, China Lake
Palo Alto/San Jose	Santa Clara
San Francisco	San Francisco
South Lake Tahoe	El Dorado
Yosemite Nat'l Park (April 1–October 31)	Mariposa
Colorado	
Aspen (January 15–March 31)	Pitkin
Keystone/Silverthorne	Summit
Steamboat Springs (December 1–March 31)	Routt
Telluride	San Miquel
Vail (November 1–March 31)	Eagle
District of Columbia	
Washington, D.C.	Washington, D.C.; the cities of Alexandria, Falls Church, and Fairfax, and the counties of Arlington, Loudoun, and Fairfax in Virginia; and the counties of Montgomery and Prince Georges in Maryland
Florida	
Key West	Monroe
Illinois	
Chicago	Du Page, Cook, and Lake
Indiana	
Nashville (June 1–October 31)	Brown
Maine	
Bar Harbor (July 1–September 14)	Hancock
Maryland	
Ocean City (May 1–September 30)	Worcester
Saint Michaels	Talbot
Massachusetts	
Boston	Suffolk
Cambridge/Lowell	Middlesex
Hyannis (July 1–September 30)	Barnstable
Martha's Vineyard/Nantucket	Dukes and Nantucket
Michigan	
Leland (May 1–September 30)	Leelanau
Mackinac Island (June 1–September 30)	Mackinac
Nevada	
Incline Village	Incline Village
Stateline	Douglas
New Jersey	
Atlantic City (April 1–November 30)	Atlantic
Ocean City/Cape May (May 15–September 30)	Cape May

Key city	*County and other defined location*
New Mexico	
Santa Fe (May 1–October 31)	Santa Fe
New York	
New York City	The boroughs of Bronx, Brooklyn, Manhattan, Queens, and Staten Island; Nassau and Suffolk Counties
White Plains	Westchester
North Carolina	
Duck/Outer Banks (May 1–September 30)	Dare
Ohio	
Sandusky (May 1–September 30)	Erie
Pennsylvania	
Chester/Radnor	Delaware
Philadelphia	Philadelphia; city of Bala Cynwyd in Montgomery County
Rhode Island	
Newport/Block Island (May 1–October 14)	Newport and Washington
Utah	
Bullfrog (April 1–October 31)	Garfield
Park City (December 1–March 31)	Summit
Virginia	
Virginia Beach (May 1–September 30)	Virginia Beach, Norfolk, Portsmouth and Chesapeake
Wintergreen	Nelson
Wisconsin	
Wisconsin Dells (June 1–September 14)	Columbia
Wyoming	
Jackson (June 1–October 14)	Teton

.04 *Changes in high-cost localities.* The list of high-cost localities in section 5.03 of this Revenue Procedure differs from the list of high-cost localities in section 5.03 of Rev. Proc. 96–28. The following localities have been added to the list of high-cost localities: Saint Michaels, Maryland; Chester/Radnor, Pennsylvania; and Block Island, Rhode Island. The portion of the year for which the following are high-cost localities has been changed: Yosemite National Park, California (April 1–October 31); Steamboat Springs, Colorado (December 1–March 31); Telluride, Colorado (all year); Vail, Colorado (November 1–March 31); Ocean City/Cape May, New Jersey (May 15–September 30); Santa Fe, New Mexico (May 1–October 31). The following localities have been removed from the list of high-cost localities: Gulf Shores, Alabama; Santa Barbara, California; Boulder, Colorado, and Denver, Colorado; Bridgeport/Danbury, Connecticut; Naples, Florida; Rockport, Maine; Annapolis, Maryland, and Baltimore, Maryland; Detroit, Michigan, and Traverse City, Michigan; Newark, New Jersey, Parsippany/Dover, New Jersey, and Princeton/Trenton, New Jersey; Lake Placid, New York; Crater Lake/Klamath Falls, Oregon; Valley Forge/Malvern, Pennsylvania; Providence, Rhode Island; Myrtle Beach, South Carolina.

.05 *Specific limitation.* A payor that uses the high-low substantiation method with respect to an employee must use that method for all amounts paid to that employee for travel away from home within CONUS during the calendar year. However, with respect to that employee, the payor may still reimburse actual expenses or use the meals only per diem method described in section 4.02 for any travel away from home, and may use the per diem substantiation method described in section 4.01 for any OCONUS travel away from home.

SECTION 6. LIMITATIONS AND SPECIAL RULES

.01 *In general.* The Federal per diem rate and the Federal M&IE rate described in section 3.02 for the locality of travel will be applied in the same manner as applied under the Federal Travel Regulations, 41 C.F.R. Part 301–7 (1996), except as provided in sections 6.02 through 6.04.

.02 *Federal per diem rate.* A receipt for lodging expenses is not required in determining the amount of expenses deemed substantiated under section 4.01 or 5.01.

.03 *Federal per diem or M&IE rate.* A payor is not required to reduce the Federal per diem rate or the Federal M&IE rate for the locality of travel for meals provided in kind, provided the payor has a reasonable belief that meal and incidental expenses were or will be incurred by the employee.

.04 *Proration of the Federal per diem or M&IE rate.* Pursuant to the Federal Travel Regulations, in determining the Federal per diem rate or the Federal M&IE rate for the locality of travel, the full applicable Federal M&IE rate is available for a full day of travel from 12:01 a.m. to 12:00 midnight. For purposes of determining the amount deemed substantiated under section 4 or 5 with respect to partial days of travel away from home, either of the following methods may be used to prorate the Federal M&IE rate to determine the Federal per diem rate or the Federal M&IE rate for the partial days of travel:

(1) Such rate may be prorated using the method prescribed by the Federal Travel Regulations. Currently the Federal Travel Regulations allow one-fourth of the applicable Federal M&IE rate for each 6-hour quarter of the day (i.e., midnight to 6 a.m., 6 a.m. to noon, noon to 6 p.m., and 6 p.m. to midnight) during any portion of which the employee or self-employed individual is traveling away from home in connection with the performance of services as an employee or self-employed individual; or

(2) Such rate may be prorated using any method that is consistently applied and in accordance with reasonable business practice. For example, if an employee travels away from home from 9 a.m. one day to 5 p.m. the next day, a method of proration that results in an amount equal to 2 times the Federal M&IE rate will be treated as being in accordance with reasonable business practice (even though only 1½ times the Federal M&IE rate would be allowed under the Federal Travel Regulations). Similarly, if a self-employed individual travels away from home from 7 p.m. one day to 9 p.m. the next day, a method of proration that results in an amount equal to 1½ times the Federal M&IE rate will be treated as being in accordance with reasonable business practice (even though only 1¼ times the Federal M&IE rate would be allowed under the Federal Travel Regulations).

.05 *Application of the 50-percent limitation on meal expenses.* When a per diem allowance is paid only for meal and incidental expenses or when an amount for meal and incidental expenses is computed pursuant to section 4.03, an amount equal to the lesser of the per diem allowance for each calendar day (or part of the calendar day, see section 6.04) or the Federal M&IE rate for the locality of travel for such day (or part of such day, see section 6.04) is treated as an expense for food and beverages. When a per diem allowance is paid for lodging, meal, and incidental expenses, the payor must treat an amount equal to the Federal M&IE rate for the locality of travel for each calendar day (or part of the calendar day, see section 6.04) the employee is away from home as an expense for food and beverages. For purposes of the preceding sentence, when a per diem allowance for lodging, meal, and incidental expenses for a full day of travel is paid at a rate that is less than the Federal per diem rate for the locality of travel, the payor may treat an amount equal to 40 percent of such per diem allowance for a full day of travel as the Federal M&IE rate for the locality of travel.

.06 *No double reimbursement or deduction.* If a payor pays a per diem allowance in lieu of reimbursing actual expenses for lodging, meal, and incidental expenses or for meal and incidental expenses in accordance with section 4 or 5, any additional payment with respect to such expenses is treated as paid under a nonaccountable plan, is included in the employee's gross income, is reported as wages or other compensation on the employee's Form W–2, and is subject to withholding and payment of employment taxes. Similarly, if an employee or self-employed individual computes the amount allowable as a deduction for meal and incidental expenses for travel away from home in accordance with section 4.03 or 4.04, no other deduction is allowed to the employee or self-employed individual with respect to such expenses. For example, assume an employee receives a per diem allowance from a payor for lodging, meal, and incidental expenses or for meal and incidental expenses incurred while traveling away from home. During that trip, the employee pays for dinner for the employee and two business associates. The payor reimburses as a business entertainment meal expense the meal expense for the employee and the two business associates. Because the payor also pays a per diem allowance to cover the cost of the employee's meals, the amount paid by the payor for the employee's portion of the business entertainment meal expense is treated as paid under a nonaccountable plan, is reported as wages or other compensation on the employee's Form W–2, and is subject to withholding and payment of employment taxes.

.07 *Related parties.* Sections 4.01, 4.02, 4.04 (to the extent it relates to section 4.02), and 5 of this revenue procedure will not apply in any case in which a payor and an employee are related within the meaning of § 267(b), but for this purpose the percentage of ownership interest referred to in § 267(b)(2) shall be 10 percent.

SECTION 7. APPLICATION

.01 If the amount of travel expenses is deemed substantiated under the rules provided in section 4 or 5, and the employee actually substantiates to the payor the elements of time, place, and business purpose of the travel expenses in accordance with paragraphs (b)(2) (travel away from home) and (c) (other than subparagraph (2)(iii)(A) thereof) of § 1.274–5T, the employee is deemed to satisfy the adequate accounting requirements of § 1.274–5T(f) as well as the requirement to substantiate by adequate records or other sufficient evidence for purposes of § 1.274–5T(c). See § 1.62–2(e)(1) for the rule that an arrangement must require business expenses to be substantiated to the payor within a reasonable period of time.

.02 An arrangement providing per diem allowances will be treated as satisfying the requirement of § 1.62–2(f)(2) with respect to returning amounts in excess of expenses if the employee is required to return within a reasonable period of time (as defined in § 1.62–2(g)) any portion of such an allowance that relates to days of travel not substantiated, even though the arrangement does not require the employee to return the portion of such an allowance that relates to days of travel substantiated and that exceeds the amount of the employee's expenses deemed substantiated. For example, assume a payor provides an employee an advance per diem allowance for meal and incidental expenses of $200, based on an anticipated 5 days of business travel at $40 per day to a locality for which the Federal M&IE rate is $34, and the employee substantiates 3 full days of business travel. The requirement to return excess amounts will be treated as satisfied if the employee is required to return

within a reasonable period of time (as defined in § 1.62–2(g)) the portion of the allowance that is attributable to the 2 unsubstantiated days of travel ($80), even though the employee is not required to return the portion of the allowance ($18) that exceeds the amount of the employee's expenses deemed substantiated under section 4.02 ($102) for the 3 substantiated days of travel. However, the $18 excess portion of the allowance is treated as paid under a nonaccountable plan as discussed in section 7.04.

.03 An employee is not required to include in gross income the portion of a per diem allowance received from a payor that is less than or equal to the amount deemed substantiated under the rules provided in section 4 or 5 if the employee substantiates the business travel expenses covered by the per diem allowance in accordance with section 7.01. See § 1.274–5T(f)(2)(i). In addition, such portion of the allowance is treated as paid under an accountable plan, is not reported as wages or other compensation on the employee's Form W–2, and is exempt from the withholding and payment of employment taxes. See § 1.62–2(c)(2) and (c)(4).

.04 An employee is required to include in gross income only the portion of the per diem allowance received from a payor that exceeds the amount deemed substantiated under the rules provided in section 4 or 5 if the employee substantiates the business travel expenses covered by the per diem allowance in accordance with section 7.01. See § 1.274–5T(f)(2)(ii). In addition, the excess portion of the allowance is treated as paid under a nonaccountable plan, is reported as wages or other compensation on the employee's Form W–2, and is subject to withholding and payment of employment taxes. See § 1.62–2(c)(3)(ii), (c)(5), and (h)(2)(i)(B).

.05 If the amount of the expenses that is deemed substantiated under the rules provided in section 4.01, 4.02, or 5 is less than the amount of the employee's business expenses for travel away from home, the employee may claim an itemized deduction for the amount by which the business travel expenses exceed the amount that is deemed substantiated, provided the employee substantiates all the business travel expenses, includes on Form 2106, Employee Business Expenses, the deemed substantiated portion of the per diem allowance received from the payor, and includes in gross income the portion (if any) of the per diem allowance received from the payor that exceeds the amount deemed substantiated. See § 1.274–5T(f)(2)(iii). However, for purposes of claiming this itemized deduction with respect to meal and incidental expenses, substantiation of the amount of the expenses is not required if the employee is claiming a deduction that is equal to or less than the amount computed under section 4.03 minus the amount deemed substantiated under section 4.02 and section 7.01. The itemized deduction is subject to the 50-percent limitation on meal and entertainment expenses provided in § 274(n) and the 2-percent floor on miscellaneous itemized deductions provided in § 67.

.06 An employee who does not receive a per diem allowance for meal and incidental expenses may deduct an amount computed pursuant to section 4.03 only as an itemized deduction. This itemized deduction is subject to the 50-percent limitation on meal and entertainment expenses provided in § 274(n) and the 2-percent floor on miscellaneous itemized deductions provided in § 67.

.07 A self-employed individual may deduct an amount computed pursuant to section 4.03 in determining adjusted gross income under § 62(a)(1). This deduction is subject to the 50-percent limitation on meal and entertainment expenses provided in § 274(n).

.08 If a payor's reimbursement or other expense allowance arrangement evidences a pattern of abuse of the rules of § 62(c) and the regulations thereunder, all payments under the arrangement will be treated as made under a nonaccountable plan. Thus, such payments are included in the employee's gross income, are reported as wages or other compensation on the employee's Form W–2, and are subject to withholding and payment of employment taxes. See § 1.62–2(c)(3), (c)(5), and (h)(2).

SECTION 8. WITHHOLDING AND PAYMENT OF EMPLOYMENT TAXES

.01 The portion of a per diem allowance, if any, that relates to the days of business travel substantiated and that exceeds the amount deemed substantiated for those days under section 4.01, 4.02, or 5 is subject to withholding and payment of employment taxes. See § 1.62–2(h)(2)(i)(B).

.02 In the case of a per diem allowance paid as a reimbursement, the excess described in section 8.01 is subject to withholding and payment of employment taxes in the payroll period in which the payor reimburses the expenses for the days of travel substantiated. See § 1.62–2(h)(2)(i)(B)(*2*).

.03 In the case of a per diem allowance paid as an advance, the excess described in section 8.01 is subject to withholding and payment of employment taxes no later than the first payroll period following the payroll period in which the days of travel with respect to which the advance was paid are substantiated. See § 1.62–2(h)(2)(i)(B)(*3*). If some or all of the days of travel with respect to which the advance was paid are not substantiated within a reasonable period of time and the employee does not return the portion of the allowance that relates to those days within a reasonable period of time, the portion of the allowance that relates to those days is subject to withholding and payment of employment taxes no later than the first payroll period following the end of the reasonable period. See § 1.62–2(h)(2)(i)(A).

.04 In the case of a per diem allowance only for meal and incidental expenses for travel away from home paid to an employee in the transportation industry by a payor that uses the rule in section 4.04(3), the excess of the per diem allowance paid for the period over the amount deemed substantiated for the period under section 4.02 (after applying section 4.04(3)), is subject to withholding and payment of employment taxes no later than the first payroll period following the payroll period in which the excess is computed. See § 1.62–2(h)(2)(i)(B)(*4*).

.05 For example, assume that an employer pays an employee a per diem allowance to cover business expenses for meals and lodging for travel away from home at a rate of 120 percent of the Federal per diem rate for the localities to which the employee travels. The employer does not require the employee to return the 20 percent by which the reimbursement for those expenses exceeds the Federal per diem rate. The employee substantiates 6 days of travel away from home: 2 days in a locality in which the Federal per diem rate is $100 and 4 days in a locality in which the Federal per diem rate is $125. The employer reimburses the employee $840 for the 6 days of travel away from home (2 × (120% × $100) + 4 × (120% × $125)), and does not require the employee to return the excess payment of $140 ((2 days × $20 ($120−$100) + 4 days × $25 ($150−$125)). For the payroll period in which the employer reim-

burses the expenses, the employer must withhold and pay employment taxes on $140. See section 8.02.

SECTION 9. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 96–28 is hereby superseded for per diem allowances paid to an employee on or after January 1, 1997 with respect to lodging, meal, and incidental expenses or with respect to meal and incidental expenses paid or incurred for travel while away from home on or after January 1, 1997 and, for purposes of computing the amount allowable as a deduction, for meal and incidental expenses paid or incurred by an employee or self-employed individual for travel while away from home on or after January 1, 1997.

Social Security Contribution and Benefit Base

Under authority contained in the Social Security Act ("the Act"), the Commissioner, Social Security Administration, has determined and announced (61 F.R. 55346, dated October 25, 1996) that the contribution and benefit base for remuneration paid in 1997, and self-employment income earned in taxable years beginning in 1997 is $65,400.

"Old-Law" Contribution and Benefit Base

General. The 1997 "old-law" contribution and benefit base is $48,600. This is the base that would have been effective under the Act without the enactment of the 1977 amendments. The base is computed under section 230(b) of the Act as it read prior to the 1977 amendments.

The "old-law" contribution and benefit base is used by:

(a) the Railroad Retirement program to determine certain tax liabilities and tier II benefits payable under that program to supplement the tier I payments which correspond to basic Social Security benefits,

(b) the Pension Benefit Guaranty Corporation to determine the maximum amount of pension guaranteed under the Employee Retirement Income Security Act (as stated in section 230(d) of the Act),

(c) Social Security to determine a year of coverage in computing the special minimum benefit, as described earlier, and

(d) Social Security to determine a year of coverage (acquired whenever earnings equal or exceed 25 percent of the "old-law" base for this purpose only) in computing benefits for persons who are also eligible to receive pensions based on employment not covered under section 210 of the Act.

Notice of Proposed Rulemaking

CONTENTS

CO–9–96 **436**
CO–24–96 **437**
CO–25–96 **439**
CO–26–96 **440**
FI–59–94 **442**
FI–32–95 **443**
FI–48–95 **449**
FI–28–96 **458**
GL–7–96 **460**
IA–292–84 **462**
IA–26–94 **479**
IA–42–95 **481**
IA–29–96 **483**
INTL–4–95 **484**
PS–39–93 **489**
PS–22–96 **491**
REG–208215–91 **491**
REG–209803–95 **497**
REG–209826–96 **498**
REG–209827–96 **507**
REG–245562–96 **509**
REG–251520–96 **511**

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

Notice of Proposed Rulemaking and Notice of Public Hearing

Section 1059 Extraordinary Dividends

CO–9–96

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations relating to certain distributions made by corporations to certain corporate shareholders. The proposed regulations are necessary to clarify that certain distributions in redemption of stock are treated as extraordinary dividends notwithstanding provisions that otherwise might exempt the distributions from extraordinary dividend treatment. Corporations that receive a distribution in redemption of stock may be affected if the redemption is either part of a partial liquidation of the redeeming corporation or is not pro rata as to all shareholders. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments and outlines of topics to be discussed at the public hearing scheduled for Wednesday, October 2, 1996, must be received by September 16, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (CO–9–96), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (CO–9–96), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. The public hearing will be held in room 3313, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC.

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) relating to the extraordinary dividend provisions under section 1059 of the Internal Revenue Code. Section 1059 was added by the Deficit Reduction Act of 1984, Public Law 98–369. One of the purposes of section 1059 is to prevent a corporate shareholder from creating an artificial loss on stock. See General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984.

Section 1059(a) generally requires a corporation that receives an extraordinary dividend on stock it has not held for at least two years before the dividend announcement date to reduce its basis (but not below zero) immediately before any sale or disposition of the stock by the nontaxed portion of the dividend (generally, the amount of the dividends received deduction). If the nontaxed portion of the dividend exceeds basis, the excess generally is treated as additional gain recognized when the stock is sold. Section 1059(c) generally defines an extraordinary dividend as a dividend that equals or exceeds the threshold percentage of the taxpayer's adjusted basis in such stock.

Sections 1059(d)(6), (e)(1), and (e)(2) were enacted as part of the Tax Reform Act of 1986. Each of those sections affects the definition of extraordinary dividends contained in section 1059(c). Section 1059(d)(6) generally excludes an extraordinary dividend from section 1059(a) treatment if the distributee is an original shareholder of the distributing corporation and the earnings and profits from which the dividend is paid are attributable solely to the original shareholder. Section 1059(e)(2) generally excludes a dividend from extraordinary dividend treatment if it is a "qualifying dividend." A dividend generally is a qualifying dividend if the distributee and distributing corporations are affiliated at the time of the distribution and the distribution is out of affiliated year earnings and profits. Both sections 1059(d)(6) and (e)(2) contemplate that the distribution that otherwise would be an extraordinary dividend subject to section 1059(a) is derived from earnings and profits accumulated while the distributee corporation is a shareholder of the distributing corporation. Generally, a corporate shareholder's ability to create an artificial loss is reduced if all of the distributing corporation's earnings and profits are accumulated while the distributee corporation is a shareholder of the distributing corporation.

Section 1059(e)(1) expands the scope of the extraordinary dividend definition in section 1059(c) by disregarding the holding period and threshold rules for certain distributions. Generally, section 1059(e)(1) provides that a non pro rata redemption or a partial liquidation that is treated as a dividend under section 301 is an extraordinary dividend to which section 1059(a) applies without regard to the threshold percentage or the period the taxpayer held such stock. See General Explanation of the Tax Reform Act of 1986, Joint Committee on Taxation, 100th Cong., 1st Sess. (May 4, 1987).

These regulations address the question of whether section 1059(d)(6) or (e)(2) applies to a distribution otherwise treated as an extraordinary dividend under section 1059(e)(1). The IRS and Treasury Department believe that applying those provisions to section 1059(e)(1) is inconsistent with the purpose of section 1059 and may create inappropriate consequences, such as basis shifting that eliminates gain or creates an artificial loss.

Accordingly, these regulations clarify that neither section 1059(d)(6) nor section 1059(e)(2) applies to a distribution treated as an extraordinary dividend under section 1059(e)(1). In finalizing these regulations, the IRS and Treasury Department will consider comments that illustrate distributions described in section 1059(e)(1) to which the application of section 1059(d)(6) or (e)(2) is appropriate or to which section 1059(e)(1) otherwise should not apply.

These regulations also address the question of whether an exchange treated as a dividend under section 356(a)(2) is subject to section 1059(e)(1). These regulations clarify that for purposes of section 1059(e)(1), an exchange under section 356(a)(1) is treated as a redemption and, to the extent any amount is treated as a dividend under section 356(a)(2), it is treated as a dividend under section 301.

Explanation of Provisions

Proposed § 1.1059(e)–1(a) provides that neither section 1059(d)(6) nor section 1059(e)(2) will prevent any distribution treated as an extraordinary dividend under section 1059(e)(1) from being treated as an extraordinary dividend. For example, if a redemption of stock is not pro rata as to all shareholders, any amount treated as a dividend under section 301 is treated as an extraordinary dividend regardless of whether the dividend is a qualifying dividend.

Proposed § 1.1059(e)–1(b) provides that for purposes of section 1059(e)(1), an exchange under section 356(a)(1) is treated as a redemption and, to the extent any amount is treated as a dividend under section 356(a)(2), it is treated as a dividend under section 301.

Proposed Effective Date

These regulations are proposed to apply to distributions announced on or after June 17, 1996.

Special Analyses

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

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled at 10 a.m. on Wednesday, October 2, 1996, room 3313, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more that 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments by September 16, 1996, and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by September 16, 1996.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Section 1.1059(e)–1 also issued under 26 U.S.C. 1059(e)(1) and (e)(2). * * *

Par. 2. Section 1.1059(e)–1 is added to read as follows:

§ 1.1059(e)–1 Non pro rata redemptions.

(a) *In general.* Section 1059(d)(6) (exception where stock held during entire existence of corporation) and section 1059(e)(2) (qualifying dividends) do not apply to a distribution treated as an extraordinary dividend under section 1059(e)(1). For example, if a redemption of stock is not pro rata as to all shareholders, any amount treated as a dividend under section 301 is treated as an extraordinary dividend regardless of whether the dividend is a qualifying dividend.

(b) *Reorganizations.* For purposes of section 1059(e)(1), an exchange under section 356(a)(1) is treated as a redemption and, to the extent any amount is treated as a dividend under section 356(a)(2), it is treated as a dividend under section 301.

(c) *Effective date.* This section applies to distributions announced (within the meaning of section 1059(d)(5)) on or after June 17, 1996.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on June 17, 1996, 8:45 a.m., and published in the issue of the Federal Register for June 18 1996, 61 F.R. 30845)

Notice of Proposed Rulemaking and Notice of Public Hearing

Consolidated Returns—Limitations on the Use of Certain Losses and Deductions

CO–24–96

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Withdrawal of prior proposed rule, notice of proposed rulemaking by cross-reference to temporary regulations, and notice of public hearing.

SUMMARY: On January 29, 1991, proposed rules under section 1502 were filed with the Office of the **Federal Register** (CO–78–90; see 56 FR 4228; 1991–1 C.B. 757). A public hearing was held on April 8, 1991. The IRS and Treasury published Notice 91–27 (1991–2 C.B. 629) to advise of intended modifications to the proposed regulations. The January, 1991, proposed rules are withdrawn, and these proposed rules are issued in their place.

In T.D. 8677 on page 119, the IRS is issuing temporary regulations relating to the carryover and carryback of losses to consolidated and separate return years. The text of those temporary regulations also serves as the text of these proposed regulations. This document also provides a notice of public hearing on these proposed regulations.

DATES: Written comments must be received by Wednesday, September 25, 1996. Outlines of topics to be discussed at the public hearing scheduled for Thursday, October 17, 1996, at 10 a.m. must be received by Thursday, September 26, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (CO–24–96), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (CO–24–96), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. The public hearing will be held in the NYU Classroom, Room 2615, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC 20224.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under the control number 1545–1237. Section 1.1502–21(b)(3) requires a response from certain consolidated groups. The IRS requires the information to assure that an election to relinquish a carryback period is properly documented.

Comments concerning the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of Treasury, Office of Information and Regulatory Affairs, Washington, DC, 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, T:FP. Washington, DC, 20224. Comments on the collection of information should be received by Monday, August 26, 1996.

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

The collection of information is in Proposed § 1.1502–21(b)(3). That section permits an election to relinquish a carryback period with respect to a consolidated net operating loss. The common parent of the group files the statement evidencing the election with the income tax return of the group. This information is required by the IRS to assure that an election to relinquish a carryback period is properly documented. The likely respondents and/or recordkeepers are certain consolidated groups of corporations. Responses to this collection of information are required to obtain a benefit (relating to the carryover of losses which would otherwise be carried back).

Books or records relating to this collection of information must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Estimated total annual reporting burden: 1,000 hours. The estimated annual burden per respondent varies from five to thirty minutes, depending on individual circumstances, with an estimated average of ten minutes. Estimated number of respondents: 6,000. Estimated annual frequency of responses: 1.

Background

Temporary regulations in T.D. 8677 on page 119 amend the Income Tax Regulations (26 CFR par 1) relating to deductions and losses of members. The temporary amendments concern the method for computing the limitations with respect to separate return limitation year (SRLY) losses. They also concern the rules relating to carryover and carryback of losses to consolidated and separate return years and to the built-in deductions rules. The final regulations that are proposed to be based on these proposed regulations would be added to part 1 of title 26 of the Code of Federal Regulations. Those final regulations would provide rules for computing the limitations with respect to separate return limitation year (SRLY) losses. They also concern the rules relating to carryover and carryback of losses to consolidated and separate return years and to the built-in deductions rules.

For the text of these new temporary regulations, see T.D. 8677 on page 119. The preamble to the temporary regulations explains the regulations.

Proposed Effective Date

For dates of application and special transition rules, see the discussion of Effective Dates under SUPPLEMENTARY INFORMATION relating to the temporary regulations, published on page 436.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations do not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations will primarily affect affiliated groups of corporations that have elected to file consolidated returns, which tend to be larger businesses. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Thursday, October 17, 1996, at 10 a.m. in the NYU Classroom, Room 2615, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments by Wednesday, September 25, 1996, and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by Thursday, September 26, 1996.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Withdrawal of Notice of Proposed Rulemaking

Accordingly, under the authority of 26 U.S.C. 7805, the notice of proposed rulemaking that was published on January 29, 1991 (56 FR 4228) is withdrawn.

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

Authority: 26 U.S.C. 7805

* * *

Section 1.1502–15 also issued under 26 U.S.C. 1502.

* * *

Section 1.1502–21 also issued under 26 U.S.C. 1502.

Section 1.1502–22 also issued under 26 U.S.C. 1502.

Section 1.1502–23 also issued under 26 U.S.C. 1502.

Section 1.1502–79 also issued under 26 U.S.C. 1502.

Section 1.1502–15A also issued under 26 U.S.C. 1502.

Section 1.1502–21A also issued under 26 U.S.C. 1502.

Section 1.1502–22A also issued under 26 U.S.C. 1502.

Section 1.1502–23A also issued under 26 U.S.C. 1502.

Section 1.1502–41A also issued under 26 U.S.C. 1502.

Section 1.1502–79A also issued under 26 U.S.C. 1502.

* * *

Par. 2. Section 1.1502–15 is added to read as follows:

§ 1.1502–15 SRLY limitation on built-in losses.

[The text of this proposed section is the same as the text of § 1.1502–15T published elsewhere in this issue of the Bulletin.]

Par. 3. Section 1.1502–21 is added to read as follows:

§ 1.1502–21 Net operating losses.

[The text of this proposed section is the same as the text of § 1.1502–21T published in T.D. 8677.]

Par. 4. Section 1.1502–22 is added to read as follows:

§ 1.1502–22 Consolidated capital gain and loss.

[The text of this proposed section is the same as the text of § 1.1502–22T published in T.D. 8677.]

Par. 5. Section 1.1502–23 is added to read as follows:

§ 1.1502–23 Consolidated net section 1231 gain or loss.

[The text of this proposed section is the same as the text of § 1.1502–23T published in T.D. 8677.]

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on June 26, 1996, 8:45 a.m., and published in the issue of the Federal Register for June 27, 1996, 61 F.R. 33393)

Notice of Proposed Rulemaking and Notice of Public Hearing

Regulations Under Section 1502 of the Internal Revenue Code of 1986; Limitations on Net Operating Loss Carryforwards and Certain Built-in Losses and Credits Following an Ownership Change of a Consolidated Group

CO–25–96

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Withdrawal of prior proposed rule, notice of proposed rulemaking by cross-reference to temporary regulations, and notice of public hearing.

SUMMARY: On February 4, 1991, proposed rules under section 1502 were published in the **Federal Register** (CO–132–87; see 56 FR 4194; 1991–1 C.B. 728). A public hearing was held on April 8, 1991. The IRS and Treasury published Notice 91–27 (1991–2 C.B. 629) to advise of intended modifications to the proposed regulations. The February, 1991, proposed rules are withdrawn and these proposed regulations are issued in their place.

In TD 8678, page 134, the IRS is issuing temporary regulations regarding the operation of sections 382 and 383 of the Internal Revenue Code of 1986 (relating to limitations on net operating loss carryforwards and certain built-in losses and credits following an ownership change) with respect to consolidated groups. The text of those temporary regulations also serves as the text of these proposed regulations. This document also provides a notice of public hearing on these proposed regulations.

DATES: Written comments must be received by Wednesday, September 25, 1996. Outlines of topics to be discussed at the public hearing scheduled for Thursday, October 17, 1996, at 10 a.m. must be received by Thursday, September 26, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (CO–25–96), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (CO–25–96), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. The public hearing will be held in the NYU Classroom, Room 2615, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under the control number 1545–1218. The collection requires a response from certain consolidated groups. The IRS requires the information described in Proposed § 1.1502–95(e) to assure that a section 382 limitation is properly determined in cases of corporations that cease to be members of a group.

Comments concerning the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC, 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, T:FP. Washington, DC 20224. Comments on the collection of information should be received by Monday, August 26, 1996.

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

The collection of information is in Proposed § 1.1502–95(e). That section permits an election with respect to the apportionment of a group section 382 limitation to a departing member. A statement evidencing the apportionment must be filed by the group and the departing member indicating relevant information regarding the apportionment. The likely respondents and/or recordkeepers are corporations that are members of certain consolidated groups. Responses to this collection of information are required to obtain a benefit (relating to the section 382 limition applicable to the departing member(s)).

Books or records relating to this collection of information must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Estimated total annual reporting burden: 380 hours. The estimated annual burden per respondent varies from ten to thirty minutes, depending on individual circumstances, with an estimated average of fifteen minutes. Estimated number of respondents: 9,125. Estimated frequency of responses: once every six years.

Background

Temporary regulations in T.D. 8678, page 134, amend the Income Tax Regulations (26 CFR Part 1) under section 1502, relating to limitations on net operating loss carryforwards and certain

built-in losses and credits following an ownership change with respect to consolidated groups. The final regulations that are proposed to be based on these proposed regulations would be added to part 1 of title 26 of the Code of Federal Regulations. Those final regulations would provide rules relating to limitations on net operating loss carryforwards and certain built-in losses following an ownership change.

For the text of these new temporary regulations, see T.D. 8678. The preamble to the temporary regulations explains the regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations do not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations will primarily affect affiliated groups of corporations that have elected to file consolidated returns, which tend to be larger businesses. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Thursday, October 17, 1996, at 10 a.m. in the NYU Classroom, Room 2615, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments by Wednesday, September 25, 1996, and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by Thursday, September 26, 1996.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Withdrawal of Notice of Proposed Rulemaking

Accordingly, under the authority of 26 U.S.C. 7805, the notice of proposed rulemaking that was published on January 29, 1991 (56 FR 4194) is withdrawn.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are proposed to be amended as follows:

PART 1—INCOME TAXES

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

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

Section 1.1502–91 also issued under 26 U.S.C. 382(m) and 26 U.S.C. 1502.

Section 1.1502–92 also issued under 26 U.S.C. 382(m) and 26 U.S.C. 1502.

Section 1.1502–93 also issued under 26 U.S.C. 382(m) and 26 U.S.C. 1502.

Section 1.1502–94 also issued under 26 U.S.C. 382(m) and 26 U.S.C. 1502.

Section 1.1502–95 also issued under 26 U.S.C. 382(m) and 26 U.S.C. 1502.

Section 1.1502–96 also issued under 26 U.S.C. 382(m) and 26 U.S.C. 1502.

Section 1.1502–98 also issued under 26 U.S.C. 382(m) and 26 U.S.C. 1502.

Section 1.1502–99 also issued under 26 U.S.C. 382(m) and 26 U.S.C. 1502.

* * *

Par. 2. Sections 1.1502–90 through 1.1502–99 are added to read as follows:

§ 1.1502–90 Table of contents.

§ 1.1502–91 Application of section 382 with respect to a consolidated group.

§ 1.1502–92 Ownership change of a loss group or a loss subgroup.

§ 1.1502–93 Consolidated section 382 limitation (or subgroup section 382 limitation.

§ 1.1502–94 Coordination with section 382 and the regulations thereunder when a corporation becomes a member of a consolidated group.

§ 1.1502–95 Rules on ceasing to be a member of a consolidated group (or loss subgroup).

§ 1.1502–96 Miscellaneous rules.

§ 1.1502–97 Special rules under section 382 for members under the jurisdiction of a court in a title 11 or similar case.

§ 1.1502–98 Coordination with section 383.

§ 1.1502–99 Effective dates.

[The text of the above proposed sections is the same as the text of § § 1.1502–90T through 1.1502–99T published in T.D. 8678.]

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on June 26, 1996, 8:45 a.m., and published in the issue of the Federal Register for June 27, 1996, 61 F.R. 33395)

Notice of Proposed Rulemaking and Notice of Public Hearing

Regulations Under Section 382 of the Internal Revenue Code of 1986; Application of Section 382 in Short Taxable Years and With Respect to Controlled Groups

CO–26–96

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Withdrawal of prior proposed rule, notice of proposed rulemaking by cross-reference to temporary regulations, and notice of public hearing.

SUMMARY: On January 29, 1991, proposed rules under section 382 of the Internal Revenue Code of 1986 (relating to limitations on net operating loss carryforwards and certain built-in losses following an ownership change) were filed with the Office of the **Federal Register** (CO–77–90; see 56 FR 4183; 1991–1 C.B. 749). The January, 1991, proposed rules are withdrawn and these proposed rules are issued in their place.

In T.D. 8679, page 25, the IRS is issuing temporary regulations relating to the application of section 382 in short taxable years and with respect to controlled

groups. These regulations comply with the statutory direction under section 382(m) to prescribe such regulations. Additional rules amend certain aspects of § 1.382–2T relating principally to the separate tracking of the stock ownership of loss corporations that cease to exist following a merger or similar transactions.

The text of those temporary regulations also serves as the text of these proposed regulations. This document also provides a notice of public hearing on these proposed regulations.

DATES: Written comments must be received by Wednesday, September 25, 1996. Outlines of topics to be discussed at the public hearing scheduled for Thursday, October 17, 1996, at 10 a.m. must be received by Thursday, September 26, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (CO–26–96), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (CO–26–96), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. The public hearing will be held in the NYU Classroom, Room 2615, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under the control number 1545–1434. Proposed § 1.382–8(h) requires a response from certain corporations that are members of controlled groups. The IRS requires this information to assure compliance with section 382(m)(5) so that the value of a loss corporation that is a member of a controlled group is not taken into account more than once in computing a section 382 limitation.

Comments concerning the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, T:FP. Washington, DC 20224. Comments on the collection of information should be received by Monday, August 26, 1996.

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

Proposed § 1.382–8(h) provides that the loss corporation must file a statement signed by it and any other member of the controlled group that elects to restore value to it indicating relevant information regarding the election. The likely respondents and/or recordkeepers are corporations that are members of certain controlled groups. Responses to this collection of information are required to obtain a benefit (relating to the restoration of value for section 382 purposes).

Books or records relating to this collection of information must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Estimated total annual reporting burden: 875 hours. The estimated annual burden per respondent varies from ten to thirty minutes, depending on individual circumstances, with an estimated average of fifteen minutes. Estimated number of respondents: 21,000. Estimated frequency of responses: once every six years.

Background

Temporary regulations in T.D. 8679, page 25, amend the Income Tax Regulations (26 CFR Part 1) under section 382 of the Internal Revenue Code of 1986. Among other changes, those regulations add temporary regulations § § 1.382–5T and 1.382–8T, and amend § 1.382–2T(f). The final regulations that are proposed to be based on these proposed regulations would be added to part 1 of title 26 of the Code of Federal Regulations. Those final regulations would provide rules relating to limitations on net operating loss carryforwards and certain built-in losses following an ownership change under section 382.

For the text of these new temporary regulations, see T.D. 8679. The preamble to the temporary regulations explains the regulations.

Special Analyses

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

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Thursday, October 17, 1996, at 10 a.m. in the NYU Classroom, Room 2615, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments by Wednesday, September 25, 1996, and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by Thursday, September 26, 1996.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Withdrawal of Notice of Proposed Rulemaking

Accordingly, under the authority of 26 U.S.C. 7805, the notice of proposed rulemaking that was published on January 29, 1991 (56 FR 4183) is withdrawn.

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by revising the entry for § 1.382–2T and adding citations for § § 1.382–5 and 1.382–8 in numerical order to read as follows:

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

Section 1.382–2T also issued under 26 U.S.C. 382(g)(4)(C), (i), (k)(1) and (6), (l)(3), (m), and 26 U.S.C. 383.* * *

Section 1.382–5 also issued under 26 U.S.C. 382(m).* * *

Section 1.382–8 also issued under 26 U.S.C. 382(m).* * *

Par. 2. Section 1.382–1 is amended by revising the entries for § 1.382–2(a)(1)(iv), and adding § § 1.382–5 and 1.382–8 to read as follows:

§ 1.382–1 Table of contents.

* * * * *

§ 1.382–2 General rules for ownership change.

(a) * * *

(1) * * *

(iv) End of separate accounting for losses and credits of distributor or transferor loss corporation.

* * * * *

§ 1.382–5 Section 382 limitation.

(a) Scope.

(b) Computation of value.

(c) Short taxable year.

(d) Successive ownership changes and absorption of a section 382 limitation.

(1) In general.

(2) Recognized built-in gains and losses.

(3) Effective date.

(e) Controlled groups.

(f) Effective date.

* * * * *

§ 1.382–8 Controlled groups.

(a) Introduction.

(b) Controlled group loss and controlled group with respect to a controlled group loss.

(c) Computation of value.

(1) Reduction in value.

(2) Restoration of value.

(3) Reduction in value by the amount restored.

(4) Appropriate adjustments.

(5) Certain reductions in the value of members of a controlled group.

(d) No double reduction.

(e) Definitions and nomenclature.

(1) Definitions in § 1.382–2T.

(2) Controlled group.

(3) Component member.

(4) Predecessors and successors.

(f) Coordination between consolidated groups and controlled groups.

(g) Examples.

(h) Time and manner of filing election to restore.

(1) Statement required.

(2) Revocation of election.

(3) Filing by component member.

(i) [Reserved]

(j) Effective date.

(1) In general.

(2) Transition rule.

(3) Corporations that are not members on January 29, 1991.

(4) Amended returns.

Par. 3. Section 1.382–2 is amended as follows:

§ 1.382–2 General rules for ownership change.

[The text of the proposed amendments to paragraphs (e)(2)(iv), (f)(1)(i), (ii) and (iii), (f)(4), (f)(5), and (f)(18)(i) is the same as the text of the amendments to paragraphs (e)(2)(iv), (f)(1)(i), (ii) and (iii), (f)(4), (f)(5), and (f)(18)(i) of § 1.382–2T, published in T.D. 8679, page 25.]

Par. 4. Sections 1.382–5 and 1.382–8 are added to read as follows:

[The text of these proposed sections is the same as the text of § § 1.382–5T and 1.382–8T published in T.D. 8679, page 25.]

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on June 26, 1996, 8:45 a.m., and published in the issue of the Federal Register on June 27, 1996, 61 F.R. 33391)

Notice of Proposed Rulemaking

Modifications of Bad Debts and Dealer Assignments of Notional Principal Contracts

FI-59-94

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In T.D. 8676 on page 9, the IRS is issuing temporary regulations relating to the allowance of a deduction for a partially worthless debt when the terms of a debt instrument have been modified. The temporary regulations provide relief to certain taxpayers that are required to recognize gain as the result of modifying a debt instrument, when a portion of the gain is in part caused by a reduction of the debt's basis attributable to a bad debt deduction claimed in a prior taxable year. The temporary regulations provide guidance to taxpayers that modify the terms of a debt instrument after deducting an amount for partial worthlessness.

In T.D. 8676 the IRS is also issuing temporary regulations relating to certain assignments of notional principal contracts by dealers in those contracts. The temporary regulations provide guidance to taxpayers relating to consequences of these assignments.

The text of those temporary regulations also serves as the text of these proposed regulations.

DATES: Written comments and requests for a public hearing must be received by September 23, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (FI-59-94), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (FI-59-94), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC 20224.

SUPPLEMENTARY INFORMATION:

Background

Temporary regulations in T.D. 8676 amend the Income Tax Regulations (26 CFR part 1) relating to section 166. The temporary regulations contain rules relating to the requirement that a debt be charged off before a deduction on account of partial worthlessness is allowed. The rules apply to certain taxpayers who are required to recognize gain as the result of a significant modification of a debt instrument.

Temporary regulations in T.D. 8676 amend the Income Tax Regulations (26 CFR part 1) relating to section 1001. The temporary regulations contain rules

relating to certain assignments of notional principal contracts by dealers in those contracts.

The text of those temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the temporary regulations.

Special Analyses

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

Comments and Requests for a Public Hearing

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

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.166-3 is added to read as follow:

§ 1.166-3 Partial or total worthlessness.

[The text of proposed paragraph (a)(3) is the same as the text of § 1.166-3T(a)(3) published in T.D. 8676].

Par. 3. Section 1.1001-4 is added to read as follows:

§ 1.1001-4 Modifications of notional principal contracts.

[The text of proposed section 1.1001-4 is the same as the text of § 1.1001-4T published in T.D. 8676].

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on June 24, 1996, 8:45 a.m., and published in the issue of the Federal Register for June 25, 1996, 61 F.R. 32728)

Notice of Proposed Rulemaking and Notice of Public Hearing

Mark-to-Market for Dealers in Securities; Equity Interests in Related Parties and the Dealer-Customer Relationship

FI–32–95

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations that make mark-to-market accounting inapplicable to most equity interests in related entities. The regulations also relate to the definition of a dealer in securities for certain federal income tax purposes. To qualify as a dealer in securities, a taxpayer must engage in transactions with customers. The proposed regulations concern the existence of dealer-customer relationships. The Revenue Reconciliation Act of 1993 amended the applicable tax law. These regulations provide guidance for taxpayers that engage in securities transactions. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments and outlines of oral comments to be presented at a public hearing scheduled for October 15, 1996, at 10 a.m., must be received by September 18, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (FI–32–95), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (FI–32–95), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC 20224. The public hearing will be held in the Commissioner's Conference Room, room 3313, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC 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 1995 (44 U.S.C. 3507).

Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224. Comments on the collection of information should be received by August 19, 1996.

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

The collection of information is described in the Explanation of Provisions section of the Preamble (rather than being included in the text of the proposed regulations). The Preamble requests comments on whether the final regulations should permit taxpayers to elect to disregard certain inter-company transactions in determining status as a dealer in securities. The preamble also indicates that, if the election is allowed to be made, it is expected that taxpayers would make it by attaching a statement to a tax return. If the final regulations allow taxpayers to make this election in this manner, the information will be required by the IRS to determine whether the election has been made, and will be used for that purpose. The likely respondents will be businesses that file consolidated tax returns. If taxpayers are allowed to make the election, responses

to this collection of information will be required to obtain the benefit of having status as a dealer in securities determined without regard to certain intercompany transactions.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Estimated total annual reporting burden: 6,000 hours.

The estimated annual burden per respondent varies from .25 hour to 1 hour, depending on individual circumstances, with an estimated average of .5 hours.

Estimated number of respondents: 12,000.

Estimated annual frequency of responses: once in the existence of each respondent.

Background

This document contains proposed regulations under section 475 of the Internal Revenue Code, which requires mark-to-market accounting for certain dealers in securities. Section 475 was added by section 13223 of the Revenue Reconciliation Act of 1993, Pubic Law 103–66, 107 Stat. 481, and is effective for all taxable years ending on or after December 31, 1993.

Temporary and proposed regulations published on December 29, 1993, [58 FR 68798] provide that stock in a 50-percent-controlled subsidiary (and interests in 50-percent-controlled partnerships and trusts) are deemed properly identified as held for investment and thus are excluded from mark-to-market accounting. The IRS is reproposing this rule with two changes. First, the IRS has concluded that the rationale for the rule applies equally to equity interests in most related persons and not just to persons controlled by the taxpayer. Second, after considering various comments received, the IRS determined that this rule prohibiting marking a security to market should not apply if two requirements are met: (1) the security is actively traded on a national securities exchange or through an interdealer quotation system; and (2) the taxpayer who marks owns less than 5 percent of all shares or interests of the same class. Comments are requested as to whether it is appropriate to allow any equity interests in related parties to be marked to market, and, if so, whether the proposed limitations are the most appropriate ones. The provisions in this document concerning these issues are referred to below in this preamble as the reproposed regulations.

When commenting on the temporary and proposed regulations, taxpayers asked the IRS to provide guidance on whether certain transactions are entered into with customers for purposes of section 475. Whether transactions are entered into with customers can affect both whether a taxpayer is a dealer in securities subject to mark-to-market accounting (see section 475(c)(1)) and whether a dealer may exempt a security from mark-to-market treatment (see section 475(b)(1)(A) and (B) and § 1.475(b)–1T(a)).

In response to these comments, on January 4, 1995, the IRS published proposed regulations [(FI–42–94) (60 FR 397)] stating that whether a taxpayer is transacting business with customers is determined based on all of the facts and circumstances (see proposed § 1.475(c)–1(c), reproposed as § 1.475(c)–1(a)). These proposed regulations also provide that the term dealer in securities includes a taxpayer that, in the ordinary course of its trade or business, regularly holds itself out as being willing and able to enter into either side of a transaction enumerated in section 475(c)(1)(B) (see proposed § 1.475(c)–1(c)(2), reproposed as § 1.475(c)–1(a)(2)).

On March 4, 1996, the IRS published Notice 96–12 (1996–10 I.R.B. 29), stating that the IRS intended to publish additional proposed regulations concerning when transactions with related parties may be transactions with customers for purposes of section 475. Notice 96–12 also described the substance of rules that the proposed regulations were expected to contain. The rules were expected to be proposed to be effective for taxable years beginning on or after February 20, 1996. The proposed regulations in this document generally reflect the substance that was described in Notice 96–12.

Explanation of Provisions

Prohibition against marking equity interests in related persons

The reproposed regulations identify certain assets that are inherently investments and, thus, may not be marked to market under section 475. The new rules retain the provision in the temporary regulations that prevents marking certain insurance products to market, but they differ from the temporary regulations in the provisions that prevent the marking of certain equity interests. Under the temporary regulations, the prohibition against marking applies only if the dealer in securities controls the issuer of an equity interest (whether it is stock in a corporation or an interest in a widely held or publicly traded partnership or trust). The reproposed regulations expand the scope of this treatment so that mark-to-market accounting cannot be used for equity interests in many related issuers. (For these purposes, the reproposed regulations incorporate by reference the relevant relations described in sections 267(b) and 707(b)(1).) The reproposed regulations also narrow the scope of this prohibition against marking so that mark-to-market accounting can be used for certain actively-traded securities, regardless of the dealer's relation to the issuer of the security, if the dealer owns less than five percent of the securities. The IRS is particularly interested in receiving comments on the scope of the reproposed rules' exception to the general prohibition on marking to market equity interests in a related person.

These reproposed regulations also contain rules to cover situations where a security begins, or ceases, to be subject to this deemed-identification rule. First, if a security is being marked to market and then, as a result of a change in facts, the regulations prohibit the security from continuing to be marked to market, the regulations require that the security be marked as of the close of business on the last day before the day when the prohibition on marking first applies.

Second, the reproposed regulations also cover situations in which the regulations have prohibited a security from being marked to market and then the prohibition on marking ceases to apply. In these cases, the deadline for the taxpayer to identify the security under section 475(b)(2) as exempt from mark-to-market treatment is generally extended until the date the prohibition on marking ceases to apply. (If the taxpayer had identified the security by the original deadline, the extension, of course, is irrelevant.) If the identification is not made on or before the deadline (as so extended), new changes in value are taken into account under the mark-to-market method, but recognition of appreciation and depreciation that occurred while the security was not being marked is suspended. This is the approach

adopted by section 475(b)(3) for securities that lose their exemption from mark-to-market treatment. The reproposed rule is to apply both when the prohibition on marking ceases because of a change in facts and when the prohibition on marking ceases because the rule covering certain actively-traded securities becomes effective.

In sum, under the reproposed regulations, the following assets held by a dealer in securities are deemed to be properly identified as held for investment: (1) stock in a corporation (or a partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust) to which the taxpayer is related (other than certain actively-traded stock or interests); and (2) an annuity, endowment, or life insurance contract. The provision concerning the second category of assets continues to be proposed to apply to all taxable years ending on or after December 31, 1993. The rules concerning the first category of assets, however, are proposed to prohibit only those marks to market that would have occurred on or after June 19, 1996. If the prohibition against marking begins to apply to a security solely because of this effective date rule, then (unlike the situation when the onset of the prohibition is caused by a change in facts) the security is not marked to market immediately before the prohibition begins.

In general, the provision allowing certain actively-traded securities to be marked to market even when the issuer of the security is related is proposed to be effective for marks to market on or after June 19, 1996. Thus, this effective date is the same as the effective date in the reproposed regulations for the general prohibition on marking to market securities issued by a related person. Until the reproposed regulations are finalized, however, all equity interests issued by controlled entities continue to be subject to the temporary regulations' prohibition against being marked to market, even if the dealer owns less than 5 percent of interests of that class and even if the interests are actively traded.

Some commenters suggested there should be no per se rule treating certain securities as held for investment, but instead there should be a rebuttable presumption to this effect for these items. Other commenters proposed to add, or delete, a variety of items to or from those deemed to be per se held for investment. The reproposed regulations do not adopt these suggestions.

Consolidated Returns

Under both the temporary and the reproposed regulations, there are situations in which the mark-to-market method may apply to a consolidated group member's stock held by another member of the group. This may result in the recognition of duplicate gain or loss. For instance, if a common parent marks to market stock in a subsidiary to reflect increases in the value of the subsidiary stock owned by the parent resulting from appreciation in the value of the subsidiary's assets, the parent will recognize gain on that stock under the mark-to-market method. The subsidiary's subsequent sale of the assets will replicate that gain at the subsidiary level. The gains will generate duplicate stock basis increases under section 475 and § 1.1502–32(b), creating the potential for an offsetting loss when the stock is subsequently marked down to fair market value under section 475. Section 1.1502–20, however, may disallow any such offsetting loss. Comments are invited regarding how to address the anomalies these rules may produce.

The dealer-customer relationship

These proposed regulations clarify that a taxpayer's transactions with members of its consolidated group or other related persons may be transactions with customers for purposes of section 475. Thus, a taxpayer may be a dealer in securities for purposes of section 475 even if its only customer transactions are transactions with members of its consolidated group. In enacting section 475, Congress adopted a taxpayer-by-taxpayer approach to determining dealer status, rather than the single-entity approach embodied in § 1.1502–13.

An example in the proposed regulations clarifies that, for purposes of section 475, transactions do not fail to be transactions with customers solely because the parties enter into them with other than arms-length pricing terms. Under section 482 and the regulations thereunder, however, the district director may make allocations between or among the members of the group if he or she determines that a member has not reported its true taxable income.

These proposed regulations generally reflect the substance of the rules set forth in Notice 96–12 (1996–10 I.R.B. 29). In response to taxpayer comments, however, certain language in Notice 96–12 has been clarified. Because of these changes, although the rules described in Notice 96–12 were expected to be proposed to be effective for taxable years beginning on or after February 20, 1996, these proposed regulations are to be effective for taxable years beginning on or after June 20, 1996. If there are any situations in which the proposed rules lead to a different result from that which would be reached under the rules described in the notice, a taxpayer may reasonably and consistently apply the rules described in the notice for any taxable year beginning on or after February 20, 1996, and before June 20, 1996.

Under these regulations, a taxpayer may be a dealer in securities based solely on transactions with other members of its consolidated group. The IRS requests comments on whether certain consolidated groups should be allowed to disregard inter-member transactions in determining a member's status as a dealer in securities. For instance, a group might be allowed to disregard inter-member transactions if the group, considered as a single corporation, would not be a dealer in securities for purposes of section 475. It is likely that the election, if permitted by the final regulations, would be made by attaching an appropriate statement to the taxpayer's return. (See the Paperwork Reduction Act section of this preamble, which requests comments on the burden that might be imposed by this requirement.) The IRS hereby requests comments on the desirability and potential terms and conditions of any such election. Comments could also address whether such an election should apply in determining whether a taxpayer had made more than negligible sales for purposes of reproposed § 1.475(c)–1(c). Further, the IRS requests comments on whether the election should be available only to groups that have not made a separate-entity election under § 1.1221–2(d)(2).

Miscellaneous

Some of the 1993 and 1995 proposed regulations are reordered.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the

Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for October 15, 1996, at 10 a.m. in the Commissioner's Conference Room, room 3313, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC 20224. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by September 18, 1996.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1, as proposed on January 4, 1995, at 60 FR 401, is further amended by revising the entries for "Section 1.475(b)–1", "Section 1.475(b)–2", and "Section 1.475(b)–4" to read as follows:

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

Section 1.475(b)–1 also issued under 26 U.S.C. 475(a) and 26 U.S.C. 475(e).

Section 1.475(b)–2 also issued under 26 U.S.C. 475(b)(2) and 26 U.S.C. 475(e). * * *

Section 1.475(b)–4 also issued under 26 U.S.C. 475(b)(2), 26 U.S.C. 475(e), and 26 U.S.C. 6001. * * *

Par. 2. Section 1.475–0, as proposed on January 4, 1995 (60 FR 401), is amended by:

1. Revising the heading and entries for § § 1.475(b)–1, 1.475(b)–2, and 1.475(b)–4.

2. Revising the entries under §§ 1.475(c)–1 and 1.475(c)–2.

3. Removing the entries under § 1.475(e)–1.

The revisions read as follows:

§ 1.475–0 Table of contents.

* * * * *

§ 1.475(b)–1 Scope of exemptions from mark-to-market requirement.

(a) Securities held for investment or not held for sale.
(b) Securities deemed identified as held for investment.
(1) In general.
(2) Relationships
(i) General rule
(ii) Attribution
(iii) Trusts treated as partnerships
(3) Securities traded on certain established financial markets.
(4) Changes in status.
(i) Onset of prohibition against marking.
(ii) Termination of prohibition against marking.
(iii) Examples
(c) Securities deemed not held for investment.
(1) General rule for dealers in notional principal contracts and derivatives.
(2) Exception for securities not acquired in dealer capacity.
(d) Special rules.
(1) Stock, partnership, and beneficial ownership interests in certain controlled corporations, partnerships, and trusts.
(i) In general.
(ii) Control defined.
(iii) Applicability.
(2) [Reserved]

§ 1.475(b)–2 Exemptions—Identification requirements.

(a) Identification of the basis for exemption.
(b) Time for identifying a security with a substituted basis.
(c) Securities involved in integrated transactions under § 1.1275–6.
(1) Definitions.
(2) Synthetic debt held by a taxpayer as a result of legging in.
(3) Securities held after legging out.

* * * * *

§ 1.475(b)–4 Exemptions—Transitional issues.

(a) Transitional identification.
(1) Certain securities previously identified under section 1236.
(2) Consistency requirement for other securities.
(b) Corrections on or before January 31, 1994.
(1) Purpose.
(2) To conform to § 1.475(b)–1(a).
(i) Added identifications.
(ii) Limitations.
(3) To conform to § 1.475(b)–1(c).
(c) Effect of corrections.

§ 1.475(c)–1 Definitions—Dealer in securities.

(a) Dealer-customer relationship.
(1) [Reserved].
(2) Transactions described in section 475(c)(1)(B).
(i) In general.
(ii) Examples.
(3) Related parties.
(i) In general.
(ii) Example.
(b) Sellers of nonfinancial goods and services.
(c) Taxpayers that purchase securities but do not sell more than a negligible portion of the securities.
(1) Exemption from dealer status.
(2) Negligible portion.
(3) Special rules.
(d) Issuance of life insurance products.

§ 1.475(c)–2 Definitions—Security.

(a) In general.
(b) Synthetic debt held by a taxpayer as a result of an integrated transaction under § 1.1275–6.
(c) Negative value REMIC residuals.
(d) Special rules.

* * * * *

§ 1.475(e)–1 Effective dates.

Par. 3. Section 1.475(b)–1 as proposed on December 29, 1993 (58 FR 68798), is amended by revising paragraph (b) and adding paragraph (d) to read as follows:

§ 1.475(b)–1 Scope of exemptions from mark-to-market requirement.

* * * * *

(b) *Securities deemed identified as held for investment*—(1) *In general.* The following items held by a dealer in securities are per se held for investment within the meaning of section 475(b)-(1)(A) and are deemed to be properly identified as such for purposes of section 475(b)(2)—

(i) Except as provided in paragraph (b)(3) of this section, stock in a corporation, or a partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust, to which the taxpayer has a relationship specified in paragraph (b)(2) of this section; or

(ii) A contract that is treated for federal income tax purposes as an annuity, endowment, or life insurance contract (see sections 817 and 7702).

(2) *Relationships*—(i) *General rule.* The relationships specified in this paragraph (b)(2) are—

(A) those described in section 267(b)(2), (3), (10), (11), or (12); or

(B) those described in section 707(b)(1)(A) or (B).

(ii) *Attribution.* The relationships described in paragraph (b)(2)(i) of this section are determined taking into account sections 267(c) and 707(b)(3), as appropriate.

(iii) *Trusts treated as partnerships.* For purposes of this paragraph (b)(2), the phrase partnership or trust is substituted for the word partnership in sections 707(b)(1) and 707(b)(3), and a reference to beneficial ownership interest is added to each reference to capital interest or profits interest in those sections.

(3) *Securities traded on certain established financial markets.* Paragraph (b)(1)(i) of this section does not apply to a security if—

(i) The security is actively traded within the meaning of § 1.1092(d)–1(a) taking into account only established financial markets identified in § 1.1092(d)–1(b)(1)(i) or (ii) (describing national securities exchanges and interdealer quotation systems), and

(ii) The taxpayer owns less than 5 percent of all of the shares or interests in the same class.

(4) *Changes in status*—(i) *Onset of prohibition against marking*—(A) Once a security begins to be described in paragraph (b)(1) of this section and for so long as it continues to be so described, section 475(a) does not apply to the security in the hands of the taxpayer.

(B) If a security has not been timely identified under section 475(b)(2) and, after the last day on which such an identification would have been timely, the security begins to be described in paragraph (b)(1) of this section, then the dealer must recognize gain or loss on the security as if it were sold for its fair market value as of the close of business of the last day before the security begins to be described in paragraph (b)(1) of this section, and gain or loss is taken into account at that time.

(ii) *Termination of prohibition against marking.* If a taxpayer did not timely identify a security under section 475(b)(2) and paragraph (b)(1) of this section applies to the security on the last day on which such an identification would have been timely but it thereafter ceases to apply—

(A) An identification of the security under section 475(b)(2) is timely if made on or before the close of the day paragraph (b)(1) of this section ceases to apply; and

(B) Unless the taxpayer timely identifies the security under section 475(b)(2) (taking into account the additional time for identification that is provided by paragraph (b)(4)(ii)(A) of this section), section 475(a) applies to changes in value of the security after the cessation in the same manner as under section 475(b)(3).

(iii) *Examples.* These examples illustrate this paragraph (b)(4):

Example 1. Onset of prohibition against marking—(A) *Facts.* Corporation H owns 75 percent of the stock of corporation *D*, a dealer in securities within the meaning of section 475(c)(1). On December 1, 1995, *D* acquired less than half of the stock in corporation *X*. *D* did not identify the stock for purposes of section 475(b)(2). On July 17, 1996, *H* acquired from other persons 70 percent of the stock of *X*. As a result, *D* and *X* became related within the meaning of paragraph (b)(2)(i) of this section. The stock of *X* is not described in paragraph (b)(3) of this section (concerning securities traded on certain established financial markets).

(B) *Holding.* Under paragraph (b)(4)(i) of this section, *D* recognizes gain or loss on its *X* stock as if the stock were sold for its fair market value at the close of business on July 16, 1996, and the gain or loss is taken into account at that time. As with any application of section 475(a), proper adjustment is made in the amount of any gain or loss subsequently realized. After July 16, 1996, section 475(a) does not apply to *D*'s *X* stock while *D* and *X* continue to be related to each other.

Example 2. Termination of prohibition against marking; retained securities identified as held for investment—(A) *Facts.* On July 1, 1996, corporation *H* owned 60 percent of the stock of corporation *Y* and all of the stock of corporation *D*, a dealer in securities within the meaning of section 475(c)(1). Thus, *D* and *Y* are related within the meaning of paragraph (b)(2)(i) of this section. Also on July 1, 1996, *D* acquired, as an investment, 10 percent of the stock of *Y*. The stock of *Y* is not described in paragraph (b)(3) of this section (concerning securities traded on certain established financial markets). When *D* acquired its shares of *Y* stock, it did not identify them for purposes of section 475(b)(2). On December 27, 1996, *D* identified its shares of *Y* stock as held for investment under section 475(b)(2). On December 30, 1996, *H* sold all of its shares of stock in *Y* to an unrelated party. As a result, *D* and *Y* cease to be related within the meaning of paragraph (b)(2)(i) of this section.

(B) *Holding.* Under paragraph (b)(4)(ii)(A) of this section, identification of the *Y* shares is timely if done on or before the close of December 30, 1996. Because *D* timely identified its *Y* shares under section 475(b)(2), it continues to refrain from marking to market its *Y* stock after December 30, 1996.

Example 3. Termination of prohibition against marking; retained securities not identified as held for investment—(A) *Facts.* The facts are the same as in *Example 2* above, except that *D* did not identify its stock in *Y* for purposes of section 475(b)(2) on or before December 30, 1996. Thus, *D* did not timely identify these securities under section 475(b)(2) (taking into account the additional time for identification provided in paragraph (b)(4)(ii)(A) of this section).

(B) *Holding.* Under paragraph (b)(4)(ii)(B) of this section, section 475(a) applies to changes in value of *D*'s *Y* stock after December 30, 1996, in the same manner as under section 475(b)(3). Thus, any appreciation or depreciation that occurred while the securities were prohibited from being marked to market is suspended. Further, section 475(a) applies only to those changes occurring after December 30, 1996.

* * * * *

(d) *Special rules*—(1) *Stock, partnership, and beneficial ownership interests in certain controlled corporations, partnerships, and trusts*—(i) *In general.* The following items held by a dealer in securities are per se held for investment within the meaning of section 475(b)(1)(A) and are deemed to be properly identified as such for purposes of section 475(b)(2)—

(A) Stock in a corporation that the taxpayer controls (within the meaning of paragraph (d)(1)(ii) of this section); or

(B) A partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust that the taxpayer controls (within the meaning of paragraph (d)(1)(ii) of this section).

(ii) *Control defined.* Control means the ownership, directly or indirectly through persons described in section 267(b) (taking into account section 267(c)), of—

(A) 50 percent or more of the total combined voting power of all classes of stock entitled to vote; or

(B) 50 percent or more of the capital interest, the profits interest, or

the beneficial ownership interest in the widely held or publicly traded partnership or trust.

(iii) *Applicability.* The rules of this paragraph (d)(1) apply only before the date 30 days after final regulations on this subject are published in the **Federal Register.**

(2) [Reserved].

Par. 4. Section 1.475(b)–2, as proposed on December 29, 1993 (58 FR 68798), is redesignated as § 1.475(b)–4.

Par. 5. Section 1.475(b)–4, as proposed on January 4, 1995 (60 FR 404), is redesignated as § 1.475(b)–2.

Par. 6. Section 1.475(c)–1, as proposed on December 29, 1993 (58 FR 68798), and amended on January 4, 1995 (60 FR 405), is amended as follows:

1. Paragraph (c) is removed.

2. Paragraphs (a) and (b) are redesignated as paragraphs (b)and (c), respectively.

3. New paragraph (a) is added to read as follows:

§ 1.475(c)–1 Definitions—Dealer in securities.

(a) *Dealer-customer relationship.* Whether a taxpayer is transacting business with customers is determined on the basis of all of the facts and circumstances.

(1) [Reserved].

(2) *Transactions described in section 475(c)(1)(B)*—(i) *In general.* For purposes of section 475(c)(1)(B), the term dealer in securities includes, but is not limited to, a taxpayer that, in the ordinary course of the taxpayer's trade or business, regularly holds itself out as being willing and able to enter into either side of a transaction enumerated in section 475(c)(1)(B).

(ii) *Examples.* The following examples illustrate the rules of this paragraph (a)(2). In the following examples, *B* is a bank:

Example 1. B regularly offers to enter into interest rate swaps with other persons in the ordinary course of its trade or business. *B* is willing to enter into interest rate swaps under which it either pays a fixed interest rate and receives a floating rate or pays a floating rate and receives a fixed rate. *B* is a dealer in securities under section 475(c)(1)(B), and the counterparties are its customers.

Example 2. B, in the ordinary course of its trade or business, regularly holds itself out as being willing and able to enter into either side of positions in a foreign currency with other banks in the interbank market. *B*'s activities in the foreign currency make it a dealer in securities under section 475(c)(1)(B), and the other banks in the interbank market are its customers.

Example 3. B engages in frequent transactions in a foreign currency in the interbank market. Unlike the facts in *Example 2*, however, *B* does not regularly hold itself out as being willing and able to enter into either side of positions in the foreign currency, and all of *B*'s transactions are driven by its internal need to adjust its position in the currency. No other circumstances are present to suggest that *B* is a dealer in securities for purposes of section 475(c)(1)(B). *B*'s activity in the foreign currency does not qualify it as a dealer in securities for purposes of section 475(c)(1)(B), and its transactions in the interbank market are not transactions with customers.

(3) *Related parties*—(i) *In general.* A taxpayer's transactions with members of its consolidated group or with other related persons may be transactions with customers for purposes of section 475. For example, transactions enumerated in section 475(c)(1)(B) between members of a consolidated group are transactions with customers if, in the ordinary course of its business, the taxpayer holds itself out as being willing and able to engage in these transactions on a regular basis. A taxpayer may be a dealer in securities within the meaning of section 475(c)(1) even if its only customer transactions are transactions with other members of its consolidated group.

(ii) *Example.* The following example illustrates this paragraph (a)(3):

Example. Risk management transactions—(1) *Facts. HC*, a hedging center, provides interest rate hedges to all of the members of its consolidated group. Because of the efficiencies created by having a centralized risk manager, group policy prohibits members other than *HC* from entering into derivative interest rate positions with outside parties. *HC* regularly holds itself out as being willing and able to, and in fact does, enter into either side of interest rate swaps with its fellow members. *HC* periodically computes its aggregate position and hedges the net risk with an unrelated party. *HC* does not otherwise enter into interest rate positions with persons that are not members of the consolidated group. Because *HC* attempts to operate at cost and the terms of its swaps do not factor in any risk of default by the affiliate, *HC*'s affiliates receive somewhat more favorable terms then they would receive from an unrelated swaps dealer.

(2) *Holding.* Because *HC* regularly holds itself out as being willing and able to enter into transactions enumerated in section 475(c)(1)(B), *HC* is a dealer in securities for purposes of section 475(c)(1)(B) and the other members are its customers.

* * * * *

Par. 7. Section 1.475(c)–2, as proposed on December 29, 1993 (58 FR 68798), and amended on January 4, 1995 (60 FR 405), is amended as follows:

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

2. Paragraph (a) and newly designated paragraph (c) are revised by removing the phrase "paragraph (b)" each place it appears and replacing it with "paragraph (c)" each place it appeared.

3. Newly designated paragraph (d) is revised by removing the phrase "paragraphs (a)(3) and (b)" and replacing it with "paragraphs (a)(3) and (c)". Newly designated paragraph (d) is further revised by removing the phrase "this paragraph (c)(1))." and replacing it with the phrase "this paragraph (d)(1)).".

4. Newly designated paragraph (b) is revised by removing the words "See § 1.475(b)–4(c)" and replacing them with the words "See § 1.475(b)–2(c)".

Par. 8. Section 1.475(e)–1, as proposed on December 29, 1993 (58 FR 68798), and amended on January 4, 1995 (60 FR 405), is revised to read as follows:

§ 1.475(e)–1 Effective dates.

(a) Section 1.475(a)–1 (concerning mark-to-market for debt instruments) applies to taxable years beginning on or after January 1, 1995.

(b) Section 1.475(a)–2 (concerning marking a security to market upon disposition) applies to dispositions or terminations of ownership occurring on or after January 4, 1995.

(c) Section 1.475(a)–3 (concerning acquisition by a dealer of a security with a substituted basis) applies to securities acquired, originated, or entered into on or after January 4, 1995.

(d) Section 1.475(b)–1 (concerning the scope of exemptions from the mark-to-market requirement) applies as follows:

(1) Section 1.475(b)–1(a) (concerning securities held for investment or not held for sale) applies to taxable years ending on or after December 31, 1993.

(2) Except as provided elsewhere in this paragraph (d)(2), § 1.475(b)–1(b)(1) (concerning securities deemed identified as held for investment) applies to taxable years ending on or after December 31, 1993.

(i) Section 1.475(b)–1(b)(1)(i) (concerning equity interests issued by a related person) applies on or after June 19, 1996. If, on June 18, 1996, a security is subject to mark-to-market accounting and, on June 19, 1996, § 1.475(b)–1(b)(1) begins to apply to the security solely because of the effective dates in this paragraph (d)(2) (rather than because of a change in facts), then the rules of § 1.475(b)–1(b)(4)(i)(A) (concerning the prohibition against marking) apply, but § 1.475(b)–1(b)-

(4)(i)(B) (imposing a mark to market on the day before the onset of the prohibition) does not apply.

(ii) Section 1.475(b)–1(b)(2) (concerning relevant relationships for purposes of determining whether equity interests in related persons are prohibited from being marked to market) applies on or after June 19, 1996.

(iii) Section 1.475(b)–1(b)(3) (concerning certain actively-traded securities) generally applies on or after June 19, 1996, to securities held on or after that date. In the case, however, of securities described in § 1.475(b)–1(d)(1)(i) (concerning equity interests issued by controlled entities), § 1.475(b)–1(b)(3) applies on or after the date thirty days after final regulations on this subject are published in the **Federal Register** to securities held on or after that date. If § 1.475(b)–1(b)(1) ceases to apply to a security by virtue of the operation of this paragraph (d)(2)(ii), the rules of § 1.475(b)–1(b)(4)(ii) apply to the cessation.

(iv) Except to the extent provided in paragraph (d)(2)(i) of this section, § 1.475(b)–1(b)(4) (concerning changes in status) applies on or after Jun 19, 1996.

(e) Section 1.475(b)–2 (concerning the identification requirements for obtaining an exemption from mark-to-market treatment) applies to identifications made on or after January 4, 1995.

(f) Section 1.475(b)–3 (concerning exemption of securities in certain securitization transactions) applies to securities acquired, originated, or entered into on or after January 4, 1995.

(g) Section 1.475(b)–4 (concerning transitional issues relating to exemptions) applies to taxable years ending on or after December 31, 1993.

(h) Section 1.475(c)–1(a) (concerning the dealer-customer relationship), except for § 1.475(c)–1(a)(1), (a)(2)(ii), and (a)(3), applies to taxable years beginning on or after January 1, 1995. Section 1.475(c)–1(a)(2)(ii) and (a)(3) (concerning certain aspects of the dealer-customer relationship) apply to taxable years beginning on or after June 20, 1996.

(i) Section 1.475(c)–1(b) (concerning sellers of nonfinancial goods and services) and (c) (concerning taxpayers that purchase securities but do not sell more than a negligible portion of the securities) applies to taxable years ending on or after December 31, 1993.

(j) Section 1.475(c)–1(d) (concerning the issuance of life insurance products) applies to taxable years beginning on or after January 1, 1995.

(k) Section 1.475(c)–2 (concerning the definition of security) applies to taxable years ending on or after December 31, 1993. Note, however, that, by its terms, § 1.475(c)–2(a)(3) applies only to interests or arrangements that are acquired on or after January 4, 1995, and that the integrated transactions to which § 1.475(c)–2(b) applies will exist only after the effective date of § 1.1275–6.

(l) Section 1.475(d)–1 (concerning the character of gain or loss) applies to taxable years ending on or after December 31, 1993.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on June 19, 1996, 8:45 a.m., and published in the issue of the Federal Register for June 20, 1996, 61 F.R. 31474)

Notice of Proposed Rulemaking and Notice of Public Hearing

Amortizable Bond Premium

FI–48–95

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations relating to the federal income tax treatment of bond premium and bond issuance premium. The proposed regulations reflect changes to the law made by the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988. The proposed regulations in this document would provide needed guidance to holders and issuers of debt instruments. This document also provides a notice of a public hearing on the proposed regulations.

DATES: Written comments must be received by September 25, 1996. Requests to appear and outlines of topics to be discussed at the public hearing scheduled for October 23, 1996, at 10 a.m. must be received by October 2, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (FI–48–95), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (FI–48–95), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. A public hearing will be held in the Commissioner's Conference Room, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507).

Comments on the collections of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224. Comments on the collections of information should be received by August 26, 1996.

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

The collections of information are in proposed §§ 1.163–13(h)(3), 1.171–4(a)(1), and 1.171–5(c)(2)(iii). This information is required by the IRS to monitor compliance with the federal tax rules for amortizing bond premium and bond issuance premium. The likely respondents are taxpayers who either acquire a bond at a premium or issue a bond at a premium. Responses to this collection of information are required to determine whether a holder of a bond has elected to amortize bond premium and to determine whether an issuer or a holder has changed its method of accounting for premium.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Estimated total annual reporting burden: 50,000 hours. The estimated annual burden per respondent varies from 0.25 hours to 0.75 hours, depending on indi-

vidual circumstances, with an estimated average of 0.5 hours.

Estimated number of respondents: 100,000.

Estimated annual frequency of responses: One time per respondent.

Background

Sections 1.171–1 through 1.171–4 of the Income Tax Regulations were promulgated in 1957 and last amended in 1968. In the Tax Reform Act of 1986, section 171(b) was amended to require that bond premium be amortized by reference to a constant yield. In the Technical and Miscellaneous Revenue Act of 1988, section 171(e) was amended to require that bond premium be amortized as an offset to interest income. The proposed regulations would substantially revise the existing regulations to reflect these amendments. In addition, the proposed regulations would revise existing guidance addressing the issuer's treatment of bond issuance premium.

Explanation of Provisions

In general, bond premium arises when a holder acquires a bond for more than the principal amount of the bond. Similarly, bond issuance premium arises when an issuer issues a bond for more than the principal amount of the bond. A holder will purchase, and an issuer will issue, a bond for more than its principal amount when the stated interest rate on the bond is higher than the current market yield for the bond.

The holder's treatment of bond premium is addressed in proposed regulations under section 171. The issuer's treatment of bond issuance premium is addressed in proposed regulations under section 163. In each case, the amortization of premium is based on constant yield principles. For this reason, the proposed regulations use concepts and definitions from the original issue discount (OID) regulations (§§ 1.1271–0 through 1.1275–6).

Determination of bond premium

Under the proposed regulations, bond premium is defined as the excess of a holder's basis in a bond over the sum of the remaining amounts payable on the bond other than payments of qualified stated interest. The holder generally determines the amount of bond premium as of the date the holder acquires the bond.

The proposed regulations provide special rules that limit a holder's basis solely for purposes of determining bond premium. For example, if a bond is convertible into stock of the issuer at the holder's option, for purposes of determining bond premium, the holder must reduce its basis in the bond by the value of the conversion option. This reduction prevents the holder from inappropriately amortizing the cost of the embedded conversion option.

Amortization of bond premium

Under section 171, the holder of a taxable bond acquired at a premium may elect to amortize bond premium. The holder of a tax-exempt bond acquired at a premium must amortize the premium. As premium is amortized, the holder's basis in the bond is reduced by a corresponding amount under section 1016(a)(5).

Under the proposed regulations, a holder amortizes bond premium by offsetting qualified stated interest income with bond premium. An offset is calculated for each accrual period using constant yield principles. However, the offset for an accrual period is only taken into account when the holder takes qualified stated interest into account under the holder's regular method of accounting. Thus, a holder using the cash receipts and disbursements method of accounting does not take bond premium into account until a qualified stated interest payment is received.

For certain bonds (e.g., bonds that pay a variable rate of interest or that provide for an interest holiday), the amount of bond premium allocable to an accrual period could exceed the amount of qualified stated interest allocable to that period. The proposed regulations address this situation by providing that the excess bond premium is not allowed as a deduction but is carried forward to future accrual periods.

Variable rate debt instruments

Because a variable rate debt instrument (VRDI) provides for variable interest payments, the yield and payment schedule of a VRDI cannot be determined without making assumptions about the amount of the variable payments. Under the OID regulations, OID on a VRDI is determined and allocated among accrual periods by reference to an equivalent fixed rate debt instrument constructed as of the issue date of the VRDI. The proposed regulations provide that bond premium on a VRDI is determined and allocated in a similar manner. Under the proposed regulations, bond premium on a VRDI is determined and allocated by reference to an equivalent fixed rate debt instrument. However, the equivalent fixed rate debt instrument is constructed as of the date the holder acquires the VRDI rather than the issue date.

Bonds subject to certain contingencies

If a bond provides for one or more alternative payment schedules, the yield of the bond cannot be determined without making assumptions about the actual payment schedule. The OID regulations provide three rules for making these assumptions. First, if one payment schedule is significantly more likely than not to occur, the yield of the debt instrument is determined by reference to this payment schedule. Second, if the debt instrument is subject to a mandatory sinking fund provision, the yield is determined without regard to the mandatory sinking fund provision. Third, notwithstanding the first two rules, if the debt instrument provides for an unconditional option or options to alter the payment schedule, the yield is determined by assuming that the issuer will exercise its options in the manner that minimizes the yield of the debt instrument and that the holder will exercise its options in the manner that maximizes the yield of the debt instrument.

The proposed regulations generally use similar assumptions to determine the holder's yield on a bond that provides for alternative payment schedules. However, in the case of an issuer's option on a taxable bond, the proposed regulations reverse the assumption by assuming that the issuer will exercise the option only if doing so would increase the yield on the bond. See section 171(b)(1)(B)(ii). As a result of this rule, a holder generally must amortize bond premium on a taxable bond by reference to the stated maturity date, even if it appears likely the bond will be called. In this case, if the bond is actually called, the proposed regulations provide that the holder may deduct the unamortized premium. If the bond is partially called and the partial call is not a pro-rata prepayment, the proposed regulations do not allow the holder to deduct a portion of the unamortized premium. Instead, the holder must recompute the yield of the bond on the date of the partial call and amortize the remaining premium by reference to the recomputed yield.

Treasury and IRS request comments on the application of the alternative payment schedule rules. Specifically, comments are requested on whether the "significantly more likely than not to occur" standard is appropriate for taxable bonds, whether ignoring mandatory sinking fund provisions is appropriate for tax-exempt bonds, and whether the distinction between pro-rata and non-pro-rata calls is appropriate.

Bond issuance premium

Under existing § 1.61–12(c), a corporate issuer treats premium received upon issuance of a bond as a separate item of income. Over the term of the bond, the premium is taken into income, and the full amount of the stated interest is deducted. The proposed regulations would revise the treatment of bond issuance premium. Under the proposed regulations, bond issuance premium is amortized as an offset to the issuer's otherwise allowable interest deduction, not as a separate item of income. The amount of bond issuance premium amortized in any period is based on a constant yield. In addition, the proposed regulations would apply to all issuers, not just corporate issuers.

De minimis rules and aggregate rules

The proposed regulations do not provide rules for *de minimis* amounts of premium or for aggregate methods of accounting for premium. Treasury and IRS request comments on whether de minimis rules or aggregate rules are necessary or appropriate.

Bonds not subject to the proposed regulations

The proposed regulations generally apply to bonds acquired or issued at a premium. Certain bonds, however, are excluded from the application of the proposed regulations. For example, the proposed regulations exclude debt instruments subject to section 1272(a)(6) (relating to certain prepayable debt instruments). No inference is intended regarding the treatment of these debt instruments.

Proposed effective dates

The proposed regulations relating to bond premium provide that the final regulations generally will apply to bonds acquired on or after the date 60 days after the date final regulations are published in the **Federal Register**. However, if a holder makes the election to amortize bond premium for the taxable year containing the date 60 days after the date final regulations are published, the regulations apply to bonds held on or after the first day of that taxable year.

The proposed regulations relating to bond issuance premium provide that the final regulations will apply to debt instruments issued on or after the date 60 days after the date final regulations are published in the **Federal Register.**

The proposed regulations also would provide automatic consent for a taxpayer to change its method of accounting for premium in certain circumstances. Because the change is made on a cut-off basis, no items of income or deduction are omitted or duplicated. Therefore, no adjustment under section 481 is allowed.

Special Analyses

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

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for October 23, 1996, at 10 a.m. in the Commissioner's Conference Room, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments by September 25, 1996, and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by October 2, 1996.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Section 1.171–2 also issued under 26 U.S.C. 171(e).

Section 1.171–3 also issued under 26 U.S.C. 171(e).

Section 1.171–4 also issued under 26 U.S.C. 171(c). * * *

Par. 2. Section 1.61–12 is amended by revising paragraph (c) to read as follows:

§ 1.61–12 Income from discharge of indebtedness.

* * * * *

(c) *Issuance and repurchase of debt instruments*—(1) *Issuance.* An issuer does not realize gain or loss upon the issuance of a debt instrument (as defined in § 1.1275–1(d)).

(2) *Repurchase*—(i) *In general.* An issuer does not realize gain or loss upon the repurchase of a debt instrument. For purposes of this paragraph (c)(2), the term *repurchase* includes the retirement of a debt instrument, the conversion of a debt instrument into stock of the issuer, and the exchange (including an exchange under section 1001) of a newly issued debt instrument for an existing debt instrument.

(ii) *Repurchase at a discount.* An issuer realizes income from the discharge of indebtedness upon the repurchase of a debt instrument for an amount less than its adjusted issue price (as defined in § 1.163–13(d)(5)). The amount of discharge of indebtedness income is equal to the excess of the adjusted issue price over the repurchase

price. To determine the repurchase price of a debt instrument that is repurchased through the issuance of a new debt instrument, see section 108(e)(10). See § 1.108–2 for rules relating to the realization of discharge of indebtedness income upon the acquisition of a debt instrument by a person related to the issuer.

(iii) *Repurchase at a premium.* An issuer may be entitled to a repurchase premium deduction upon the repurchase of a debt instrument for an amount greater than its adjusted issue price (as defined in § 1.163–13(d)(5)). See § 1.163–7(c) for the treatment of repurchase premium.

(3) *Bond issuance premium.* For rules relating to an issuer's interest deduction for a debt instrument issued with bond issuance premium, see § 1.163–13.

(4) *Effective date.* This paragraph (c) applies to debt instruments issued on or after the date that is 60 days after the date final regulations are published in the **Federal Register.**

* * * * *

Par. 3. Section 1.163–7 is amended by revising the first sentence of paragraph (c) to read as follows:

§ 1.163–7 Deduction for OID on certain debt instruments.

* * * * *

(c) *Deduction upon repurchase.* Except to the extent disallowed by any other section of the Internal Revenue Code (e.g., section 249) or this paragraph (c), if a debt instrument is repurchased by the issuer for a price in excess of its adjusted issue price (as defined in § 1.163–13(d)(5)), the excess (repurchase premium) is deductible as interest for the taxable year in which the repurchase occurs. * * *

* * * * *

Par. 4. Section 1.163–13 is added to read as follows:

§ 1.163–13 Treatment of bond issuance premium.

(a) *General rule.* If a debt instrument is issued with bond issuance premium, this section limits the amount of the issuer's interest deduction otherwise allowable under section 163(a). In general, the issuer determines its interest deduction by offsetting the interest allocable to an accrual period with the bond issuance premium allocable to that period. Bond issuance premium is allocable to an accrual period based on a constant yield. The use of a constant yield to amortize bond issuance premium is intended to conform the treatment of debt instruments having bond issuance premium with those having original issue discount. Unless otherwise provided, the terms used in this section have the same meaning as those terms in section 163(e), sections 1271 through 1275, and the corresponding regulations. Moreover, the provisions of this section apply in a manner consistent with those of section 163(e), sections 1271 through 1275, and the corresponding regulations. In addition, the anti- abuse rule in § 1.1275–2(g) applies for purposes of this section. For rules dealing with the treatment of bond premium by a holder, see §§ 1.171–1 through 1.171–5.

(b) *Exceptions.* This section does not apply to—

(1) A debt instrument to which section 1272(a)(6) applies (relating to certain interests in or mortgages held by a REMIC, and certain other debt instruments with payments subject to acceleration); or

(2) A debt instrument to which § 1.1275–4 applies (relating to certain debt instruments that provide for contingent payments).

(c) *Bond issuance premium.* Bond issuance premium is the excess, if any, of the issue price of a debt instrument over its stated redemption price at maturity. For purposes of this section, the issue price of a convertible bond (as defined in § 1.171–1(e)(1)(iii)(C)) does not include an amount equal to the value of the conversion option.

(d) *Offsetting qualified stated interest with bond issuance premium*—(1) *In general.* An issuer amortizes bond issuance premium by offsetting the qualified stated interest allocable to an accrual period with the bond issuance premium allocable to the accrual period. This offset occurs when the issuer takes the qualified stated interest into account under its regular method of accounting.

(2) *Qualified stated interest allocable to an accrual period.* See § 1.446–2(b) to determine the accrual period to which qualified stated interest is allocable and to determine the accrual of qualified stated interest within an accrual period.

(3) *Bond issuance premium allocable to an accrual period.* The bond issuance premium allocable to an accrual period is determined under this paragraph (d)(3). Within an accrual period, the bond issuance premium allocable to the period accrues ratably.

(i) *Step one: Determine the debt instrument's yield to maturity.* The yield to maturity of a debt instrument is determined under the rules of § 1.1272–1(b)(1)(i).

(ii) *Step two: Determine the accrual periods.* The accrual periods are determined under the rules of § 1.1272–1(b)(1)(ii).

(iii) *Step three: Determine the bond issuance premium allocable to the accrual period.* The bond issuance premium allocable to an accrual period is the excess of the qualified stated interest allocable to the accrual period over the product of the adjusted issue price at the beginning of the accrual period and the yield. In performing this calculation, the yield must be stated appropriately taking into account the length of the particular accrual period. Principles similar to those in § 1.1272–1(b)(4) apply in determining the bond issuance premium allocable to an accrual period.

(4) *Bond issuance premium in excess of qualified stated interest.* If the bond issuance premium allocable to an accrual period exceeds the qualified stated interest allocable to the accrual period for a debt instrument, the excess is carried forward to the next accrual period and offsets qualified stated interest in that accrual period to the extent of the disallowed amount. If the amount carried forward to an accrual period exceeds the qualified stated interest for that period, the excess is carried forward to subsequent accrual periods, beginning with the next accrual period, and is used to offset qualified stated interest in those accrual periods to the extent of the excess. If an excess amount exists on the date the debt instrument is retired, the issuer takes this amount into account as ordinary income.

(5) *Adjusted issue price.* In general, the adjusted issue price of a debt instrument is determined under the rules of § 1.1275–1(b). In addition, the adjusted issue price of the debt instrument is decreased by the amount of bond issuance premium previously allocable under paragraph (d)(3) of this section.

(e) *Special rules*—(1) *Variable rate debt instruments issued with bond issuance premium.* Bond issuance premium on a variable rate debt instrument is determined by reference to the stated redemption price at maturity of the equivalent fixed rate debt instrument constructed as of the issue date. In addition, the issuer allocates bond issuance premium on a variable rate debt instrument among the accrual periods by reference to the equivalent fixed rate debt instrument. The equivalent fixed

rate debt instrument is determined using the principles of § 1.1275–5(e).

(2) *Remote and incidental contingencies.* For purposes of determining and amortizing bond issuance premium, if a bond provides for a contingency that is remote or incidental (within the meaning of § 1.1275–2(h)), the contingency is taken into account under the rules for remote and incidental contingencies in § 1.1275–2(h).

(f) *Example.* The following example illustrates the rules of this section.

Example—(i) *Facts.* On February 1, 1999, X issues for $110,000 a debt instrument maturing on February 1, 2006, with a stated principal amount of $100,000, payable at maturity. The debt instrument provides for unconditional payments of interest of $10,000, payable on February 1 of each year. X uses the calendar year as its taxable year, X uses the cash receipts and disbursements method of accounting, and X decides to use annual accrual periods ending on February 1 of each year. X's calculations assume a 30-day month and 360-day year.

(ii) *Amount of bond issuance premium.* The issue price of the debt instrument is $110,000. Because the interest payments on the debt instrument are qualified stated interest, the stated redemption price at maturity of the debt instrument is $100,000. Therefore, the amount of bond issuance premium is $10,000 ($110,000 – $100,000).

(iii) *Bond issuance premium allocable to the first accrual period.* Based on the payment schedule and the issue price of the debt instrument, the yield of the debt instrument is 8.07 percent, compounded annually. (Although, for purposes of simplicity, the yield as stated is rounded to two decimal places, the computations do not reflect this rounding convention.) The bond issuance premium allocable to the accrual period ending on February 1, 2000, is the excess of the qualified stated interest allocable to the period ($10,000) over the product of the adjusted issue price at the beginning of the period ($110,000) and the yield (8.07 percent, compounded annually). Therefore, the bond issuance premium allocable to the accrual period is $1,118.17 ($10,000 – $8,881.83).

(iv) *Premium used to offset interest.* Although X makes an interest payment of $10,000 on February 1, 2000, X only deducts interest of $8,881.83, the qualified stated interest allocable to the period ($10,000) offset with bond issuance premium allocable to the period ($1,118.17).

(g) *Effective date.* This section applies to debt instruments issued on or after the date that is 60 days after the date final regulations are published in the **Federal Register.**

(h) *Consent to change method of accounting.* The Commissioner grants consent for an issuer to change its method of accounting for bond issuance premium on debt instruments issued on or after the date that is 60 days after the date final regulations are published in the **Federal Register. However, this consent is granted only if—**

(1) The change is made to comply with this section;

(2) The change is made for the first taxable year for which the issuer must account for a debt instrument under this section; and

(3) The issuer attaches to its federal income tax return for the taxable year containing the change a statement that it has changed its method of accounting under this section.

Par. 5. Sections 1.171–1 through 1.171–4 are revised to read as follows:

§ 1.171–1 Bond premium.

(a) *Overview*—(1) *In general.* This section and §§ 1.171–2 through 1.171–5 provide rules for the determination and amortization of bond premium by a holder. In general, a holder amortizes bond premium by offsetting the interest allocable to an accrual period with the premium allocable to that period. Bond premium is allocable to an accrual period based on a constant yield. The use of a constant yield to amortize bond premium is intended generally to conform the treatment of bond premium to the treatment of original issue discount under sections 1271 through 1275. Unless otherwise provided, the terms used in this section and §§ 1.171–2 through 1.171–5 have the same meaning as those terms in sections 1271 through 1275 and the corresponding regulations. Moreover, the provisions of this section and §§ 1.171–2 through 1.171–5 apply in a manner consistent with those of sections 1271 through 1275 and the corresponding regulations. In addition, the anti-abuse rule in § 1.1275–2(g) applies for purposes of this section and §§ 1.171–2 through 1.171–5.

(2) *Cross-references.* For rules dealing with the adjustments to a holder's basis to reflect the amortization of bond premium, see § 1.1016–5(b). For rules dealing with the treatment of bond issuance premium by an issuer, see § 1.163–13.

(b) *Scope*—(1) *In general.* Except as provided in paragraph (b)(2) of this section, this section and §§ 1.171–2 through 1.171–5 apply to any bond that, upon its acquisition by the holder, is held with bond premium. For purposes of this section and §§ 1.171–2 through 1.171–5, the term *bond* has the same meaning as the term *debt instrument* in § 1.1275–1(d).

(2) *Exceptions.* This section and §§ 1.171–2 through 1.171–5 do not apply to—

(i) A bond to which section 1272(a)(6) applies (relating to certain interests in or mortgages held by a REMIC, and certain other debt instruments with payments subject to acceleration);

(ii) A bond to which § 1.1275–4 applies (relating to certain debt instruments that provide for contingent payments);

(iii) A bond held by a holder that has made a § 1.1272–3 election with respect to the bond;

(iv) A bond that is stock in trade of the holder, a bond of a kind that would properly be included in the inventory of the holder if on hand at the close of the taxable year, or a bond held primarily for sale to customers in the ordinary course of the holder's trade or business; or

(v) A bond issued before September 28, 1985, unless the bond bears interest and was issued by a corporation or by a government or political subdivision thereof.

(c) *General rule*—(1) *Tax-exempt obligations.* A holder must amortize bond premium on a bond that is a tax-exempt obligation. See § 1.171–2(c) *Example 4.*

(2) *Taxable bonds.* A holder may elect to amortize bond premium on a taxable bond. Except as provided in paragraph (c)(3) of this section, a taxable bond is any bond other than a tax-exempt obligation. See § 1.171–4 for rules relating to the election to amortize bond premium on a taxable bond.

(3) *Bonds the interest on which is partially excludable.* For purposes of this section and §§ 1.171–2 through 1.171–5, a bond the interest on which is partially excludable from gross income (e.g., a securities acquisition loan under section 133) is treated as two instruments, a tax-exempt obligation and a taxable bond. The holder's basis in the bond and each payment on the bond are allocated between the two instruments based on the ratio of the interest excludable to the total interest payable on the bond.

(d) *Determination of bond premium*—(1) *In general.* A holder acquires a bond at a premium if the holder's basis in the bond immediately after its acquisition by the holder exceeds the sum of all amounts payable on the bond after the acquisition date (other than payments of qualified stated interest). This excess is bond premium, which is amortizable under § 1.171–2.

(2) *Additional rules for amounts payable on certain bonds.* Additional rules apply to determine the amounts payable on a variable rate debt instrument and

on a bond that provides for certain alternative payment schedules. See § 1.171–3.

(e) *Basis.* A holder determines its basis in a bond under this paragraph (e). This determination of basis applies only for purposes of this section and §§ 1.171–2 through 1.171–5. Because of the application of this paragraph (e), the holder's basis in the bond for purposes of these sections may differ from the holder's basis for determining gain or loss on the sale or exchange of the bond.

(1) *Determination of basis*—(i) *In general.* In general, the holder's basis in the bond is the holder's basis for determining loss on the sale or exchange of the bond.

(ii) *Bonds acquired in certain exchanges.* If the holder acquired the bond in exchange for other property (other than in a reorganization defined in section 368) and the holder's basis in the bond is determined in whole or in part by reference to the holder's basis in the other property, the holder's basis in the bond may not exceed its fair market value immediately after the exchange. See paragraph (f) *Example 1* of this section. If the bond is acquired in a reorganization, see section 171(b)(4)(B).

(iii) *Convertible bonds*—(A) *General rule.* If the bond is a convertible bond, the holder's basis in the bond is reduced by an amount equal to the value of the conversion option. The value of the conversion option may be determined under any reasonable method. For example, the holder may determine the value of the conversion option by comparing the market price of the convertible bond to the market prices of similar bonds that do not have conversion options. See paragraph (f) *Example 2* of this section.

(B) *Convertible bonds acquired in certain exchanges.* If the bond is a convertible bond acquired in a transaction described in paragraph (e)(1)(ii) of this section, the holder's basis in the bond may not exceed its fair market value immediately after the exchange reduced by the value of the conversion option.

(C) *Definition of convertible bond.* A convertible bond is a bond that provides the holder with an option to convert the bond into stock of the issuer, stock or debt of a related party (within the meaning of section 267(b) or 707(b)(1)), or into cash or other property in an amount equal to the approximate value of that stock or debt.

(2) *Basis in bonds held by certain transferees.* Notwithstanding paragraph (e)(1) of this section, if the bond is transferred basis property (as defined in section 7701(a)(43)) and the transferor had acquired the bond at a premium, the holder's basis in the bond is—

(i) The holder's basis for determining loss on the sale or exchange of the bond; reduced by

(ii) Any amounts that the transferor could not have amortized under this paragraph (e) or under § 1.171–4(c).

(f) *Examples.* The following examples illustrate the rules of this section.

Example 1. Bond received in liquidation of a partnership interest—(i) *Facts.* PR is a partner in partnership PRS. PRS does not have any unrealized receivables or substantially appreciated inventory items as defined in section 751. On January 1, 1997, PRS distributes to PR a taxable bond, issued by an unrelated corporation, in liquidation of PR's partnership interest. At that time, the fair market value of PR's partnership interest is $40,000 and the basis is $100,000. The fair market value of the bond is $40,000.

(ii) *Determination of basis.* Under section 732(b), PR's basis in the bond is equal to PR's basis in the partnership interest. Therefore, PR's basis for determining loss on the sale or exchange of the bond is $100,000. However, under paragraph (e)(1)(ii) of this section, PR's basis in the bond is $40,000 for purposes of this section and §§ 1.171–2 through 1.171–5.

Example 2. Convertible bond—(i) *Facts.* On January 1, 1997, A purchases for $1,100 B corporation's bond maturing on January 1, 2000, with a stated principal amount of $1,000, payable at maturity. The bond provides for unconditional payments of interest of $30 on January 1 and July 1 of each year. In addition, the bond is convertible into 15 shares of B corporation stock at the option of the holder. On January 1, 1997, B corporation's nonconvertible, publicly-traded, three-year debt with similar credit rating trades at a price that reflects a yield of 6.75 percent, compounded semiannually.

(ii) *Determination of basis.* A's basis for determining loss on the sale or exchange of the bond is $1,100. As of January 1, 1997, discounting the remaining payments on the bond at the yield at which B's similar nonconvertible bonds trade (6.75 percent, compounded semiannually) results in a present value of $980. Thus, the value of the conversion option is $120. Under paragraph (e)(1)(iii)(A) of this section, A's basis is $980 ($1,100 – $120) for purposes of this section and §§ 1.171–2 through 1.171–5. The sum of all amounts payable on the bond other than qualified stated interest is $1,000. Because A's basis (as determined under paragraph (e)(1)(iii)(A) of this section) does not exceed $1,000, A does not acquire the bond at a premium.

§ 1.171–2 Amortization of bond premium.

(a) *Offsetting qualified stated interest with premium*—(1) *In general.* A holder amortizes bond premium by offsetting the qualified stated interest allocable to an accrual period with the bond premium allocable to the accrual period. This offset occurs when the holder takes the qualified stated interest into account under the holder's regular method of accounting.

(2) *Qualified stated interest allocable to an accrual period.* See § 1.446–2(b) to determine the accrual period to which qualified stated interest is allocable and to determine the accrual of qualified stated interest within an accrual period.

(3) *Bond premium allocable to an accrual period.* The bond premium allocable to an accrual period is determined under this paragraph (a)(3). Within an accrual period, the bond premium allocable to the period accrues ratably.

(i) *Step one: Determine the holder's yield.* The holder's yield is the discount rate that, when used in computing the present value of all remaining payments to be made on the bond (including payments of qualified stated interest), produces an amount equal to the holder's basis in the bond as determined under § 1.171–1(e). For this purpose, the remaining payments include only payments to be made after the date the holder acquires the bond. The yield is calculated as of the date the holder acquires the bond, must be constant over the term of the bond, and must be calculated to at least two decimal places when expressed as a percentage.

(ii) *Step two: Determine the accrual periods.* A holder determines the accrual periods for the bond under the rules of § 1.1272–1(b)(1)(ii).

(iii) *Step three: Determine the bond premium allocable to the accrual period.* The bond premium allocable to an accrual period is the excess of the qualified stated interest allocable to the accrual period over the product of the holder's adjusted acquisition price (as defined in paragraph (b) of this section) at the beginning of the accrual period and the holder's yield. In performing this calculation, the yield must be stated appropriately taking into account the length of the particular accrual period. Principles similar to those in § 1.1272–1(b)(4) apply in determining the bond premium allocable to an accrual period.

(4) *Bond premium in excess of qualified stated interest.* If the bond premium allocable to an accrual period exceeds the qualified stated interest allocable to the accrual period for that bond, the excess is carried forward to the next accrual period and offsets qualified stated interest in that accrual period to the extent of the disallowed amount. If the bond premium carried forward to an

accrual period exceeds the qualified stated interest for that period, the excess is carried forward to subsequent accrual periods, beginning with the next accrual period, and is used to offset qualified stated interest in those accrual periods to the extent of the excess.

(5) *Additional rules for certain bonds.* Additional rules apply to determine the amortization of bond premium on a variable rate debt instrument and on a bond that provides for certain alternative payment schedules. See § 1.171–3.

(b) *Adjusted acquisition price.* The adjusted acquisition price of a bond at the beginning of the first accrual period is the holder's basis as determined under § 1.171–1(e). Thereafter, the adjusted acquisition price is the holder's basis in the bond decreased by—

(1) The amount of bond premium previously allocable under paragraph (a)(3) of this section; and

(2) The amount of any payment previously made on the bond other than a payment of qualified stated interest.

(c) *Examples.* The following examples illustrate the rules of this section. Each example assumes the holder uses the calendar year as its taxable year and has elected to amortize bond premium, effective for all relevant taxable years. In addition, each example assumes a 30-day month and 360-day year. Although, for purposes of simplicity, the yield as stated is rounded to two decimal places, the computations do not reflect this rounding convention.

Example 1. Taxable bond—(i) *Facts.* On February 1, 1999, A purchases for $110,000 a taxable bond maturing on February 1, 2006, with a stated principal amount of $100,000, payable at maturity. The bond provides for unconditional payments of interest of $10,000, payable on February 1 of each year. A uses the cash receipts and disbursements method of accounting, and A decides to use annual accrual periods ending on February 1 of each year.

(ii) *Amount of bond premium.* The interest payments on the bond are qualified stated interest. Therefore, the sum of all amounts payable on the bond (other than the interest payments) is $100,000. Under § 1.171–1, the amount of bond premium is $10,000 ($110,000 – $100,000).

(iii) *Bond premium allocable to the first accrual period.* Based on the remaining payment schedule of the bond and A's basis in the bond, A's yield is 8.07 percent, compounded annually. The bond premium allocable to the accrual period ending on February 1, 2000, is the excess of the qualified stated interest allocable to the period ($10,000) over the product of the adjusted acquisition price at the beginning of the period ($110,000) and A's yield (8.07 percent, compounded annually). Therefore, the bond premium allocable to the accrual period is $1,118.17 ($10,000 – $8,881.83).

(iv) *Premium used to offset interest.* Although A receives an interest payment of $10,000 on February 1, 2000, A only includes in income $8,881.83, the qualified stated interest allocable to the period ($10,000) offset with bond premium allocable to the period ($1,118.17). Under § 1.1016–5(b), A's basis in the bond is reduced by $1,118.17 on February 1, 2000.

Example 2. Alternative accrual periods—(i) *Facts.* The facts are the same as in *Example 1* of this paragraph (c) except that A decides to use semiannual accrual periods ending on February 1 and August 1 of each year.

(ii) *Bond premium allocable to the first accrual period.* Based on the remaining payment schedule of the bond and A's basis in the bond, A's yield is 7.92 percent, compounded semiannually. The bond premium allocable to the accrual period ending on August 1, 1999, is the excess of the qualified stated interest allocable to the period ($5,000) over the product of the adjusted acquisition price at the beginning of the period ($110,000) and A's yield, stated appropriately taking into account the length of the accrual period (7.92 percent/2). Therefore, the bond premium allocable to the accrual period is $645.29 ($5,000 – $4,354.71). Although the accrual period ends on August 1, 1999, the qualified stated interest of $5,000 is not taken into income until February 1, 2000, the date it is received. Likewise, the bond premium of $645.29 is not taken into account until February 1, 2000. The adjusted acquisition price of the bond on August 1, 1999, is $109,354.71 (the adjusted acquisition price at the beginning of the period ($110,000) less the bond premium allocable to the period ($645.29)).

(iii) *Bond premium allocable to the second accrual period.* Because the interval between payments of qualified stated interest contains more than one accrual period, the adjusted acquisition price at the beginning of the second accrual period must be adjusted for the accrued but unpaid qualified stated interest. Therefore, the adjusted acquisition price on August 1, 1999, is $114,354.71 ($109,354.71 + $5,000). The bond premium allocable to the accrual period ending on February 1, 2000, is the excess of the qualified stated interest allocable to the period ($5,000) over the product of the adjusted acquisition price at the beginning of the period ($114,354.71) and A's yield, stated appropriately taking into account the length of the accrual period (7.92 percent/2). Therefore, the bond premium allocable to the accrual period is $472.88 ($5,000 – $4,527.12).

(iv) *Premium used to offset interest.* Although A receives an interest payment of $10,000 on February 1, 2000, A only includes in income $8,881.83, the qualified stated interest of $10,000 ($5,000 allocable to the accrual period ending on August 1, 1999, and $5,000 allocable to the accrual period ending on February 1, 2000) offset with bond premium of $1,118.17 ($645.29 allocable to the accrual period ending on August 1, 1999, and $472.88 allocable to the accrual period ending on February 1, 2000). As indicated in *Example 1* of this paragraph (c), this same amount would be taken into income at the same time had A used annual accrual periods.

Example 3. Holder uses accrual method of accounting—(i) *Facts.* The facts are the same as in *Example 1* of this paragraph (c) except that A uses the accrual method of accounting. Thus, for the accrual period ending on February 1, 2000, the qualified stated interest allocable to the period is $10,000, and the bond premium allocable to the period is $1,118.17. Because the accrual period extends beyond the end of A's taxable year, A must allocate these amounts between the two taxable years.

(ii) *Amounts allocable to the first taxable year.* The qualified stated interest allocable to the first taxable year is $9,166.67 ($10,000 x 11/12). The bond premium allocable to the first taxable year is $1,024.99 ($1,118.17 x 11/12).

(iii) *Premium used to offset interest.* For 1999, A includes in income $8,141.68, the qualified stated interest allocable to the period ($9,166.67) offset with bond premium allocable to the period ($1,024.99). Under § 1.1016–5(b), A's basis in the bond is reduced by $1,024.99 in 1999.

(iv) *Amounts allocable to the next taxable year.* The remaining amounts of qualified stated interest and bond premium allocable to the accrual period ending on February 1, 2000, are taken into account for the taxable year ending on December 31, 2000.

Example 4. Tax-exempt obligation—(i) *Facts.* On January 15, 1999, C purchases for $120,000 a tax-exempt obligation maturing on January 15, 2006, with a stated principal amount of $100,000, payable at maturity. The obligation provides for unconditional payments of interest of $9,000, payable on January 15 of each year. C uses the cash receipts and disbursements method of accounting, and C decides to use annual accrual periods ending on January 15 of each year.

(ii) *Amount of bond premium.* The interest payments on the obligation are qualified stated interest. Therefore, the sum of all amounts payable on the obligation (other than the interest payments) is $100,000. Under § 1.171–1, the amount of bond premium is $20,000 ($120,000 – $100,000).

(iii) *Bond premium allocable to the first accrual period.* Based on the remaining payment schedule of the obligation and C's basis in the obligation, C's yield is 5.48 percent, compounded annually. The bond premium allocable to the accrual period ending on January 15, 2000, is the excess of the qualified stated interest allocable to the period ($9,000) over the product of the adjusted acquisition price at the beginning of the period ($120,000) and C's yield (5.48 percent, compounded annually). Therefore, the bond premium allocable to the accrual period is $2,420.55 ($9,000 – $6,579.45).

(iv) *Premium used to offset interest.* Although C receives an interest payment of $9,000 on January 15, 2000, C only receives tax-exempt interest income of $6,579.45, the qualified stated interest allocable to the period ($9,000) offset with bond premium allocable to the period ($2,420.55). Under § 1.1016–5(b), C's basis in the obligation is reduced by $2,420.55 on January 15, 2000.

§ 1.171–3 Special rules for certain bonds.

(a) *Variable rate debt instruments.* Bond premium on a variable rate debt instrument is determined by reference to the stated redemption price at maturity of the equivalent fixed rate debt instrument constructed for the variable rate debt instrument. In addition, a holder allocates bond premium on a variable rate debt instrument among the accrual periods by reference to the equivalent fixed rate debt instrument. The equivalent fixed rate debt instrument is determined as of the date the variable rate debt instrument is acquired by the holder and is constructed using the principles of § 1.1275–5(e). See paragraph (d) *Example 1* of this section.

(b) *Yield and remaining payment schedule of certain bonds subject to contingencies*—(1) *Applicability.* This paragraph (b) provides rules that apply in determining the yield and remaining payment schedule of certain bonds that provide for an alternative payment schedule (or schedules) applicable upon the occurrence of a contingency (or contingencies). This paragraph (b) applies, however, only if the timing and amounts of the payments that comprise each payment schedule are known as of the date the holder acquires the bond (the *acquisition date*) and the bond is subject to paragraph (b)(2), (3), or (4) of this section. A bond does not provide for an alternative payment schedule merely because there is a possibility of impairment of a payment (or payments) by insolvency, default, or similar circumstances. See § 1.1275–4 for the treatment of a bond that provides for a contingency that is not described in this paragraph (b).

(2) *Remaining payment schedule that is significantly more likely than not to occur.* If, based on all the facts and circumstances as of the acquisition date, a single remaining payment schedule for a bond is significantly more likely than not to occur, this remaining payment schedule is used to determine and amortize bond premium under §§ 1.171–1 and 1.171–2.

(3) *Mandatory sinking fund provision.* Notwithstanding paragraph (b)(2) of this section, if a bond is subject to a mandatory sinking fund provision described in § 1.1272–1(c)(3) and the use and terms of the provision meet reasonable commercial standards, the provision is ignored for purposes of determining and amortizing bond premium under §§ 1.171–1 and 1.171–2.

(4) *Treatment of certain options*—(i) *Applicability.* Notwithstanding paragraphs (b)(2) and (3) of this section, the rules of this paragraph (b)(4) determine the remaining payment schedule of a bond that provides the holder or issuer with an unconditional option or options, exercisable on one or more dates during the remaining term of the bond, to alter the bond's remaining payment schedule.

(ii) *Operating rules.* A holder determines the remaining payment schedule of a bond by assuming that each option will (or will not) be exercised under the following rules:

(A) *Issuer options.* The issuer of a tax-exempt obligation is deemed to exercise or not exercise an option or combination of options in the manner that minimizes the holder's yield on the obligation. The issuer of a taxable bond is deemed to exercise or not exercise an option or combination of options in the manner that maximizes the holder's yield on the bond.

(B) *Holder options.* A holder is deemed to exercise or not exercise an option or combination of options in the manner that maximizes the holder's yield on the bond.

(C) *Multiple options.* If both the issuer and the holder have options, the rules of paragraphs (b)(4)(ii)(A) and (B) of this section are applied to the options in the order that they may be exercised. Thus, the deemed exercise of one option may eliminate other options that are later in time.

(5) *Subsequent adjustments*—(i) *In general.* Except as provided in paragraph (b)(5)(ii) of this section, if a contingency described in this paragraph (b) (including the exercise of an option described in paragraph (b)(4) of this section) actually occurs or does not occur, contrary to the assumption made pursuant to this paragraph (b) (a *change in circumstances*), then solely for purposes of section 171, the bond is treated as retired and reacquired by the holder on the date of the change in circumstances for an amount equal to the adjusted acquisition price of the bond as of that date. If, however, the change in circumstances results in a substantially contemporaneous pro-rata prepayment as defined in § 1.1275–2(f)(2), the pro-rata prepayment is treated as a payment in retirement of a portion of the bond. See paragraph (d) *Example 2* of this section.

(ii) *Bond premium deduction on the issuer's call of a taxable bond.* If a change in circumstances results from an issuer's call of a taxable bond or a partial call that is a pro- rata prepayment, the holder may deduct as bond premium an amount equal to the excess, if any, of the adjusted acquisition price of the bond over the greater of the amount received on redemption or the amount payable on maturity.

(c) *Remote and incidental contingencies.* For purposes of determining and amortizing bond premium, if a bond provides for a contingency that is remote or incidental (within the meaning of § 1.1275–2(h)), the contingency is taken into account under the rules for remote and incidental contingencies in § 1.1275–2(h).

(d) *Examples.* The following examples illustrate the rules of this section. Each example assumes the holder uses the calendar year as its taxable year and, except as otherwise stated, has elected to amortize bond premium, effective for all relevant taxable years. In addition, each example assumes a 30-day month and 360-day year. Although, for purposes of simplicity, the yield as stated is rounded to two decimal places, the computations do not reflect this rounding convention.

Example 1. Variable rate debt instrument—(i) *Facts.* On March 1, 1999, E purchases for $110,000 a taxable bond maturing on March 1, 2007, with a stated principal amount of $100,000, payable at maturity. The bond provides for unconditional payments of interest on March 1 of each year based on the percentage appreciation of a nationally-known commodity index. On March 1, 1999, it is reasonably expected that the bond will yield 12 percent, compounded annually. E uses the cash receipts and disbursements method of accounting, and E decides to use annual accrual periods ending on March 1 of each year. Assume that the bond is a variable rate debt instrument under § 1.1275–5.

(ii) *Amount of bond premium.* Because the bond is a variable rate debt instrument, E determines and amortizes its bond premium by reference to the equivalent fixed rate debt instrument constructed for the bond as of March 1, 1999. Because the bond provides for interest at a single objective rate that is reasonably expected to yield 12 percent, compounded annually, the equivalent fixed rate debt instrument for the bond is an eight-year bond with a principal amount of $100,000, payable at maturity. It provides for annual payments of interest of $12,000. E's basis in the equivalent fixed rate debt instrument is $110,000. The sum of all amounts payable on the equivalent fixed rate debt instrument (other than payments of qualified stated interest) is $100,000. Under § 1.171–1, the amount of bond premium is $10,000 ($110,000 – $100,000).

(iii) *Bond premium allocable to each accrual period.* E allocates bond premium to the remaining accrual periods by reference to the payment schedule on the equivalent fixed rate debt instrument. Based on the payment schedule of the equivalent fixed rate debt instrument and E's basis in the bond, E's yield is 10.12 percent, compounded annually. The bond premium allocable to the accrual period ending on March 1, 2000, is the excess of the qualified stated interest allocable to the period for the equivalent fixed rate debt instrument ($12,000) over the product of the adjusted acquisition price at the beginning of the period ($110,000) and E's yield (10.12 percent, compounded annually). Therefore, the bond premium allocable to the accrual period is $870.71 ($12,000 – $11,129.29). The bond premium allocable to all the accrual periods is listed in the following schedule:

Accrual period ending	*Adjusted acquisition price at beginning of accrual period*	*Premium allocable to accrual period*
3/1/00	$110,000.00	$870.71
3/1/01	109,129.29	958.81
3/1/02	108,170.48	1,055.82
3/1/03	107,114.66	1,162.64
3/1/04	105,952.02	1,280.27
3/1/05	104,671.75	1,409.80
3/1/06	103,261.95	1,552.44
3/1/07	101,709.51	1,709.51
		$10,000.00

(iv) *Qualified stated interest for each accrual period.* Assume the bond actually pays the following amounts of qualified stated interest:

Accrual period ending	*Qualified stated interest*
3/1/00	$15,000.00
3/1/01	0.00
3/1/02	0.00
3/1/03	10,000.00
3/1/04	8,000.00
3/1/05	12,000.00
3/1/06	15,000.00
3/1/07	8,500.00

(v) *Premium used to offset interest.* E's interest income for each accrual period is determined by offsetting the qualified stated interest allocable to the period with the bond premium allocable to the period. For the accrual period ending on March 1, 2000, E includes in income $14,129.29, the qualified stated interest allocable to the period ($15,000) offset with the bond premium allocable to the period ($870.71). For the accrual period ending on March 1, 2001, the bond premium allocable to the period ($958.81) exceeds the qualified stated interest allocable to the period ($0). Therefore, the excess of $958.81 ($958.81 - $0) is carried forward to the next accrual period. For the next accrual period, the qualified stated interest for the period is insufficient to offset the bond premium allocable to the period ($1,055.82) and the amount carried forward from the prior period ($958.81). Thus, $2,014.63 ($1,055.82 + $958.81) is carried forward to the accrual period ending on March 1, 2003, and offsets qualified stated interest allocable to that period. The amount E includes in income for each accrual period is shown in the following schedule:

Accrual period ending	*Qualified stated interest*	*Premium allocable to accrual period*	*Interest income*	*Premium carryforward*
3/1/00	$15,000.00	$870.71	$14,129.29	
3/1/01	0.001	958.81	0.00	958.81
3/1/02	0.00	1,055.82	0.00	2,014.63
3/1/03	10,000.00	1,162.64	6,822.73	
3/1/04	8,000.00	1,280.27	6,719.73	
3/1/05	12,000.00	1,409.80	10,590.20	
3/1/06	15,000.00	1,552.44	13,447.56	
3/1/07	8,500.00	1,709.51	6,790.49	
		$10,000.00		

Example 2. Partial call that results in a pro-rata prepayment—(i) *Facts.* On April 1, 1999, M purchases for $110,000 N's taxable bond maturing on April 1, 2006, with a stated principal amount of $100,000, payable at maturity. The bond provides for unconditional payments of interest of $10,000, payable on April 1 of each year. N has the option to call all or part of the bond on April 1, 2001, at a 5 percent premium over the principal amount. M uses the cash receipts and disbursements method of accounting.

(ii) *Determination of yield and the remaining payment schedule.* M's yield determined without regard to the call option is 8.07 percent, compounded annually. M's yield determined by assuming N exercises its call option is 6.89 percent, compounded annually. Under paragraph (b)(4)(ii)(A) of this section, it is assumed N will not exercise the call option because exercising the option would minimize M's yield. Thus, for purposes of determining and amortizing bond premium, the bond is assumed to be a seven-year bond with a single principal payment at maturity of $100,000.

(iii) *Amount of bond premium.* The interest payments on the bond are qualified stated interest. Therefore, the sum of all amounts payable on the bond (other than the interest payments) is $100,000. Under § 1.171–1, the amount of bond premium is $10,000 ($110,000 - $100,000).

(iv) *Bond premium allocable to the first two accrual periods.* For the accrual period ending on April 1, 2000, M includes in income $8,881.83, the qualified stated interest allocable to the period ($10,000) offset with bond premium allocable to the period ($1,118.17). The adjusted acquisition price on April 1, 2000, is $108,881.83 ($110,000 - $1,118.17). For the accrual period ending on April 1, 2001, M includes in income $8,791.54, the qualified stated interest allocable to the period ($10,000) offset with bond premium allocable to the period ($1,208.46). The adjusted acquisition price on April 1, 2001, is $107,673.37 ($108,881.83 - $1,208.46).

(v) *Partial call.* Assume N calls one-half of M's bond for $52,500 on April 1, 2001. Because it was assumed the call would not be exercised, the call is a change in circumstances. However, the partial call is also a pro-rata prepayment within the meaning of § 1.1275–2(f)(2). As a result, the call is treated as a retirement of one-half of the bond. Under paragraph (b)(5)(ii) of this section, M may deduct $1,336.68, the excess of its adjusted acquisition price in the retired portion of the bond ($107,673.37/2, or $53,836.68) over the amount received on redemption ($52,500). M's adjusted basis in the portion of the bond that remains outstanding is $53,836.68 ($107,673.37 - $53,836.68).

§ 1.171–4 Election to amortize bond premium on taxable bonds.

(a) *Time and manner of making the election*—(1) *In general.* A holder makes the election to amortize bond premium by offsetting interest income with bond premium in the holder's timely filed federal income tax return for the first taxable year to which the holder desires the election to apply. The holder should attach to the return a statement that the holder is making the election under this section.

(2) *Coordination with OID election.* If a holder makes an election under § 1.1272–3 for a bond with bond premium, the holder is deemed to have made the election under this section.

(b) *Scope of election.* The election under this section applies to all taxable bonds held during or after the taxable year for which the election is made.

(c) *Election to amortize made in a subsequent taxable year*—(1) *In general.* If a holder elects to amortize bond premium and holds a taxable bond acquired before the taxable year for which the election is made, the holder may not amortize amounts that would have been amortized in prior taxable years had an election been in effect for those prior years.

(2) *Example.* The following example illustrates the rule of this paragraph (c).

Example—(i) *Facts.* On May 1, 1999, C purchases for $130,000 a taxable bond maturing on May 1, 2006, with a stated principal amount of $100,000, payable at maturity. The bond provides for unconditional payments of interest of $15,000, payable on May 1 of each year. C uses the cash receipts and disbursements method of accounting and the calendar year as its taxable year. C has not previously elected to amortize bond premium, but does so for 2002.

(ii) *Amount to amortize.* C's basis for determining loss on the sale or exchange of the bond is $130,000. Thus, under § 1.171–1, the amount of bond premium is $30,000. Under § 1.171–2, if a bond premium election were in effect for the prior taxable years, C would have amortized $3,257.44 of bond premium on May 1, 2000, and $3,551.68 of bond premium on May 1, 2001, based on annual accrual periods ending on May 1. Thus, for 2002 and future years to which the election applies, C may amortize only $23,190.88 ($30,000 - $3,257.44 - $3,551.68).

(d) *Revocation of election.* The election under this section may not be revoked unless approved by the Commissioner.

Par. 6. Section 1.171–5 is added to read as follows:

§ 1.171–5 Effective date and transition rules.

(a) *Effective date*—(1) *In general.* This section and §§ 1.171–1 through 1.171–4 apply to bonds acquired on or after the date 60 days after the date final regulations are published in the **Federal Register.** However, if a holder makes the election under § 1.171–4 for the taxable year containing the date 60 days after the date final regulations are published in the **Federal Register**, this section and §§ 1.171–1 through 1.171–4

apply to bonds held on or after the first day of that taxable year.

(2) *Transition rule for use of constant yield.* Notwithstanding paragraph (a)(1) of this section, § 1.171–2(a)(3) (providing that the bond premium allocable to an accrual period is determined with reference to a constant yield) does not apply to a bond issued before September 28, 1985.

(b) *Coordination with existing election.* A holder is deemed to have made the election under § 1.171–4 if the holder elected to amortize bond premium under section 171 and that election is effective on the date 60 days after the date final regulations are published in the **Federal Register.**

(c) *Accounting method changes*—(1) *Consent to change.* A holder required to change its method of accounting for bond premium to comply with §§ 1.171–1 through 1.171–3 must secure the consent of the Commissioner in accordance with the requirements of § 1.446–1(e). Paragraph (c)(2) of this section provides the Commissioner's automatic consent for certain changes. A holder making the election does not need the Commissioner's consent.

(2) *Automatic consent.* The Commissioner grants consent for a holder to change its method of accounting for bond premium with respect to bonds to which §§ 1.171–1 through 1.171–3 apply. The consent granted by this paragraph (c)(2) applies provided—

(i) The holder elected to amortize bond premium under section 171 for a taxable year prior to the taxable year containing the date 60 days after the date final regulations are published in the **Federal Register** and that election has not been revoked;

(ii) The change is made for the first taxable year for which the holder must account for a bond under §§ 1.171–1 through 1.171–3; and

(iii) The holder attaches to its return for the taxable year containing the change a statement that it has changed its method of accounting under this section.

Par. 7. Section 1.1016–5 is amended by revising paragraph (b) to read as follows:

§ 1.1016–5 Miscellaneous adjustments to basis.

* * * * *

(b) *Amortizable bond premium.* A holder's basis in a bond is reduced by the amount of bond premium used to offset qualified stated interest income under § 1.171–2. This reduction occurs when the holder takes the qualified stated interest into account under the holder's regular method of accounting. In addition, a holder's basis in a taxable bond is reduced by the amount of bond premium allowed as a deduction under § 1.171–3(b)(5)(ii) (relating to the issuer's call of a taxable bond).

* * * * *

§ 1.1016–9 [Removed]

Par. 8. Section 1.1016–9 is removed.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Reigster on June 26, 1996, 8:45 a.m., and published in the issue of the Federal Register for June 27, 1996, 61 F.R. 33396)

Notice of Proposed Rulemaking and Notice of Public Hearing

Arbitrage Restrictions on Tax-Exempt Bonds

FI–28–96

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations on the arbitrage restrictions applicable to tax-exempt bonds issued by state and local governments. Changes to applicable law were made by the Tax Reform Act of 1986. These proposed regulations affect issuers of tax-exempt bonds and would provide guidance for complying with the arbitrage regulations.

DATES: Written comments must be received by September 25, 1996. Requests to speak (with outlines of oral comments) at a public hearing scheduled for Thursday, October 24, 1996, at 10 a.m. must be received by October 3, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (FI–28–96), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (FI–28–96), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. The public hearing will be held in the Commissioner's Conference Room, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507).

Comments on the collections of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224. Comments on the collections of information should be received by August 26, 1996.

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

The collections of information are in proposed § 1.148–5(d)(6)(v), (vi), and (vii). This information is required by the IRS to verify compliance with section 148. This information will be used to establish a rebuttable presumption that a Treasury obligation is purchased at fair market value. The likely respondents and/or recordkeepers are state or local governments. Responses to this collection of information are required to establish a rebuttable presumption that a Treasury obligation is purchased at fair market value.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 25 U.S.C. 6103.

Estimated total annual reporting and recordkeeping burden: 2,400 hours.

The estimated annual burden per respondent/recordkeeper varies from 2 hours to 30 hours, depending on individual circumstances, with an estimated average of 6 hours.

Estimated number of respondents/recordkeepers: 400.

Estimated annual frequency of responses: on occasion.

Background

This document contains proposed regulations amending the Income Tax Regulations (26 CFR part 1) under section 148 of the Internal Revenue Code to provide guidance on nonpurpose investments for purposes of arbitrage yield restrictions under section 148.

Explanation of Provisions

A. *Background of proposed regulations*

Section 148 provides rules concerning the use of proceeds of state and local bonds to acquire higher yielding investments. Section 148(a) provides that, except as otherwise permitted by section 148, interest on a state or local bond generally is tax-exempt only if the issuer invests bond proceeds at a yield not exceeding the bond yield. Section 148(f) provides, in general, that interest on a state or local bond is tax-exempt only if the issuer rebates to the United States certain earnings from investing bond proceeds at a yield exceeding the bond yield.

Section 1.148–6(c) provides that gross proceeds of an issue of bonds are not allocated to a payment for a nonpurpose investment in an amount greater than the fair market value of that investment on the purchase date. For this purpose only, the fair market value of a nonpurpose investment is adjusted to take into account qualified administrative costs allocable to that investment.

Regulations relating to the arbitrage yield restriction rules are in §§ 1.148–0 through 1.148–11 and in §§ 1.148–1T, 1.148–2T, 1.148–3T, 1.148–4T, 1.148–5T, 1.148–6T, 1.148–9T, 1.148–10T, and 1.148–11T. The proposed regulations would clarify and revise certain provisions of these regulations.

B. *Bona fide solicitation*

Section 1.148–5(d)(6)(iii) provides that the purchase price of a guaranteed investment contract is treated as its fair market value on the purchase date if the issuer makes a bona fide solicitation for a guaranteed investment contract that meets the requirements of that section. The proposed regulations would clarify that a solicitation for a guaranteed investment contract is rebuttably presumed to be bona fide if the following requirements are met: (i) if the issuer uses an agent to conduct the bidding process, the agent does not bid to provide the investment; (ii) all bidders have equal opportunity to bid so that, for example, no bidder is given the opportunity to review other bids (a last look) before bidding; and (iii) all bidders are reasonably competitive providers of investments of the type purchased.

C. *Rebuttable presumption for establishing fair market value*

Section 1.148–5(d)(6)(iii) provides a safe harbor for establishing fair market value for guaranteed investment contracts. The definition of guaranteed investment contract generally does not include the purchase of investments for an escrow for an advance refunding transaction.

The proposed regulations would provide a rebuttable presumption for establishing fair market value for United States Treasury obligations purchased other than directly from the United States Treasury. The proposed regulations would apply the principles underlying the safe harbor in the regulations for establishing fair market value for guaranteed investment contracts.

D. *Qualified administrative costs*

Section 1.148–5(e)(2)(i) provides in general that, in determining payments and receipts on nonpurpose investments, qualified administrative costs are taken into account. Thus, qualified administrative costs increase the payments for, or decrease the receipts from, the investments.

The proposed regulations would provide a special rule to determine qualified administrative costs for United States Treasury obligations purchased other than directly from the United States Treasury.

Proposed Effective Dates

The regulations are proposed to apply to bonds sold on or after the date 60 days after the adoption of final regulations. In addition, these regulations are proposed to apply after that date to permit an issuer to apply these regulations to bonds to which certain other regulations under section 148 apply that were sold prior to that date.

Special Analyses

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

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Thursday, October 24, 1996, at 10 a.m., in the Commissioner's Conference Room, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments by September 25, 1996, and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by October 3, 1996.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.148–5 is amended by adding paragraphs (d)(6)(iv) through (d)(6)(viii) and (e)(2)(iv) to read as follows:

§ 1.148–5 Yield and valuation of investments.

* * * * *

(d) * * *

(6) * * *

(iv) *Rebuttable presumption for establishing that a solicitation for a guaranteed investment contract is bona fide.* For purposes of paragraph (d)(6)(iii)(A) of this section, a solicitation for a guaranteed investment contract is rebuttably presumed to be bona fide if the other requirements of paragraph (d)(6)(iii) of this section and the following requirements are satisfied:

(A) If the issuer uses an agent to conduct the bidding process, the agent does not bid to provide the investment;

(B) All bidders have equal opportunity to bid so that, for example, no bidder is given the opportunity to review other bids (a last look) before bidding; and

(C) All bidders are reasonably competitive providers of investments of the type purchased.

(v) *Rebuttable presumption for establishing fair market value for United States Treasury obligations purchased other than directly from the United States Treasury.* The purchase price of United States Treasury obligations that are purchased other than directly from the United States Treasury is rebuttably presumed to be the fair market value on the purchase date if all of the following requirements are satisfied:

(A) The issuer conducts in good faith a solicitation for the purchase of Treasury obligations that meets the requirements of paragraphs (d)(6)(iv)(A) through (C) of this section, and the issuer receives at least three bona fide bids from providers that have no material financial interest in the issue. For this purpose, underwriters and financial advisors for an issue are considered to have a material financial interest in the issue.

(B) The issuer purchases the highest-yielding Treasury obligations for which a qualifying bid is made.

(C) The yield on the Treasury obligations purchased is not significantly less than the yield then available from the provider on reasonably comparable Treasury obligations offered to other persons for purchase on terms comparable to those offered to the issuer from a source of funds other than gross proceeds of tax-exempt bonds. If closely comparable forward prices are not offered to other persons for purchase from a source other than gross proceeds of tax-exempt bonds, a reasonable basis for this comparison may be by reference to implied forward prices for Treasury obligations based on standard financial formulas. In general, a certificate provided by an agent conducting the bidding process detailing this comparison establishes that this comparability standard is met.

(D) In no event is the yield on any Treasury obligation purchased less than the highest yield then available on a United States Treasury security — State and Local Government Series from the United States Department of the Treasury, Bureau of Public Debt, with the same maturity.

(E) The terms of the agreement to purchase the Treasury obligations are reasonable.

(F) The issuer retains the items enumerated in paragraphs (d)(vi) and (vii) of this section with the bond documents.

(vi) *Copies.* The items described in this paragraph (d)(vi) are a copy of each of the following—

(A) The purchase agreement or confirmation and a statement detailing any oral and other terms of the agreement;

(B) The receipt or other record of the amount actually paid by the issuer for the Treasury obligations, including a statement setting out the amount of any brokerage commission, broker fee, or bidding fee paid to or by the seller of the Treasury obligations; and

(C) Each bid that is received with respect to the solicitation of the Treasury obligations (clearly stamped to show date and time when the bid was received) and a description of the bidding procedure used.

(vii) *Statement.* The item described in this paragraph (d)(vii) is a statement from the issuer, dated as of the issue date of the bonds, certifying, under penalties of perjury, that—

(A) If the issuer used an agent to conduct the bidding process, the agent did not bid to provide the investment;

(B) All bidders had equal opportunity to bid so that, for example, no bidder had an opportunity to review other bids before bidding;

(C) All bidders are reasonably competitive sellers of Treasury obligations; and

(D) The issuer received at least three bona fide bids from providers that have no material financial interest in the issue. (viii) For purposes of paragraphs (d)(6)(v) through (vii) of this section, the term *issuer* means only the entity that actually issues the bonds and not a conduit borrower of the issuer.

(e) * * *

(2) * * *

(iv) *Special rule for United States Treasury obligations purchased other than directly from the United States Treasury.* For Treasury obligations purchased other than directly from the United States Treasury, a fee paid to a bidding agent is a qualified administrative cost only if the following requirements are satisfied:

(A) The fee must be reasonable. In general, a fee must be separately stated in order for the issuer to have a basis for determining that a fee is reasonable. The fee is presumed to be reasonable if it does not exceed .02 percent of the amount invested in Treasury obligations.

(B) The fee must be comparable to a fee that would be charged for a reasonably comparable investment of Treasury obligations if acquired with a source of funds other than gross proceeds of tax-exempt bonds. This comparability standard must be applied even if no identical investments are customarily acquired with a source of funds other than gross proceeds of tax-exempt bonds. In general, reference must be made to the bidding fees paid by investors that are not issuers of tax-exempt bonds in those transactions that are most closely comparable to the purchase of investments by the issuer of tax-exempt bonds. For example, reference to the bidding fees generally paid for the purchase of forward contracts for Treasury obligations is ordinarily a reasonable method of determining whether bidding fees are reasonable.

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Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on June 26, 1996, 8:45 a.m., and published in the issue of the Federal Register for June 27, 1996, 61 F.R. 33405)

Notice of Proposed Rulemaking

Sale of Seized Property

GL-7-96

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to the sale

of seized property. The proposed regulations reflect changes concerning the setting of a minimum price for seized property by the Tax Reform Act of 1986. The proposed regulations affect all sales of seized property.

DATES: Written comments and requests for a public hearing must be received by September 11, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (GL-007-96), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered to: CC:DOM:CORP:R (GL-007-96), room 5228, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC.

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Procedure and Administration Regulations (26 CFR part 301) relating to the sale of seized property under section 6335 of the Internal Revenue Code (Code). The Tax Reform Act of 1986 amended section 6335(e), relating to the manner and conditions of sale, to authorize the Secretary to determine whether it would be in the best interest of the United States to buy seized property at the minimum price set by the Secretary. These proposed regulations reflect this change.

Explanation of Provisions

Section 1570 of the Tax Reform Act of 1986 amended section 6335(e) of the Code to require the Secretary to determine before the sale of seized property whether it would be in the best interest of the United States to purchase such property at the minimum price set by the Secretary. The best interest determination is to be based on criteria prescribed by the Secretary. If, at the sale, one or more persons offer at least the minimum price, the property shall be sold to the highest bidder. If no one offers at least the minimum price and the Secretary has determined that it would be in the best interest of the United States to purchase the property for the minimum price, the property will be declared sold to the United States for the minimum price. If no one offers the minimum price and the Secretary has not determined that it would be in the best interest of the United States to purchase the property for the minimum price, the property shall be released to the owner of the property and the expense of the levy and sale shall be added to the amount of tax for the collection of which the United States made the levy. Any property released shall remain subject to any lien imposed by subchapter C of chapter 64 of subtitle F of the Code.

The proposed regulations reflect the changes made by the Tax Reform Act of 1986. The regulations propose to authorize district directors to make the required determination whether it would be in the best interest of the United States to purchase seized property for the minimum price. In addition, the regulations propose to set forth factors the district director may consider when determining the best interest of the United States. The district director may consider all relevant facts and circumstances including for example: (1) marketability of the property; (2) cost of maintaining the property; (3) cost of repairing or restoring the property; (4) cost of transporting the property; (5) cost of safeguarding the property; (6) cost of potential toxic waste cleanup; and (7) other factors pertinent to the type of property.

Special Analyses

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

Comments and Requests for a Public Hearing

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

* * * * *

Proposed Amendments to the Regulations

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

PART 301—PROCEDURE AND ADMINISTRATION

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

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

Par. 2. Section 301.6335-1 is amended as follows:

1. Paragraph (c)(3) is revised.

2. Paragraphs (c)(4) through (c)(9) are redesignated as paragraphs (c)(5) through (c)(10).

3. New paragraph (c)(4) is added.

The additions and revision read as follows:

301.6335-1 Sale of seized property.

* * * * *

(c) * * *

(3) *Determinations relating to minimum price*—(i) *Minimum price.* Before the sale of property seized by levy, the district director shall determine a minimum price, taking into account the expenses of levy and sale, for which the property shall be sold. The internal revenue officer conducting the sale may either announce the minimum price before the sale begins, or defer announcement of the minimum price until after the receipt of the highest bid, in which case, if the highest bid is greater than the minimum price, no announcement of the minimum price shall be made.

(ii) *Purchase by the United States.* Before the sale of property seized by levy, the district director shall determine whether the purchase of property by the United States at the minimum price would be in the best interest of the United States. In determining whether the purchase of property would be in the best interest of the United States, the district director may consider all relevant facts and circumstances including for example—

(*a*) Marketability of the property;

(*b*) Cost of maintaining the property;

(*c*) Cost of repairing or restoring the property;

(*d*) Cost of transporting the property;

(*e*) Cost of safeguarding the property;

(*f*) Cost of potential toxic waste cleanup; and

(*g*) Other factors pertinent to the type of property.

(iii) *Effective date.* This paragraph (c)(3) applies to determinations relating to minimum price made on or after [date final regualtions are published in the **Federal Register**].

(4) *Disposition of property at sale—* (i) *Sale to highest bidder at or above minimum price.* If one or more persons offer to buy the property for at least the amount of the minimum price, the property shall be sold to the highest bidder.

(ii) *Property deemed sold to United States at minimum price.* If no one offers at least the amount of the minimum price for the property and the Secretary has determined that it would be in the best interest of the United States to purchase the property for the minimum price, the property shall be declared to be sold to the United States for the minimum price.

(iii) *Release to owner.* If the property is not declared to be sold under paragraph (c)(4)(i) or (ii) of this section, the property shall be released to the owner of the property and the expense of the levy and sale shall be added to the amount of tax for the collection of which the United States made the levy. Any property released under this paragraph (c)(4)(iii) shall remain subject to any lien imposed by subchapter C of chapter 64 of subtitle F of the Internal Revenue Code.

(iv) *Effective date.* This paragraph (c)(4) applies to dispositions of property at sale made on or after [date final regulations are published in the **Federal Register**].

* * * * *

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on June 12, 1996, 8:45 a.m., and published in the issue of the Federal Register for June 13, 1996, 61 F.R. 30012)

Notice of Proposed Rulemaking and Notice of Public Hearing

Section 467 Rental Agreements

IA–292–84

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations relating to the treatment of rent and interest under certain agreements for the lease of tangible property. The proposed regulations apply to certain rental agreements that provide increasing or decreasing rents, or deferred or prepaid rent. This document also provides notice of a public hearing on these regulations.

DATES: Written comments, requests to appear and outlines of topics to be discussed at the public hearing scheduled for September 25, 1996, must be received by September 3, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (IA–292–84), Room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (IA–292–84), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. The public hearing will be held in the Commissioner's Conference Room, 3rd Floor, 1111 Constitution Avenue NW, Washington, DC.

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) relating to section 467 of the Internal Revenue Code (Code). This section was added by the Tax Reform Act of 1984. In general, section 467 requires parties to certain rental agreements to accrue rent and interest in accordance with the rules specified in section 467. These proposed regulations provide guidance regarding the applicability of section 467, and the amount of rent and interest required to be accrued under section 467. No inference should be drawn from any provision in the proposed regulations concerning whether an arrangement constitutes a lease for Federal income tax purposes.

Explanation of Provisions

1. *Section 467 rental agreements*

Section 467(a) provides that, if a rental agreement is a section 467 rental agreement, the lessor and lessee must take into account for a taxable year the section 467 rent and the section 467 interest for that year. A section 467 rental agreement is a rental agreement that has increasing or decreasing rents, or prepaid or deferred rents. A rental agreement has increasing or decreasing rents if the annualized fixed rent allocated to any rental period exceeds the annualized fixed rent allocated to any other rental period in the lease term. The proposed regulations provide that a rent holiday at the beginning of the lease term is disregarded in determining whether the rental agreement has increasing or decreasing rent if the rent holiday period is three months or less.

In addition, the proposed regulations provide that a rental agreement has increasing or decreasing rent if it requires (or may require) the payment of contingent rent, other than contingent rent that is contingent due to (a) a provision computing rent based on a percentage of the lessee's gross or net receipts (but only if the percentage does not vary throughout the term of the lease); (b) adjustments based on a reasonable price index; or (c) a provision requiring the lessee to pay real estate taxes, insurance premiums, maintenance costs, or any other cost (other than a debt service cost) that relates to the leased property and is not within the control of the lessor or lessee or a person related to the lessor or lessee.

Section 467(d)(1)(A) provides that a rental agreement has deferred rent if rent allocated to a calendar year is payable after the close of the succeeding calendar year. The proposed regulations provide that there is prepaid rent if rent allocated to a calendar year is payable prior to the beginning of the prior calendar year.

Section 467(d)(2) provides that section 467 does not apply to a rental agreement if the aggregate rental payments and other consideration to be received for the use of the property do not exceed $250,000.

2. *Section 467 rent*

Under the proposed regulations, the section 467 rent for a taxable year is the sum of the fixed rent for any rental periods that begin and end in the taxable year, a ratable portion of the fixed rent for other rental periods beginning or ending in the taxable year, and any contingent rent that accrues in

the taxable year. In general, the proposed regulations provide that rental periods may be of any length as long as (a) the rental periods are one year or less, cover the entire lease term, and do not overlap, and (b) each scheduled payment under the rental agreement occurs within 30 days of the beginning or end of a rental period. The amount of fixed rent for a rental period depends on the terms of the rental agreement.

A. *Disqualified leaseback or long-term agreement*

Section 467 provides that if the section 467 rental agreement is a leaseback or long-term agreement and has increasing or decreasing rents a principal purpose of which is tax avoidance (a disqualified leaseback or long-term agreement), the fixed rent for each rental period is the constant rental amount. The proposed regulations provide that (a) the Commissioner, rather than the parties to the rental agreement, will determine whether a rental agreement is a disqualified leaseback or long-term agreement and (b) a rental agreement will not be disqualified unless it requires more than $2,000,000 in rental payments and other consideration. The proposed regulations also provide that, if either the lessor or the lessee is not subject to Federal income tax on its income or is a tax-exempt entity (within the meaning of section 168(h)(2)), the rental agreement will be closely scrutinized, and clear and convincing evidence will be required to establish that tax avoidance is not a principal purpose for providing increasing or decreasing rent.

Section 467(b)(5) provides that regulations should set forth circumstances under which section 467 rental agreements will not be treated as disqualified leasebacks or long-term agreements, including circumstances relating to the use of price indices, percentage rents, reasonable rent holidays, or changes in amounts paid to third parties. In addition to these safe harbors, which have been included in the proposed regulations, the Conference Committee Report stated that the Committee anticipated that regulations under section 467 would adopt standards under which leases providing for fluctuations in rents by no more than a reasonable percentage above or below the average rent over the term of the lease will be deemed not motivated by tax avoidance. The report cited the standards for advance rulings on leveraged lease transactions set forth in Rev. Proc. 75–21 (1975–1 C.B. 715), and stated that such standards may not be appropriate for real estate leases. H.R. Rep. No. 861, 98th Cong., 2d Sess. 893 (1984).

The proposed regulations contain a safe harbor providing that tax avoidance will not be considered to be a principal purpose for providing increasing or decreasing rents if the rents allocable to each calendar year of the lease do not vary from the average annual rents over the entire lease term by more than 10 percent. This safe harbor is based on, but is not identical to, the safe harbor contained in Rev. Proc. 75–21. The proposed regulations do not provide a safe harbor specifically applicable to real estate leases. The IRS and the Treasury Department invite comments regarding the nature and extent of a safe harbor for such leases, as well as comments on whether additional safe harbors are appropriate either generally or for particular industries.

Section 467(e)(1) provides that the constant rental amount is the amount that, if paid at the end of each rental period, would result in a present value equal to the present value of all amounts payable under the disqualified leaseback or long-term agreement. If constant rental accrual is required, all rental periods must be equal in length except for an initial or final short rental period.

B. *Agreements without adequate interest*

If the section 467 rental agreement is not a disqualified leaseback or long-term agreement and does not provide adequate interest for prepaid or deferred rent, the proposed regulations provide that the fixed rent for each rental period is the proportional rental amount. The proportional rental amount is the fixed rent allocated to the rental period under the rental agreement multiplied by a fraction, the numerator of which is the present value of the amounts payable as fixed rent and interest on fixed rent under the rental agreement and the denominator of which is the present value of the fixed rent allocated to each rental period under the rental agreement. Under the proposed regulations, a rental agreement provides adequate interest if (a) no deferred or prepaid rent is required under the agreement, (b) there is deferred or prepaid rent but the agreement requires the payment of interest at an adequate single fixed rate, or (c) there is deferred or prepaid rent but the present values of rent payments and rent accruals meet certain tests set forth in the proposed regulations.

C. *Rental agreement accrual*

The proposed regulations provide that if neither the constant rental amount nor the proportional rental amount is required to be accrued, the fixed rent for a rental period is the fixed rent allocated to that rental period in accordance with the section 467 rental agreement. The amount of fixed rent allocated to a rental period by the rental agreement depends on whether the agreement provides a specific allocation of fixed rent. The proposed regulations provide that if a rental agreement provides a specific allocation of fixed rent, the amount of fixed rent allocated to each rental period during the lease term is the amount of rent allocated to that period by the agreement. For this purpose, a rental agreement that allocates rent to a period is treated as allocating rent ratably within that period. Thus, if a rental agreement provides that $120,000 is allocated to each calendar year in the lease term, $10,000 of rent is allocated to each calendar month. In general, under the proposed regulations, a rental agreement specifically allocates fixed rent if the agreement unambiguously specifies, for periods of no longer than a year, a fixed amount of rent for which the lessee becomes liable on account of the use of the property during that period.

If a section 467 rental agreement does not provide a specific allocation of fixed rent, the amount of fixed rent allocated to a rental period is the amount of fixed rent payable during that rental period.

3. *Section 467 interest*

The section 467 interest for a taxable year is the sum of the interest on fixed rent for any rental period that begins and ends in the taxable year, a ratable portion of the interest on fixed rent for any other rental period beginning or ending in the taxable year, and any interest that accrues on contingent rent during the taxable year. If a section

467 rental agreement provides an adequate stated rate of interest, the interest on fixed rent for a rental period is the interest provided in the agreement for that period. If no adequate stated rate of interest is provided, the interest on fixed rent for a rental period is determined under the section 467 loan rules.

Under the proposed regulations, there is a deemed loan (a section 467 loan) in a rental period if, at the beginning of that period, there is a difference between the amount of fixed rent payable under the section 467 rental agreement and the amount of fixed rent required to be accrued under the proposed regulations. For rental periods in which there is a section 467 loan, the interest for the rental period is equal to the product of the principal balance of the section 467 loan at the beginning of the rental period and the yield of the section 467 loan.

In general, the principal balance of a section 467 loan as of the beginning of any rental period is the difference between the cumulative amount of accrued fixed rent and interest and the cumulative amount of fixed rent and interest payable under the section 467 rental agreement. The yield of a section 467 loan is the discount rate at which the sum of the present values of all amounts payable by the lessee as fixed rent and interest on fixed rent, plus the sum of the negative present values of all amounts payable by the lessor as interest on prepaid fixed rent, equals the sum of the present values of the fixed rent allocated to the rental periods.

The amount constituting a section 467 loan may be either positive or negative. For purposes of applying any aspect of the proposed regulations relating to a section 467 loan, the principal balance of the loan should be clearly identified as either positive or negative. For example, if the principal balance of a loan at the beginning of a rental period is a negative number, the interest on the loan for that period will also be a negative number.

4. *Rental agreements with variable rates of interest*

The proposed regulations provide rules for section 467 rental agreements that provide for certain types of variable rates of interest. The rules in the proposed regulations are similar to the rules provided in §1.1275–5 for the computation of original issue discount (OID) for variable rate debt instruments providing for interest at qualified floating rates. Under the proposed regulations, a rental agreement provides variable interest if the rental agreement provides for stated interest that is paid or compounded at least annually at a rate or rates that meet the requirements of §1.1275–5(a)(3)(i)(A) or (B) and §1.1275–5(a)(4). If a rental agreement provides for fluctuations in interest other than pursuant to one or more qualified floating rates the interest will be subject to the rules for contingent payments.

Under the proposed regulations, if a section 467 rental agreement provides variable interest, the fixed rate substitutes (determined in the same manner as under §1.1275–5(e) treating the agreement date as the issue date) for the variable rates of interest called for by the agreement must be used in computing the proportional rental amount, the constant rental amount, the principal balance of a section 467 loan, and the yield of a section 467 loan. Further, in determining the interest on fixed rent for any rental period, the variable interest adjustment amount must be taken into account. The variable interest adjustment amount for a rental period is the difference between (a) the amount of interest that would have accrued during the rental period under the terms of the rental agreement, and (b) the amount of interest that would have accrued during the rental period under the terms of the agreement using the fixed rate substitutes.

5. *Rental agreements with contingent payments*

The proposed regulations reserve on the issue of the section 467 treatment of contingent rent. The IRS and the Treasury Department anticipate that regulations addressing this issue will provide rules for contingent rent similar to those provided for computing OID for contingent payment debt instruments in §1.1275–4. The IRS and the Treasury Department invite comments regarding the application of the §1.1275–4 rules to section 467 rental agreements.

6. *Recapture*

Section 467(c) provides that if a section 467 rental agreement is a leaseback or long-term agreement providing for increasing rent but is not subject to constant rental accrual, and the property subject to the agreement is disposed of, a portion of the gain realized on the disposition is required to be recaptured by the lessor as ordinary income. Accordingly, a leaseback or long-term agreement could be subject to section 467(c) even though it does not require more than $2,000,000 in rental payments and other consideration and is thus not subject to constant rental accrual.

The recapture amount is equal to the lesser of the prior understated inclusions or the section 467 gain. The prior understated inclusions are the excess of (a) the aggregate amount of section 467 rent and section 467 interest for the period during which the lessor held the property, determined as if the section 467 rental agreement were a disqualified leaseback or long-term agreement, over (b) the aggregate amount of section 467 rent and section 467 interest accrued by the lessor during that period. The section 467 gain is the excess of (a) the amount realized from the disposition, over (b) the sum of the adjusted basis of the property and the amount of any gain from the disposition that is treated as ordinary income under any provision of subtitle A of the Code other than section 467(c) (*e.g.*, section 1245 or 1250).

In the case of a disposition that is not a sale, exchange, or involuntary conversion, the section 467 gain is the excess of (a) the fair market value of the property on the date of disposition, over (b) the sum of the adjusted basis of the property and the amount of any gain from the disposition that is treated as ordinary income under Code provisions other than section 467(c). The regulations provide exceptions to this recapture rule for dispositions by gift, transfers at death, and certain tax-free transactions.

7. *Other disposition rules*

Under the proposed regulations, if property subject to a section 467 rental agreement is sold, exchanged, or otherwise disposed of, the section 467 rent for a period is taken into account by the owner of the property during the period. The lessee, however, must continue to take section 467 rent and section 467 interest into account without regard to the change of ownership.

Further, if there is a sale, exchange

or other disposition of property subject to a section 467 rental agreement, the beginning balance of the transferor's section 467 loan after the transfer equals the net present value at the time of the transfer of all amounts subsequently payable as fixed rent and interest on fixed rent to the transferor and all amounts subsequently payable as interest on prepaid fixed rent by the transferor. The transferor must continue to take into account interest on the transferor's section 467 loan balance after the transfer. The beginning balance of the transferee's section 467 loan is equal to the principal balance of the section 467 loan immediately before the transfer reduced by the beginning balance of the transferor's section 467 loan after the transfer. Amounts payable to the transferor after the transfer are not taken into account in adjusting the transferee's section 467 loan balance.

Finally, under the proposed regulations, if there is a disposition of property subject to a section 467 rental agreement, the transferor and transferee must treat the beginning balance of the transferee's section 467 loan as a liability that is either assumed in connection with the transfer of the property or secured by the property acquired subject to the liability (if negative) and as a reduction in the consideration for the transfer of the property (if positive). In the case of a positive section 467 loan balance, a reduction in the consideration for the transfer of the property is appropriate because the transferee will also be deemed to have acquired an asset other than the property itself, i.e., the loan, and a portion of the total consideration should be allocated to the loan balance. Similar rules apply to transfers of leasehold interests under section 467 rental agreements.

In order to account for any timing differences that may exist between a schedule of payments under a section 467 rental agreement and a separate schedule providing an allocation of rent, it will be necessary, in appropriate cases, to determine the amount of a section 467 loan balance even if the rental agreement does not have either deferred or prepaid rent or if the rental agreement has deferred or prepaid rent but provides adequate stated interest. The proposed regulations provide that the section 467 loan rules apply to rental agreements described in the preceding sentence, but only for purposes of the rules relating to dispositions of property subject to a section 467 rental agreement and the rules relating to transfers of leasehold interests under a section 467 rental agreement.

Although the proposed regulations contain rules applicable to all dispositions of property subject to a section 467 rental agreement and all transfers of leasehold interests under a section 467 rental agreement, the regulations reserve guidance on the question of whether special rules should be provided for transfers of property and leasehold interests in transactions in which gain or loss is not recognized in whole or in part. Examples of these transactions would include transfers between a partnership and one or more of its partners, transfers to a controlled corporation under section 351, transfers pursuant to a reorganization described in section 368(a), like-kind exchanges subject to section 1031, and transfers by gift or upon the death of the owner of the property or the holder of the leasehold interest. The IRS and Treasury Department invite comments on whether special rules should be provided for any of these transactions.

8. *Proposed effective date*

The regulations are proposed to be effective for (1) rental agreements entered into after the date that final regulations under section 467 are published and (2) disqualified leasebacks and long-term agreements entered into after June 3, 1996. No inference should be drawn from the proposed effective date concerning the treatment of rental agreements entered into before the regulations are applicable. Moreover, the IRS will, in appropriate circumstances, apply the provisions of section 467 requiring constant rental accrual to rental agreements entered into on or before June 3, 1996.

9. *Issues not addressed*

The proposed regulations do not address the application of section 467 to payments for services. The IRS and the Treasury Department invite comments on the appropriate scope of rules under section 467 for transactions involving deferred payments for services in light of the scope of section 404. In addition, the IRS and the Treasury Department invite comments on whether rules should be provided for transactions involving prepayments for services.

The proposed regulations do not address the application of section 467 to transactions sometimes referred to as "lease strips" or "stripping transactions", as described in Notice 95–53 (1995–44 I.R.B. 21). Notice 95–53 provides that regulations will be issued pursuant to section 7701(*l*) (and, as appropriate, other sections of the Code) recharacterizing stripping transactions. The IRS and the Treasury Department invite comments on whether rules should be provided that would apply section 467 to such transactions.

The proposed regulations do not provide for an adjustment to section 467 rent and interest where a section 467 rental agreement is modified. The IRS and the Treasury Department invite comments on the appropriate treatment of the lessor and lessee in these cases.

The proposed regulations do not provide rules addressing the treatment of payments by the lessor to induce a lessee to enter into a rental agreement.

Special Analyses

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

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for September 25, 1996 at 10 a.m. in the Commissioner's Conference Room, 1111 Constitution Avenue NW, Washington, DC. Because of access restrictions, visitors will not be admitted

beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments and submit an outline of the topics to be discussed and the time to be devoted to each topic by September 3, 1996. A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

* * * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Section 1.467–1 is also issued under 26 U.S.C. 467.

Section 1.467–2 is also issued under 26 U.S.C. 467.

Section 1.467–3 is also issued under 26 U.S.C. 467.

Section 1.467–4 is also issued under 26 U.S.C. 467.

Section 1.467–5 is also issued under 26 U.S.C. 467.

Section 1.467–6 is also issued under 26 U.S.C. 467.

Section 1.467–7 is also issued under 26 U.S.C. 467.

Section 1.467–8 is also issued under 26 U.S.C. 467.

* * *

Par. 2. In §1.61–8, the first sentence of paragraph (b) is revised to read as follows:

§1.61–8 Rents and royalties.

* * * * * *

(b) * * * Except as provided in section 467 and the regulations thereunder, gross income includes advance rentals, which must be included in income for the year of receipt regardless of the period covered or the method of accounting employed by the taxpayer. * * *

* * * * * *

Par. 3. In §1.451–1, paragraph (g) is added to read as follows:

§1.451–1 General rule for taxable year of inclusion.

* * * * * *

(g) *Timing of income from section 467 rental agreements.* For the timing of income with respect to section 467 rental agreements, see section 467 and the regulations thereunder.

Par. 4. Section 1.461–1 is amended by:

1. Adding a sentence at the end of paragraph (a)(1).

2. Adding paragraph (a)(2)(iii)(E).

The additions read as follows:

§1.461–1. General rule for taxable year of deduction.

(a) * * * (1) * * * See section 467 and the regulations thereunder for rules under which a liability arising out of the use of property pursuant to a section 467 rental agreement is taken into account.

(2) * * *

(iii) * * *

(E) Except as otherwise provided by regulations or other published guidance issued by the Commissioner, in the case of a liability arising out of the use of property pursuant to a section 467 rental agreement, the all events test (including economic performance) is considered met in the taxable year in which the liability is to be taken into account under section 467 and the regulations thereunder.

* * * * * *

Par. 5. Section 1.461–4 is amended by:

1. Revising the heading of paragraph (d)(3)(ii).

2. Redesignating the text of paragraph (d)(3)(ii) following the heading as paragraph (d)(3)(ii)(A) and adding a heading for newly designated paragraph (d)(3)(ii)(A).

2. Adding paragraph (d)(3)(ii)(B).

3. Adding sentence at the end of the introductory text of paragraph (d)(7).

The revisions and additions read as follows:

§1.461–4 Economic performance.

* * * * * *

(d) * * *

(3) * * *

(ii) *Exceptions*—(A) *Volume, frequency of use, or income.* * * *

(B) *Section 467 rental agreements.* In the case of a liability arising out of the use of property pursuant to a section 467 rental agreement, economic performance occurs as provided in §1.461–1(a)(2)(iii)(E).

* * * * * *

(7) * * * Assume further that the examples do not involve section 467 rental agreements and, therefore, section 467 is not applicable.

* * * * * *

Par. 6. Sections 1.467–0 through 1.467–8 are added to read as follows:

§1.467–0 Table of contents.

This section lists the major captions that appear in §§1.467–1 through 1.467–8.

§1.467–1 Treatment of lessors and lessees generally.

(a) Overview.
  (1) In general.
  (2) Cases in which rules are inapplicable.
  (3) Limited effect for rental agreements with total rents between $250,000 and $2,000,000.
  (4) Summary of rules.
    (i) Basic rules.
    (ii) Special rules.

(b) Method of accounting for section 467 rental agreements.

(c) Section 467 rental agreements.
  (1) In general.
  (2) Increasing or decreasing rent.
    (i) Fixed rent.
      (A) In general.
      (B) Certain rent holidays disregarded.
    (ii) Fixed rent allocated to a rental period.
      (A) Specific allocation.
        (*1*) In general.
        (*2*) Rental agreements specifically allocating fixed rent.
      (B) No specific allocation.

(iii) Contingent rent.
(A) In general.
(B) Certain contingent rent disregarded.
(3) Deferred or prepaid rent.
(i) Deferred rent.
(ii) Prepaid rent.
(iii) Rent allocated to a calendar year.
(iv) Examples.
(4) Rental agreements involving total payments of $250,000 or less.
(i) In general.
(ii) Special rules in computing amount described in paragraph (c)(4)(i).
(d) Section 467 rent.
(1) In general.
(2) Fixed rent for a rental period.
(i) Constant rental accrual.
(ii) Proportional rental accrual.
(iii) Section 467 rental agreement accrual.
(e) Section 467 interest.
(1) In general.
(2) Interest on fixed rent for a rental period.
(i) In general.
(ii) Section 467 rental agreements with adequate interest.
(3) Treatment of interest.
(f) Modification of a rental agreement.
(g) Treatment of amounts payable by essor to lessee.
(1) Interest.
(2) Other amounts. [Reserved]
(h) Meaning of terms.
(i) [Reserved]
(j) Computational rules.
(1) Counting conventions.
(2) Conventions regarding timing of rent and payments.
(i) In general.
(ii) Time amount is payable.
(3) Annualized fixed rent.
(4) Allocation of fixed rent within a period.
(5) Rental period length.

§1.467–2 Rent accrual for section 467 rental agreements without adequate interest.

(a) Section 467 rental agreement for which proportional rental accrual is required.
(b) Adequate interest on fixed rent.
(1) In general.
(2) Section 467 rental agreements that provide for a variable rate of interest.
(c) Computation of proportional rental amount.
(1) In general.
(2) Section 467 rental agreements that provide for a variable rate of interest.
(d) Present value.
(e) Applicable Federal rate.
(1) In general.
(2) Source of applicable Federal rates.
(3) 110 percent of applicable Federal rate.
(4) Term of the section 467 rental agreement.
(i) In general.
(ii) Section 467 rental agreements with variable interest.
(f) Examples.

§1.467–3 Disqualified leasebacks and long-term agreements.

(a) General rule.
(b) Disqualified leaseback or long-term agreement.
(1) In general.
(2) Leaseback.
(3) Long-term agreement.
(i) In general.
(ii) Statutory recovery period.
(A) In general.
(B) Special rule for leases of properties having different statutory recovery periods.
(c) Tax avoidance as principal purpose for increasing or decreasing rent.
(1) In general.
(2) Safe harbors.
(d) Calculating constant rental amount.
(1) In general.
(2) Initial or final short periods.
(3) Method to determine constant rental amount; no short periods.
(i) Step 1.
(ii) Step 2.
(iii) Step 3.
(e) Example.

§1.467–4 Section 467 loan.

(a) In general.
(1)
Overview.
(2) No section 467 loan in the case of certain section 467 rental agreements.
(3) Rental agreements subject to constant rental accrual.
(4) Special rule in applying the provisions of §1.467–7(e) or §1.467–7(f).
(b) Principal balance.
(1) In general.
(2) Section 467 rental agreements that provide for prepaid fixed rent and adequate stated interest.
(3) Timing of payments.
(c) Yield.
(1) In general.
(i) Method of determining yield.
(ii) Method of stating yield.
(iii) Rounding adjustments.
(2) Yield of section 467 rental agreements for which constant rental amount or proportional rental amount is computed.
(3) Determination of present values.
(d) Contingent payments.
(e) Section 467 rental agreements that call for payments before or after the lease term.
(f) Examples.

§1.467–5 Section 467 rental agreements with variable interest.

(a) Variable interest on deferred or prepaid rent.
(1) In general.
(2) Exceptions.
(b) Variable rate treated as fixed.
(1) In general.
(2) Variable interest adjustment amount.
(i) In general.
(ii) Sign of adjustment.
(3) Section 467 loan balance.
(c) Examples.

§1.467–6 Section 467 rental agreements with contingent payments. [Reserved]

§1.467–7 Section 467 recapture and other rules relating to dispositions.

(a) Section 467 recapture.
(b) Recapture amount.
(1) In general.
(2) Prior understated inclusions.
(i) In general.
(ii) Partial rental periods.
(3) Section 467 gain.
(i) In general.
(ii) Certain dispositions.

(c) Special rules.
  (1) Gifts.
  (2) Dispositions at death.
  (3) Certain tax-free exchanges.
    (i) In general.
    (ii) Dispositions covered.
  (4) Dispositions by transferee.
  (5) Like-kind exchanges and involuntary conversions.
  (6) Installment sales.
  (7) Dispositions covered by sections 170(e), 341(e)(12), or 751(c).
(d) Examples.
(e) Other rules relating to dispositions.
  (1) In general.
  (2) Treatment of section 467 loan.
  (3) Special rules for transfers in certain nonrecognition transactions. [Reserved]
(f) Treatment of assignments by lessee and lessee-financed renewals.
  (1) Substitute lessee use.
  (2) Lessor use.
  (3) Special rules for transfers in certain nonrecognition transactions. [Reserved]

§1.467–8 Effective date.

§1.467–1 Treatment of lessors and lessees generally.

(a) *Overview*—(1) *In general.* When applicable, section 467 requires a lessor and lessee of tangible property to treat rents consistently and to use the accrual method of accounting regardless of their overall method of accounting. In addition, in certain cases involving tax avoidance, the lessor and lessee must take rent and stated or imputed interest into account under a constant rental method, pursuant to which time value of money principles are applied to treat the rent as having accrued ratably over the entire lease term.

(2) *Cases in which rules are inapplicable.* Section 467 applies only to leases (or other similar arrangements) that constitute section 467 rental agreements as defined in paragraph (c) of this section. For example, a rental agreement is not a section 467 rental agreement, and, therefore, is not subject to the provisions of this section and §§1.467–2 through 1.467–8 (the section 467 regulations), if it specifies equal amounts of rent for each month (or other similar period) throughout the lease term and all payments of rent are due in the year to which the rent relates (or in the preceding or succeeding year). In addition, the section 467 regulations do not apply to a rental agreement that requires total rents of $250,000 or less determined, for this purpose, by disregarding any adjustments based on a reasonable price index and the amount of any rent resulting from the lessee's obligation to pay certain third-party expenses of the lessor.

(3) *Limited effect for rental agreements with total rents between $250,000 and $2,000,000.* A rental agreement is a section 467 rental agreement, and, therefore, the section 467 regulations generally apply, if the agreement requires total rents of more than $250,000 and does not specify equal amounts of rent for each month (or other similar period) throughout the lease term. If, however, the rental agreement requires total rents of $2,000,000 or less (determined by disregarding adjustments and excluding the same types of rent that are disregarded or excluded for purposes of the $250,000 threshold requirement) and all payments of rent are due in the year to which the rent relates (or in the preceding or succeeding year), the only effect of the section 467 regulations is to require the lessor and lessee to take rent into account in the year to which the rent relates.

(4) *Summary of rules*—(i) *Basic rules.* Paragraph (c) of this section provides rules for determining whether a rental agreement is a section 467 rental agreement. Paragraphs (d) and (e) of this section provide rules for determining the amount of rent and interest, respectively, required to be taken into account by a lessor and lessee under a section 467 rental agreement. Paragraphs (f) through (h) and (j) of this section provide various definitions and special rules relating to the application of the section 467 regulations.

(ii) *Special rules.* Section 1.467–2 provides rules for section 467 rental agreements that have deferred or prepaid rents without providing for adequate interest. Section 1.467–3 provides rules for application of the constant rental accrual requirement, including criteria for determining whether an agreement is subject to this requirement. Section 1.467–4 provides rules for establishing and adjusting a section 467 loan, the amount that a lessor is deemed to have loaned to the lessee, or vice versa, pursuant to the application of the section 467 regulations. Sections 1.467–5 and 1.467–6 provide rules for applying the section 467 regulations where a rental agreement requires variable interest or certain contingent payments. Section 1.467–7 provides rules for the treatment of dispositions by a lessor of property subject to a section 467 rental agreement and the treatment of assignments by lessees and certain lessee-financed renewals of a section 467 rental agreement. Finally, §1.467–8 provides the effective date rules for the section 467 regulations.

(b) *Method of accounting for section 467 rental agreements.* If a rental agreement is a section 467 rental agreement, as described in paragraph (c) of this section, the lessor and lessee must each take into account for any taxable year—

(1) The section 467 rent for the taxable year (as defined in paragraph (d) of this section); and

(2) The section 467 interest for the taxable year (as defined in paragraph (e) of this section).

(c) *Section 467 rental agreements*—(1) *In general.* Except as otherwise provided in paragraph (c)(4) of this section, the term *section 467 rental agreement* means a rental agreement, as defined in paragraph (h) of this section, that has increasing or decreasing rents (as described in paragraph (c)(2) of this section), or prepaid or deferred rents (as described in paragraph (c)(3) of this section).

(2) *Increasing or decreasing rent*—(i) *Fixed rent*—(A) *In general.* A rental agreement has increasing or decreasing rent if the annualized fixed rent, as described in paragraph (j)(3) of this section, allocated to any rental period exceeds the annualized fixed rent allocated to any other rental period in the lease term.

(B) *Certain rent holidays disregarded.* Notwithstanding the provisions of paragraph (c)(2)(i)(A) of this section, a rental agreement does not have increasing or decreasing rent if the increasing or decreasing rent is solely attributable to a rent holiday provision allowing reduced rent (including no rent) for a period at the beginning of the lease term, but only if the duration of the rent holiday does not exceed three months.

(ii) *Fixed rent allocated to a rental period*—(A) *Specific allocation*—(*1*) *In general.* If a rental agreement provides

a specific allocation of fixed rent, as described in paragraph (c)(2)(ii)(A)(*2*) of this section, the amount of fixed rent allocated to each rental period during the lease term is the amount of fixed rent allocated to that period by the rental agreement.

(2) *Rental agreements specifically allocating fixed rent.* A rental agreement specifically allocates fixed rent if the rental agreement unambiguously specifies, for periods no longer than a year, a fixed amount of rent for which the lessee becomes liable on account of the use of the property during that period, and the total amount of fixed rent specified is equal to the total amount of fixed rent payable under the lease. For example, a rental agreement providing that rent is $100,000 per calendar year, and that provides for total payments of fixed rent equal to the total amount specified, specifically allocates rent. Similarly, a rental agreement that states the amount of rent accruing each month or the amount of rent allocated to each year contains a specific allocation if the total payments of fixed rent equal the total amount specified. A rental agreement stating only when rent is payable does not specifically allocate rent.

(B) *No specific allocation.* If a rental agreement does not provide a specific allocation of fixed rent (for example, because the total amount of fixed rent specified is not equal to the total amount of fixed rent payable under the lease), the amount of fixed rent allocated to a rental period is the amount of fixed rent payable during that rental period. If an amount of fixed rent is payable before the beginning of the lease term, it is allocated to the first rental period in the lease term. If an amount of fixed rent is payable after the end of the lease term, it is allocated to the last rental period in the lease term.

(iii) *Contingent rent*—(A) *In general.* A rental agreement has increasing or decreasing rent if it requires (or may require) the payment of contingent rent (as defined in paragraph (h) of this section), other than contingent rent described in paragraph (c)(2)(iii)(B) of this section.

(B) *Certain contingent rent disregarded.* Contingent rent is disregarded for purposes of this paragraph (c)(2)(iii) to the extent—

(*1*) The rent is contingent solely as the result of a provision pursuant to which the rent is equal to a percentage of the lessee's receipts (gross or net), but only if the percentage does not vary throughout the term of the lease;

(2) The rent is contingent solely as the result of an adjustment based on a reasonable price index, as defined in paragraph (h) of this section; or

(*3*) The rent is contingent solely as the result of a provision requiring the lessee to pay third-party costs, as defined in paragraph (h) of this section.

(3) *Deferred or prepaid rent*—(i) *Deferred rent.* A rental agreement has deferred rent under this paragraph (c)(3) if the amount of rent allocated to a calendar year (determined under paragraph (c)(3)(iii) of this section), when added to the rent allocated to all preceding calendar years, exceeds the cumulative amount of rent payable as of the close of the succeeding calendar year.

(ii) *Prepaid rent.* A rental agreement has prepaid rent under this paragraph (c)(3) if the amount of rent allocated to a calendar year (determined under paragraph (c)(3)(iii) of this section), when added to the rent allocated to all preceding calendar years, is less than the cumulative amount of rent payable before the beginning of the preceding calendar year.

(iii) *Rent allocated to a calendar year.* For purposes of this paragraph (c)(3), the rent allocated to a calendar year is the sum of—

(A) The fixed rent allocated to any rental period (determined under paragraph (c)(2)(ii) of this section) that begins and ends in the calendar year;

(B) A ratable portion of the fixed rent allocated to any other rental period that begins or ends in the calendar year; and (C) Any contingent rent that accrues during the calendar year as provided in §1.467–6.

(iv) *Examples.* The following examples illustrate the application of this paragraph (c)(3):

Example 1. (i) A and B enter into a rental agreement that provides for the lease of property to begin on January 1, 1997, and end on December 31, 2000. The rental agreement provides that rent of $100,000 accrues during each year of the lease term. Under the rental agreement, no rent is payable during calendar year 1997, a payment of $100,000 is to be made on December 31, 1998, and December 31, 1999, and a payment of $200,000 is to be made on December 31, 2000. A and B both select the calendar year as their rental period. Thus, under paragraph (c)(3)(iii) of this section, the amount of rent allocated to each rental period under paragraph (c)(2)(ii) of this section is $100,000. Therefore, the rental agreement does not have increasing or decreasing rent as described in paragraph (c)(2)(i) of this section.

(ii) Under paragraph (c)(3)(i) of this section, a rental agreement has deferred rent if, at the close of a calendar year, the cumulative amount of rent allocated under paragraph (c)(3)(iii) of this section exceeds the cumulative amount of rent payable as of the close of the succeeding year. In this example, there is no deferred rent: the rent allocated to 1997 ($100,000) does not exceed the cumulative rent payable as of December 31, 1998 ($100,000); the rent allocated to 1998 and preceding years ($200,000) does not exceed the cumulative rent payable as of December 31, 1999 ($200,000); the rent allocated to 1999 and preceding years ($300,000) does not exceed the cumulative rent payable as of December 31, 2000 ($400,000); and the rent allocated to 2000 and preceding years ($400,000) does not exceed the cumulative rent payable as of December 31, 2001 ($400,000). Therefore, because the rental agreement does not have increasing or decreasing rent and does not have prepaid or deferred rent, the rental agreement is not a section 467 rental agreement.

Example 2. (i) A and B enter into a rental agreement that provides for the lease of personal property for ten years, beginning on January 1, 1997, and ending on December 31, 2006. The rental agreement provides for accruals of rent of $10,000 during each month of the lease term. Under paragraph (c)(3)(iii) of this section, $120,000 is allocated to each calendar year. The rental agreement provides for a $1,200,000 payment on December 31, 1997.

(ii) The rental agreement does not have increasing or decreasing rent as described in paragraph (c)(2)(i) of this section. The rental agreement provides prepaid rent under paragraph (c)(3)(ii) of this section because an amount of rent allocated to a calendar year, when added to the rent allocated to all preceding calendar years, is less than the cumulative amount of rent payable before the beginning of the preceding calendar year. For example, the rent allocated to 1999 and preceding calendar years ($360,000) is less than the cumulative amount of rent payable before the beginning of the preceding calendar year ($1,200,000 is payable on December 31, 1997). Accordingly, the rental agreement is a section 467 rental agreement.

(4) *Rental agreements involving total payments of $250,000 or less*—(i) *In general.* A rental agreement is not a section 467 rental agreement if, taking into account any payments of contingent rent, and any other contingent consideration, the sum of the aggregate amount of rental payments under the rental agreement and the aggregate value of other consideration to be received for the use of property is not reasonably expected, as of the agreement date (as defined in paragraph (h) of this section), to exceed $250,000.

(ii) *Special rules in computing amount described in paragraph (c)(4)(i).* The following rules apply in determining the amount described in paragraph (c)(4)(i) of this section—

(A) Stated interest on deferred rent is not taken into account. However, the Commissioner may recharacterize a

portion of stated interest as additional rent if a rental agreement provides for interest on deferred rent at a rate that, in light of all of the facts and circumstances, is clearly greater than the arm's-length rate of interest that would have been charged in a lending transaction between the lessor and lessee.

(B) Consideration that does not involve a cash payment is taken into account at its fair market value. A liability that is either assumed or secured by property acquired subject to the liability is taken into account at its remaining principal amount or, in the case of an obligation originally issued at a discount, at its adjusted issue price.

(C) All leases that are part of the same transaction or a series of related transactions are treated as a single lease. Whether two or more leases are part of the same transaction or a series of related transactions depends on all the facts and circumstances.

(D) Any increase or decrease in rent payable solely as a result of an adjustment based on a reasonable price index is not taken into account.

(E) Contingent rent described in paragraph (c)(2)(iii)(B)(*3*) of this section is not taken into account.

(d) *Section 467 rent*—(1) *In general.* The section 467 rent for a taxable year is the sum of—

(i) The fixed rent for any rental period (determined under paragraph (d)(2) of this section) that begins and ends in the taxable year;

(ii) A ratable portion of the fixed rent for any other rental period beginning or ending in the taxable year; and

(iii) In the case of a section 467 rental agreement that provides for contingent rent, the contingent rent that accrues during the taxable year as provided in §1.467–6.

(2) *Fixed rent for a rental period*—(i) *Constant rental accrual.* In the case of a section 467 rental agreement that is a disqualified leaseback or long-term agreement (as described in §1.467–3(b)), the fixed rent for a rental period is the constant rental amount (as determined under §1.467–3(d)).

(ii) *Proportional rental accrual.* In the case of a section 467 rental agreement that is not described in paragraph (d)(2)(i) of this section, and does not provide adequate interest on fixed rent (as determined under §1.467–2(b)), the fixed rent for a rental period is the proportional rental amount (as determined under §1.467–2(c)).

(iii) *Section 467 rental agreement accrual.* In the case of a section 467 rental agreement that is not described in paragraph (d)(2)(i) or (ii) of this section, the fixed rent for a rental period is the amount of fixed rent allocated to the rental period under the rental agreement, as determined under paragraph (c)(2)(ii) of this section.

(e) *Section 467 interest*—(1) *In general.* The section 467 interest for a taxable year is the sum of—

(i) The interest on fixed rent for any rental period that begins and ends in the taxable year;

(ii) A ratable portion of the interest on fixed rent for any other rental period beginning or ending in the taxable year; and

(iii) In the case of a section 467 rental agreement that provides for contingent rent, any interest that accrues on the contingent rent during the taxable year as provided in §1.467–6.

(2) *Interest on fixed rent for a rental period*—(i) *In general.* Except as provided in paragraph (e)(2)(ii) of this section and §1.467–5(b)(1)(ii), the interest on fixed rent for a rental period is equal to the product of—

(A) The principal balance of the section 467 loan (as described in §1.467–4(b)) at the beginning of the rental period; and

(B) The yield of the section 467 loan (as described in §1.467–4(c)).

(ii) *Section 467 rental agreements with adequate interest.* Except in the case of a section 467 rental agreement that is a disqualified leaseback or long-term agreement, if a section 467 rental agreement provides adequate interest under §1.467–2(b)(1)(i) (agreements with no deferred or prepaid rent) or §1.467–2(b)(1)(ii) (agreements with adequate stated interest at a single fixed rate), the interest on fixed rent for a rental period is the amount of interest provided in the rental agreement for the period.

(3) *Treatment of interest.* If the section 467 interest for a rental period is a positive amount, the lessor has interest income and the lessee has an interest expense. If the section 467 interest for a rental period is a negative amount, the lessee has interest income and the lessor has an interest expense.

(f) *Modification of a rental agreement.* If, after the lease date, the lessor and lessee agree to a substantial modification of the terms of a lease, the modified lease is treated, except as provided in this paragraph (f), as a new rental agreement for purposes of this section and §§1.467–2 through 1.467–8. If a principal purpose of such a modification is to avoid the purpose or intent of section 467, the Commissioner may treat the original and modified lease as a single rental agreement for purposes of this section and §§1.467–2 through 1.467–8.

(g) *Treatment of amounts payable by lessor to lessee*—(1) *Interest.* For purposes of determining present value, any amounts payable by the lessor to the lessee as interest on prepaid rent are treated as negative amounts.

(2) *Other amounts.* [Reserved]

(h) *Meaning of terms.* The following meanings apply for purposes of this section and §§1.467–2 through 1.467–8—

(1) *Agreement date* means the earlier of the lease date or the first date on which there is a binding written contract that substantially sets forth the terms under which the property will be leased.

(2) *Contingent rent* means any rent that is not fixed rent, including any amount reflecting an adjustment based on a reasonable price index.

(3) *Fixed rent* means any rent to the extent its amount and the time at which it will be paid are fixed and determinable under the terms of the section 467 rental agreement as of the lease date, as defined in paragraph (h)(4) of this section. For this purpose, the possibility of a breach or other early termination of the rental agreement and any provision that makes adjustments based on a reasonable price index are disregarded in determining whether amounts specified in the agreement are fixed rent.

(4) *Lease date* means the date on which the lessee first has the right to use property that is the subject of the section 467 rental agreement.

(5) *Lease term* means the period during which the lessee has the use of property subject to the section 467 rental agreement. An option period is included in the lease term only if it is expected, as of the agreement date, that the option will be exercised by either the lessor or the lessee. For this purpose, a lessor is generally expected to exercise an option if, for example, as of the agreement date, the rent in effect

for the option period exceeds the expected market rental for the property during such period. Similarly, a lessee is generally expected to exercise an option if, for example, as of the agreement date, the rent for the option period is less than the expected market rental for such period. The lessor's or lessee's determination that an option period is either included in or excluded from the lease term is not binding on the Commissioner. If the lessee (or a related person) agrees that one or both of them will or could be obligated to make payments in the nature of rent (within the meaning of §1.168(i)-2(b)-(2)) for a period when another lessee (the substitute lessee) or the lessor will have use of the property subject to the rental agreement, the Commissioner may, in appropriate cases, treat the period when the substitute lessee or lessor will have use of the property as part of the lease term. See paragraph §1.467-7(f) for special rules applicable to the lessee, substitute lessee, and lessor.

(6) An adjustment is *based on a reasonable price index* if the adjustment reflects inflation or deflation occurring over a period during the lease term and is determined consistently under any generally recognized index for measuring inflation or deflation.

(7) Except as otherwise provided in this paragraph (h)(7), two persons are *related persons* if they either have a relationship to each other that is specified in section 267(b) or section 707(b)(1) or are related entities within the meaning of sections 168(h)(4)(A), (B), or (C). For purposes of determining whether a section 467 rental agreement is a leaseback within the meaning of §1.467-3(b)(2), two persons are *related persons* if they are related persons within the meaning of section 465(b)(3)(C).

(8) *Rental agreement* includes any agreement, whether written or oral, that provides for the use of tangible property and is treated as a lease for Federal income tax purposes.

(9) *Third-party costs* include any real estate taxes, insurance premiums, maintenance costs, or any other cost (other than a debt service cost) that relates to the leased property and is not within the control of the lessor or lessee or any related person.

(i) [Reserved].

(j) *Computational rules.* For purposes of this section and §§1.467-2 through 1.467-8, the following rules apply—

(1) *Counting conventions.* Any reasonable counting convention may be used (*e.g.*, 30 days per month/360 days per year) to determine the length of a rental period or to perform any computation. Rental periods of the same descriptive length, for example annual, semiannual, quarterly, or monthly, may be treated as being of equal length.

(2) *Conventions regarding timing of rent and payments*—(i) *In general.* For purposes of determining present values and yield—

(A) Except as otherwise provided in this section and §§1.467-2 through 1.467-7, the rent allocated to a rental period is taken into account on the last day of the rental period;

(B) Any amount payable during the first half of the first rental period is treated as payable on the first day of that rental period;

(C) Any amount payable during the first half of any other rental period is treated as payable on the last day of the preceding rental period; and

(D) Any amount payable during the second half of a rental period is treated as payable on the last day of the rental period.

(ii) *Time amount is payable.* For purposes of this paragraph (j)(2), an amount is payable on the last day for timely payment (that is, the last day such amount may be paid without incurring interest, computed at an arm's-length rate, or a substantial penalty charge) and an amount payable at the midpoint of a rental period is treated as payable during the first half of the rental period.

(3) *Annualized fixed rent.* Annualized fixed rent is determined by multiplying the fixed rent allocated to the rental period under paragraph (c)(2)(ii) of this section by a number that represents the ratio of one year to the length of the rental period. Thus, if the fixed rent allocated to a rental period is $100,000 and the rental period is one month, the annualized fixed rent allocated to the rental period is $1,200,000.

(4) *Allocation of fixed rent within a period.* A rental agreement that allocates fixed rent to any period is treated as allocating fixed rent ratably within that period. Thus, if a rental agreement provides that $120,000 is allocated to each calendar year in the lease term, $10,000 of rent is allocated to each calendar month.

(5) *Rental period length.* Except as provided in §1.467-3(d)(1) (relating to agreements for which constant rental accrual is required), rental periods may be of any length and may vary in length as long as—

(i) The rental periods are one year or less, cover the entire lease term, and do not overlap;

(ii) Each scheduled payment under the rental agreement (other than a payment scheduled to occur before or after the lease term) occurs within 30 days of the beginning or end of a rental period; and

(iii) In the case of a rental agreement that does not provide a specific allocation of fixed rent, the rental periods selected do not cause the agreement to be treated as a section 467 rental agreement unless all alternative rental period schedules would result in such treatment.

§1.467-2 Rent accrual for section 467 rental agreements without adequate interest.

(a) *Section 467 rental agreement for which proportional rental accrual is required.* Under §1.467-1(d)(2)(ii), the fixed rent for each rental period is the proportional rental amount, defined under paragraph (c) of this section, if—

(1) The section 467 rental agreement is not a disqualified leaseback or long-term agreement under §1.467-3(b); and

(2) The section 467 rental agreement does not provide adequate interest on fixed rent under paragraph (b) of this section.

(b) *Adequate interest on fixed rent*
(1) *In general.* A section 467 rental agreement provides adequate interest on fixed rent if, disregarding any contingent rent—

(i) The rental agreement has no prepaid or deferred rent as described in §1.467-1(c)(3);

(ii) The rental agreement has prepaid or deferred rent, and—

(A) The rental agreement provides interest (the stated rate of interest) on deferred or prepaid fixed rent at a single fixed rate (as defined in §1.1273-1(c)(1)(iii));

(B) The stated rate of interest on fixed rent is no lower than 110 percent of the applicable Federal rate (as

defined in paragraph (e)(3) of this section);

(C) The amount of deferred or prepaid fixed rent on which interest is charged is adjusted at least annually to reflect the amount of deferred or prepaid fixed rent as of a date no earlier than the date of the preceding adjustment and no later than the date of the succeeding adjustment; and

(D) The rental agreement requires interest to be paid or compounded at least annually;

(iii) The rental agreement provides for deferred rent but no prepaid rent, and the sum of the present values of all amounts payable by the lessee as fixed rent (and interest, if any, thereon) is equal to or greater than the sum of the present values of the fixed rent allocated to each rental period; or

(iv) The rental agreement provides for prepaid rent but no deferred rent, and the sum of the present values of all amounts payable by the lessee as fixed rent, plus the sum of the negative present values of all amounts payable by the lessor as interest, if any, on prepaid fixed rent, is equal to or less than the sum of the present values of the fixed rent allocated to each rental period.

(2) *Section 467 rental agreements that provide for a variable rate of interest.* For purposes of the adequate interest test under paragraph (b)(1) of this section, if a section 467 rental agreement provides for variable interest, the rental agreement is treated as providing for fixed rates of interest on deferred or prepaid fixed rent equal to the fixed rate substitutes (determined in the same manner as under §1.1275–5(e) treating the agreement date as the issue date) for the variable rates called for by the rental agreement. For purposes of this section, a rental agreement provides for variable interest if the rental agreement provides for stated interest that is paid or compounded at least annually at a rate or rates that meet the requirements of §1.1275–5(a)(3)(i)(A) or (B) and §1.1275–5(a)(4).

(c) *Computation of proportional rental amount*—(1) *In general.* The proportional rental amount for a rental period is the amount of fixed rent allocated to the rental period under §1.467–1(c)(2)(ii), multiplied by a fraction. The numerator of the fraction is the sum of the present values of the amounts payable under the terms of the section 467 rental agreement as fixed rent and interest thereon. The denominator of the fraction is the sum of the present values of the fixed rent allocated to each rental period under the rental agreement.

(2) *Section 467 rental agreements that provide for a variable rate of interest.* To calculate the proportional rental amount for a section 467 rental agreement that provides for a variable rate of interest, see §1.467–5.

(d) *Present value.* For purposes of determining adequate interest under paragraph (b) of this section or the proportional rental amount under paragraph (c) of this section, present values are determined as of the first day a fixed rent payment is called for by the section 467 rental agreement if the rental agreement calls for payments of fixed rent prior to the lease term. Otherwise, present values are determined as of the first day of the first rental period in the lease term. The present value of any amount is determined using a discount rate equal to 110 percent of the applicable Federal rate. For purposes of the present value determination under paragraph (b)(1)-(iv) of this section, the fixed rent allocated to a rental period must be discounted from the first day of the rental period. For other conventions and rules relating to the determination of present value, see §1.467–1(g) and (j).

(e) *Applicable Federal rate*—(1) *In general.* The applicable Federal rate for a section 467 rental agreement is the applicable Federal rate in effect on the agreement date. Except as otherwise provided in this section, the *applicable Federal rate* for a rental agreement means—

(i) The Federal short-term rate if the term of the rental agreement is not over 3 years;

(ii) The Federal mid-term rate if the term of the rental agreement is over 3 years but not over 9 years; and

(iii) The Federal long-term rate if the term of the rental agreement is over 9 years.

(2) *Source of applicable Federal rates.* The Internal Revenue Service publishes the applicable Federal rates, based on annual, semiannual, quarterly, and monthly compounding, each month in the Internal Revenue Bulletin (see §601.601(d) of this chapter. However, the applicable Federal rates may be based on any compounding assumption. To convert a rate based on one compounding assumption to an equivalent rate based on a different compounding assumption, see §1.1272–1(j), *Example 1.*

(3) *110 percent of applicable Federal rate.* For purposes of §1.467–1, this section and §§1.467–3 through 1.467–8, 110 percent of the applicable Federal rate means 110 percent of the applicable Federal rate based on semiannual compounding, or any rate based on a different compounding assumption that is equivalent to 110 percent of the applicable Federal rate based on semiannual compounding.

(4) *Term of the section 467 rental agreement*—(i) *In general.* For purposes of determining 110 percent of the applicable Federal rate under this paragraph (e), the term of the section 467 rental agreement includes the lease term, any period before the lease term beginning with the first day an amount of fixed rent is payable under the terms of the rental agreement, and any period after the lease term ending with the last day an amount of fixed rent or interest thereon is payable under the rental agreement.

(ii) *Section 467 rental agreements with variable interest.* If a section 467 rental agreement provides variable interest on prepaid or deferred fixed rent, the term of the rental agreement for purposes of calculating 110 percent of the applicable Federal rate is determined in accordance with paragraph (e)(4)(i) of this section by substituting for the term of the rental agreement, the longest period between interest rate adjustment dates, or, if the rental agreement provides an initial fixed rate of interest on prepaid or deferred fixed rent, the period between the agreement date and the last day the fixed rate applies, if this period is longer. If, as described in §1.1274–4(c)(2)(ii), the rental agreement provides for a qualified floating rate (as defined in §1.1275–5(b)) that in substance resembles a fixed rate, 110 percent of the applicable Federal rate is determined by reference to the lease term.

(f) *Examples.* The following examples illustrate the application of this section. In each of these examples it is assumed that constant rental accrual does not apply:

Example 1. (i) C agrees to lease property from D for five years beginning on January 1, 1998, and ending on December 31, 2002. The section

467 rental agreement provides that rent of $100,000 accrues in each calendar year in the lease term and that rent of $500,000 plus $120,000 of interest is payable on December 31, 2002. Assume that the parties select the calendar year as the rental period and that 110 percent of the applicable Federal rate based on annual compounding is 10 percent.

(ii) The rental agreement has deferred rent under §1.467–1(c)(3)(i) because the fixed rent allocated to calendar years 1998, 1999, and 2000 is not paid until 2002. In addition, because the rental agreement does not state an interest rate, the rental agreement does not satisfy the requirements of paragraph (b)(1)(ii) of this section. Thus, the adequacy of interest must be determined under paragraph (b)(1)(iii) of this section.

(iii)(A) Because the rental agreement has deferred fixed rent and no prepaid rent, the agreement has adequate interest only if the present value rules provided in paragraph (b)(1)(iii) are met. The present value of all fixed rent and interest payable under the rental agreement is $384,971.22, determined as follows: $384,971.22 = $620,000/(1.10)^5. The present value of all fixed rent allocated under the rental agreement (discounting the amount of fixed rent allocated to a rental period from the last day of the rental period) is $379,078.68, determined as follows:

$$\$379,078.78 = \$1000,000 \times \frac{1-(1.10)^5}{.10}$$

(B) Accordingly, the sum of the present values of amounts payable exceeds the sum of the present values of fixed rent allocated. The rental agreement provides adequate interest on fixed rent.

(iv) For an example illustrating the computation of the yield on the rental agreement and the allocation of the interest and rent provided for under the rental agreement, see §1.467–4(f), *Example 2.*

Example 2. (i) E and F enter into a section 467 rental agreement for the lease of equipment beginning on January 1, 1998, and ending on December 31, 2002. The rental agreement provides that rent of $100,000 accrues for each calendar month during the lease term. All rent is payable on December 31, 2002, together with interest on accrued rent at a qualified floating rate set at a current value (as defined in §1.1275–5(a)(4)) that is compounded at the end of each calendar month and adjusted at the beginning of each calendar month throughout the lease term. Therefore, the rental agreement provides for variable interest within the meaning of paragraph (b)(2) of this section.

(ii) On the agreement date the qualified floating rate is 7.5 percent, and 110 percent of the applicable Federal rate, as defined in paragraph (e)(3) of this section, based on monthly compounding, is 7 percent. Under paragraph (b)(2) of this section, the fixed rate substitute for the qualified floating rate is 7.5 percent and the agreement is treated as providing for interest at this fixed rate for purposes of determining whether adequate interest is provided under paragraph (b) of this section. Accordingly, the requirements of paragraph (b)(1)(ii) of this section are satisfied, and the rental agreement has adequate interest.

Example 3. (i) X and Y enter into a section 467 rental agreement for the lease of real property beginning on January 1, 1998, and ending on December 31, 2000. The rental agreement provides that rent of $80,000 is allocable to 1998, $100,000 is allocable to 1999, and $120,000 is allocable to 2000. Under the rental agreement, Y must make a $300,000 payment on December 31, 2000. Assume that both X and Y choose the calendar year as the rental period, X and Y are calendar year taxpayers, and 110 percent of the applicable Federal rate is 8.5 percent compounded annually. Assume further that the rental agreement fails to provide adequate interest under paragraph (b)(1) of this section. Therefore, under §1.467–1(d)-(2)(ii), the fixed rent for each rental period is the proportional rental amount.

(ii)(A) The proportional rental amount is computed under paragraph (c) of this section. Because the rental agreement does not call for any fixed rent payments prior to the lease term, under paragraph (d) of this section, present value is determined as of the first day of the first rental period in the lease term. The sum of the present values of the amounts payable by the lessee under the rental agreement is computed as follows:

$$\$234,872.43 = \frac{\$300,000}{(1 + .085)^3}$$

(B) The sum of the present values of the fixed rent allocated to each rental period (discounting the fixed rent allocated to a rental period from the last day of such rental period) is computed as follows:

$$\$252,627.22 = \frac{\$80,000}{(1+.085)} + \frac{\$100,000}{(1+.085)^2} + \frac{\$120,000}{(1+.085)^3}$$

(C) Thus, the fraction for determining the proportional rental amount is .9297194 ($234,872.43/$252,627.22). The section 467 fixed rents for the taxable years within the lease term are:

Taxable year	*Section 467 rent*
1998	$ 74,377.55 ($ 80,000 × .9297194)
1999	92,971.94 ($100,000 × .9297194)
2000	111,566.33 ($120,000 × .9297194)

§1.467–3 Disqualified leasebacks and long-term agreements.

(a) *General rule.* Under §1.467–1(d)(2)(i), constant rental accrual (as described under paragraph (d) of this section) must be used to determine the fixed rent for each rental period in the lease term if the section 467 rental agreement is a disqualified leaseback or long-term agreement within the meaning of paragraph (b) of this section.

(b) *Disqualified leaseback or long-term agreement*—(1) *In general.* A leaseback (as defined in paragraph (b)(2) of this section) or a long-term agreement (as defined in paragraph (b)(3) of this section) is disqualified only if—

(i) The amount determined with respect to the section 467 rental agreement under §1.467–1(c)(4) (relating to the exception for rental agreements involving total payments of $250,000 or less) exceeds $2,000,000;

(ii) A principal purpose for providing increasing or decreasing rent is the avoidance of Federal income tax (as described in paragraph (c) of this section); and

(iii) The Commissioner determines that it is appropriate to treat the section 467 rental agreement as a disqualified leaseback or long-term agreement.

(2) *Leaseback.* A section 467 rental agreement is a leaseback if the lessee (or a related person) had any interest (other than a de minimis interest) in the property at any time during the two-year period ending on the agreement date. For this purpose, interests in property include options and agreements to purchase the property (whether or not the lessee or related person was considered the owner of the property for Federal income tax purposes) and, in the case of subleased property, any interest as a sublessor.

(3) *Long-term agreement*—(i) *In general.* A section 467 rental agreement is a long-term agreement if the lease term exceeds 75 percent of the statutory recovery period for the property.

(ii) *Statutory recovery period*—(A) *In general.* The term *statutory recovery period* means—

(*1*) In the case of property depreciable under section 168, the applicable period determined under section 467(e)(3)(A);

(*2*) In the case of land, 19 years; and

(*3*) In the case of any other tangible property, the period that would apply under section 467(e)(3)(A) if the property were property to which section 168 applied.

(B) *Special rule for leases of properties having different statutory recovery periods.* In the case of a lease of two or more related properties that have different statutory recovery periods, the statutory recovery period for purposes of paragraph (b)(3)(ii)(A) of this section is the weighted average, based on the fair market values of the properties on the lease date, of the statutory recovery periods of each of the properties.

(c) *Tax avoidance as principal purpose for increasing or decreasing*

rent—(1) *In general.* Whether tax avoidance is a principal purpose for providing increasing or decreasing rent in a leaseback or long-term agreement is based on all of the facts and circumstances. However, if either the lessee or the lessor is not subject to Federal income tax on its income or is a tax-exempt entity (within the meaning of section 168(h)(2)), the agreement will be closely scrutinized and clear and convincing evidence will be required to establish that tax avoidance is not a principal purpose for providing increasing or decreasing rent.

(2) *Safe harbors.* Tax avoidance is not considered to be a principal purpose for providing increasing or decreasing rent if—

(i) The rent allocated to each calendar year (determined without regard to any increase or decrease attributable to a provision described in paragraph (c)(2)(ii)(C) of this section) does not vary from the average rent allocated to all calendar years by more than 10 percent (for this purpose, the rent allocated to a partial calendar year is adjusted by multiplying the rent by the number of partial years in a full calendar year); or

(ii) All of the increases and decreases in rent are attributable to one or more of the following provisions—

(A) A provision requiring an increase in rent equal to a percentage of the lessee's receipts (gross or net) if the percentage does not vary throughout the term of the lease;

(B) A provision requiring an adjustment based on a reasonable price index as described in §1.467–1(h);

(C) A provision requiring the lessee to pay third-party costs as described in §1.467–1(h); or

(D) A rent holiday provision allowing reduced rent (including no rent) for an interim period at the beginning of the lease term, but only if the duration of the rent holiday does not exceed the lesser of 24 months or 10 percent of the lease term and there is a substantial business purpose for the rent holiday provision.

(d) *Calculating constant rental amount*—(1) *In general.* Except as provided in paragraph (d)(2) of this section, the constant rental amount is the amount that, if paid at the end of each rental period, would result in a present value equal to the present value of all amounts payable under the disqualified leaseback or long-term agreement as rent and interest. In computing the constant rental amount, the rules for determining present value are the same as those provided in §1.467–2(d) for computing the proportional rental amount. If constant rental accrual is required, all rental periods (other than an initial or final short period of not more than one month) must be equal in length and satisfy the requirements of §1.467–1(j)(5).

(2) *Initial or final short periods.* If a disqualified leaseback or long-term agreement has an initial or final short rental period, the constant rental amount for the initial or final short period may be determined under any reasonable method. However, the sum of the present values of all the constant rental amounts must equal the present values of all amounts payable under the disqualified leaseback or long-term agreement as rent and interest. Any adjustment necessary to eliminate the section 467 loan balance because of the method used to determine the constant rental amount for short periods must be taken into account as section 467 rent for the final rental period.

(3) *Method to determine constant rental amount; no short periods*—(i) *Step 1.* Determine the present value of amounts payable under the disqualified leaseback or long-term agreement as rent or interest.

(ii) *Step 2.* Determine the present value of $1 to be received at the end of each rental period during the lease term as of the first day of the first rental period during the lease term (or, if earlier, the first day a rent payment is required under the rental agreement).

(iii) *Step 3.* Divide the amount determined in paragraph (d)(3)(i) of this section (Step 1) by the number of dollars determined in paragraph (d)(3)(ii) of this section (Step 2).

(e) *Example.* The following example illustrates the application of paragraph (d) of this section:

Example. (i) X and Y enter into a disqualified leaseback for a 5-year lease of personal property beginning on January 1, 1998, and ending on December 31, 2002. The rental agreement provides that $0 of rent is allocated to years 1998, 1999, and 2000, and that rent of $17,500,000 is allocated to years 2001 and 2002. The rental agreement provides that the rent allocated to each year is payable on December 31 of that year. Assume all rental periods are the calendar year. Assume also that 110 percent of the applicable Federal rate based on annual compounding is 12 percent.

(ii) Step 1 in calculating the constant rental amount is to determine the present value of the two payments due under the rental agreement as follows:

$$\$21,051,536 = \frac{\$17,500,000}{(1.12)^4} + \frac{\$17,500,000}{(1.12)^5}$$

(iii) Because no amounts of rent are payable before the lease term, Step 2 in calculating the constant rental amount is to determine the present value as of the first day of the lease term of $1 to be received at the end of each rental period during the lease term. This results in a present value of $3.6047762. In Step 3 the amount determined in Step 1 is divided by the number of dollars determined in Step 2. Thus, the constant rental amount is $5,839,901 for each calendar year during the lease term computed as follows:

$$\$5,839,901 = \frac{\$21,051,536}{3.6047762}$$

§1.467–4 Section 467 loan.

(a) *In general*—(1) *Overview.* Except as provided in paragraph (a)(2) of this section, the section 467 loan rules of this section apply to a section 467 rental agreement if, as of the first day of that period, there is a difference between the amount of fixed rent payable under the rental agreement on or before the first day and the amount of fixed rent required to be accrued in accordance with §1.467–1(d)(2) before the first day. Paragraph (b) of this section provides rules for computing the principal balance of a section 467 loan at the beginning of any rental period. The principal balance of a section 467 loan may be positive or negative. For purposes of the Code, if the principal balance is positive, the amount represents a loan from the lessor to the lessee and, if the principal balance is negative, the amount represents a loan from the lessee to the lessor.

(2) *No section 467 loan in the case of certain section 467 rental agreements.* Except as provided in paragraph (a)(3) and (4) of this section, this section does not apply to section 467 rental agreements that provide adequate interest under §1.467–2(b)(1)(i) (agreements with no deferred or prepaid rent) or §1.467–2(b)(1)(ii) (agreements with deferred or prepaid rent that provide adequate stated interest at a single fixed rate).

(3) *Rental agreements subject to constant rental accrual.* Notwithstanding the provisions of paragraph (a)(2) of this section, this section applies to

rental agreements subject to constant rental accrual under §1.467–3.

(4) *Special rule in applying the provisions of §1.467–7(e) or (f).* Notwithstanding the provisions of paragraph (a)(2) of this section, this section applies to rental agreements that provide adequate interest under §1.467–2(b)(1)(i) or (ii), but only for purposes of applying the provisions of §1.467–7(e) (relating to dispositions of property subject to a section 467 rental agreement) or §1.467–7(f) (relating to assignments by lessees and lessee-financed renewals) to a transaction described therein. Further, for section 467 rental agreements that provide adequate interest under §1.467–2(b)-(1)(i) or (ii), the section 467 interest that accrues on the section 467 loan balance after the sale, exchange, or other disposition under §1.467–7(e) or the assignment or renewal under §1.467–7(f) is the section 467 interest that accrues under the terms of the rental agreement (if any).

(b) *Principal balance*—(1) *In general.* Except as provided in paragraph (b)(2) of this section or in §1.467–7(e) or (f), the principal balance of the section 467 loan at the beginning of a rental period equals the fixed rent accrued in preceding rental periods—

(i) Increased by the interest on fixed rent includible in the gross income of the lessor for preceding rental periods and any amount payable by the lessor on or before the first day of the rental period as interest on prepaid fixed rent; and

(ii) Decreased by the interest on prepaid fixed rent includible in the gross income of the lessee for preceding rental periods and any amount payable by the lessee on or before the first day of the rental period as fixed rent or interest thereon.

(2) *Section 467 rental agreements that provide for prepaid fixed rent and adequate stated interest.* If a section 467 rental agreement calls for prepaid fixed rent and provides adequate interest under §1.467–2(b)(1)(iv), the principal balance of the section 467 loan at the beginning of a rental period equals the principal balance determined under paragraph (b)(1) of this section, plus the fixed rent accrued for that rental period.

(3) *Timing of payments.* For purposes of this paragraph (b), the day on which an amount is payable is determined under the rules of §1.467–1(j)(2).

(c) *Yield*—(1) *In general*—(i) *Method of determining yield.* Except as provided in paragraph (c)(2) of this section, the yield of a section 467 loan is the discount rate at which the sum of the present values of all amounts payable by the lessee as fixed rent and interest on fixed rent, plus the sum of the present values of all amounts payable by the lessor as interest on prepaid fixed rent, equals the sum of the present values of the fixed rent that accrues in accordance with §1.467–1(d)(2). The yield must be constant over the term of the section 467 rental agreement, and, when expressed as a percentage, must be calculated to at least two decimal places.

(ii) *Method of stating yield.* In determining the section 467 interest for a rental period, the yield of the section 467 loan must be stated appropriately by taking into account the length of the rental period. Section 1.1272–1(j) *Example 1* provides a formula for converting a yield based on a period of one length to an equivalent yield based on a period of a different length.

(iii) *Rounding adjustments.* Any adjustment necessary to eliminate the section 467 loan because of rounding the yield to two or more decimal places must be taken into account as section 467 interest for the final rental period determined as provided in paragraph (e) of this section.

(2) *Yield of section 467 rental agreements for which constant rental amount or proportional rental amount is computed.* In the case of a section 467 rental agreement to which §1.467–1(d)(2)(i) or (ii) applies, the yield of the section 467 loan equals 110 percent of the applicable Federal rate (based on a compounding period equal to the rental period).

(3) *Determination of present values.* The rules for determining present value in computing the yield of a section 467 loan are the same as those provided in §1.467–2(d) for computing the proportional rental amount.

(d) *Contingent payments.* Except as otherwise required under §1.467–6, contingent payments are not taken into account in calculating either the yield or the principal balance of a section 467 loan.

(e) *Section 467 rental agreements that call for payments before or after the lease term.* If a section 467 rental agreement calls for the payment of fixed rent or interest thereon before the beginning of the lease term, this section must be applied by treating the period beginning on the first day an amount is payable and ending on the day before the beginning of the first rental period of the lease term as one or more rental periods. If a rental agreement calls for the payment of fixed rent or interest thereon after the end of the lease term, this section must be applied by treating the period beginning on the day after the end of the last rental period of the lease term and ending on the last day an amount of fixed rent or interest thereon is payable as one or more rental periods. Rental period length for the period before the lease term or after the lease term is determined in accordance with the rules of §1.467–1(j)(5).

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

Example. (i)(A) A leases property to B for a three-year period beginning on January 1, 1998, and ending on December 31, 2000. The section 467 rental agreement has the following rent allocation schedule and payment schedule:

	Rent Allocation	*Payment*
1998	$400,000	
1999	600,000	
2000	800,000	$1,800,000

(B) The rental agreement requires a $1.8 million payment to be made on December 31, 2000, but does not provide for interest on deferred rent. Assume A and B choose the calendar year as the rental period length. Assume further that 110 percent of the applicable Federal rate based on annual compounding is 10 percent.

(ii) The rental agreement is not a disqualified leaseback or long-term agreement because it does not provide for the payment of more than $2,000,000 in rent (determined pursuant to §1.467–3(b)(1)(i)). Because the section 467 rental agreement does not provide adequate interest under §1.467–2(b) and is not subject to constant rental accrual, the fixed rent that accrues during each rental period is the proportional rental amount as described in §1.467–2(c). The proportional rental amounts for each rental period are as follows:

1998	$370,370.37
1999	555,555.56
2000	740,740.74

(iii) A section 467 loan arises at the beginning of the second rental period because the rent payable on or before that day (zero) is less than the fixed rent accrued under §1.467–1(d)(2) in all preceding rental periods ($370,370.37). Under paragraph (c)(2) of this section, the yield of the loan is equal to 110 percent of the applicable Federal rate (10 percent compounded annually). Because no payments are treated as made on or before the first day of the second rental period,

the principal balance of the loan at the beginning of the second rental period is $370,370.37. The interest for the second rental period on fixed rent is $37,037.04 (.10 × $370,370.37) and, under §1.467–1(e)(3), is treated as interest income of the lessor and as an interest expense of the lessee.

(iv) Because no payments are made on or before the first day of the third rental period, the principal balance of the loan at the beginning of the third rental period is equal to the fixed rent accrued during the first and second rental periods plus the lessor's interest income on fixed rent for the second rental period ($962,962.97 = $370,370.37 + $555,555.56 + $37,037.04). The interest for the third rental period on fixed rent is $96,296.30 (.10 × $962,962.97). Thus, the sum of the fixed rent and interest on fixed rent for the three rental periods is equal to the total amount paid over the lease term (first year fixed rent accrual, $370,370.37, plus second year fixed rent and interest accrual, $555,555.56 + $37,037.04, plus third year fixed rent and interest accrual, $740,740.74 + $96,296.30, equals $1,800,000). B takes the amounts of interest and rent into account as expense and A takes such amounts into account as income for the calendar years identified above, regardless of their respective methods of accounting.

Example 2. (i) The facts are the same as in *Example 1*, §1.467–2(f).

(ii)(A) Pursuant to paragraph (c)(1) of this section, the yield of the section 467 loan is 10.775078%, compounded annually. The following is a schedule of the rent allocable to each rental period during the lease term, the balance of the section 467 loan as of the end of each rental period (determined, in the case of the calendar year 2002, without regard to the single payment of rent and interest in the amount of $620,000 payable on the last day of the lease term), and the interest on the section 467 loan allocable to each rental period:

Calendar Year	*Section 467 Interest*	*Section 467 Rent*	*Section 467 Loan Balance*
1988	$ 0	$100,000.00	$100,000.00
1999	10,775.08	100,000.00	210,775.08
2000	22,711.18	100,000.00	333,486.26
2001	35,933.41	100,000.00	469,419.67
2002	50,580.33	100,000.00	620,000.00

(B) C takes the amounts of interest and rent into account as expense and D takes such amounts into account as income for the calendar years identified above, regardless of their respective methods of accounting.

§1.467–5 Section 467 rental agreements with variable interest.

(a) *Variable interest on deferred or prepaid rent*—(1) *In general.* This section provides rules for computing section 467 rent and interest in the case of section 467 rental agreements providing variable interest. For purposes of this section, a rental agreement provides for variable interest if the rental agreement provides for stated interest that is paid or compounded at least annually at a rate or rates that meet the requirements of §1.1275–5(a)-(3)(i)(A) or (B) and §1.1275–5(a)(4). If a section 467 rental agreement provides for interest that is neither variable interest nor determined by reference to a fixed rate, the amount of any interest will be treated as a contingent payment subject to §1.467–6.

(2) *Exceptions.* This section is not applicable to section 467 rental agreements that provide adequate interest under §1.467–2(b)(1)(i) (agreements with no deferred or prepaid rent) or §1.467–2(b)(1)(ii) (rental agreements with stated interest at a single fixed rate). The exceptions in this paragraph (a)(2) do not apply to rental agreements subject to constant rental accrual under §1.467–3.

(b) *Variable rate treated as fixed*—(1) *In general.* If a section 467 rental agreement provides variable interest—

(i) The fixed rate substitutes (determined in the same manner as under §1.1275–5(e) treating the agreement date as the issue date) for the variable rates of interest on prepaid or deferred fixed rent provided by the rental agreement must be used in computing the proportional rental amount under §1.467–2(c), the constant rental amount under §1.467–3(d), the principal balance of a section 467 loan under §1.467–4(b), and the yield of a section 467 loan under §1.467–4(c); and

(ii) The interest on fixed rent for any rental period is equal to the amount that would be determined under §1.467–1(e)(2) if the section 467 rental agreement did not provide variable interest, using the fixed rate substitutes determined under paragraph (b)(1)(i) of this section in place of the variable rates called for by the rental agreement, plus the variable interest adjustment amount provided in paragraph (b)(2) of this section.

(2) *Variable interest adjustment amount*—(i) *In general.* The variable interest adjustment amount for a rental period equals the difference between—

(A) The amount of interest that, without regard to section 467, would have accrued during the rental period under the terms of the section 467 rental agreement; and

(B) The amount of interest that, without regard to section 467, would have accrued during the rental period under the terms of the section 467 rental agreement using the fixed rate substitutes determined under paragraph (b)(1)(i) of this section in place of the variable interest rates called for by the rental agreement.

(ii) *Sign of adjustment.* If the amount determined under paragraph (b)(2)(i)-(A) of this section is greater than the amount determined under paragraph (b)(2)(i)(B) of this section, the variable interest adjustment amount is positive. If the amount determined under paragraph (b)(2)(i)(A) of this section is less than the amount determined under paragraph (b)(2)(i)(B) of this section, the variable interest adjustment amount is negative.

(3) *Section 467 loan balance.* The variable interest adjustment amount is not taken into account in determining the principal balance of a section 467 loan under §1.467–4(b). Instead, the section 467 loan balance is computed as if all amounts payable under the section 467 rental agreement were based on the fixed rate substitutes determined under paragraph (b)(1)(i) of this section.

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

Example 1. (i) X and Y enter into a section 467 rental agreement for the lease of personal property beginning on January 1, 1998, and ending on December 31, 2000. It allocates $100,000 of rent to 1998, $200,000 to 1999, and $100,000 to 2000, and requires the lessee to pay all $400,000 of rent on December 31, 2000. The rental agreement requires the accrual of interest on unpaid accrued rent at two different qualified floating rates (as defined in §1.1275–5(b)), one for 1999 and the other for 2000, such interest to be paid on December 31 of the year it accrues. The rental agreement provides that the qualified floating rate is set at a current value within the meaning of §1.1275–5(a)(4). Assume that on the agreement date, 110 percent of the applicable Federal rate is 10 percent, compounded annually.

(ii) The rental agreement is not a disqualified leaseback or long-term agreement because it does not provide for the payment of more than $2,000,000 in rent (determined pursuant to §1.467–3(b)(1)(i)). To determine if the section 467 rental agreement provides for adequate interest under §1.467–2(b), §1.467–2(b)(2) requires the use of fixed rate substitutes (in this example determined in the same manner as under §1.1275–5(e)(3)(i) treating the agreement date as the issue date) in place of the variable rates called for by the rental agreement. Assume that on the agreement date the qualified floating rates, and therefore the fixed rate substitutes, relating to 1999 and 2000 are 10 and 15 percent compounded annually. Taking into account the fixed rate substitutes, the sum of the present values of all amounts payable by the lessee as fixed rent and interest thereon is greater than the sum of the present values of the fixed rent allocated to each rental period. Accordingly, the rental agreement provides adequate interest under §1.467–2(b)(1)(iii) and the fixed rent accruing in

each calendar year during the rental agreement is the fixed rent allocated under the rental agreement.

(iii) Because the section 467 rental agreement provides for variable interest on unpaid accrued fixed rent at qualified floating rates and the qualified floating rates are set at a current value, the requirements of §1.1275–5(a)(3)(i)(A) and (4) are met and the rental agreement provides for variable interest within the meaning of paragraph (a)(1) of this section. Therefore, under paragraph (b)(1)(i) of this section, the yield of the section 467 loan is computed based on the fixed rate substitutes. Under §1.467–4(c), the constant yield (rounded to two decimal places) equals 13.63 percent compounded annually. Based on the fixed rate substitutes, the fixed rent, interest on fixed rent, and the principal balance of the section 467 loan, for each calendar year during the lease term, are as follows:

	Accrued Rent	*Accrued Interest*	*Projected Payment*	*Cumulative Loan*
1998	$100,000	$ 0	$ 0	$100,000
1999	200,000	13,630	(10,000)	303,630
2000	100,000	41,370	(445,000)	0

(iv) To compute the actual reported interest on fixed rent for each calendar year, the variable interest adjustment amount, as described in paragraph (b)(2) of this section, must be added to the accrued interest determined in paragraph (iii) of this *Example 1*. Assume that the variable rates for 1999 and 2000 are actually 11 and 14 percent, respectively. Without regard to section 467, the interest that would have accrued during each calendar year under the terms of the section 467 rental agreement, and the interest that would have accrued under the terms of the rental agreement using the fixed rate substitutes determined under paragraph (b)(1)(i) are as follows:

	Accrued Interest Under Rental Agreement	*Accrued Interest Using Fixed Rate Substitutes*
1998	$ 0	$ 0
1999	11,000	10,000
2000	42,000	45,000

(v) Under paragraph (b)(2) of this section, the variable interest adjustment amount is $1,000 ($11,000 – $10,000) for 1999 and is –$3,000 ($42,000 – $45,000) for 2000. Thus, under paragraph (b)(1)(ii) of this section, the actual interest on fixed rent for 1999 is $14,630 ($13,630 + $1,000) and for 2000 is $38,370 ($41,370 – $3,000).

Example 2. (i) The facts are the same as in *Example 1* except that 110 percent of the applicable Federal rate is 15 percent compounded annually and the section 467 rental agreement does not provide adequate interest under §1.467–2(b). Consequently, the fixed rent for each calendar year during the lease is the proportional rental amount.

(ii) The sum of the present values of the fixed rent provided for each calendar year during the lease term, discounted at 15 percent compounded annually, equals $303,936.87.

(iii)(A) Paragraph (b)(1)(i) of this section requires the proportional rental amount to be computed based on the assumption that interest will accrue and be paid based on the fixed rate substitutes. Thus, the sum of the present values of the projected payments under the section 467 rental agreement equals $300,156.16, computed as follows:

$ 10,000/(1.15)^2	=	$ 7,561.44
445,000/(1.15)^3	=	$300,156.16

(B) The fraction for computing the proportional rental amount equals .9875609 ($300,156.16/$303,936.87).

(iv) Based on the fixed rate substitutes, the fixed rent, interest on fixed rent, and the balance of the section 467 loan for each calendar year during the lease term are as follows:

	Proportional Rent	*Accrued Interest*	*Projected Payment*	*Cumulative Loan*
1998	$ 98,756.09	$ 0.00	$ 0	$ 98,756.09
1999	197,512.18	14,813.41	(10,000)	301,081.68
2000	98,756.09	45,162.23	(445,000)	0.00

(v) The variable interest adjustment amount in this example is the same as in *Example 1*. Under paragraph (b)(1)(ii) of this section, the actual interest on fixed rent for 1999 is $15,813.41 ($14,813.41 + $1,000) and for 2000 is $42,162.23 ($45,162.23 – $3,000).

§1.467–6 Section 467 rental agreements with contingent payments. [Reserved]

§1.467–7 Section 467 recapture and other rules relating to dispositions.

(a) *Section 467 recapture.* Notwithstanding any other provision of the Code, except as provided in paragraph (c) of this section, a lessor disposing of property in a transaction to which this section applies must recognize the recapture amount (determined under paragraph (b) of this section) and treat that amount as ordinary income. This section applies to any disposition of property subject to a section 467 rental agreement that—

(1) Is a leaseback (as defined in §1.467–3(b)(2)) or a long-term agreement (as defined in §1.467–3(b)(3));

(2) Is not disqualified under §1.467–3(b)(1); and

(3) Allocates to any rental period fixed rent that, when annualized, exceeds the annualized fixed rent allocated to any preceding rental period.

(b) *Recapture Recapture amount*—(1) *In general.* The recapture amount for a disposition is the lesser of—

(i) The prior understated inclusions (determined under paragraph (b)(2) of this section); or

(ii) The section 467 gain (determined under paragraph (b)(3) of this section).

(2) *Prior understated inclusions*—(i) *In general.* The prior understated inclusions are the excess (if any) of—

(A) The aggregate amount of section 467 rent and section 467 interest for the period during which the lessor held the property, determined as if the section 467 rental agreement were a disqualified leaseback or long-term agreement; over

(B) The aggregate amount of section 467 rent and section 467 interest accrued by the lessor during that period.

(ii) *Partial rental periods.* For purposes of this paragraph (b)(2), the aggregate amounts described in paragraph (b)(2)(i)(A) and (B) of this section include a ratable portion of the section 467 rent and section 467 interest for any partial rental period during which the lessor held the property.

(3) *Section 467 gain*—(i) *In general.* Except as otherwise provided in paragraph (b)(3)(ii) of this section, the section 467 gain is the excess (if any) of—

(A) The amount realized from the disposition; over

(B) The sum of the adjusted basis of the property and the amount of any gain from the disposition that is treated as ordinary income under any provision of subtitle A of the Code other than section 467(c) (*e.g.*, section 1245 or 1250).

(ii) *Certain dispositions.* In the case of a disposition that is not a sale, exchange, or involuntary conversion, the section 467 gain is the excess (if any) of the fair market value of the property on the date of disposition over the amount determined under paragraph (b)(3)(i)(B) of this section.

(c) *Special rules*—(1) *Gifts.* Paragraph (a) of this section does not apply to a disposition by gift. However, see paragraph (c)(4) of this section for dispositions by transferees.

(2) *Dispositions at death.* Paragraph (a) of this section does not apply to a disposition if the basis of the property in the hands of the transferee is determined under section 1014(a). In the case of items constituting income in respect of a decedent, see section 691.

(3) *Certain tax-free exchanges*—(i) *In general.* The recapture amount in the case of a disposition to which this paragraph (c)(3) applies is limited to the amount of gain recognized to the transferor (determined without regard to paragraph (a) of this section), reduced by the amount of any gain from the disposition that is treated as ordinary income under any provision of

subtitle A of the Code other than section 467(c).

(ii) *Dispositions covered.* This paragraph (c)(3) applies to a disposition of property if the basis of the property in the hands of the transferee is determined by reference to its basis in the hands of the transferor by reason of the application of section 332, 351, 361, 721, or 731.

(4) *Dispositions by transferee.* If the recapture amount with respect to a disposition of property (the first disposition) is limited under paragraph (c)(1) or (3) of this section and the transferee subsequently disposes of the property in a transaction to which this section applies, the amount described in paragraph (b)(2)(i)(A) of this section must be increased for purposes of determining the recapture amount for such subsequent disposition by the excess (if any) of—

(i) The recapture amount on the first disposition, determined without regard to the limitations of paragraphs (c)(1) and (3) of this section; over

(ii) The recapture amount on the first disposition determined after application of such limitations.

(5) *Like-kind exchanges and involuntary conversions.* If property is disposed of or converted and, before the application of paragraph (a) of this section, gain is not recognized in whole or in part under section 1031 or 1033, then the amount of section 467 gain taken into account by the lessor is limited to the sum of—

(i) The amount of gain recognized on the disposition or conversion of the property (determined without regard to paragraph (a) of this section); plus

(ii) The fair market value of property acquired that is not subject to a section 467 rental agreement and that is not taken into account under paragraph (c)(5)(i) of this section.

(6) *Installment sales.* In the case of an installment sale of property to which paragraph (a) of this section applies—

(i) The recapture amount is recognized and treated as ordinary income in the year of the disposition; and

(ii) Any gain in excess of the recapture amount shall be reported under the installment method of accounting if and to the extent that method is otherwise available under section 453.

(7) *Dispositions covered by sections 170(e), 341(e)(12), or 751(c).* For purposes of sections 170(e), 341(e)(12), and 751(c), amounts treated as ordinary income under paragraph (a) of this section must be treated in the same manner as amounts treated as ordinary income under section 1245 or 1250.

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

Example 1. (i) X and Y enter into a section 467 rental agreement for a 5-year lease of personal property beginning on January 1, 1997, and ending on December 31, 2001. The rental agreement provides that $0 of rent is allocated to 1997, 1998, and 1999, and $175,000 is allocated to each of the years 2000 and 2001. The rental agreement provides that the calendar year will be the rental period and that the rent allocated to each calendar year is payable on the last day of that calendar year. Assume that both X and Y are calendar year taxpayers and that 110 percent of the applicable Federal rate is 11 percent, compounded annually. Assume further that the rental agreement is a long-term agreement (as defined in §1.467–3(b)(3)). The rental agreement is not a disqualified leaseback or long-term agreement because it does not provide for the payment of more than $2,000,000 in rent (determined pursuant to §1.467–3(b)(1)(i)). Therefore, the fixed rent allocated under §1.467–1(c)(2)(ii) is zero for the first three rental periods and $175,000 for the fourth and fifth rental periods.

(ii) On December 31, 1999, X sells the property subject to the section 467 rental agreement to an unrelated person for $990,000. At the time of the sale, X's adjusted basis in the property is $550,000. Thus, X's gain on the sale of the property is $440,000. Assume that none of this gain would be treated as ordinary income under any provision of the Internal Revenue Code other than section 467(c). Under paragraph (a) of this section, X is required to take the recapture amount into account as ordinary income. Under paragraph (b) of this section, the recapture amount is the lesser of the prior understated inclusions or the section 467 gain.

(iii)(A) In computing the prior understated inclusions under paragraph (b)(2), assume that the section 467 rent and section 467 interest (based on constant rental accrual) would be taken into account as follows if the section 467 rental agreement were a disqualified long-term agreement:

	Section 467 Rent	*Section 467 Interest*
1997	$59,290.59	$ 0
1998	59,290.59	6,521.96
1999	59,290.59	13,761.35
2000	59,290.59	21,797.06
2001	59,290.59	11,466.68

(B) The aggregate amount of the section 467 rent and section 467 interest (based on constant rental accrual) for 1997, 1998, and 1999 is $198,155.08 ((3 × $59,290.59) + $6,521.96 + $13,761.35). Since X did not take any section 467 rent or section 467 interest into account in 1997, 1998, and 1999, the prior understated inclusions are also $198,155.08. Since none of the gain is treated as ordinary income under any provision of the Code other than section 467(c), the entire amount of gain ($440,000) is section 467 gain. Accordingly, the recapture amount (the lesser of the prior understated inclusions or the section 467 gain) treated as ordinary income is $198,155.08.

Example 2. (i) The facts are the same as in *Example 1* except that the section 467 rental agreement specifies that rents accrue and are paid in the following pattern:

	Allocation	*Payment*
1997	$60,000	$ 0
1998	65,000	0
1999	70,000	0
2000	75,000	175,000
2001	80,000	175,000

(ii)(A) Assume the section 467 rental agreement does not provide for adequate interest under §1.467–2(b), and, therefore, the fixed rent for a rental period is the proportional rental amount. *See* §1.467–1(d)(2)(ii). Assume that, under §1.467–2(c), the following amounts would be required to be taken into account:

	Section 467 Rent	*Section 467 Interest*
1997	$51,585.97	$ 0
1998	55,884.80	5,674.46
1999	60,183.63	12,445.98
2000	64,482.46	20,435.23
2001	68,781.28	10,526.19

(B) The amount of section 467 rent and section 467 interest taken into account by A for 1997, 1998, and 1999 is $185,774.84. Thus, the prior understated inclusions are $12,380.24 (the excess of the aggregate amount of section 467 rent and section 467 interest, based on constant rental accrual, for these three years, $198,155.08, over the aggregate amount of section 467 rent and section 467 interest actually taken into account, $185,774.84). Since this amount is less than the section 467 gain, the recapture amount treated as ordinary income is also $12,380.24.

(e) *Other rules relating to dispositions*—(1) *In general.* If property subject to a section 467 rental agreement is sold, exchanged, or otherwise disposed of, the section 467 rent for a period is taken into account by the owner of the property during the period. The lessee, however, must continue to take section 467 rent and section 467 interest into account without regard to the change of ownership.

(2) *Treatment of section 467 loan.* If there is a sale, exchange, or other disposition of property subject to a section 467 rental agreement (the transfer), the following rules apply in determining the amount of the section 467 loan for the period after the transfer, the amount realized by the transferor, and the transferee's basis in the property:

(i) The beginning balance of the transferor's section 467 loan is equal to the net present value at the time of the transfer of all subsequent amounts payable as fixed rent and interest on fixed rent to the transferor and all subsequent amounts payable as interest on prepaid fixed rent by the transferor.

The transferor must continue to take into account interest on the transferor's section 467 loan balance after the date of the transfer.

(ii) The beginning balance of the transferee's section 467 loan is equal to the principal balance of the section 467 loan immediately before the transfer reduced (below zero, if appropriate) by the beginning balance of the transferor's section 467 loan. Amounts payable to the transferor are not taken into account in adjusting the transferee's section 467 loan balance.

(iii) If the beginning balance of the transferee's section 467 loan is negative, the transferor and transferee must treat the balance as a liability that is either assumed in connection with the transfer of the property or secured by the property acquired subject to the liability. If the beginning balance of the transferee's section 467 loan is positive, the transferor and transferee must treat the balance as an additional asset acquired in connection with the transfer of the property. In the case of a positive beginning balance of the transferee's section 467 loan, the transferee will have an initial cost basis in the section 467 loan equal to the lesser of the beginning balance of the loan or the aggregate consideration for the transfer of the property subject to the section 467 rental agreement and the transfer of the transferor's interest in the section 467 loan.

(3) *Special rules for transfers in certain nonrecognition transactions.* [Reserved]

(f) *Treatment of assignments by lessee and lessee-financed renewals*— (1) *Substitute lessee use.* If a lessee assigns its interest in a section 467 rental agreement to a substitute lessee or a period when a substitute lessee has the use of property subject to a rental agreement is otherwise included in the lease term under §1.467–1(h), the section 467 rent for a period is taken into account by the person having the use of the property during the period. In addition, the following rules apply in determining the amount of the section 467 loan for the period when the substitute lessee has use of the property and in computing the taxable income of the lessee and substitute lessee—

(i) The beginning balance of the lessee's section 467 loan is equal to the net present value, as of the date on which the substitute lessee first has use of the property, of all amounts subsequently payable by the lessee as fixed rent and interest on fixed rent and all amounts subsequently payable as interest on prepaid fixed rent to the lessee. For purposes of this paragraph (f), any amount otherwise payable by the lessee shall not be treated as an amount subsequently payable by the lessee to the extent that such payment, if made by the lessee, would give rise to a right of contribution or other similar claim against the substitute lessee or any other person. The lessee must continue to take into account interest on the lessee's section 467 loan balance after the substitute lessee first has use of the property.

(ii) The beginning balance of the substitute lessee's section 467 loan is equal to the principal balance of the section 467 loan immediately before the substitute lessee first has use of the property reduced (below zero, if appropriate) by the beginning balance of the lessee's section 467 loan. Amounts payable by the lessee to any person other than the substitute lessee (or a related person) or payable to the lessee by any person other than the substitute lessee (or a related person) are not taken into account in adjusting the substitute lessee's section 467 loan balance.

(iii) If the beginning balance of the substitute lessee's section 467 loan is positive, the beginning balance is treated as— (A) Gross income of the lessee for the taxable year in which the substitute lessee first has use of the property; and

(B) A liability that is either assumed in connection with the transfer of the leasehold interest to the substitute lessee or secured by property acquired subject to the liability.

(iv) If the beginning balance of the substitute lessee's section 467 loan is negative—

(A) The beginning balance is treated as an amount incurred by the lessee for the taxable year in which the substitute lessee first has use of the property; and

(B) Repayments of the beginning balance are items of gross income of the substitute lessee in the taxable year in which the repayment occurs (determined by applying any repayment first to the beginning balance of the substitute lessee's section 467 loan).

(v) For purposes of paragraph (f)(1)(iv)(B) of this section, repayments occur as the negative balance is amortized through the net accrual of rent and negative interest.

(2) *Lessor use.* If a period when the lessor has the use of property subject to a section 467 rental agreement is included in the lease term under §1.467–1(h), the section 467 rent for the period is not taken into account and the lessor is treated as a substitute lessee for purposes of paragraph (f)(1) of this section.

(3) *Special rules for transfers in certain nonrecognition transactions.* [Reserved]

§1.467–8 Effective date.

Sections 1.467–1 through 1.467–7 are effective for—

(a) Rental agreements entered into after the date these regulations are published as final regulations in the **Federal Register**; and

(b) Disqualified leasebacks and long-term agreements entered into after June 3, 1996.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on May 31, 1996, 8:45 a.m., and published in the issue of the Federal Register for June 3, 1996, 61 F.R. 27834)

Notice of Proposed Rulemaking and Notice of Public Hearing

Qualified Small Business Stock

IA-26-94

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations relating to the 50-percent exclusion for gain from certain small business stock. The proposed regulations reflect changes to the law made by the Omnibus Budget Reconciliation Act of 1993 (OBRA '93) and provide guidance to the issuers and owners of the stock of certain small businesses. This document also provides a notice of public hearing on these proposed regulations.

DATES: Written comments and outlines of oral comments to be presented at the public hearing scheduled for October 3, 1996, must be received by September 4, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (IA-26-94), Room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington,

DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (IA-26-94), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. The public hearing will be held in Room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC 20224.

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) relating to section 1202 of the Internal Revenue Code. Section 1202 was added by section 13113 of OBRA '93. Section 1202 allows a taxpayer (other than a corporation) to exclude 50 percent of certain gain from the sale of qualified small business stock held for more than 5 years.

Section 1202(c)(1) provides that only stock acquired after August 10, 1993, at its original issuance in exchange for money, property other than stock, or as compensation for services to the corporation (other than as an underwriter) qualifies for the exclusion (the original issue requirement). Section 1202(c)(3) provides two rules to prevent evasion of the original issue requirement. Under the first rule, the exclusion does not apply to stock acquired by the taxpayer if, at any time during the 4-year period beginning 2 years before the issuance of such stock, the corporation purchased (directly or indirectly) any of its stock from the taxpayer or a related person. Section 1202(c)(3)(A). Under the second rule, the exclusion does not apply to stock issued by a corporation if, during the 2-year period beginning 1 year before the issuance of such stock, the corporation made one or more purchases of its stock with an aggregate value (as of the time of the respective purchases) exceeding 5 percent of the aggregate value of all of its stock as of the beginning of the 2-year period. Section 1202(c)(3)(B).

The IRS and Treasury are concerned that, in many cases, redemptions that have neither the purpose nor the effect of evading the original issue requirement may result in disqualification under these rules. Section 1202(k) authorizes Treasury to prescribe such regulations as may be appropriate to carry out the purposes of section 1202.

Explanation of Provisions

The proposed regulations permit a corporation to redeem de minimis amounts of stock without violating the anti-evasion rules. The proposed regulations also provide that certain redemptions that are incident to events affecting a shareholder and are unlikely to result in evasion of the original issue requirement are disregarded in determining whether redemptions exceed the de minimis amounts. In particular, redemptions upon termination of a shareholder's employment or the death, disability, or mental incompetency of a shareholder are disregarded. Finally, the regulations clarify that transfers of stock by a shareholder to an employee in connection with the performance of services are not treated as redemptions for purposes of the anti-evasion rules.

The regulations will apply to stock issued after the date they are published as final regulations. The regulations will also apply to stock issued on or before that date, but only with respect to the effect of redemptions occurring after that date.

Special Analyses

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

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and 8 copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

The IRS and Treasury invite comments on matters addressed in the proposed regulations and suggestions for any additional exceptions and clarifications that may be appropriate in the context of the purpose of section 1202(c)(3) and the regulatory authority granted in section 1202(k). The IRS and Treasury specifically invite comments from the small business community.

The IRS and Treasury are particularly interested in comments regarding the scope of the exception for redemptions incident to termination of employment. The IRS and Treasury are committed to extending the exception to independent contractors, but seek comments regarding how to determine when a termination of the independent contractor's services has occurred.

A public hearing has been scheduled for October 3, 1996, at 10 a.m. in Room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments and an outline of topics to be discussed and the time to be devoted to each topic (signed original and 8 copies) by September 4, 1996.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

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Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Section 1.1202-2 is also issued under 26 U.S.C. 1202(k).

* * *

Par. 2. Sections 1.1202-0 and 1.1202-2 are added to read as follows:

§ 1.1202-0 Table of contents.

This section lists the major captions that appear in the regulations under § 1.1202-2.

§ 1.1202-2 Qualified small business stock; effect of redemptions.

(a) Redemptions from taxpayer or related person.

(1) In general.

(2) De minimis amount.

(b) Significant redemptions.

(1) In general.

(2) De minimis amount.

(c) Transfers by shareholders in connection with the performance of services not treated as purchases.

(d) Exceptions for termination of services, death, or disability or mental incompetency.

(1) Termination of services.

(2) Death.

(3) Disability or mental incompetency.

(e) Effective date.

§ 1.1202-2 Qualified small business stock; effect of redemptions.

(a) *Redemptions from taxpayer or related person*—(1) *In general.* Stock acquired by a taxpayer is not qualified small business stock if, in one or more purchases during the 4-year period beginning on the date 2 years before the issuance of the stock, the issuing corporation purchases (directly or indirectly) more than a de minimis amount of its stock from the taxpayer or from a person related (within the meaning of section 267(b) or 707(b)) to the taxpayer.

(2) *De minimis amount.* For purposes of this paragraph (a), stock exceeds a de minimis amount only if the aggregate amount paid for the stock exceeds $10,000 and more than 2 percent of the stock held by the taxpayer and related persons is acquired. The following rules apply for purposes of determining whether the 2-percent limit is exceeded. The percentage of stock acquired in any single purchase is determined by dividing the stock's value (as of the time of purchase) by the value (as of the time of purchase) of all stock held (directly or indirectly) by the taxpayer and related persons immediately before the purchase. The percentage of stock acquired in multiple purchases is the sum of the percentages determined for each separate purchase.

(b) *Significant redemptions*—(1) *In general.* Stock is not qualified small business stock if, in one or more purchases during the 2-year period beginning on the date 1 year before the issuance of the stock, the issuing corporation purchases more than a de minimis amount of its stock and the purchased stock has an aggregate value (as of the time of the respective purchases) exceeding 5 percent of the aggregate value of all of the issuing corporation's stock as of the beginning of such 2-year period.

(2) *De minimis amount.* For purposes of this paragraph (b), stock exceeds a de minimis amount only if the aggregate amount paid for the stock exceeds $10,000 and more than 2 percent of all outstanding stock is purchased. The following rules apply for purposes of determining whether the 2-percent limit is exceeded. The percentage of the stock acquired in any single purchase is determined by dividing the stock's value (as of the time of purchase) by the value (as of the time of purchase) of all stock outstanding immediately before the purchase. The percentage of stock acquired in multiple purchases is the sum of the percentages determined for each separate purchase.

(c) *Transfers by shareholders in connection with the performance of services not treated as purchases.* A transfer of stock by a shareholder to an employee or independent contractor (or to a beneficiary of an employee or independent contractor) is not treated as a purchase of the stock by the issuing corporation for purposes of this section even if the stock is treated as having first been transferred to the corporation under § 1.83-6(d)(1) (relating to transfers by shareholders to employees or independent contractors).

(d) *Exceptions for termination of services, death, or disability or mental incompetency.* A stock purchase is disregarded for purposes of this section if—

(1) *Termination of services*—(i) *Employees and directors.* The stock was acquired by the seller in connection with the performance of services as an employee or director and the stock is purchased from the seller incident to the seller's retirement or other bona fide termination of such services;

(ii) *Independent contractors.* [Reserved];

(2) *Death.* The stock is purchased from the deceased shareholder's estate, beneficiary, heir, surviving joint tenant, or from a surviving spouse or a trust established by a decedent, the stock is purchased within 3 years and 9 months from the date of death, and the stock (or an option to acquire the stock) was acquired by the seller before or on account of the death of the decedent; or

(3) *Disability or mental incompetency.* The stock is purchased incident to the disability or mental incompetency of the selling shareholder.

(e) *Effective date.* This section applies to stock issued after the date these regulations are published as final regulations in the **Federal Register**. This section also applies to stock issued on or before the date these regulations are published as final regulations in the **Federal Register**, but only with respect to the effect of purchases by the issuing corporation that occur after that date.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on June 3, 1996, 11:29 a.m., and published in the issue of the Federal Register for June 6, 1996, 61 F.R. 28821)

Notice of Proposed Rulemaking and Notice of Public Hearing

Definition of Reasonable Basis

IA–42–95

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations relating to the accuracy-related penalty regulations under chapter 1 of the Internal Revenue Code. These amendments are necessary to define reasonable basis and provide corrections to final regulations relating to the accuracy-related penalty under chapter 1 of the Internal Revenue Code. The proposed regulations would affect all taxpayers who file tax returns. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronically generated comments must be received by February 10, 1997. Outlines of topics to be discussed at the public hearing scheduled for February 25, 1997, must be received by February 4, 1997.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (IA–42–95), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (IA–42–95), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Wash-

ington, DC., or electronically, via the IRS Internet site at: http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in room 3313, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC.

SUPPLEMENTARY INFORMATION:

Background

On September 1, 1995, the IRS issued Treasury Decision 8617 (60 FR 45663), setting forth final regulations relating to the accuracy-related penalty under chapter 1 of the Internal Revenue Code. These regulations provided guidance concerning the reasonable basis standard for purposes of the negligence penalty (section 6662(b)(1)) and for purposes of the disclosure exception to the penalties for disregarding rules or regulations (section 6662(b)(1)) and substantial understatement of income tax (section 6662(b)(2)). In the preamble to the final regulations, Treasury requested comments and suggestions on providing further guidance on the reasonable basis standard. Treasury has not received any additional comment letters in response to this request for comments. Previous comments that were addressed in the preamble to the final regulations published on September 1, 1995 have been considered in drafting these proposed regulations.

Explanation of Provision

Under the final regulations currently in place, the reasonable basis standard is "significantly higher than the not frivolous standard applicable to preparers under 6694." These proposed regulations provide that the reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. A return position will generally satisfy the reasonable basis standard if it is reasonably based on one or more of the authorities set forth in § 1.6662–4(d)(3)(iii) (taking into account the relevance and persuasiveness of the authorities, and subsequent developments). Additionally, the proposed regulations clarify that if a return position does not satisfy the reasonable basis standard, the reasonable cause and good faith exception as set forth in § 1.6664–4 may still provide relief from the penalty.

Special Analyses

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

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely (in the manner described under the ADDRESSES caption) to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for February 25, 1997, at 10 a.m., in room 3313, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written or electronically generated comments (in the manner described under the ADDRESSES caption) by February 10, 1997, and submit an outline of the topics to be discussed and the time devoted to each topic by February 4, 1997.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.6662–0 is amended by:

1. Revising the entry for § 1.6662–2.

2. Removing the entries for §§ 1.6662–3(b)(3)(i) and (ii).

3. Revising the entry for § 1.6662–7(d). 4

. Removing the entries for §§ 1.6662–7(d)(1) and (2).

The amendments and revisions read as follows:

§ 1.6662–0 Table of contents.

* * * * *

§ 1.6662–2 Accuracy-related penalty.

* * * * *

§ 1.6662–7 Omnibus Budget Reconciliation Act of 1993 changes to the accuracy-related penalty.

* * * * *

(d) Reasonable basis.

* * * * *

Par. 3. Section § 1.6662–3 is amended by:

1. Revising the third sentence in paragraph (b)(1) introductory text.

2. Revising paragraph (b)(3).

The revisions read as follows:

§ 1.6662–3 Negligence or disregard of rules or regulations.

* * * * *

(b)* * *(1) * * * A return position that has a reasonable basis as defined in paragraph (b)(3) of this section is not attributable to negligence. * * *

* * * * *

(3) *Reasonable basis.* Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. If a return position is reasonably based on one or more of the authorities set forth in § 1.6662–4(d)(3)(iii) (taking into account the relevance and persuasiveness of the authorities, and subsequent developments), the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard as defined in § 1.6662–4(d)(2). In addition, the reasonable cause and good faith exception, as set forth in § 1.6664–4, may provide

relief from the penalty, even if a return position does not satisfy the reasonable basis standard.

* * * * *

Par. 4. In § 1.6662–4, the second sentence in paragraph (d)(2) is revised to read as follows:

§ 1.6662–4 Substantial understatement of income tax.

* * * * *

(d) * * *

(2) * * * The substantial authority standard is less stringent than the more likely than not standard (the standard that is met when there is a greater than 50-percent likelihood of the position being upheld), but more stringent than the reasonable basis standard as defined in § 1.6662–3(b)(3). * * *

* * * * *

Par. 5. In 1.6662–7, paragraph (d) is revised to read as follows:

§ 1.6662–7 Omnibus Budget Reconciliation Act of 1993 changes to the accuracy-related penalty.

* * * * *

(d) *Reasonable basis.* For purposes of §§ 1.6662–3(c) and 1.6662–4(e) and (f) (relating to methods of making adequate disclosure), the provisions of § 1.6662–3(b)(3) apply in determining whether a return position has a reasonable basis.

Par. 6. Section 1.6664–0 is amended by:

1. Revising the entry for paragraph (c)(2) of § 1.6664–4.

2. Removing the entries for paragraphs (c)(1)(iii), (c)(2)(i), and (c)(2)(ii) of § 1.6664–4.

The revision reads as follows:

§ 1.6664–0 Table of contents.

* * * * *

§ 1.6664–4 Reasonable cause and good faith exception to section 6662 penalties.

* * * * *

(c) * * *

(2) Advice defined.

* * * * *

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on November 8, 1996, 8:45 a.m., and published in the issue of the Federal Register for November 12, 1996, 61 F.R. 58020)

Notice of Proposed Rulemaking and Notice of Public Hearing

Extensions of Time to Make Elections

IA–29–96

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: In TD 8680, on page 194, the IRS is issuing temporary regulations relating to extensions of time for making certain elections under the Internal Revenue Code (Code). The regulations provide the standards that the Commissioner will use to grant taxpayers extensions of time for making these elections. The text of those temporary regulations also serves as the text of these proposed regulations. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments must be received by September 25, 1996. Outlines of oral comments to be presented at the public hearing scheduled for Wednesday, October 30, 1996, at 10 a.m. must be received by October 9, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (IA–29–96), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (IA–29–96), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. The public hearing will be held in the IRS Classroom (room 2617), Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget (OMB) for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507).

Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224. Comments on the collection of information should be received by August 26, 1996.

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

The collection of information is in §§ 301.9100–2T and 301.9100–3T. This information is required for a taxpayer to obtain an extension of time to make an election. This information will be used by the IRS to determine whether to grant an extension of time to make an election. The likely respondents are businesses or other for-profit institutions, small businesses or organizations, nonprofit institutions, individuals or households, and farms.

Books or records relating to the collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Estimated total annual reporting burden: 5,000 hours
Estimated annual burden per respondent: 10 hours.
Estimated number of respondents: 500
Estimated annual frequency of responses: Occasional

Background

Temporary regulations in TD 8680, on page 194, amend 26 CFR part 301. The temporary regulations contain rules relating to extensions of time for making certain elections.

The text of those temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the temporary regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C.

chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Wednesday, October 30, 1996, at 10 a.m. in the IRS Classroom (room 2617), Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the building lobby more than 15 minutes before the hearing starts.

The rules of § 601.601(a)(3) apply to the hearing.

Persons that have submitted written comments by September 25, 1996, and want to present oral comments at the hearing must submit, by October 9, 1996, an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies). A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

* * * * *

Proposed Amendments to the Regulations

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

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 is amended by removing the entries for §§ 301.9100–1T through 301.9100–3T and adding entries in numerical order to read as follows:

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

Section 301.9100–1 also issued under 26 U.S.C. 6081;

Section 301.9100–2 also issued under 26 U.S.C. 6081;

Section 301.9100–3 also issued under 26 U.S.C. 6081; * * *

Par. 2. Sections 301.9100–1 and 301.9100–1T through 301.9100–3T are removed.

Par. 3. Sections 301.9100–1 through 301.9100–3 are added to read as follows:

§ 301.9100–1 Extensions of time to make elections.

§ 301.9100–2 Automatic extensions.

§ 301.9100–3 Other extensions.

[The text of these above proposed sections are the same as the text of §§ 301.9100-1T through 301.9100–3T published in TD 8680.]

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on June 26, 1996, 8:45 a.m., and published in the issue of the Federal Register for June 27, 1996, 61 F.R. 33408)

Notice of Proposed Rulemaking and Notice of Public Hearing

Allocation of Loss on Disposition of Stock

INTL–4–95

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed Income Tax Regulations relating to the allocation of loss realized on the disposition of stock. These regulations will affect United States and foreign shareholders of stock in domestic and foreign corporations. The regulations are necessary to modify existing guidance with respect to stock losses. This document also contains a notice of public hearing on the regulations.

DATES: Written comments must be received by October 7, 1996. Outlines of topics to be discussed at the public hearing scheduled for November 6, 1996, at 10 a.m. must be received by October 16, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (INTL–4–95), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (INTL–4–95), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington DC. The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507).

Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224. Comments on the collection of information should be received by September 6, 1996.

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

The collection of information under section 865(j)(1) is in § 1.865–2(e)(2)-(ii). The proposed regulations provide that in order for taxpayers to elect retroactive application of the regulations, taxpayers must comply with the reporting requirements contained in § 1.865–2(e)(2)(ii). This information is required by the IRS as a condition for a taxpayer to elect to apply the rules of § 1.865–2 retroactively. This information will be used to determine whether a taxpayer properly applied the regulations. The respondents generally will be U.S. corporations or individuals that sell or otherwise dispose of stock in a foreign corporation of which the seller owns more than 10% of the vote or value.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Estimated total annual reporting burden: 4,000 hours. The estimated annual burden per respondent varies from 1 hour to 5 hours, depending on individual circumstances, with an estimated average of 2 hours.

Estimated number of respondents: 2,000.

Estimated annual frequency of responses: Once.

Background

This document contains proposed regulations amending the Income Tax Regulations (26 CFR Part 1) under sections 861, 865, and 904 of the Internal Revenue Code. These regulations are also issued under authority contained in section 7805 of the Internal Revenue Code.

Explanation of Provisions

This notice of proposed rulemaking provides rules under section 865(j) relating to the treatment of losses from the sale or other disposition of stock.

Section 1.865–1 provides that the allocation of loss on the disposition of property not governed by § 1.865–2 continues to be governed by the generally applicable rules of § 1.861–8, except as provided in other administrative pronouncements. For example, Notice 89–58 (1989–1 C.B. 699) remains in effect with respect to losses described in that Notice. The treatment of portfolio stock, which is excluded from § 1.865–2, will be reviewed in the context of a broader project dealing with similar portfolio investments, including debt instruments and derivative financial products. Allocation of loss on the disposition of stock of a regulated investment company and stock of an S corporation also will continue to be governed by §§ 1.861–8(e)(7)(i) and (ii).

Section 1.865–2(a) provides the general rule that stock losses are allocated in the same manner as stock gains (determined without regard to sections 1248 and 865(f)). Thus, stock loss generally is allocated to the residence of the seller. Loss recognized by a United States resident on the disposition of stock attributable to a foreign branch is allocated to foreign source income if a gain would have been taxable by the foreign country and the highest marginal rate of tax imposed in that foreign country is at least 10 percent. Loss recognized by a nonresident alien individual or foreign corporation with respect to stock constituting a United States real property interest reduces United States source income, in accordance with section 897.

Section 1.865–2(b) provides exceptions to the general rule. Section 1.865–2(b)(1) provides a dividend recapture rule that applies to losses realized on a disposition of stock within 24 months following the inclusion of a dividend or similar amount. To the extent of the dividend recapture amount, the loss shall be allocated to the same class of income as the dividend. Under a *de minimis* rule, the recapture rule will not apply if the sum of all dividend recapture amounts is less than 10 percent of the realized loss.

A dividend recapture amount includes an actual dividend, a subpart F or qualified electing fund inclusion attributable to a dividend received by a controlled foreign corporation in a separate limitation category other than that for passive income, and an inclusion attributable to section 956 or 956A. Dividends from foreign corporations, which often are sheltered from United States tax by foreign tax credits and do not reduce the shareholder's basis in the stock, may reduce the selling price of the stock, thereby creating or increasing a loss on sale. Similarly, the identified subpart F inclusions may increase the shareholder's stock basis without substantially affecting the value of the stock, offering similar opportunities to create a tax mismatch from an economic "wash" by pairing tax-sheltered foreign source inclusions and United States source loss.

Section 1.865–2(b)(2) provides a consistency rule requiring generally that loss recognized on the disposition of an 80%-owned foreign affiliate reduces foreign source passive income if, within the past five years, the seller or any member of its consolidated group recognized gain on the disposition of a foreign affiliate that was sourced under section 865(f). In order to provide relief for taxpayers that could have taken steps to avoid section 865(f) treatment on gain sales occurring prior to the publication of these proposed regulations, the five-year lookback period will be phased in so that losses will be tainted only by reason of gains recognized after September 6, 1996.

Section 1.865–2(b)(3) provides anti-abuse rules designed to prevent taxpayers from changing the allocation of a loss with respect to stock or other property by entering into certain transactions.

Section 1.865–2(c) provides rules of general application. Section 1.865–2(c)(1) provides that a partner's distributive share of loss resulting from a disposition of stock by a partnership is allocated as if the partner disposed of the stock. In an appropriate case the loss may be attributable to a fixed place of business of the partnership rather than to the partner's residence.

Section 1.865–2(c)(2) provides that worthlessness shall be treated as a disposition for purposes of the stock loss allocation rules.

Section 1.865–2(d) provides definitions.

Under § 1.865–2(e), the regulations are proposed to be effective for taxable years beginning after 60 days after the date final regulations are published in the **Federal Register**. However, a taxpayer may elect to apply the regulations retroactively to stock losses in all open post-1986 taxable years. A taxpayer generally may make the election by attaching a statement to an original or amended federal income tax return filed after final regulations are published in the **Federal Register**. However, the election will not be effective unless amended returns are filed within 120 days of the date final regulations are published in the **Federal Register**.

Section 1.904–4(c) is proposed to be amended to provide rules specifically addressing the treatment of loss allocated to the section 904(d) separate category for passive income. The proposed amendments provide that, for purposes of the grouping rules relating to the high-tax kick-out described in section 904(d)(2)(F), a passive loss is initially allocated to a group based on the foreign tax that was, or would have been, imposed on the transaction had the sale resulted in a gain under foreign law. If, after allocation and apportionment of all deductions, net income in a group is less than zero, any taxes imposed with respect to the group are considered related to general limitation income. The net loss is not considered related to general limitation income, but proportionately reduces income in the other passive income groups. The determination of whether income in the positive income groups is high-taxed is made after this allocation of loss groups. Any net loss in the section 904(d) separate category for passive income constitutes a separate limitation loss governed by section 904(f)(5).

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations do not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations will primarily affect U.S. owners of significant interests in foreign corporations, which owners generally are large multinational corporations. This certification is also based upon the fact that, even in cases in which the regulation applies to small entities, the burden imposed by the collection of information in the regulation, which is merely an election to apply the regulation to prior taxable years, is not substantial and, therefore, the collection of information will not impose a significant economic impact on such entities. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (signed original and eight (8) copies) that are timely submitted to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for November 6, 1996, at 10 a.m., in room 2615, Internal Revenue Building, 1111 Constitution Avenue NW, Washington DC. Because of access restrictions, visitors will not be admitted beyond the building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons that wish to present oral comments at the hearing must submit written comments by October 7, 1996 and submit an outline of topics to be discussed and time to be devoted to each topic (signed original and eight (8) copies) by October 16, 1996.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Adoption of Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Section 1.865–1 is also issued under 26 U.S.C. 865(j)(1).

Section 1.865–2 is also issued under 26 U.S.C. 865(j)(1).

Par. 2. Section 1.861–8 is amended by adding paragraph (e)(7)(iii) to read as follows: § 1.861–8 Computation of taxable income from sources within the United States and from other sources and activities.

* * * * *

(e) * * *

(7) * * *

(iii) *Special rules for allocation of loss from disposition of stock.* See § 1.865–2 for special rules regarding the allocation of loss recognized on certain dispositions of stock in taxable years beginning after December 31, 1986.

Par. 3. Sections 1.865–1 and 1.865–2 are added under the undesignated center heading, DETERMINATION OF SOURCES OF INCOME, to read as follows:

§ 1.865–1 Loss from the disposition of personal property.

Allocation of loss on the sale or other disposition of portfolio stock, stock of a regulated investment company (as defined in section 851), stock of an S corporation (as defined in section 1361), and other personal property not governed by § 1.865–2 is governed by § 1.861–8 or other administrative pronouncements. Portfolio stock is, with respect to a taxpayer, stock in a corporation in which the taxpayer owns, or is considered to own under the rules of section 267(c), less than 10 percent of the total combined voting power of all classes of stock entitled to vote of such corporation and less than 10 percent of the total value of the stock of such corporation.

§ 1.865–2 Loss from the disposition of certain stock.

(a) *General rules for allocation of loss on disposition of stock*—(1) *Allocation against gain.* Except as otherwise provided in § 1.865–1 and paragraph (b) of this section, loss recognized on the sale or other disposition of stock shall be allocated to the class of gross income and, if necessary, apportioned between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income, with respect to which gain (other than gain treated as a dividend under section 1248) from the sale of such stock would give rise in the hands of the seller (without regard to section 865(f)). For purposes of section 904, any such loss shall be allocated to the separate category to which such gain would have been assigned (without regard to section 904(d)(2)(A)(iii)(III)). For purposes of § 1.904–4(c)(2)(ii)(A), any loss allocated to passive income shall be allocated (prior to the application of § 1.904–4(c)(2)(ii)(B)) to the group of passive income to which gain on the sale would have been assigned if the sale of the stock had resulted in the recognition of a gain under the law of the relevant foreign jurisdiction or jurisdictions. See section 904(f)(5) and the regulations under that section for rules regarding the treatment of separate limitation losses.

(2) *Stock attributable to foreign office.* Except as otherwise provided in § 1.865–1 and paragraph (b) of this section, in the case of loss on the sale or other disposition of stock (other than stock constituting inventory) by a United States resident that is attributable to an office or other fixed place of business in a foreign country within the meaning of section 865(e)(3), the loss shall be allocated to reduce foreign source income if a gain would have been taxable by the foreign country and the highest marginal rate of tax imposed in the foreign country is at least 10 percent.

(3) *Stock constituting a United States real property interest.* Loss recognized by a nonresident alien individual or a foreign corporation on the sale or other disposition of stock that constitutes a United States real property interest shall be allocated to reduce United States source income. For additional rules governing the treatment of such loss, see section 897 and the regulations thereunder.

(b) *Exceptions*—(1) *Dividend recapture exception*—(i) *In general.* Except as otherwise provided in § 1.865–1, if a taxpayer realizes a loss on a disposition of stock, and the taxpayer included in income a dividend recapture amount (or amounts) with respect to such stock at any time during the recapture period, then, to the extent of the dividend recapture amount (or amounts), the loss shall be allocated and apportioned on a proportionate basis to the class or classes of gross income or the statutory or residual grouping or groupings of gross income to which the dividend recapture amount was assigned.

(ii) *Exception for de minimis amounts.* Paragraph (b)(1)(i) of this section shall not apply to a loss realized by a taxpayer on the disposition of stock if the sum of all dividend recapture amounts included in income by the taxpayer with respect to such stock during the recapture period is less than 10 percent of the realized loss.

(2) *Consistency exception*—(i) *In general.* Except to the extent provided in paragraph (b)(1) of this section, loss recognized by a taxpayer with respect to the sale or other disposition of stock of a foreign affiliate (or of a corporation that was a foreign affiliate within the five-year period preceding the date of the sale) or a foreign affiliate holding company shall be allocated to reduce foreign source income if the taxpayer (or, in the case of a taxpayer that is a member of a consolidated group (within the meaning of § 1.1502–1(h)) at the time the loss is recognized, the consolidated group) recognized gain on the disposition of any stock that was sourced under section 865(f) within the five-year period ending on the last day of the taxable year in which the loss was recognized. See paragraph (a)(1) of this section for rules relating to the allocation of the loss to separate categories described in section 904(d).

(ii) *Phased-in lookback period.* The rule of paragraph (b)(2)(i) of this section shall apply only if gain sourced under section 865(f) was recognized after September 6, 1996.

(3) *Anti-abuse rules.* If one of the principal purposes of a reorganization within the meaning of section 368(a), liquidation under section 332, transfer to a corporation under section 351, transfer to a partnership under section 721, transfer to a trust, distribution by a partnership, distribution by a trust, or transfer to or from a qualified business unit (within the meaning of section 989(a)) is to change the allocation of a built-in loss on the disposition of stock (or other personal property), the loss shall be allocated as if it were recognized on the disposition of the stock (or other personal property) immediately prior to the reorganization, liquidation, transfer, or distribution. In addition, if a loss recognized by a taxpayer with respect to the sale or other disposition of stock in a corporation is primarily attributable to loss with respect to one or more financial instruments held by the corporation, and one of the taxpayer's principal purposes for holding the financial instrument or instruments through the corporation is to allocate loss under § 1.865–2, the stock loss shall be allocated under § 1.865–1 as if it were recognized on the disposition of such financial instrument or instruments. Whether a taxpayer has a principal purpose to allocate loss under § 1.865–2 shall be determined by taking into account all the facts and circumstances, including whether the corporation engages in business activities (other than trading financial instruments) and whether the taxpayer or any related person or persons (within the meaning of section 267(b) or 954(d)(3)) hold positions that offset loss positions held by the corporation. For purposes of this paragraph (b)(3), positions are offsetting if the risk of loss of holding one or more positions is substantially diminished by holding one or more other positions. A person may have a principal purpose of affecting loss allocation even though this purpose is outweighed by other purposes (taken together or separately).

(4) *Example.* The application of this paragraph (b) may be illustrated by the following example:

Example. (i) *P*, a domestic corporation, is a United States shareholder of *N*, a controlled foreign corporation. *N* has never had any subpart F income and all of its earnings and profits are described in section 959(c)(3). On August 5, 1997, *N* distributes a dividend to *P* in the amount of $100. The dividend gives rise to a $5 foreign withholding tax, and *P* is deemed to have paid an additional $45 of foreign income tax with respect to the dividend under section 902. Under section 904(d)(3) the dividend is general limitation income described in section 904(d)(1)(I).

(ii) On February 6, 1998, *P* sells its shares of *N* and recognizes a $110 loss. In 1998, *P* has the following taxable income, excluding the loss on the sale of *N*:

(A) $1,000 of foreign source income that is general limitation income described in section 904(d)(1)(I), which is subject to foreign taxes of $400;

(B) $1,000 of foreign source capital gain that is passive income described in section 904(d)(1)(A) attributable to gain on the sale of stock in a foreign affiliate that is sourced under section 865(f), which is subject to foreign taxes of $30.

(iii) The $100 dividend paid in 1997 is a dividend recapture amount that was included in *P*'s income within the recapture period preceding the disposition of the *N* stock. The de minimis exception of paragraph (b)(1)(ii) of this section does not apply because the $100 dividend recapture amount exceeds 10 percent of the $110 loss. Therefore, to the extent of the $100 dividend recapture amount, the loss must be allocated under paragraph (b)(1)(i) of this section to the separate limitation category to which the dividend was assigned (general limitation income).

(iv) Because *P* recognized gain on the sale of stock in a foreign affiliate that was sourced under section 865(f) within the period described in paragraph (b)(2)(i) of this section, *P*'s remaining $10 loss on the disposition of the *N* stock is allocated to foreign source passive income under paragraph (b)(2)(i) of this section.

(v) After allocation of the stock loss, *P*'s taxable income in 1998 consists of $900 of foreign source general limitation income and $990 of foreign source passive income.

(c) *Rules of application*—(1) *Loss recognized by partnership.* A partner's distributive share of loss resulting from the sale or other disposition of stock by a partnership shall be allocated and apportioned in accordance with this section as if the partner had disposed of the stock. If a sale of stock is attributable to an office or other fixed place of business of the partnership within the meaning of section 865(e)(3), such office or fixed place of business shall be considered to be an office of the partner for purposes of this section.

(2) *Worthless stock.* For purposes of this section, worthlessness giving rise to a deduction under section 165(g) (including section 165(g)(3)) with respect to stock shall be treated as a disposition.

(d) *Definitions*—(1) *Terms defined in § 1.861–8.* See § 1.861–8 for the meaning of *class of gross income*, *statutory grouping of gross income*, and *residual grouping of gross income.*

(2) *Dividend recapture amount.* A dividend recapture amount is a dividend (except for an amount treated as a dividend under section 78), an inclusion described in section 951(a)(1)(A)(i) (but only to the extent attributable to a dividend included in the earnings of a controlled foreign corporation that is included in foreign personal holding company income under section 954(c)(1)(A) and that, pursuant to section 904(d)(3)(B), is treated as income in a separate category other than the separate category for passive income described in section 904(d)(2)(A)), an inclusion described in section 951(a)(1)(B) or (C), and an inclusion described in section 1293(a)(1) (but only to the extent attributable to a dividend that is included in

the earnings of a qualified electing fund and that, pursuant to section 904(d)(3)(I), is treated as income in a separate category other than the separate category for passive income described in section 904(d)(2)(A)).

(3) *Foreign affiliate.* A foreign affiliate is a foreign corporation that is a member of the affiliated group (within the meaning of section 1504(a) without regard to section 1504(b)) that includes the taxpayer.

(4) *Foreign affiliate holding company.* A foreign affiliate holding company is any corporation, substantially all the assets of which consist of stock of one or more foreign affiliates, held directly or indirectly. For purposes of this paragraph, any assets acquired or held by a corporation with a principal purpose of avoiding foreign affiliate holding company status shall be disregarded.

(5) *Recapture period.* A recapture period is the 24-month period preceding the date on which a taxpayer realizes a loss on a disposition of stock, increased by any period of time in which the taxpayer has diminished its risk of loss in a manner described in section 246(c)(4) and the regulations thereunder.

(6) *Taxpayer.* A taxpayer shall include all predecessors or successors of the taxpayer.

(7) *United States resident.* See section 865(g) and the regulations thereunder for the definition of United States resident.

(e) *Effective date*—(1) *In general.* This section is effective for taxable years beginning after the date that is 60 days after the date these regulations are published as final regulations in the **Federal Register**.

(2) *Prior year election*—(i) *In general.* A taxpayer may elect to apply the rules of this section to all (but not less than all) of its taxable years that begin after December 31, 1986, and on or before the date that is 60 days after the date these regulations are published as final regulations in the **Federal Register**, and with respect to which the statute of limitations expires after the date that is 120 days after the date these regulations are published as final regulations in the **Federal Register**. The election shall be effective only if the taxpayer satisfies all the applicable requirements specified in paragraph (e)(2)(ii) of this section.

(ii) *Requirements for election*—(A) *Statement filed with original or amended return.* For each taxable year subject to the election, a taxpayer shall file an original or amended federal income tax return that reflects the rules of this section and includes the statement described in paragraph (e)(2)(ii)(C) of this section. Amended returns filed pursuant to this section must be filed on or before the date that is 120 days after the date these regulations are published as final regulations in the **Federal Register.**

(B) *Presentation of statement upon audit.* A taxpayer that is under examination with respect to any taxable year subject to the election on the date that is 120 days after the date these regulations are published as final regulations in the **Federal Register** must furnish a copy of the statement described in paragraph (e)(2)(ii)(C) of this section for all years subject to the election to the revenue agent responsible for examining its federal income tax returns on or before the date that is 140 days after the date these regulations are published as final regulations in the **Federal Register**. For purposes of this paragraph (e)(2)(ii)(B), a taxpayer is under examination beginning on the date the taxpayer (or any member of the consolidated group of which the taxpayer is a member) has been contacted in any manner by a representative of the Internal Revenue Service for the purpose of scheduling any type of examination of any of its federal income tax returns and ending on the earliest of the date: the taxpayer (or consolidated group of which the taxpayer is a member) receives a "no change" letter; the taxpayer (or consolidated group of which the taxpayer is a member) pays the deficiency (or proposed deficiency); or on which a deficiency, jeopardy, termination, bankruptcy, or receivership assessment is made. An electing taxpayer that is not under examination with respect to any taxable year subject to the election on the date that is 120 days after the date these regulations are published as final regulations in the **Federal Register** and is contacted thereafter by a representative of the Internal Revenue Service for the purpose of scheduling any type of examination of any of its federal income tax returns for a year subject to the election must furnish a copy of the statement described in paragraph (e)(2)(ii)(C) of this section for all years subject to the election to the revenue agent responsible for examining its federal income tax returns within 20 days of being contacted.

(C) *Contents of statement.* The statement shall be entitled "ELECTION UNDER § 1.865–2(e)(2) TO APPLY RETROACTIVELY § 1.865–2 STOCK LOSS ALLOCATION RULES." The statement shall identify, for the taxable year subject to the election, each loss from the disposition of stock that is subject to this section and that was incurred by the taxpayer or by any controlled foreign corporation (within the meaning of section 953(c)(1)(B) or 957) with respect to which the taxpayer is a United States shareholder (within the meaning of section 951(b) or 953(c)(1)(A)). For each such loss, the statement shall provide the name and identifying number of the entity that incurred the loss, the amount of the loss, and the paragraph of this section under which the loss is allocated. Each loss subject to paragraph (b)(1) of this section shall be separately identified with a notation stating "Subject to dividend recapture under § 1.865–2(b)(1)." The statement shall also include the following declaration: "No losses, other than those so identified herein, are subject to § 1.865–2(b)(1)." The statement shall indicate whether the taxpayer or any controlled foreign corporation (within the meaning of section 953(c)(1)(B) or 957) with respect to which the taxpayer is a United States shareholder (within the meaning of section 951(b) or 953(c)(1)(A)) acquired the stock after July 8, 1996, as a result of a transaction described in paragraph (b)(3) of this section (regardless of the purpose or purposes of the transaction). An election shall not be effective unless each statement required by this paragraph (e)(2)(ii) contains all the information specified herein.

Par. 4. Section 1.904–0 is amended by revising the entry for § 1.904–4(c)(2)(ii) and adding entries for paragraphs (c)(2)(ii)(A) and (B) of that section to read as follows:

§ 1.904–0 Outline of regulation provisions for section 904.

* * * * *

§ 1.904–4 Separate application of section 904 with respect to certain categories of income.

* * * * *

(c) * * *

(2) * * *

(ii) Grouping rules.

(A) Initial allocation and apportionment of deductions.

(B) Reallocation of loss groups.

Par. 5. Section 1.904–4 is amended by revising paragraphs (c)(1) and (c)(2)

and adding paragraph (c)(8) *Example 11* and *Example 12* to read as follows:

(c) *High-taxed income*—(1) *In general.* Income received or accrued by a United States person that would otherwise be passive income shall not be treated as passive income if the income is determined to be high-taxed income. Income shall be considered to be high-taxed income if, after allocating expenses, losses and other deductions of the United States person to that income under paragraph (c)(2)(ii) of this section, the sum of the foreign income taxes paid or accrued by the United States person with respect to such income and the foreign taxes deemed paid or accrued by the United States person with respect to such income under section 902 or section 960 exceeds the highest rate of tax specified in section 1 or section 11, whichever applies (and with reference to section 15 if applicable), multiplied by the amount of such income (including the amount treated as a dividend under section 78). If, after application of this paragraph (c), income that would otherwise be passive income is determined to be high-taxed income, such income shall be treated as general limitation income, and any taxes imposed on that income shall be considered related to general limitation income under § 1.904–6. If, after application of this paragraph (c), passive income is less than zero, the loss shall constitute a passive separate limitation loss (subject to the rules of section 904(f)(5) and the regulations under that section), but any taxes imposed on passive income shall be considered related to general limitation income under § 1.904–6. For additional rules regarding losses related to passive income, see paragraph (c)(2) of this section. Income and taxes shall be translated at the appropriate rates, as determined under sections 986, 987 and 989 and the regulations under those sections, before application of this paragraph (c). For purposes of allocating taxes to groups of income, United States source passive income is treated as any other passive income. In making the determination whether income is high-taxed, however, only foreign source income, as determined under United States tax principles, is relevant. See paragraph (c)(8) *Examples* (10), (11) and (12) of this section for examples illustrating the application of this paragraph (c)(1) and paragraph (c)(2) of this section.

(2) *Grouping of items of income in order to determine whether passive income is high-taxed income*—(i) *Effective date.* For purposes of determining whether passive income is high-taxed income, the grouping rules of paragraphs (c)(3), (c)(4), and (c)(5) of this section apply to taxable years beginning after December 31, 1987. See notice 87–6 for the grouping rules applicable to taxable years beginning after December 31, 1986 and before January 1, 1988. Paragraph (2)(ii)(B) of this section is effective for taxable years beginning after the date that is 60 days after the date these regulations are published as final regulations in the **Federal Register.**

(ii) *Grouping rules*(A) *Initial allocation and apportionment of deductions.* For purposes of determining whether passive income is high-taxed, expenses, losses and other deductions shall be allocated and apportioned initially to each of the groups of passive income (described in paragraphs (c)(3), (4), and (5) of this section) under the rules of §§ 1.861–8 through 1.861–14T, 1.865–1, and 1.865–2. Taxpayers that allocate and apportion interest expense on an asset basis may nevertheless apportion passive interest expense among the groups of passive income on a gross income basis. If loss from the disposition of property gives rise to foreign tax (e.g., the transaction giving rise to the loss is treated under foreign law as having given rise to a gain), the foreign tax shall be allocated to the group of passive income to which the loss is allocated under this paragraph (c)(2)(ii)(A), without regard to paragraph (c)(2)(ii)(B) of this section. A determination of whether passive income is high-taxed shall be made only after application of paragraph (c)(2)(ii)(B) of this section (if applicable).

(B) *Reallocation of loss groups.* If, after allocation and apportionment of expenses, losses and other deductions under paragraph (c)(2)(ii)(A) of this section, the sum of the allocable deductions exceeds the gross income in one or more groups, the excess deductions shall proportionately reduce income in the other groups (but not below zero), and any taxes imposed with respect to such loss group or groups shall be considered related to general limitation income.

* * * * *

(8) * * *

Example 11. *P*, a domestic corporation, earns the following items of gross income: $100 of foreign source, passive limitation interest income not subject to any foreign tax, $200 of foreign source, passive limitation royalty income subject to a 5 percent foreign withholding tax (foreign tax paid is $10), $1300 of foreign source, passive limitation rental income subject to a 25 percent foreign withholding tax (foreign tax paid is $325), $500 of foreign source, general limitation income that gives rise to a $250 foreign tax, and $2000 of U.S. source capital gain that is not subject to any foreign tax. *P* has a $700 deduction allocable to its passive rental income. *P*'s only other deduction is a $500 capital loss on a sale of stock that is allocated to foreign source passive limitation income under § 1.865–2(b)(2). If *P* had recognized a gain on the stock sale under foreign law, the gain would not have been subject to foreign tax. The $500 capital loss is initially allocated to the group of passive income not subject to any foreign tax, and the $400 amount by which the capital loss exceeds the income in the group must be reapportioned to the other groups under paragraph (c)(2)(ii)(B) of this section. The net royalty income is thus reduced by $100 to $100 ($200 − ($400 x (200/800))) and the net rental income is reduced by $300 to $300 ($1300 − $700 − ($400 x (600/800))). The $100 net royalty income is not high-taxed and remains passive income. The $300 net rental income is high-taxed because the foreign taxes exceed the highest United States rate of tax on that income. Under the high-tax kick-out, the $300 of net rental income (the gross rental income and expenses allocated and apportioned thereto) and the $325 of associated foreign tax are assigned to the general limitation category.

Example 12. The facts are the same as in *Example 11* except the amount of the capital loss that is allocated under § 1.865–2(b)(2) and paragraph (c)(2) of this section to the group of foreign source passive income subject to no foreign tax is $1100. Under paragraph (c)(2)(ii)(B) of this section, the excess deductions of $1000 must be reapportioned to the $200 of net royalty income subject to a 5% withholding tax and the $600 of net rental income subject to a 25% withholding tax. The income in each of these groups is reduced to zero, and the foreign taxes imposed on the rental and royalty income are considered related to general limitation income. The remaining loss of ($200) constitutes a separate limitation loss with respect to passive income.

* * * * *

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on July 5, 1996, 8:45 a.m., and published in the issue of the Federal Register for July 8, 1996, 61 F.R. 35696)

Notice of Proposed Rulemaking and Notice of Public Hearing

Definition of Structure

PS–39–93

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations relating to deductions available upon demolition of a building. These proposed regulations reflect changes to the law made by the

Tax Reform Act of 1984 and affect owners and lessees of real property who demolish buildings. This document also provides notice of a public hearing on these regulations.

DATES: Written comments, requests to appear and outlines of topics to be discussed at the public hearing scheduled for October 9, 1996, must be received by September 19, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (PS–39–93), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (PS–39–93), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC.

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed regulations under section 280B of the Internal Revenue Code. Section 280B was added by the Tax Reform Act of 1976, Public Law 94–455, 2124(b), 90 Stat. 1520, 1918 (Oct. 4, 1976), and significant amendments were made to the provision by the Economic Recovery Tax Act of 1981, Public Law 97–34, 212(d)(2)(C) and (e)(2), 95 Stat. 172, 239 (Aug. 13, 1981) (1981 Act) and the Tax Reform Act of 1984, Public Law 98–369, 1063, 98 Stat. 494, 1047 (July 18, 1984) (1984 Act). Transition rules were provided in the Tax Reform Act of 1986, Public Law 99–514, 1978(h), 100 Stat. 2085, 2904 (Oct. 22, 1986) (1986 Act). As originally enacted, section 280B required any costs or losses incurred on account of the demolition of any certified historic structure (a building or structure meeting certain requirements) to be capitalized into the land upon which the demolished structure was located. The 1981 Act modified the definition of certified historic structure for purposes of section 280B from a building or structure meeting certain requirements to a building (or its structural components) meeting certain requirements. The 1984 Act substituted "any structure" for "certified historic structure." These proposed regulations define what "structure" means for purposes of section 280B.

Explanation of Provisions

These proposed regulations define the term "structure" for purposes of section 280B as a building and its structural components as those terms are defined in § 1.48–1(e) of the Income Tax Regulations. Thus, under section 280B, a structure will include only a building and its structural components and not other inherently permanent structures such as oil and gas storage tanks, blast furnaces, and coke ovens.

The proposed regulations rely on the legislative history underlying the 1984 and 1986 Acts, which refer repeatedly to buildings rather than to structures generally. In addition, the legislative history of the 1984 Act discusses the difficulty of applying the intent test of § 1.165–3 of the regulations, which applies to the demolition of buildings, and indicates that the newly added language is meant to eliminate this difficulty.

Proposed effective date

The regulations are proposed to be effective on and after the date that final regulations are filed with the **Federal Register**.

Special Analyses

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

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for October 9, 1996, in the Commissioner's Conference Room. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by September 18, 1996.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.280B–1 is added to read as follows:

§ 1.280B–1 Demolition of structures.

(a) *In general.* Section 280B provides that, in the case of the demolition of any structure, no deduction otherwise allowable under chapter 1 of subtitle A shall be allowed to the owner or lessee of such structure for any amount expended for the demolition or any loss sustained on account of the demolition, and that the expenditure or loss shall be treated as properly chargeable to the capital account with respect to the land on which the demolished structure was located.

(b) *Definition of structure.* For purposes of section 280B, the term *structure* means a building, as defined in § 1.48–1(e)(1), and the structural components of that building, as defined in § 1.48–1(e)(2).

(c) *Effective date.* This section applies with respect to demolitions occurring on or after the date that the final regulations are filed with the **Federal Register**.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on June 19, 1996, 8:45 a.m., and published in the issue of the Federal Register for June 20, 1996, 61 F.R. 31473)

Notice of Proposed Rulemaking

Generation-Skipping Transfer Tax

PS–22–96

AGENCY: Internal Revenue Service (IRS), Treasury

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to the final generation-skipping transfer (GST) tax regulations under chapter 13 of the Internal Revenue Code (Code). This document proposes a change to the final regulations and is necessary to provide guidance to taxpayers so that they may comply with chapter 13 of the Code.

DATES: Written comments and requests for a public hearing must be received by September 10, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (PS–22–96), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (PS–22–96), Courier's Desk, Internal Revenue Service, 1111 Constitution NW, Washington, DC. 20224.

SUPPLEMENTARY INFORMATION:

Background

On December 24, 1992, the IRS published a notice of proposed rulemaking in the **Federal Register** (57 FR 61356) containing proposed regulations under sections 2611, 2612, 2613, 2632, 2641, 2642, 2652, 2653, 2654, and 2663. On December 27, 1995, the IRS published final regulations in the **Federal Register** (60 FR 66898) under sections 2611, 2612, 2613, 2632, 2641, 2642, 2652, 2653, 2654, and 2663. This proposed regulation will delete § 26.2652–1(a)(4) and two related examples.

Explanation of Provision

Section 2652(a)(1) provides generally, that the term *transferor* means—(A) in the case of any property subject to the tax imposed by chapter 11, the decedent, and (B) in the case of any property subject to the tax imposed by chapter 12, the donor. An individual is treated as transferring any property with respect to which the individual is the transferor. Under § 26.2652–1(a)(2), a transfer is subject to Federal gift tax if a gift tax is imposed under section 2501(a) and is subject to Federal estate tax if the value of the property is includible in the decedent's gross estate determined under section 2031 or section 2103. Under § 26.2652–1(a)(4), the exercise of a power of appointment that is not a general power of appointment is also treated as a transfer subject to Federal estate or gift tax by the holder of the power if the power is exercised in a manner that may postpone or suspend the vesting, absolute ownership, or power of alienation of an interest in property for a period, measured from the date of the creation of the trust, extending beyond any specified life in being at the date of creation of the trust plus a period of 21 years plus, if necessary, a reasonable period of gestation.

The purpose of the rule in § 26.2652–1(a)(4) was to apply the GST tax when it may not otherwise have applied. It was never intended to (nor could it) prevent the application of the tax pursuant to the statutory provisions that apply based on the original taxable transfer. To eliminate any uncertainty concerning the proper application of the GST tax, the regulations under section 2652(a) will be clarified by eliminating § 26.2652– 1(a)(4) and *Example 9* and *Example 10* in § 26.2652–1(a)(6) from the final regulations.

Proposed Effective Date

These amendments apply to transfers to trusts on or after June 12, 1996.

Special Analysis

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

Comments and Requests for a Public Hearing

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

* * * * *

Proposed Amendments to the Regulations

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

PART 26—GENERATION-SKIPPING TRANSFER TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1986

Paragraph 1. The authority citation for part 26 continues to read, in part, as follows:

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

Par. 2 Section 26.2652–1 is amended as follows:

1. Paragraph (a)(4) is removed and paragraphs (a)(5) and (a)(6) are redesignated as paragraphs (a)(4) and (a)(5), respectively.

2. In newly designated paragraph (a)(5), *Examples 9* and *10* are removed and *Example 11* is redesignated as *Example 9.*

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on June 11, 1996, 8:45 a.m., and published in the issue of the Federal Register for June 12, 1996, 61 F.R. 29714)

Notice of Proposed Rulemaking

Disclaimer of Interests and Powers

REG-208215-91

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to the treatment of disclaimers for estate and gift tax purposes. The regulations propose to clarify certain provisions governing the disclaimer of property interests and powers and, in addition, to conform the regulations to court decisions holding the current regulation in-

valid with respect to the disclaimer of joint property interests. The proposed regulations will affect persons who disclaim interests, powers or interests in jointly owned property after the effective date of these regulations.

DATES: Written comments and requests for a public hearing must be received by November 19, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG-208215-91), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG-208215-91), Courier's Desk Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternately, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option of the IRS Home Page, or by submitting comments directly to the IRS Internet site at http:\\www.irs.ustreas.gov\prod\tax_regs\comments.html.

SUPPLEMENTARY INFORMATION:

Background

This document proposes to amend the Estate and Gift Tax Regulations (26 CFR parts 20 and 25) under sections 2041, 2046, 2056, 2511, 2514, and 2518, relating to the disclaimer of interests in property and powers over property.

1. *Interests and powers subject to the disclaimer rules*

Under section 2518(a), if a person makes a qualified disclaimer, then for transfer tax purposes, the interest disclaimed is treated as never having passed to the person disclaiming. Under section 2518(b)(2)(A), in order to have a qualified disclaimer, an interest must be disclaimed within 9 months of the date of "the transfer creating the interest" in the person disclaiming. A person to whom any interest passes by reason of the exercise or lapse of a general power of appointment must disclaim the interest passing within 9 months after the exercise or lapse.

The current regulations provide that section 2518 applies to the disclaimer of interests or powers created pursuant to "taxable transfers" made after December 31, 1976. They further provide that the 9-month period within which the disclaimer must be made is to be determined with reference to the "taxable transfer" creating the interest in the disclaimant. The term "taxable transfer" was incorporated into the regulation based on a statement in the legislative history underlying the enactment of section 2518. H.R. Conf. Rep. No. 1515, 94th Cong., 2d Sess. 623 (1976).

Because the reference point under the regulation is the "taxable transfer" creating the interest, the existing regulation could be viewed as implying that the disclaimer of an interest created in a transfer that is outside the scope of the estate or gift tax need not comply with the requirements of section 2518. For example, if the disclaimed property constitutes an interest in foreign situs property created pursuant to a transfer by a nonresident alien donor or decedent, the transfer by the nonresident alien would not be within the scope of the gift tax or estate tax. However, a disclaimer of such an interest would have to comply with section 2518; otherwise, there could be transfer tax consequences to the disclaimant.

Similarly, the regulations do not specifically address the disclaimer of a property interest passing as a result of the lapse or release of a general power of appointment created on or before October 21, 1942. Under sections 2041(a)(1) and 2514(a), the lapse or release of a pre-1942 power is not subject to transfer tax.

The scope of the term "taxable transfer", as used in § 25.2511-1(c)(2), a related provision governing the disclaimer of interests created in taxable transfers made prior to January 1, 1977, was considered in the Eighth Circuit decision in *United States v. Irvine*, 981 F.2d 991 (8th Cir. 1992), *rev'd*, 114 S.Ct 1473 (1994), and in *Ordway v. United States*, 908 F.2d 890 (11th Cir. 1991). In these cases, the disclaimant argued that a disclaimer that did not satisfy the requirements of § 25.2511-1(c)(2) was nonetheless effective for estate and gift tax purposes because the trust interest that was disclaimed was created pursuant to a transfer in trust made prior to the enactment of the federal gift tax. Accordingly, the disclaimant argued that the interest was not created in a "taxable transfer" prior to January 1, 1977, the regulation did not apply and the disclaimer had only to be effective under state law to avoid federal tax. The Service argued in both cases that the term "taxable transfer" references a generic completed gift under § 25.2511-2 of the regulations. The Eleventh Circuit agreed with the Service in *Ordway*, while the Eighth Circuit disagreed in *Irvine*. The Supreme Court did not resolve this issue in its review of *Irvine*. The Court concluded that even if § 25.2511-2 did not apply, the disclaimer caused the transfer of an interest that had not been timely disclaimed, and the transfer was subject to gift tax. In view of the conflicting Eighth and Eleventh Circuit decisions in *Irvine* and *Ordway*, the Treasury and the IRS believe that it is appropriate to clarify the regulations.

2. *Disclaimer of Jointly-owned Property*

The current regulations provide, in general, that in order to be a qualified disclaimer under section 2518, a surviving joint tenant's disclaimer of *both* an interest passing to the joint tenant on the creation of the tenancy, and the survivorship interest in the joint tenancy or tenancy by the entirety, must be made within 9 months after the transfer creating the tenancy. Further, a joint tenant cannot make a qualified disclaimer of any portion of a joint interest attributable to consideration furnished by that tenant.

Section 25.2518-2(c)(4)(ii) provides a special rule with respect to joint tenancies and tenancies by the entirety in real property created after 1976 but prior to 1982. During that period, section 2515 applied in determining the gift tax consequences of the creation of a joint tenancy with right of survivorship or tenancy by the entirety in real property between husband and wife. Under section 2515, the creation of the tenancy was not treated as a gift subject to gift tax unless the parties elected to treat the creation of the tenancy as a gift. Rather, a transfer subject to gift tax occurs on the termination of the tenancy (other than by reason of the death of one of the tenants) if the proceeds of termination are not divided according to the consideration furnished by each party to the tenancy. Under § 25.2518-2(c)(4)-(ii), in general, an interest in a tenancy created between 1976 and 1982 can be disclaimed within 9 months of the date of death of the first joint tenant to die, provided no election was made under section 2515 to treat the creation of the tenancy as a gift. The disclaimant can disclaim up to the portion of the tenancy included in the decedent's gross estate under section 2040.

Section 2515 was enacted in the Internal Revenue Code of 1954, effective

for tenancies created after December 31, 1954, and was repealed with respect to tenancies created after December 31, 1981, by the Economic Recovery Tax Act of 1981. The Technical and Miscellaneous Revenue Act of 1988 added section 2523(i)(3) which provides that, where the spouse of a donor is not a citizen of the United States, the principles of section 2515, as such section was in effect before its repeal, shall apply (except for the provisions providing for an election), in determining the gift tax consequences of the creation of a joint tenancy or tenancy by the entirety in real property between husband and wife.

Although section 2515 was effective for tenancies created after 1954 and before 1982, and, in addition, the principles of section 2515 are currently effective for tenancies created on or after July 14, 1988, where the donee spouse is not a citizen, the special rule in the current regulation applies only to tenancies subject to section 2515 created after 1976 and before 1982.

The validity of the current regulations with respect to joint interests that are unilaterally severable has been the subject of repeated litigation. In *Kennedy v. Commissioner*, 804 F.2d 1332 (7th Cir. 1986), the court held that the surviving spouse's survivorship interest in the decedent's one-half interest in jointly held real property was created on the decedent's death since, prior to that time, the decedent could have unilaterally severed the interest and defeated the spouse's survivorship right in that interest. Accordingly, the court held that the survivorship interest could be disclaimed within 9 months of the decedent's death. The court concluded that the current regulations are invalid to the extent that they require a survivorship interest in a severable joint tenancy to be disclaimed within 9 months of the creation of the tenancy. In *Estate of Dancy v. Commissioner*, 872 F.2d 84 (4th Cir. 1989) (involving personal property), and *McDonald v. Commissioner*, 853 F.2d 1494 (8th Cir. 1988) (involving real property), the courts also held the regulations invalid.

In *McDonald*, the Eighth Circuit remanded the case to the Tax Court to determine if the disclaimer was otherwise qualified under section 2518. On remand, the Service argued that since the joint property was attributable entirely to consideration furnished by the disclaiming spouse, the spouse could not disclaim any interest in the property under section 2518. The Tax Court rejected this argument in *McDonald v. Commissioner*, T.C.M. 1989-140.

The Service announced in A.O.D. CC-1990-06 (Feb. 7, 1990) that it will follow these decisions.

3. *Disclaimer of Joint Bank Accounts*

For gift tax purposes, the creation of a joint bank account is treated as an incomplete transfer since, generally, the contributing joint tenant may unilaterally withdraw contributed funds without the consent of the other joint tenant. Accordingly, unless a noncontributing joint tenant has withdrawn the funds, the transfer to a joint bank account does not become complete before the death of the first joint tenant.

Explanation of Provisions

1. *Interests and Powers Subject to the Disclaimer Rules*

The proposed amendment clarifies that the application of section 2518, or the commencement of the 9-month period, is not dependent on the actual imposition of a transfer tax when the interest to be disclaimed is created. The proposed amendment substitutes the statutory language of section 2518(b)-(2)(A), "transfer creating the interest," for "taxable transfer" as the reference point for determining the scope of the regulations as well as when the time period for making the disclaimer commences. Under the proposed amendment, the term "transfer creating the interest" includes any inter vivos transfer that would be a completed gift under the gift tax regulations, whether or not a gift tax liability arises on the transfer and whether or not the transfer comes within the scope of the gift tax. Similarly, the amendment clarifies that, for testamentary transfers, the transfer creating the interest occurs on the date of the decedent's death, whether or not an estate tax is imposed on the transfer and whether or not the transfer comes within the scope of the estate tax. The amendment also clarifies that, in the case of a disclaimer of an interest passing pursuant to the exercise, lapse, or release of a general power of appointment, the disclaimer must be made within 9 months of the exercise, lapse, or release of the power, regardless of whether the exercise, lapse, or release is subject to estate or gift tax. The proposed regulations make conforming changes to the estate and gift tax regulations.

2. *Disclaimer of Jointly-Owned Property*

The proposed amendments would revise the regulations to provide that, in general, if a joint tenancy may be unilaterally severed by either party, then a surviving joint tenant may disclaim the one-half survivorship interest in property held in joint tenancy with right of survivorship within 9 months of the death of the first joint tenant to die, even if the surviving joint tenant provided some or all of the consideration for the creation of the tenancy.

The rationale of the courts in *Dancy*, *Kennedy*, and *McDonald* does not apply to joint interests that cannot be unilaterally severed under applicable state law, such as interests held in tenancy by the entirety. In tenancies by the entirety, the donee spouse's joint interest in the property that cannot be unilaterally severed is created on the date the tenancy is created. Therefore, the proposed amendment to the regulations would reaffirm that any interest in a nonseverable cotenancy, including the survivorship interest, must be disclaimed within 9 months of the date of the creation of the tenancy. However, the Service requests comments on whether or under what circumstances (e.g., tenancy by the entirety ownership of a personal residence) the rule applicable to unilaterally severable interests should apply to interests that are not unilaterally severable.

The proposed amendments would extend the special rule in § 25.2518-2(c)(4)(ii) to tenancies created after December 31, 1954, and on or before December 31, 1981, the entire period during which section 2515 was in effect. In addition, the special rule would be expanded to include tenancies created on or after July 14, 1988, where the spouse of the donor is not a United States citizen. Under section 2523(i)(3), the creation of such tenancies is also subject to the rules of former section 2515. The special rule reflects the gift tax treatment of the creation of a joint tenancy or tenancy by the entirety that was subject to section 2515. The relief afforded by the special rule will apply to all tenancies that were subject on creation to section 2515. Under the special rule, the amount that the surviving joint tenant can disclaim is dependent on the amount that is includible in the decedent's gross estate.

3. *Disclaimer of Joint Bank Accounts*

The proposed regulations provide specific rules to address the disclaimer of joint bank accounts. Because the transfer creating the interest in the funds remaining in the bank account at the death of the first joint tenant to die occurs at that tenant's death, the 9-month period for making the qualified disclaimer commences on the death of the first joint tenant.

The proposed regulations also clarify that a surviving joint tenant cannot disclaim any portion of the account attributable to that survivor's contribution to the account. These contributed funds are property owned by the survivor during the cotenancy and the survivor cannot disclaim property the survivor has always owned and never transferred. Further, the proposed regulations clarify that this rule applies even if only one-half of the property is included in the decedent's gross estate under section 2040(b) because the joint tenants are married.

The proposed regulations also clarify the estate tax treatment of a disclaimed interest in a joint bank account. State law generally treats a disclaimant as predeceasing the decedent with respect to the disclaimed interest. The disclaimed interest in a joint bank account (the creation of which is treated as an incomplete gift under the gift tax regulations), would lose its character as joint property and pass through the decedent's probate estate. Accordingly, under such circumstances, the interest disclaimed is subject to inclusion in the decedent's gross estate under section 2033, rather than section 2040(a) (providing for inclusion based on the contribution of each tenant) or section 2040(b) (providing for inclusion of one-half the property in the case of certain joint tenancies between spouses). The balance of the account not subject to the disclaimer retains its character as joint property and is includible in the decedent's gross estate under either section 2040(a) or section 2040(b).

These rules are also made applicable to joint brokerage accounts, since the transfer tax treatment of these accounts generally parallels the treatment of joint bank accounts. See Rev. Rul. 69-148, 1969-1 C.B. 226.

Proposed Effective Dates

The amendments to § § 25.2518-1(a) and 25.2518-2(c)(3) (substituting the statutory language in section 2518(b)-(2)(A) "transfer creating the interest," for "taxable transfer") and conforming changes to § § 20.2041-3(d)(6)(i), 20.2046-1, 20.2056(d)-2(a) and (b), 25.2511-1(c)(1), 25.2514-3(c)(5), are proposed to be effective for transfers creating the interest or power to be disclaimed made after the date of publication as final regulations in the Federal Register. However, Treasury and the IRS do not view these amendments as prescribing any new rules for applying section 2518.

The amendments to § 25.2518-2(c)(4) (relating to the disclaimer of joint property and bank accounts) are proposed to be effective for disclaimers made after the date these regulations are published in the Federal Register as final regulations.

Special Analyses

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

Comments and Requests for a Public Hearing

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

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 20 and 25 are proposed to be amended as follows:

PART 20—ESTATE TAX; ESTATES OF DECEDENTS DYING AFTER AUGUST 16, 1954

Paragraph 1. The authority citation for part 20 continues to read in part:

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

Par. 2. Section 20.2041-3 is amended as follows:

1. Paragraph (d)(6)(i) is amended by revising the first sentence and by adding a new second sentence.

2. Paragraph (d)(6)(iii) is added.

The additions and revisions read as follows:

§ 20.2041-3 Powers of appointment created after October 21, 1942.

* * * * *

(d) * * *

(6)(i) A disclaimer or renunciation of a general power of appointment created in a transfer made after December 31, 1976, is not considered to be the release of the power if the disclaimer or renunciation is a qualified disclaimer as described in section 2518 and the corresponding regulations. For rules relating to when the transfer creating the power occurs, see § 25.2518-2(c)(3). * * *

* * * * *

(iii) The first and second sentences of paragraph (d)(6)(i) of this section are effective for transfers creating the power to be disclaimed made after the date of publication as final regulations in the Federal Register.

* * * * *

Par. 3. Section 20.2046-1 is revised to read as follows:

§ 20.2046-1 Disclaimed property.

(a) This section shall apply to the disclaimer or renunciation of an interest in the person disclaiming by a transfer made after December 31, 1976. For rules relating to when the transfer creating the interest occurs, see § 25.2518-2(c)(3) and (c)(4) of chapter 12. If a qualified disclaimer is made with respect to such a transfer, the Federal estate tax provisions are to apply with respect to the property interest disclaimed as if the interest had never been transferred to the person making the disclaimer. See section 2518 and the corresponding regulations for rules relating to a qualified disclaimer.

(b) The first and second sentences of this section are effective for transfers creating the interest to be disclaimed made after the date of publication as final regulations in the Federal Register.

Par. 4. Section 20.2056(d)-2 is amended as follows:

1. Paragraph (a) is amended by revising the first sentence and adding a new

sentence after the first sentence, and paragraph (b) is revised.

2. A new paragraph (c) is added.

The additions and revisions read as follows:

§ 20.2056(d)-2 Marital deduction; effect of disclaimers of post-December 31, 1976 transfers.

(a) * * * If a surviving spouse disclaims an interest in property passing to such spouse from the decedent created in a transfer made after December 31, 1976, the effectiveness of the disclaimer will be determined by section 2518 and the corresponding regulations. For rules relating to when the transfer creating the interest occurs, see § 25.2518-2(c)(3) and (c)(4) of chapter 12. * * *

(b) *Disclaimer by a person other than a surviving spouse.* If an interest in property passes to a person other than the surviving spouse from a decedent, and the interest is created in a transfer made after December 31, 1976, and —

(1) The person other than the surviving spouse makes a qualified disclaimer with respect to such interest, and

(2) The surviving spouse is entitled to such interest in property as a result of such disclaimer, the disclaimed interest is treated as passing directly from the decedent to the surviving spouse. For rules relating to when the transfer creating the interest occurs, see § 25.2518-2(c)(3) and (c)(4) of chapter 12.

(c) *Effective date.* The first and second sentences of paragraphs (a) and (b) of this section are effective for transfers creating the interest to be disclaimed made after the date of publication as final regulations in the Federal Register.

PART 25—GIFT TAX; GIFTS MADE AFTER DECEMBER 31, 1954

Par. 5. The authority citation for part 25 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * * Section 25.2518-2 is also issued under 26 U.S.C. 2518(b). * * *

Par. 6. Section 25.2511-1 is amended as follows:

1. In paragraph (c)(1), the fourth sentence is revised.

2. A new paragraph (c)(3) is added.

The additions and revisions read as follows:

§ 25.2511-1 Transfers in general.

* * * * *

(c)(1) * * * However, in the case of a transfer creating an interest in property (within the meaning of § 25.2518-2(c)(3) and (c)(4)) made after December 31, 1976, this paragraph (c)(1) shall not apply to the donee if, as a result of a qualified disclaimer by the donee the interest passes to a different donee. * * *

* * * * *

(3) The fourth sentence of paragraph (c)(1) of this section is effective for transfers creating an interest to be disclaimed made after the date of publication as final regulations in the Federal Register.

* * * * *

Par. 7. Section 25.2514-3 is amended as follows:

1. Paragraph (c)(5) is amended by revising the first sentence and adding a new second sentence.

2. A new paragraph (c)(7) is added.

The additions and revisions read as follows:

§ 25.2514-3 Powers of appointment created after October 21, 1942.

* * * * *

(c) * * *

(5) * * * A disclaimer or renunciation of a general power of appointment created in a transfer made after December 31, 1976, is not considered a release of the power for gift tax purposes if the disclaimer or renunciation is a qualified disclaimer as described in section 2518 and the corresponding regulations. For rules relating to when a transfer creating the power occurs, see § 25.2518-2(c)(3). * * *

* * * * *

(7) The first and second sentences of paragraph (5) of § 25.2514-3(c) are effective for transfers creating the power to be disclaimed made after the date of publication as final regulations in the Federal Register.

* * * * *

Par. 8. Section 25.2518-1 is amended as follows:

1. Paragraph (a)(1) is revised.

2. In paragraph (a)(2), the third, fourth, and fifth sentences of the *Example* are revised and a new sentence is added after the third sentence.

3. A new paragraph (a)(3) is added.

The additions and revisions read as follows:

§ 25.2518-1 Qualified disclaimers of property; In general.

(a) * * * (1) *In general.* The rules described in § § 25.2518-1 through 25.2518-3 apply to the qualified disclaimer of an interest in property which is created in the person disclaiming by a transfer made after December 31, 1976. In general, a qualified disclaimer is an irrevocable and unqualified refusal to accept the ownership of an interest in property. For rules relating to the determination of when a transfer creating an interest occurs, see § 25.2518-2(c)(3) and (4).

(2) * * * The transfer creating the remainder interest in the trust occurred in 1968. See § 25.2511-1(c)(2). Therefore, section 2518 does not apply to the disclaimer of the remainder interest because the transfer creating the interest was made prior to January 1, 1977. If, however, W had caused the gift to be incomplete by also retaining the power to designate the person or persons to receive the trust principal at death, and, as a result, no transfer (within the meaning of § 25.2511-1(c)(2)) of the remainder interest was made at the time of the creation of the trust, section 2518 would apply to any disclaimer made after W's death with respect to an interest in the trust property.

(3) Section 25.2518-1(a)(1) is effective for transfers creating the interest to be disclaimed made after the date of publication as final regulations in the Federal Register.

* * * * *

Par. 9. Section 25.2518-2 is amended as follows:

1. Paragraph (c)(3) is redesignated as paragraph (c)(3)(i).

2. Newly designated paragraph (c)(3)(i) is amended as follows:

a. In the first, eighth, and eleventh sentences, the word "taxable" is removed in each place it appears.

b. In the third and ninth sentences, the language "taxable transfer" is removed and "transfer creating an interest" is added in each place it appears.

c. The fourth, fifth, sixth, and seventh sentences are revised.

d. A new sentence is added after the fourth sentence.

3. A new paragraph (c)(3)(ii) is added.

4. Paragraph (c)(4) is revised.

5. In paragraph (c)(5), *Example (7)* is revised.

6. In paragraph (c)(5), *Example (9)* is redesignated as *Example (13)* and newly designated *Example (13)* is revised.

7. In paragraph (c)(5), *Example (8)* is redesignated as *Example (9)* and newly designated *Example (9)* is revised.

8. In paragraph (c)(5), *Example (10)* is redesignated as *Example (12)* and the

first sentence of newly designated *Example (12)* is revised.

9. In paragraph (c)(5), new *Examples (8), (10), (11), (14),* and *(15),* are added.

The additions and revisions read as follows:

§ 25.2518-2 Requirements for a qualified disclaimer.

* * * * *

(c) * * *

(3)(i) * * * With respect to transfers made by a decedent at death or transfers that become irrevocable at death, the transfer creating the interest occurs on the date of the decedent's death, even if an estate tax is not imposed on the transfer. For example, a bequest of foreign-situs property by a nonresident alien decedent is regarded as a transfer creating an interest in property even if the transfer would not be subject to estate tax. If there is a transfer creating an interest in property during the transferor's lifetime and such interest is later included in the transferor's gross estate for estate tax purposes (or would have been included if such interest were subject to estate tax), the 9-month period for making the qualified disclaimer is determined with reference to the earlier transfer creating the interest. In the case of a general power of appointment, the holder of the power has a 9-month period after the transfer creating the power in which to disclaim. If a person to whom any interest in property passes by reason of the exercise, release, or lapse of a general power desires to make a qualified disclaimer, the disclaimer must be made within a 9-month period after the exercise, release, or lapse regardless of whether the exercise, release, or lapse is subject to estate or gift tax. * * *

(ii) Sentences 1, 3 through 10, and 12 of paragraph (c)(3)(i) of this section are effective for transfers creating the interest to be disclaimed made after the date of publication as final regulations in the Federal Register.

(4) *Joint property — (i) Interests that are unilaterally severable.* Except as provided in paragraph (c)(4)(iv) of this section with respect to joint bank accounts and joint brokerage accounts, in the case of an interest in a joint tenancy with right of survivorship or a tenancy by the entirety that either joint tenant can sever unilaterally under local law, a qualified disclaimer of the interest to which the disclaimant succeeds as donee upon creation of the tenancy must be made no later than 9 months after the creation of the tenancy. A qualified disclaimer of the survivorship interest to which the survivor succeeds by operation of law upon the death of the first joint tenant to die must be made no later than 9 months after the death of the first joint tenant to die. See, however, section 2518(b)(2)(B) for a special rule in the case of disclaimers by persons under age 21. Except as provided in paragraph (c)(4)(iii) of this section (with respect to certain tenancies in real property created after 1954 and before 1982 and certain tenancies created on or after July 14, 1988), the interest that may be disclaimed within 9 months after the death of the first joint tenant to die is the interest to which the disclaimant succeeds by right of survivorship, regardless of the portion of the property attributable to consideration furnished by the disclaimant and regardless of the portion of the property that is included in the decedent's gross estate under section 2040. See § 25.2518-2(c)(5), *Example (7).*

(ii) *Interests that are not unilaterally severable.* Except as provided in paragraph (c)(4)(iii) of this section with respect to interests created after 1954 and before 1982 and certain interests created after July 14, 1988, if an interest in joint property with right of survivorship or an interest held as a tenant by the entirety is not unilaterally severable under local law, a qualified disclaimer of the interest or any portion of the interest must be made no later than 9 months after the transaction creating the tenancy. A tenant by the entirety or other cotenant who cannot unilaterally sever the interest under applicable local law cannot make a qualified disclaimer of any portion of the joint interest to the extent attributable to consideration furnished by that tenant even if the disclaimer is made within 9 months of the creation of the tenancy. See § 25.2518-2(c)(5), *Example (8).*

(iii) *Tenancies in real property between spouses created before 1982 and certain tenancies in real property between spouses created on or after July 14, 1988.* In the case of a joint tenancy between spouses or a tenancy by the entirety in real property created after 1954 and before 1982 where no election was made under section 2515, or a joint tenancy between spouses or a tenancy by the entirety in real property created on or after July 14, 1988, to which section 2523(i)(3) applies (relating to the creation of a tenancy where the spouse of the donor is not a United States citizen), the surviving spouse must make a qualified disclaimer no later than 9 months after the death of the first spouse to die. The surviving spouse may disclaim any portion of the joint interest that is includible in the decedent's gross estate under section 2040. See § 25.2518-2(c)(5), *Examples (9)* and *(10).*

(iv) *Special rule for joint bank and brokerage accounts established between spouses or between persons other than husband and wife.* In the case of a transfer to a joint bank account or a joint brokerage account, if a transferor may unilaterally withdraw the transferor's own contributions from the account without the consent of the other cotenant, the transfer creating the survivor's interest in a decedent's share of the account occurs on the death of the deceased cotenant. Accordingly, if a surviving joint tenant desires to make a qualified disclaimer with respect to funds contributed by a deceased cotenant, the disclaimer must be made within 9 months of the cotenant's death. The surviving joint tenant may not disclaim any portion of the joint account attributable to consideration furnished by that surviving joint tenant. See § 25.2518-2(c)(5), *Examples* 13, 14 and 15, regarding the treatment of disclaimed interests under sections 2518, 2033 and 2040.

(v) *Effective date.* This paragraph (c)(4) is effective for disclaimers made after the date of publication as final regulations in the Federal Register.

(5) *Examples.* * * *

* * * * *

Example (7). On February 1, 1990, A purchased real property with A's funds. Title to the property was conveyed to "A and B, as joint tenants with right of survivorship." Under applicable state law, the joint interest is unilaterally severable by either tenant. B dies on May 1, 1997, and is survived by A. On January 1, 1998, A disclaims the one-half survivorship interest in the property to which A succeeds as a result of B's death. Assuming that the other requirements of section 2518(b) are satisfied, A has made a qualified disclaimer of the one-half survivorship interest (but not the interest retained by A upon the creation of the tenancy, which may not be disclaimed by A). The result is the same whether or not A and B are married and regardless of the proportion of consideration furnished by A and B in purchasing the property.

Example (8). On March 1, 1997, A purchases a parcel of real property that is conveyed to A and A's spouse, B, as tenants by the entirety. A provides the consideration for the purchase. Under applicable state law, the tenancy cannot be unilaterally severed by either tenant. In order to be a qualified disclaimer, any disclaimer by B of B's interest in the property must be made within 9 months of the creation of the tenancy (i.e., within 9 months of March 1, 1997). Since A provided the entire consideration for the property and the

tenancy is not unilaterally severable, A may not disclaim any interest in the tenancy.

Example (9). On March 1, 1977, H and W purchase a tract of vacant land which is conveyed to them as tenants by the entirety. The entire consideration is paid by H. H does not elect, under section 2515, to have the transaction treated as a transfer for purposes of Chapter 12. H dies on June 1, 1997. W can disclaim one-half of the joint interest because this is the interest includible in H's gross estate under section 2040(b). Assuming that W's disclaimer is received by the executor of H's estate no later than 9 months after June 1, 1997, and the other requirements of section 2518(b) are satisfied, W's disclaimer of one-half of the property would be a qualified disclaimer because the transfer which created W's interest is treated as not occurring until H's death, since no election was made under section 2515. The result would be the same if the property was held in joint tenancy with right of survivorship that was unilaterally severable under local law.

Example (10). Assume the same facts as in example (9) except that the land was purchased on March 1, 1989, and W is not a United States citizen. W has until 9 months after June 1, 1997, to make a qualified disclaimer, and can disclaim the entire joint interest because this is the interest includible in H's gross estate under section 2040(a). The result would be the same if the property was held in joint tenancy with right of survivorship that was unilaterally severable under local law.

Example (11). In 1986, spouses A and B purchased a personal residence taking title as joint tenants with right of survivorship. Under applicable state law, the interest in the tenancy may be unilaterally severed by either party. B dies on July 10, 1997. A wishes to disclaim the one-half undivided interest to which A would succeed by right of survivorship. If A makes the disclaimer, the property interest would pass under B's will to their child C. C, an adult, and A resided in the residence at B's death and will continue to reside there in the future. A continues to own a one-half undivided interest in the property. Assuming that the other requirements of section 2518(b) are satisfied, A may make a qualified disclaimer with respect to the one-half undivided survivorship interest in the residence if A delivers the written disclaimer to the personal representative of B's estate by April 10, 1998, since A is not deemed to have accepted the interest or any of its benefits prior to that time and A's occupancy of the residence after B's death is consistent with A's retained undivided ownership interest.

Example (12). H and W, husband and wife, reside in state X, a community property state. * * *

Example (13). On July 1, 1990, A opens a bank account that is held jointly with B, A's spouse, and transfers $50,000 of A's money to the account. A and B are United States citizens. A can regain the entire account without B's consent. The transfer is not a completed gift under § 25.2511-1(h)(4). A dies on August 15, 1997, and B disclaims the entire amount in the bank account on October 15, 1997. Assuming that the remaining requirements of section 2518(b) are satisfied, B made a qualified disclaimer under section 2518(a) because the disclaimer was made within 9 months after A's death at which time B had succeeded to full dominion and control over the account. Under state law, B is treated as predeceasing A with respect to the disclaimed interest. The disclaimed account balance passes through A's probate estate and is no longer joint property includible in A's gross estate under section 2040. The entire account is, instead, includible in A's gross estate under section 2033. The result would be the same if A and B were not married.

Example (14). The facts are the same as *Example (13)*, except that B, rather than A, dies on August 15, 1997. A may not make a qualified disclaimer with respect to any of the funds in the bank account, because A furnished the funds for the entire account and A did not relinquish dominion and control over the funds.

Example (15). The facts are the same as *Example (13)*, except that B disclaims 40 percent of the funds in the account. Since, under state law, B is treated as predeceasing A with respect to the disclaimed interest, the 40 percent portion of the account balance that was disclaimed passes as part of A's probate estate, and is no longer characterized as joint property. This 40 percent portion of the account balance is, therefore, includible in A's gross estate under section 2033. The remaining 60 percent of the account balance that was not disclaimed retains its character as joint property and, therefore, is includible in A's gross estate as provided in section 2040(b). Therefore, 30 percent (1/2 x 60 percent) of the account balance is includible in A's gross estate under section 2040(b), and a total of 70 percent of the aggregate account balance is includible in A's gross estate. If A and B were not married, then the 40 percent portion of the account subject to the disclaimer would be includible in A's gross estate as provided in section 2033 and the 60 percent portion of the account not subject to the disclaimer would be includible in A's gross estate as provided in section 2040(a), because A furnished all of the funds with respect to the account.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on August 20, 1996, 8:45 a.m., and published in the issue of the Federal Register for August 21, 1996, 61 F.R. 43197)

Notice of Proposed Rulemaking and Notice of Public Hearing

Magnetic Media Filing Requirements for Information Returns

REG–209803–95

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: In ***T.D. 8683, page 169, the IRS is issuing temporary regulations relating to the requirements for filing information returns on magnetic media or in other machine-readable form under section 6011(e) of the Internal Revenue Code. The text of those temporary regulations also serves as the text of the proposed regulations. This document also contains a proposed amendment to § 301.6011–2(g)(2). This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments must be received by January 8, 1997. Outlines of topics to be discussed at the public hearing scheduled for February 5, 1997, must be received by January 15, 1997.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–209803–95), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–209803–95), Courier's Desk, Internal Revenue Service, 1111 Constitution Ave., NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in Room 3313 of the Internal Revenue Building, 1111 Constitution Ave., NW, Washington, DC.

SUPPLEMENTARY INFORMATION:

Background

Temporary regulations in T.D. 8683 amend the Income Tax Regulations (26 CFR part 1) relating to section 6045 and the Procedure and Administration Regulations (26 CFR part 301) relating to section 6011(e). The temporary regulations contain rules relating to the filing requirements of information returns on magnetic media or in other machine-readable form under section 6011(e).

The text of those temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the temporary regulations.

Special Analyses

It has been determined that these proposed regulations are not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required.

It is hereby certified that the regulations in this document will not have a significant economic impact on a substantial number of small entities. This certification is based on a determination that these regulations impose no additional reporting or recordkeeping requirement and only prescribe the method of filing information returns that are already required to be filed. Further, these regulations are consistent with the

requirements imposed by statute. Section 6011(e)(2)(A) provides that, in prescribing regulations providing standards for determining which returns must be filed on magnetic media or in other machine-readable form, the Secretary shall not require any person to file returns on magnetic media unless the person is required to file at least 250 returns during the calendar year. Consistent with the statutory provision, these regulations do not require information returns to be filed on magnetic media unless 250 or more returns are required to be filed. Further, the economic impact caused by requiring filing on magnetic media should be minimal. If a taxpayer's operations are computerized, reporting in accordance with the regulations should be less costly than filing on paper. If the taxpayer's operations are not computerized, the incremental cost of magnetic media reporting should be minimal in most cases because of the availability of computer service bureaus. In addition, the existing regulations provide that the IRS may waive the magnetic media filing requirements upon a showing of hardship. It is anticipated that the waiver authority will be exercised so as not to unduly burden taxpayers lacking both the necessary data processing facilities and access at a reasonable cost to computer service bureaus. Accordingly, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required.

Pursuant to section 7805(f) of the Internal Revenue Code, these proposed regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for February 5, 1997, at 10 am. The hearing will be held in room 3313 of the Internal Revenue Building, 1111 Constitution Ave., NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must submit written comments by January 8, 1997, and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by January 15, 1997.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. In § 1.6045–1, paragraph (l) is revised to read as follows:

§ 1.6045–1 Returns of information of brokers and barter exchanges.

[The text of paragraph (l) as proposed is the same as the first sentence of § 1.6045–1T(l) published in T.D. 8683, page 169.

Par. 3. In § 1.6045–2, paragraph (g)(2) is revised to read as follows:

§ 1.6045–2 Furnishing statement required with respect to certain substitute payments.

[The text of paragraph (g)(2) as proposed is the same as the text of the first sentence of § 1.6045–2T(g)(2) published in T.D. 8683, page 169.

PART 301—PROCEDURE AND ADMINISTRATION

Par. 4. The authority citation for part 301 continues to read in part as follows:

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

Par. 5. Section 301.6011–2 is amended by revising paragraphs (a)(1), (b)(1) and (2), (c)(1)(i) and (iii), (c)(2), (f) and (g)(2), and by adding (c)(1)(iv), and by removing paragraphs (c)(3) and (4) and the last sentence of paragraph (e). The revisions and additions read as follows:

§ 301.6011–2 Required use of magnetic media.

[The text of paragraphs (a)(1), (b)(1) and (2), (c)(1)(i), (iii), and (iv), (c)(2), (f), and (g)(2) as proposed is the same as the text in § 301.6011–2T(a)(1), (b)(1) and (2), (c)(1)(i), (iii), and (iv), (c)(2), (f), and the first sentence of (g)(2) published in T.D. 8683, page 169.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on October 9, 1996, 8:45 a.m., and published in the issue of the Federal Register for October 10, 1996, 61 F.R. 53161)

Notice of Proposed Rulemaking and Notice of Public Hearing

Application of the Grantor Trust Rules to Nonexempt Employees' Trusts

REG–209826–96

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations relating to the application of the grantor trust rules to nonexempt employees' trusts. The proposed regulations clarify that the grantor trust rules generally do not apply to domestic nonexempt employees' trusts, and clarify the interaction between the grantor trust rules, the rules generally governing the taxation of nonqualified deferred compensation arrangements, and the antideferral rules for United States persons holding interests in foreign entities. The proposed regulations affect nonexempt employees' trusts funding deferred compensation arrangements, as well as U.S. persons holding interests in certain foreign corporations and foreign partnerships with deferred compensation arrangements funded through foreign nonexempt employees' trusts. In addition, the proposed regulations affect U.S. persons that have deferred compensation arrangements funded through certain foreign nonexempt employees' trusts. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments must be received by December 26, 1996. Requests to speak (with outlines of oral comments to be discussed) at the public

hearing scheduled for January 15, 1997, at 10:00 a.m. must be submitted by December 24, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–209826–96), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG– 209826–96), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224. Comments on the collection of information should be received by November 26, 1996. Comments are specifically requested concerning:

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

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

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

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

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

The collection of information in this proposed regulation is in § 1.671–1(h)(3)(iii). This information is required by the IRS to determine accurately the portion of certain foreign employees' trusts properly treated as owned by the employer. This information will be used to notify the Commissioner that certain entities are relying on an exception for reasonable funding. The collection of information is mandatory. The likely respondents are businesses or other for-profit organizations.

Estimated total annual reporting burden: **1,000 hours.**

The estimated annual burden per respondent varies from **.5 hours** to **1.5 hours**, depending on individual circumstances, with an estimated average of **1 hour.**

Estimated number of respondents: **1,000.**

Estimated annual frequency of responses: **On occasion.**

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

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

On May 7, 1993, the IRS issued proposed regulations under section 404A (58 FR 27219). The section 404A proposed regulations provide that section 404A is the exclusive means by which an employer may take a deduction or reduce earnings and profits for amounts used to fund deferred compensation in situations other than those in which a deduction or reduction of earnings and profits is permitted under section 404 (the "exclusive means" rule).

The section 404A proposed regulations do not provide rules regarding the treatment of income and ownership of assets of foreign trusts established to fund deferred compensation arrangements, but refer to "other applicable provisions," including the grantor trust rules of subpart E of the Internal Revenue Code of 1986, as amended. Thus, the 1993 proposed section 404A regulations imply that, if an employer cannot or does not elect section 404A treatment for a foreign trust established to fund the employer's deferred compensation arrangements, the employer may be treated as the owner of the entire trust for purposes of subtitle A of the Code under sections 671 through 679 even though all or part of the trust assets are set aside for purposes of satisfying liabilities under the plan. Conversely, some commentators believe that, for U.S. tax purposes, a foreign employer would not be treated as the owner of any portion of a foreign trust established to fund a section 404A qualified foreign plan even though all or part of the trust assets might be used for purposes other than satisfying liabilities under the plan. A number of different rules, in addition to the grantor trust rules, potentially affect the taxation of foreign trusts established to fund deferred compensation arrangements. These rules include: the nonexempt deferred compensation trust rules of sections 402(b) and 404(a)(5); the partnership rules of subchapter K; and the antideferral rules, which include subpart F and the passive foreign investment company (PFIC) rules (sections 1291 through 1297).

Following publication of the proposed 1993 regulations and enactment of section 956A in August of 1993, comments were received concerning both the asset ownership rules for foreign employees' trusts and the "exclusive means" rule for deductions or reductions in earnings and profits. These proposed regulations address only comments concerning income and asset ownership rules for foreign employees' trusts for federal income tax purposes. A foreign employees' trust is a nonexempt employees' trust described in section 402(b) that is part of a deferred compensation plan, and that is a foreign trust within the meaning of section 7701(a)(31). Comments concerning the "exclusive means" rule will be addressed in future regulations.

Statutory Background

1. Transfers of Property Not Complete for Tax Purposes

In certain situations, assets that are owned by a trust as a legal matter may be treated as owned by another person

for tax purposes. Thus, assets may be treated as owned by a pension trust for non-tax legal purposes but not for tax purposes. This occurs, for example, if the person who has purportedly transferred assets to the trust retains the benefits and burdens of ownership. *See, e.g., Frank Lyon Co. v. United States*, 435 U.S. 561 (1978); *Corliss v. Bowers*, 281 U.S. 376 (1930); *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221 (1981); Rev. Proc. 75–21 (1975–1 C.B. 715). If, under these principles, no assets have been transferred to an employees' trust for federal tax purposes, these proposed regulations do not apply.

2. Subpart E—Grantors and others treated as substantial owners

Even if there has been a completed transfer of trust assets, the subpart E rules may apply to treat the grantor as the owner of a portion of the trust for federal income tax purposes. Subpart E of part I of subchapter J, chapter 1 of the Code (sections 671 through 679) taxes income of a trust to the grantor or another person notwithstanding that the grantor or other person may not be a beneficiary of the trust. Under section 671, a grantor or another person includes in computing taxable income and credits those items of income, deduction, and credit against tax that are attributable to or included in any portion of a trust of which that person is treated as the owner.

Sections 673 through 679 set forth the rules for determining when the grantor or another person is treated as the owner of a portion of a trust for federal income tax purposes. Under sections 673 through 678, the grantor trust rules apply only if the grantor or other person has certain powers or interests. For example, section 676 provides that the grantor is treated as the owner of a portion of a trust where, at any time, the power to revest in the grantor title to that portion is exercisable by the grantor or a nonadverse party, or both. A grantor who is the owner of a trust under subpart E is treated as the owner of the trust property for federal income tax purposes. See Rev. Rul. 85–13 (1985–1 C.B. 184). This document is made available by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

Section 679 generally applies to a U.S. person who directly or indirectly transfers property to a foreign trust, subject to certain exceptions described below. Section 679 generally treats a U.S. person transferring property to a foreign trust as the owner of the portion of the trust attributable to the transferred property for any taxable year of that person for which there is a U.S. beneficiary of any portion of the trust. In general, a trust is treated as having a U.S. beneficiary for a taxable year of the U.S. transferor unless, under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of a U.S. person, and unless no part of the income or corpus of the trust could be paid to or for the benefit of a U.S. person if the trust were terminated at any time during the taxable year. A U.S. person is treated as having made an indirect transfer to the foreign trust of property if a non-U.S. person acts as a conduit with respect to the transfer or if the U.S. person has sufficient control over the non-U.S. person to direct the transfer by the non-U.S. person rather than itself.

Section 679(a) provides several exceptions from the application of section 679 for certain compensatory trusts. Under these exceptions, section 679 does not apply to a trust described in section 404(a)(4) or section 404A. Pursuant to amendments made in section 1903(b) of the Small Business Job Protection Act of 1996 (SBJPA), section 679 also does not apply to any transfer of property after February 6, 1995, to a trust described in section 402(b).

3. Taxability of beneficiary of nonexempt employees' trust

Section 402(b) provides rules for the taxability of beneficiaries of a nonexempt employees' trust. Under section 402(b)(1), employer contributions to a nonexempt employees' trust generally are included in the gross income of the employee in accordance with section 83. Section 402(b)(2) provides that amounts distributed or made available from a nonexempt employees' trust generally are taxable to the distributee under the rules of section 72 in the taxable year in which distributed or made available. Section 402(b)(4) provides that, under certain circumstances, a highly compensated employee is taxed each year on the employee's vested accrued benefit (other than the employee's investment in the contract) in a nonexempt employees' trust. Under section 402(b)(3), a beneficiary of a nonexempt employees' trust generally is not treated as the owner of any portion of the trust under subpart E. The rules of section 402(b) apply to a beneficiary of a nonexempt employees' trust regardless of whether the trust is a domestic trust or a foreign trust.

4. Employer deduction for contributions to a nonexempt employees' trust

Section 404(a)(5) provides rules regarding the deductibility of contributions to a nonqualified deferred compensation plan. Under section 404(a)(5), any contribution paid by an employer under a deferred compensation plan, if otherwise deductible under chapter 1 of the Code, is deductible only in the taxable year in which an amount attributable to the contribution is includible in the gross income of employees participating in the plan, and only if separate accounts are maintained for each employee. Section 1.404(a)–12(b)(1) clarifies that an employer's deduction for contributions to a nonexempt employees' trust is restricted to the amount of the contribution, and excludes any income received by the trust with respect to contributed amounts.

5. The partnership rules of subchapter K

A partnership is not subject to income taxation. However, a partner must take into account separately on its return its distributive share of the partnership's income, gain, loss, deduction, or credit. A U.S. partner of a foreign partnership is subject to U.S. tax on its distributive share of partnership income. In addition, a foreign partnership may have a controlled foreign corporation (CFC) partner which must take into account its distributive share of partnership income, gain, loss, or deduction in determining its taxable income. These distributive share inclusions of the CFC may result in subpart F income and thus income to a U.S. shareholder of the CFC. If the grantor trust rules do not apply to any portion of a foreign employees' trust, a foreign partnership could fund a foreign employees' trust in excess of the amount needed to meet its obligations to its employees under its deferred compensation plan and yet retain control over the excess amount. As a result, the foreign partnership would not have to include items in taxable income attributable to the excess amount, and consequently the U.S. partner or CFC would not have to include those items in its income.

6. The antideferral rules of subpart F, including section 956A, and PFIC

A U.S. person that owns stock in a foreign corporation generally pays no U.S. tax currently on income earned by

the foreign corporation. Instead, the United States defers taxation of that income until it is distributed to the U.S. person. The antideferral rules, however, which include subpart F and the PFIC rules, limit this deferral in certain situations.

Subpart F of part III of Subchapter N (sections 951 through 964) applies to CFCs. A foreign corporation is a CFC if more than 50 percent of the total voting power of all classes of stock entitled to vote, or the total value of the stock in the corporation, is owned by "U.S. shareholders" (defined as U.S. persons who own ten percent or more of the voting power of all classes of stock entitled to vote) on any day during the foreign corporation's taxable year. The United States generally taxes U.S. shareholders of the CFC currently on their pro rata share of the CFC's subpart F income and sections 956 and 956A amounts. In effect, the U.S. shareholders are treated as having received a distribution out of the earnings and profits (E&P) of the CFC.

The types of income earned by a foreign employees' trust (dividends, interest, income equivalent to interest, rents and royalties, and annuities) are generally subpart F income. The inclusion under section 956 is based on the CFC's investment in U.S. property, which generally includes stock of a U.S. shareholder of the CFC. A U.S. shareholder's section 956A amount for a taxable year is the lesser of two amounts. The first amount is the excess of the U.S. shareholder's pro rata share of the CFC's "excess passive assets" over the portion of the CFC's E&P treated as previously included in gross income by the U.S. shareholder under section 956A. For purposes of section 956A, "passive asset" includes any asset which produces (or is held for the production of) passive income, and generally includes property that produces dividends, interest, income equivalent to interest, rents and royalties, and annuities, subject to exceptions that generally are not relevant in this context. The second amount is the U.S. shareholder's pro rata share of the CFC's "applicable earnings" to the extent accumulated in taxable years beginning after September 30, 1993.

Section 1501(a)(2) of SBJPA repeals section 956A. The repeal is effective for taxable years of foreign corporations beginning after December 31, 1996, and for taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

If a CFC employer is not treated for federal income tax purposes as the owner of any portion of a foreign employees' trust under the grantor trust rules, then to the extent that passive assets contributed by a CFC to a nonexempt employees' trust would otherwise result in subpart F consequences for the CFC and its shareholders, the CFC's contribution could allow those consequences to be avoided. For example, a contribution by a CFC of passive assets to its foreign employees' trust could reduce the CFC's subpart F earnings and profits, and its applicable earnings or passive assets for section 956A purposes, and could affect the CFC's increase in investment in U.S. property for purposes of section 956, all of which could affect a U.S. shareholder's pro rata subpart F inclusions for the taxable year.

In contrast to the subpart F rules, the PFIC rules apply to any U.S. person who directly or indirectly owns any stock in a foreign corporation that is a PFIC under either an income or asset test. A foreign corporation, including a CFC, is a PFIC if either (1) 75 percent or more of its gross income for the taxable year is passive income or (2) at least 50 percent of the value of the corporation's assets produce passive income or are held for the production of passive income. For this purpose, passive income generally is the same type of income (dividends, interest, income equivalent to interest, rents and royalties, and annuities) that would be earned by a foreign employees' trust.

Under the PFIC rules, a U.S. person who is a direct or indirect shareholder of a PFIC is subject to a special tax regime upon either disposition of the PFIC's stock or receipt of certain distributions (excess distributions) from the PFIC. A shareholder, however, may avoid the application of this special regime by electing to include its pro rata share of certain of the PFIC's passive income in the year in which the foreign corporation earns it.

If the grantor trust rules did not apply to any portion of a foreign employees' trust, a contribution by a foreign corporation of passive assets to a nonexempt employees' trust would enable a U.S. person to avoid the PFIC rules if those assets would otherwise generate PFIC consequences for the foreign corporation and its shareholders. For example, by transferring passive assets to its nonexempt employees' trust in excess of the amount needed to meet obligations to its employees under its deferred compensation plan while retaining control over the excess amount, a foreign corporation could divest itself of a sufficient amount of passive assets and the passive income they produce to avoid meeting the income and asset tests. Furthermore, a foreign corporation that is a PFIC could minimize income inclusions for a U.S. shareholder that has made an election to include PFIC income currently by transferring income-producing assets to a foreign employees' trust.

Overview of proposed regulations

Under the proposed regulations, an employer is not treated as an owner of any portion of a domestic nonexempt employees' trust described in section 402(b) for federal income tax purposes. Section 404(a)(5) and § 1.404(a)–12(b) provide a deduction to the employer solely for contributions to a nonexempt employees' trust, and not for any income of the trust. This rule is inconsistent with treating the employer as owning any portion of a nonexempt employees' trust, which would require the employer to recognize the trust's income that it may not deduct under section 404(a)(5). Accordingly, such a trust is treated as a separate taxable trust that is taxed under the rules of section 641 et seq. The rule in the proposed regulations is consistent with the holdings of a number of private letter rulings with respect to nonexempt employees' trusts and with the Service's treatment of trusts that no longer qualify as exempt under 501(a) (because they are no longer described in section 401(a)) as separate taxable trusts rather than as grantor trusts. See also Rev. Rul. 74–299 (1974–1 C.B. 154). This document is made available by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

Under the proposed regulations, an employer generally is not treated as the owner of any portion of a foreign nonexempt employees' trust for federal income tax purposes, except as provided under section 679. The proposed regulations, however, also provide that the grantor trust rules apply to determine whether an employer that is a CFC or a U.S. employer is treated as the owner of a specified "fractional interest" in a foreign employees' trust. This rule applies whether or not the employer elects section 404A treatment for the trust.

Under the proposed regulations, this rule also applies in the case of an employer that is a foreign partnership with one or more partners that are U.S. persons or CFCs (U.S.-related partnership). Such an employer is treated as the owner of a portion of a foreign employees' trust under these proposed regulations only if the employer retains a grantor trust power or interest over a foreign employees' trust and has a specified "fractional interest" in the trust.

Under these proposed regulations, the grantor trust rules of subpart E do not apply to a foreign employees' trust with respect to a foreign employer other than a CFC or a U.S.-related foreign partnership, except for cases in which assets are transferred to a foreign employees' trust with a principal purpose of avoiding the PFIC rules. The IRS and Treasury will continue to consider whether these regulations should provide additional antiabuse rules that may be necessary for other purposes, including for purposes of calculating earnings and profits, determining the foreign tax credit limitation, and applying the interest allocation rules of § 1.882–5.

Explanation of Provisions

1. § 1.671–1(g): Domestic nonexempt employees' trusts

The proposed regulations provide that an employer is not treated for federal income tax purposes as an owner of any portion of a nonexempt employees' trust described in section 402(b) that is part of a deferred compensation plan, and that is not a foreign trust within the meaning of section 7701(a)(31), regardless of whether the employer has a power or interest described in sections 673 through 677 over any portion of the trust. This rule is analogous to the rule set forth in § 1.641(a)–0, which provides that subchapter J, including the grantor trust rules, does not apply to tax-exempt employees' trusts.

2. § 1.671–1(h): Subpart E rules for certain foreign employees' trusts

The proposed regulations provide Subpart E rules for foreign employees' trusts of CFCs, foreign partnerships, and U.S. employers that apply for all federal income tax purposes. Under the proposed regulations, except as provided under section 679 or the proposed regulations (as described below), an employer is not treated as an owner of any portion of a foreign employees' trust for federal income tax purposes. If an employer is treated as the owner of a portion of a foreign employees' trust for federal income tax purposes as described below, then the employer is considered to own the trust assets attributable to that portion of the trust for all federal income tax purposes. Thus, for example, if an employer is treated as the owner of a portion of a foreign employees' trust for federal income tax purposes as described below, then income of the trust that is attributable to that portion of the trust increases the employer's earnings and profits for purposes of sections 312 and 964.

A foreign employees' trust is a nonexempt employees' trust described in section 402(b) that is part of a deferred compensation plan, and that is a foreign trust within the meaning of section 7701(a)(31). The proposed regulations apply to any foreign employees' trust of a CFC or U.S.-related foreign partnership, whether or not a trust funds a qualified foreign plan (as defined in section 404A(e)). The proposed regulations clarify that the income inclusion and asset ownership rules apply to the entity whose employees or independent contractors are covered under the deferred compensation plan.

A. Plan of CFC employer

The proposed regulations provide that, if a CFC maintains a deferred compensation plan funded through a foreign employees' trust, then, with respect to the CFC, the provisions of subpart E apply to the portion of the trust that is the fractional interest of the trust described in the proposed regulations.

B. Plan of U.S. employer

The proposed regulations provide that if a U.S. person maintains a deferred compensation plan funded through a foreign employees' trust, then, with respect to the U.S. person, the provisions of subpart E apply to the portion of the trust that is the fractional interest of the trust described in the proposed regulations.

C. Plan of U.S.-related foreign partnership employer

The proposed regulations provide that, if a U.S.-related foreign partnership maintains a deferred compensation plan funded through a foreign employees' trust, then, with respect to the U.S.-related foreign partnership, the provisions of subpart E apply to the portion of the trust that is the fractional interest of the trust described in the proposed regulations. The IRS and Treasury solicit comments on whether these regulations should provide a safe harbor rule for a U.S.-related foreign partnership that maintains a deferred compensation plan funded through a foreign employees' trust if U.S. or CFC partnership interests are de minimis. The IRS and Treasury specifically solicit comments concerning the amount of U.S. or CFC partnership interests that would qualify as "de minimis."

D. Plan of non-CFC foreign employer

The proposed regulations provide that a foreign employer that is not a CFC is treated as an owner of a portion of a foreign employees' trust only as provided in the antiabuse rule of § 1.1297–4.

E. Fractional interest

The fractional interest of a foreign employees' trust described above is defined in the proposed regulations as an undivided fractional interest in the trust for which the fraction is equal to the relevant amount determined for the employer's taxable year divided by the fair market value of trust assets determined for the employer's taxable year.

F. Relevant amount

The relevant amount for the employer's taxable year is defined in the proposed regulations as the amount, if any, by which the fair market value of trust assets, plus the fair market value of any assets available to pay plan liabilities (including any amount held under an annuity contract that exceeds the amount that is needed to satisfy the liabilities provided for under the contract) that are held in the equivalent of a trust within the meaning of section 404A(b)(5)(A), exceed the plan's accrued liability, determined using a projected unit credit funding method.

The relevant amount is reduced to the extent the taxpayer demonstrates to the Commissioner that the relevant amount is attributable to amounts that were properly contributed to the trust pursuant to a reasonable funding method, or experience that is favorable relative to any actuarial assumptions used that the Commissioner determines to be reasonable. In addition, if an employer that is a controlled foreign corporation otherwise would be treated as the owner of a fractional interest in a foreign employees' trust, the taxpayer may rely on this rule only if it so indicates on a statement attached to a timely filed Form 5471. The IRS and Treasury solicit comments regarding the most appropriate way in which to extend a filing

requirement to partners in U.S.-related foreign partnerships and other affected taxpayers.

G. Plan's accrued liability

Under the proposed regulations, the plan's accrued liability for a taxable year of the employer is computed as of the plan's measurement date for the employer's taxable year. The plan's accrued liability is determined using a projected unit credit funding method, taking into account only liabilities relating to services performed for the employer or a predecessor employer. In addition, the plan's accrued liability is reduced (but not below zero) by any liabilities that are provided for under annuity contracts held to satisfy plan liabilities.

Because CFCs generally are required to determine their taxable income by reference to U.S. tax principles, the definition of a plan's "accrued liability" refers to § 1.412(c)(3)–1. This definition generally is intended to track the method used for calculating pension costs under Statement of Financial Accounting Standards No. 87, Employers' Accounting for Pensions (FAS 87), available from the Financial Accounting Standards Board, 401 Merritt 7, Norwalk, CT 06856. Under the method required to be used to calculate FAS 87's projected benefit obligation (PBO), plan costs are based on projected salary levels. Because many taxpayers already compute PBO annually to determine the pension costs of their nonexempt employees' trusts for financial reporting, the timing, interval and method to compute plan liabilities under § 1.671–1(h) should minimize taxpayer burden. The IRS and Treasury solicit comments regarding the extent to which the proposed regulations conform to existing procedures under FAS 87 and applicable foreign law, and regarding appropriate conforming adjustments.

H. Fair market value of trust assets

Under the proposed regulations, for a taxable year of the employer, the fair market value of trust assets, and the fair market value of retirement annuities or other assets held in the equivalent of a trust, equals the fair market value of those assets, as of the measurement date for the employer's taxable year. The fair market value of these assets is adjusted to include contributions made between the measurement date and the end of the employer's taxable year.

I. De minimis exception

The proposed regulations provide an exception to the general rule for determining the relevant amount. If the relevant amount would not otherwise be greater than the plan's normal cost for the plan year ending with or within the employer's taxable year, then the relevant amount is considered to be zero.

J. Proposed effective date and transition rules

The proposed regulations are proposed to be prospective. For taxable years ending prior to September 27, 1996, employers generally would not be treated for federal income tax purposes as owning the assets of foreign nonexempt employees' trusts (except as provided under section 679), consistent with the rules applying to domestic nonexempt employees' trusts. A transition rule, for purposes of § 1.671–1(h), exempts certain amounts from the application of the proposed regulations. This exemption is phased out over a ten-year period. There is a special transition rule for any foreign corporation that becomes a CFC after September 27, 1996. In addition, there is a special transition rule for certain entities that become U.S.-related foreign partnerships after September 27, 1996.

3. § 1.671–2: General asset ownership rules

The proposed regulations provide that a person who is treated as the owner of any portion of a trust under subpart E is considered to own the trust assets attributable to that portion of the trust for all federal income tax purposes.

4. § 1.1297–4: Subpart E rules for foreign employers that are not controlled foreign corporations

Under the proposed regulations, a foreign employer other than a CFC is not treated as the owner of any portion of a foreign nonexempt employees' trust for purposes of sections 1291 through 1297, except for cases in which a principal purpose for transferring property to the trust is to avoid classification of a foreign corporation as a PFIC (as defined in section 1296) or, if the foreign corporation is classified as a PFIC, in cases in which a principal purpose for transferring property to the trust is to avoid or to reduce taxation of U.S. shareholders of the PFIC under section 1291 or 1293. The effective date of this rule is September 27, 1996.

Income inclusion and related asset ownership rules for foreign welfare benefit plans

The IRS and Treasury solicit comments on the need for (and content of) income inclusion and asset ownership rules for foreign welfare benefit trusts.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations do not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations will primarily affect U.S. owners of significant interests in foreign entities, which owners generally are large multinational corporations. This certification is also based on the fact that the burden imposed by the collection of information in the regulation, which is a requirement that certain entities may rely on an exception for reasonable funding only if they indicate such reliance on a statement attached to a timely filed Form 5471, is minimal, and, therefore, the collection of information will not impose a significant economic impact on such entities. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for January 15, 1997, at 10:00 a.m. in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments by December 26, 1996, and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by December 24, 1996.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entry for sections 1.1291–10T, 1.1294–1T, 1.1295–1T, and 1.1297–3T and adding entries in numerical order to read as follows:

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

Section 1.671–1 also issued under 26 U.S.C. 404A(h) and 672(f)(2)(B). * * *

Section 1.1291–10T also issued under 26 U.S.C. 1291(d)(2).

Section 1.1294–1T also issued under 26 U.S.C. 1294.

Section 1.1295–1T also issued under 26 U.S.C. 1295.

Section 1.1297–3T also issued under 26 U.S.C. 1297(b)(1).

Section 1.1297–4 also issued under 26 U.S.C. 1297(f). * * *

Par. 2. Section 1.671–1 is amended by adding paragraphs (g) and (h) to read as follows:

§ 1.671–1 Grantors and others treated as substantial owners; scope.

* * * * *

(g) *Domestic nonexempt employees' trust*—(1) *General rule.* An employer is not treated as an owner of any portion of a nonexempt employees' trust described in section 402(b) that is part of a deferred compensation plan, and that is not a foreign trust within the meaning of section 7701(a)(31), regardless of whether the employer has a power or interest described in sections 673 through 677 over any portion of the trust. See section 402(b)(3) and § 1.402(b)–1(b)(6) for rules relating to treatment of a beneficiary of a nonexempt employees' trust as the owner of a portion of the trust.

(2) *Example.* The following example illustrates the rules of paragraph (g)(1) of this section:

Example. Employer X provides nonqualified deferred compensation through Plan A to certain of its management employees. Employer X has created Trust T to fund the benefits under Plan A. Assets of Trust T may not be used for any purpose other than to satisfy benefits provided under Plan A until all plan liabilities have been satisfied. Trust T is classified as a trust under § 301.7701–4 of this chapter, and is not a foreign trust within the meaning of section 7701(a)(31). Under § 1.83– 3(e), contributions to Trust T are considered transfers of property to participants within the meaning of section 83. On these facts, Trust T is a nonexempt employees' trust described in section 402(b). Because Trust T is a nonexempt employees' trust described in section 402(b) that is part of a deferred compensation plan, and that is not a foreign trust within the meaning of section 7701(a)(31), Employer X is not treated as an owner of any portion of Trust T.

(h) *Foreign employees' trust*—(1) *General rules.* Except as provided under section 679 or as provided under this paragraph (h)(1), an employer is not treated as an owner of any portion of a foreign employees' trust (as defined in paragraph (h)(2) of this section), regardless of whether the employer has a power or interest described in sections 673 through 677 over any portion of the trust.

(i) *Plan of CFC employer.* If a controlled foreign corporation (as defined in section 957) maintains a deferred compensation plan funded through a foreign employees' trust, then, with respect to the controlled foreign corporation, the provisions of subpart E apply to the portion of the trust that is the fractional interest described in paragraph (h)(3) of this section.

(ii) *Plan of U.S. employer.* If a United States person (as defined in section 7701(a)(30)) maintains a deferred compensation plan that is funded through a foreign employees' trust, then, with respect to the U.S. person, the provisions of subpart E apply to the portion of the trust that is the fractional interest described in paragraph (h)(3) of this section.

(iii) *Plan of U.S.-related foreign partnership employer*— (A) *General rule.* If a U.S.-related foreign partnership (as defined in paragraph (h)(1)(iii)(B) of this section) maintains a deferred compensation plan funded through a foreign employees' trust, then, with respect to the U.S.-related foreign partnership, the provisions of subpart E apply to the portion of the trust that is the fractional interest described in paragraph (h)(3) of this section.

(B) *U.S.-related foreign partnership.* For purposes of this paragraph (h), a U.S.-related foreign partnership is a foreign partnership in which a U.S. person or a controlled foreign corporation owns a partnership interest either directly or indirectly through one or more partnerships.

(iv) *Application of § 1.1297–4 to plan of foreign non-CFC employer.* A foreign employer that is not a controlled foreign corporation may be treated as an owner of a portion of a foreign employees' trust as provided in § 1.1297–4.

(v) *Application to employer entity.* The rules of paragraphs (h)(1)(i) through (h)(1)(iv) of this section apply to the employer whose employees benefit under the deferred compensation plan funded through a foreign employees' trust, or, in the case of a deferred compensation plan covering independent contractors, the recipient of services performed by those independent contractors, regardless of whether the plan is maintained through another entity. Thus, for example, where a deferred compensation plan benefitting employees of a controlled foreign corporation is funded through a foreign employees' trust, the controlled foreign corporation is considered to be the grantor of the foreign employees' trust for purposes of applying paragraph (h)(1)(i) of this section.

(2) *Foreign employees' trust.* A foreign employees' trust is a nonexempt employees' trust described in section 402(b) that is part of a deferred compensation plan, and that is a foreign trust within the meaning of section 7701(a)(31).

(3) *Fractional interest for paragraph (h)(1)*—(i) *In general.* The fractional interest for a foreign employees' trust used for purposes of paragraph (h)(1) of this section for a taxable year of the employer is an undivided fractional interest in the trust for which the fraction is equal to the relevant amount for the employer's taxable year divided by the fair market value of trust assets for the employer's taxable year.

(ii) *Relevant amount*—(A) *In general.* For purposes of applying paragraph (h)(3)(i) of this section, and except as provided in paragraph (h)(3)(iii) of this section, the relevant amount for the employer's taxable year is the amount, if any, by which the fair market value of trust assets, plus the fair market value of any assets available to pay plan liabili-

ties that are held in the equivalent of a trust within the meaning of section 404A(b)(5)(A), exceed the plan's accrued liability. The following rules apply for this purpose:

(*1*) The plan's accrued liability is determined using a projected unit credit funding method that satisfies the requirements of § 1.412(c)(3)–1, taking into account only liabilities relating to services performed through the measurement date for the employer or a predecessor employer.

(*2*) The plan's accrued liability is reduced (but not below zero) by any liabilities that are provided for under annuity contracts held to satisfy plan liabilities.

(*3*) Any amount held under an annuity contract that exceeds the amount that is needed to satisfy the liabilities provided for under the contract (e.g., the value of a participation right under a participating annuity contract) is added to the fair market value of any assets available to pay plan liabilities that are held in the equivalent of a trust.

(*4*) If the relevant amount as determined under this paragraph (h)(3)(ii), without regard to this paragraph (h)(3)(ii)(A)(4), is greater than the fair market value of trust assets, then the relevant amount is equal to the fair market value of trust assets.

(B) *Permissible actuarial assumptions for accrued liability.* For purposes of paragraph (h)(3)(ii)(A) of this section, a plan's accrued liability must be calculated using an interest rate and other actuarial assumptions that the Commissioner determines to be reasonable. It is appropriate in determining this interest rate to look to available information about rates implicit in current prices of annuity contracts, and to look to rates of return on high-quality fixed-income investments currently available and expected to be available during the period prior to maturity of the plan benefits. If the qualified business unit computes its income or earnings and profits in dollars pursuant to the dollar approximate separate transactions method under § 1.985–3, the employer must use an exchange rate that can be demonstrated to clearly reflect income, based on all relevant facts and circumstances, including appropriate rates of inflation and commercial practices.

(iii) *Exception for reasonable funding.* The relevant amount does not include an amount that the taxpayer demonstrates to the Commissioner is attributable to amounts that were properly contributed to the trust pursuant to a reasonable funding method, applied using actuarial assumptions that the Commissioner determines to be reasonable, or any amount that the taxpayer demonstrates to the Commissioner is attributable to experience that is favorable relative to any actuarial assumptions used that the Commissioner determines to be reasonable. For this paragraph (h)(3)(iii) to apply to a controlled foreign corporation employer described in paragraph (h)(1)(i) of this section, the taxpayer must indicate on a statement attached to a timely filed Form 5471 that the taxpayer is relying on this rule. For purposes of this paragraph (h)(3)(iii), an amount is considered contributed pursuant to a reasonable funding method if the amount is contributed pursuant to a funding method permitted to be used under section 412 (e.g., the entry age normal funding method) that is consistently used to determine plan contributions. In addition, for purposes of this paragraph (h)(3)(iii), if there has been a change to that method from another funding method, an amount is considered contributed pursuant to a reasonable funding method only if the prior funding method is also a funding method described in the preceding sentence that was consistently used to determine plan contributions. For purposes of this paragraph (h)(3)(iii), a funding method is considered reasonable only if the method provides for any initial unfunded liability to be amortized over a period of at least 6 years, and for any net change in accrued liability resulting from a change in funding method to be amortized over a period of at least 6 years.

(iv) *Reduction for transition amount.* The relevant amount is reduced (but not below zero) by any transition amount described in paragraphs (h)(5), (h)(6), or (h)(7) of this section.

(v) *Fair market value of assets.* For purposes of paragraphs (h)(3)(i) and (ii) of this section, for a taxable year of the employer, the fair market value of trust assets, and the fair market value of other assets held in the equivalent of a trust within the meaning of section 404A(b)(5)(A), equals the fair market value of those assets, as of the measurement date for the employer's taxable year, adjusted to include contributions made after the measurement date and by the end of the employer's taxable year.

(vi) *Annual valuation.* For purposes of determining the relevant amount for a taxable year of the employer, the fair market value of plan assets, and the plan's accrued liability as described in paragraphs (h)(3)(ii) and (iii) of this section, and the normal cost as described in paragraph (h)(4) of this section, must be determined as of a consistently used annual measurement date within the employer's taxable year.

(vii) *Special rule for plan funded through multiple trusts.* In cases in which a plan is funded through more than one foreign employees' trust, the fractional interest determined under paragraph (h)(3)(i) of this section in each trust is determined by treating all of the trusts as if their assets were held in a single trust for which the fraction is determined in accordance with the rules of this paragraph (h)(3).

(4) *De minimis exception.* If the relevant amount is not greater than the plan's normal cost for the plan year ending with or within the employer's taxable year, computed using a funding method and actuarial assumptions as described in paragraph (h)(3)(ii) of this section or as described in paragraph (h)(3)(iii) of this section if the requirements of that paragraph are met, that are used to determine plan contributions, then the relevant amount is considered to be zero for purposes of applying paragraph (h)(3)(i) of this section.

(5) *General rule for transition amount*—(i) *General rule.* If paragraphs (h)(6) and (h)(7) of this section do not apply to the employer, the transition amount for purposes of paragraph (h)(3)(iv) of this section is equal to the preexisting amount multiplied by the applicable percentage for the year in which the employer's taxable year begins.

(ii) *Preexisting amount.* The preexisting amount is equal to the relevant amount of the trust, determined without regard to paragraphs (h)(3)(iv) and (h)(4) of this section, computed as of the measurement date that immediately precedes September 27, 1996, disregarding contributions to the trust made after the measurement date.

(iii) *Applicable percentage.* The applicable percentage is equal to 100 percent for the employer's first taxable year ending after this document is published as a final regulation in the **Federal Register** and prior taxable years of the employer, and is reduced (but not below zero) by 10 percentage points for each subsequent taxable year of the employer.

(6) *Transition amount for new CFCs*—(i) *General rule.* In the case of

a new controlled foreign corporation employer, the transition amount for purposes of paragraph (h)(3)(iv) is equal to the pre-change amount multiplied by the applicable percentage for the year in which the new controlled foreign corporation employer's taxable year begins.

(ii) *Pre-change amount.* The pre-change amount for purposes of paragraph (h)(6)(i) is equal to the relevant amount of the trust, determined without regard to paragraphs (h)(3)(iv) and (h)(4) of this section and disregarding contributions to the trust made after the measurement date, for the new controlled foreign corporation employer's last taxable year ending before the corporation becomes a new controlled foreign corporation employer.

(iii) *Applicable percentage*—(A) *General rule.* Except as provided in paragraph (h)(6)(iii)(B) of this section, the applicable percentage is equal to 100 percent for a new controlled foreign corporation employer's first taxable year ending after the corporation becomes a controlled foreign corporation. The applicable percentage is reduced (but not below zero) by 10 percentage points for each subsequent taxable year of the new controlled foreign corporation.

(B) *Interim rule.* For any taxable year of a new controlled foreign corporation employer that ends on or before the date this document is published as a final regulation in the **Federal Register**, the applicable percentage is equal to 100 percent. The applicable percentage is reduced by 10 percentage points for each subsequent taxable year of the new controlled foreign corporation employer that ends after the date this document is published as a final regulation in the **Federal Register.**

(iv) *New CFC employer.* For purposes of paragraph (h)(6) of this section, a new controlled foreign corporation employer is a corporation that first becomes a controlled foreign corporation within the meaning of section 957 after September 27, 1996. A new controlled foreign corporation employer includes a corporation that was a controlled foreign corporation prior to, but not on, September 27, 1996, and that first becomes a controlled foreign corporation again after September 27, 1996.

(v) *Anti-stuffing rule.* Notwithstanding paragraph (h)(6)(iii) of this section, if, prior to becoming a controlled foreign corporation, a corporation contributes amounts to a foreign employees' trust with a principal purpose of obtaining tax benefits by increasing the pre-change amount, the applicable percentage with respect to those amounts is 0 percent for all taxable years of the new controlled foreign corporation employer.

(7) *Transition amount for new U.S.-related foreign partnerships*—(i) *General rule.* In the case of a new U.S.-related foreign partnership employer, the transition amount for purposes of paragraph (h)(3)(iv) of this section is equal to the pre-change amount multiplied by the applicable percentage for the year in which the new U.S.-related foreign partnership employer's taxable year begins.

(ii) *Pre-change amount.* The pre-change amount for purposes of paragraph (h)(7)(i) of this section is equal to the relevant amount of the trust, determined without regard to paragraphs (h)(3)(iv) and (h)(4) of this section and disregarding contributions to the trust made after the measurement date, for the entity's last taxable year ending before the entity becomes a new U.S.-related foreign partnership employer.

(iii) *Applicable percentage*—(A) *General rule.* Except as provided in paragraph (h)(7)(iii)(B) of this section, the applicable percentage is equal to 100 percent for a new U.S.-related foreign partnership employer's first taxable year ending after the entity becomes a new U.S.-related foreign partnership employer. The applicable percentage is reduced (but not below zero) by 10 percentage points for each subsequent taxable year of the new U.S.-related foreign partnership employer.

(B) *Interim rule.* For any taxable year of a new U.S.-related foreign partnership employer that ends on or before the date this document is published as a final regulation in the **Federal Register**, the applicable percentage is equal to 100 percent. The applicable percentage is reduced by 10 percentage points for each subsequent taxable year of the new U.S.-related foreign partnership employer that ends after the date this document is published as a final regulation in the **Federal Register.**

(iv) *New U.S.-related foreign partnership employer.* For purposes of paragraph (h)(7) of this section, a new U.S.-related foreign partnership employer is an entity that was a foreign corporation other than a controlled foreign corporation, or that was a foreign partnership other than a U.S.-related foreign partnership, and that changes from this status to a U.S.-related foreign partnership after September 27, 1996. A new U.S.-related foreign partnership employer includes a corporation that was a U.S.-related foreign partnership prior to, but not on, September 27, 1996, and that first becomes a U.S.-related foreign partnership again after September 27, 1996.

(v) *Anti-stuffing rule.* Notwithstanding paragraph (h)(7)(iii) of this section, if, prior to becoming a new U.S.-related foreign partnership employer, an entity contributes amounts to a foreign employees' trust with a principal purpose of obtaining tax benefits by increasing the pre-change amount, the applicable percentage with respect to those amounts is 0 percent for all taxable years of the new U.S.-related foreign partnership employer.

(8) *Examples.* The following examples illustrate the rules of paragraph (h) of this section. In each example, the employer has a power or interest described in sections 673 through 677 over the foreign employees' trust, and the monetary unit is the applicable functional currency (FC) determined in accordance with section 985(b) and the regulations thereunder.

Example 1. (i) Employer X is a controlled foreign corporation (as defined in section 957). Employer X maintains a defined benefit retirement plan for its employees. Employer X's taxable year is the calendar year. Trust T, a foreign employees' trust, is the sole funding vehicle for the plan. Both the plan year of the plan and the taxable year of Trust T are the calendar year.

(ii) As of December 31, 1997, Trust T's measurement date, the fair market value (as described in paragraph (h)(3)(iv) of this section) of Trust T's assets is FC 1,000,000, and the amount of the plan's accrued liability is FC 800,000, which includes a normal cost for 1997 of FC 50,000. The preexisting amount for Trust T is FC 40,000. Thus, the relevant amount for 1997 is FC 160,000 (which is greater than the plan's normal cost for the year). Employer X's shareholder does not indicate on a statement attached to a timely filed Form 5471 that any of the relevant amount qualifies for the exception described in paragraph (h)(3)(iii) of this section. Therefore, the fractional interest for Employer X's taxable year ending on December 31, 1997, is 16 percent. Employer X is treated as the owner for federal income tax purposes of an undivided 16 percent interest in each of Trust T's assets for the period from January 1, 1997 through December 31, 1997. Employer X must take into account a 16 percent pro rata share of each item of income, deduction or credit of Trust T during this period in computing its federal income tax liability.

Example 2. Assume the same facts as in *Example 1*, except that Employer X's shareholder indicates on a statement attached to a timely filed Form 5471 and can demonstrate to the satisfaction of the Commissioner that, in reliance on paragraph (h)(3)(iii) of this section, FC 100,000 of the fair market value of Trust T's assets is attributable to favorable experience relative to reasonable actuarial assumptions used. Accordingly, the relevant

amount for 1997 is FC 60,000. Because the plan's normal cost for 1997 is less than FC 60,000, the de minimis exception of paragraph (h)(4) of this section does not apply. Therefore, the fractional interest for Employer X's taxable year ending on December 31, 1997, is 6 percent. Employer X is treated as the owner for federal income tax purposes of an undivided 6 percent interest in each of Trust T's assets for the period from January 1, 1997, through December 31, 1997. Employer X must take into account a 6 percent pro rata share of each item of income, deduction or credit of Trust T during this period in computing its federal income tax liability.

(9) *Effective date.* Paragraphs (g) and (h) of this section apply to taxable years of an employer ending after September 27, 1996.

Par. 3. Section 1.671–2 is amended by adding paragraph (f) to read as follows:

§ 1.671–2 Applicable principles

* * * * *

(f) For purposes of subtitle A of the Internal Revenue Code, a person that is treated as the owner of any portion of a trust under subpart E is considered to own the trust assets attributable to that portion of the trust.

Par. 4. Section 1.1297–4 is added to read as follows:

§ 1.1297–4 Application of subpart E of subchapter J with respect to foreign employees' trusts.

(a) *General rules.* For purposes of part VI of subchapter P, chapter 1 of the Code, a foreign employer that is not a controlled foreign corporation is not treated as the owner of any portion of a foreign employees' trust (as defined in § 1.671–1(h)(2)) except as provided in this paragraph (a), regardless of whether the employer has a power or interest described in sections 673 through 677 over any portion of the trust.

(1) *Principal purpose to avoid classification as a passive foreign investment company.* If a principal purpose for a transfer of property by any person to a foreign employees' trust (as defined in § 1.671–1(h)(2)) is to avoid classification of a foreign corporation as a passive foreign investment company, then the following rule applies. If the foreign employer has a power or interest described in sections 673 through 677 over the trust, then the grantor trust rules of subpart E of part I of subchapter J, chapter 1 of the Code will apply, for purposes of part VI of subchapter P, to a fixed dollar amount in the trust that is equal to the fair market value of the property that is transferred for the purpose of avoiding classification as a passive foreign investment company. Whether a principal purpose for a transfer is the avoidance of classification as a passive foreign investment company will be determined on the basis of all of the facts and circumstances, including whether the amount of assets held by the foreign employees' trust is reasonably related to the plan's anticipated liabilities, taking into account any local law and practice relating to proper funding levels.

(2) Principal purpose to reduce or eliminate taxation under section 1291 or 1293. If a principal purpose for a transfer of property by any person to a foreign employees' trust (as defined in § 1.671–1(h)(2)) is to reduce or eliminate taxation under section 1291 or 1293, then the following rule applies. If the foreign employer has a power or interest described in sections 673 through 677 over the trust, then the provisions of subpart E will apply, for purposes of part VI of subchapter P, to a fixed dollar amount in the trust that is equal to the fair market value of the property transferred for the purpose of reducing or eliminating taxation under section 1291 or 1293. Whether a principal purpose for a transfer is to reduce or eliminate taxation under section 1291 or 1293 will be determined on the basis of all the facts and circumstances, including whether the amount of assets held by the foreign employees' trust is reasonably related to the plan's anticipated liabilities, taking into account any local law and practice relating to proper funding levels.

(3) *Application to employer entity.* The rules of this section apply to the employer whose employees benefit under the deferred compensation plan funded through the foreign employees' trust, or, in the case of a deferred compensation plan covering independent contractors, the recipient of services performed by those independent contractors, regardless of whether the plan is maintained through another entity. Thus, for example, where a deferred compensation plan benefitting employees of a foreign employer that is not a controlled foreign corporation is funded through a foreign employees' trust, the foreign employer is considered to be the grantor of the foreign employees' trust for purposes of this paragraph (a).

(b) *Effective date.* This section applies to taxable years of a foreign corporation ending after September 27, 1996.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on September 26, 1996, 8:45 a.m., and published in the issue of the Federal Register for September 27, 1996, 61 F.R. 50778)

Notice of Proposed Rulemaking and Notice of Public Hearing

Treatment of Section 355 Distributions by U.S. Corporations to Foreign Persons

REG–209827–96

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: In * * * TD 8682, page 12, the IRS is issuing temporary regulations revising the final regulations under section 367(e)(1) with respect to section 355 distributions of stock or securities by domestic corporations to foreign persons. The IRS is also modifying the temporary regulations under section 6038B to provide that distributions described under section 367(e)(1) are subject to rules under section 6038B. The text of those temporary regulations also serves as the text of these proposed regulations. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments must be received by November 7, 1996. Outlines of topics to be discussed at the public hearing scheduled for November 20, 1996, at 10 a.m. must be received by October 31, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (INTL 0020–96), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (INTL–0020–96), Courier's Desk, Internal Revenue Service, 1111 Constitution Ave. NW, Washington, DC. The public hearing will be held in the IRS Auditorium, Internal

Revenue Building, 1111 Constitution Avenue NW, Washington, DC.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507).

Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax regs/comments.html. Comments on the collection of information should be received by October 15, 1996.

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

The collection of information under section 367(e)(1) is in § 1.367(e)–1T(c)(1)(ii), (2)(i)(C) and (3). The temporary regulations provide that in order for taxpayers to qualify for either the "U.S. real property holding corporation exception" or the "publicly traded corporation" exception, taxpayers must comply with the reporting requirements contained in § 1.367(e)–1T(c)(1)(ii) and § 1.367(e)–1T(c)(2)(i)(C), respectively. The temporary regulations also modify the reporting requirements under the "gain recognition agreement" exception (§ 1.367(e)–1T(c)(3)). Under the temporary regulations, the controlled corporation, in addition to the distributing corporation, must sign the gain recognition agreement (§ 1.367(e)–1T(c)(3)(ii)(F) and (iii)), extend the statute of limitations accordingly (§ 1.367(e)–1T(c)(3)-(ii)(F) and (iv)), and annually report its distributees to the distributing corporation but not the Service (§ 1.367(e)–1T(c)(3)(v)(B)). This information is required by the IRS as a condition for a taxpayer to qualify for an exception to the general rule of taxation under section 367(e)(1), and to avoid the penalties contained under section 6038B. This information will be used to determine whether a taxpayer properly qualifies for a claimed exception. The respondents generally will be U.S. corporations, probably subsidiaries of foreign multinationals, that are either distributing another corporation or being distributed under section 355, pursuant to a corporate restructuring.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Estimated total annual reporting burden: 2,124 hours. (This equals the sum of (i) the prior burden of 1,604 hours, and (ii) the additional burden of 520 hours contained in the new regulations.) The estimated annual burden per respondent varies from 1 hour to 8 hours, depending on individual circumstances, with an estimated average of 2 hours.

Estimated number of respondents: 462.

Estimated annual frequency of responses: Once (in the case of taxpayers that qualify for the U.S. real property holding company exception and the publicly traded company exception). Annually (in the case of taxpayers that qualify for the gain recognition agreement exception).

Background

The *** T.D. 8682, page 12, amends the Income Tax Regulations (26 CFR part 1) under section 367(e)(1). The temporary regulations under section 367(e)(1) contain rules relating to the distribution of stock or securities under section 355 by a domestic corporation to a person that is not a U.S. person.

The text of T.D. 8682 also serves as the text of these proposed regulations. The preamble to T.D. 8682 explains the reasons for the modifications to the final regulations contained in the temporary regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations do not have a significant impact on a substantial number of small entities. This certification is based on the fact that these regulations will primarily affect large multinational corporations with foreign shareholders. The regulations do not significantly alter the reporting or recordkeeping duties of small entities. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Notice of Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the Internal Revenue Service. All comments will be available for public inspection and copying.

A public hearing has been scheduled for November 20, 1996, at 10 a.m. in the IRS Auditorium. Because of access restrictions, visitors will not be admitted beyond the building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments by November 7, 1996, and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by October 31, 1996.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.367(e)–1 is added to read as follows:

§ 1.367(e)–1 Treatment of section 355 distributions by U.S. corporations to foreign persons.

[The text of this proposed section is the same as the text of § 1.367(e)–1T published in T.D. 8682].

Par. 3. Section 1.6038B–1, as proposed on May 16, 1986, at 51 FR 17990, is amended by revising the second sentence of paragraph (b)(2)(i) and adding the text of paragraph (e) to read as follows:

§ 1.6038B–1 Reporting of transfers described in section 367.

[The text of proposed paragraphs (b)(2)(i) and (e) are the same as the text of § 1.6038B–1T(b)(2)(i) and (e) published in T.D. 8682.]

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on August 9, 1996, 12:19 p.m., and published in the issue of the Federal Register for August 14, 1996, 61 F.R. 42217)

Notice of Proposed Rulemaking

Relief From Disqualification for Plans Accepting Rollovers

REG–245562–96

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Proposed regulations.

SUMMARY: This document contains proposed regulations that would provide guidance on the qualification of retirement plans that accept rollover contributions from employees. These regulations affect plan administrators of qualified plans that accept rollover contributions.

DATES: Written comments must be received by December 18, 1996.

ADDRESSES: Send submissions to CC:DOM:CORP:R (REG–245562–96), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (REG–245562–96), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html

SUPPLEMENTARY INFORMATION:

Background

On September 22, 1995, Final Income Tax Regulations (T.D. 8619 [1995–2 C.B. 41]) under sections 401(a)(31) and 402(c) were published in the **Federal Register** (60 FR 49199). The final regulations provide guidance for complying with the Unemployment Compensation Amendments of 1992 (UCA).

UCA expanded the types of distributions from a qualified plan that are eligible to be rolled over to an individual retirement account or individual retirement annuity, or to another qualified plan that accepts rollovers (collectively referred to as eligible retirement plans). Such distributions are referred to as eligible rollover distributions. UCA also added a new qualification provision under section 401(a)(31) that requires qualified plans to provide employees with a direct rollover option. Under a direct rollover option, an employee may elect to have an eligible rollover distribution paid directly to an eligible retirement plan. The direct rollover option is provided in addition to the pre-existing rollover provisions under section 402. Thus, an employee who receives an eligible rollover distribution but who does not elect a direct rollover still has the option to roll over the distribution to an eligible retirement plan within 60 days of receipt.

The final regulations under section 401(a)(31) provide that a plan that accepts a direct rollover from another plan will not fail to satisfy section 401(a) or 403(a) merely because the plan making the distribution is, in fact, not qualified under section 401(a) or 403(a) at the time of the distribution, if, prior to accepting the rollover, the receiving plan reasonably concluded that the distributing plan was qualified under section 401(a) or 403(a). The regulations provide, as an example, that the receiving plan may reasonably conclude that the distributing plan was qualified under section 401(a) or 403(a) if, prior to accepting the rollover, the plan administrator of the distributing plan provided the receiving plan with a statement that the distributing plan had received a determination letter from the Commissioner indicating that the plan was qualified. The plan administrator is not required to verify this information, such as by obtaining a copy of the distributing plan's plan document or determination letter, in order to reasonably conclude that the distributing plan is qualified under section 401(a) or 403(a).

Explanation of Provisions

1. *Overview*

The relief to be provided in these proposed regulations is intended to increase the portability of qualified plan benefits when an employee changes jobs. This objective would be achieved by reassuring a plan sponsor that acceptance of an amount as a rollover contribution, in appropriate circumstances, will not affect the plan's qualification under section 401(a) or 403(a).

2. *Expansion of existing relief for receiving plans*

These proposed regulations would expand and clarify in several respects the relief provided in the regulations under section 401(a)(31) issued last year. First, the proposed regulations would clarify and expand the relief from disqualification currently provided for plans that accept direct rollovers. The protection would be expanded to be available not only if the plan administrator reasonably concludes the distributing plan is qualified under section 401(a) or 403(a) (even if later it is determined that the distributing plan is not a qualified plan), but also if the plan administrator reasonably concludes that a distribution meets the other requirements to be an eligible rollover distribution (but later it is determined that this conclusion was incorrect). Further, the proposed regulation would clarify that if the plan administrator reaches these conclusions reasonably, and satisfies the corrective distribution requirement described below, the contribution will be treated as a rollover contribution for purposes of applying qualification requirements under section 401(a) or 403(a) to the plan. Thus, if the contribution was not, in fact, a distribution from a qualified plan or for any other reason fails to be an eligible rollover distribution within the meaning of section 402(c), the contribution nevertheless would be treated as a rollover contribution as opposed to, for example,

an employee contribution for purposes of section 401(m) or for purposes of section 415.

Second, the regulations would extend this expanded relief from disqualification to plans that accept rollover contributions other than direct rollover contributions. Thus, the relief would apply to plans that accept rollover contributions made by an employee within 60 days of the date of the distribution from a plan. Further, the relief would apply to plans that accept rollover contributions from a "conduit IRAs," i.e., an individual retirement plan that does not contain any amount attributable to any source other than a rollover contribution (as defined in section 402) from a plan qualified under section 401(a) or an annuity qualified under section 403(a). The relief would apply if (a) when accepting a rollover contribution, the plan administrator of the receiving plan reasonably concludes that the contribution is an eligible rollover distribution from a qualified plan (or an amount distributed from a conduit IRA) and that the contribution satisfies the other applicable requirements of section 402(c) or 408(d)-(3) for treatment as a rollover contribution and (b) the receiving plan satisfies the corrective distribution requirement described below.

The regulations would provide examples of the actions that a plan administrator might take to reasonably conclude that an employee's contribution satisfies the requirements for treatment as a rollover contribution. The examples are intended to be merely illustrative. Plan administrators may develop other approaches or procedures for reasonably reaching this conclusion.

Finally, the regulations would provide that if the receiving plan later obtains actual knowledge or otherwise determines that the distributing plan was not qualified at the time of the distribution, that any portion of the distribution was not an eligible rollover distribution or an amount distributed from a conduit IRA, or that the contribution to the plan otherwise did not satisfy the applicable requirements of section 402 or 408 for treatment as a rollover contribution, a corrective distribution equal to the amount of the contribution plus any earnings attributable to the contribution would be required to be made to the employee within a reasonable time after such determination.

Special Analyses

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

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or comments transmitted via Internet that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing may be scheduled if requested in writing by a person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the **Federal Register**.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.401(a)(31)–1 is amended as follows:

1. Under the heading "List of Questions," redesignating Q–14 through Q–18 as Q–15 through Q–19, respectively, and adding new Q–14.

2. Under the heading "Question and Answers," removing designation (a) and the paragraph heading, and removing paragraph (b) from A–13.

3. Under the heading "Question and Answers," redesignating Q&A–14 through Q&A–18 as Q&A–15 through Q&A–19, respectively, and adding Q&A–14.

The additions read as follows:

§ 1.401(a)(31)–1 Requirement to offer direct rollover of eligible rollover distributions; questions and answers.

* * * * *

LIST OF QUESTIONS

* * * * *

Q–14: If a plan accepts an invalid rollover contribution, whether or not as a direct rollover, how will the contribution be treated for purposes of applying the qualification requirements of section 401(a) or 403(a) to the plan?

* * * * *

QUESTIONS AND ANSWERS

* * * * *

Q–14: If a plan accepts an invalid rollover contribution, whether or not as a direct rollover, how will the contribution be treated for purposes of applying the qualification requirements of section 401(a) or 403(a) to the plan?

A–14: (a) *Acceptance of invalid rollover contribution.* If a plan accepts an invalid rollover contribution, the contribution will be treated, for purposes of applying the qualification requirements of section 401(a) or 403(a) to the receiving plan, as if it were a valid rollover contribution, if the following two conditions are satisfied. First, when accepting the amount from the employee as a rollover contribution, the plan administrator of the receiving plan reasonably concludes that the contribution is a valid rollover contribution. Second, if the plan administrator of the receiving plan later determines that the contribution was an invalid rollover contribution, the amount of the invalid rollover contribution, plus any earnings attributable thereto, is distributed to the employee within a reasonable time after such determination.

(b) *Definitions.* For purposes of this Q&A–14:

(1) An invalid rollover contribution is an amount that is accepted by a plan as a rollover within the meaning of Q&A–1 of § 1.402(c)–2 (or as a rollover contribution within the meaning of section 408(d)(3)(A)(ii)) but that is not an eligible rollover distribution from a

qualified plan (or an amount described in section 408(d)(3)(A)(ii)) or that does not satisfy the other requirements of section 401(a)(31), 402(c), or 408(d)(3) for treatment as a rollover or a rollover contribution.

(2) A valid rollover contribution is a contribution that is accepted by a plan as a rollover within the meaning of Q&A–1 of § 1.402(c)–2 or as a rollover contribution within the meaning of section 408(d)(3) and that satisfies the requirements of section 401(a)(31), 402(c), or 408(d)(3) for treatment as a rollover or a rollover contribution.

(c) The provisions of paragraph (a) of this Q&A–14 are illustrated by the following examples:

Example 1. (a) Employer X maintains for its employees Plan M, a profit sharing plan qualified under section 401(a). Plan M provides that any employee of Employer X may make a rollover contribution to Plan M. Employee A is an employee of Employer X, will not have attained age 70 1/2 by the end of the year, and has a vested account balance in Plan O (a plan maintained by Employee A's prior employer). Employee A elects a single sum distribution from Plan O and elects that it be paid to Plan M in a direct rollover.

(b) Employee A provides the plan administrator of Plan M with a letter from the plan administrator of Plan O stating that Plan O has received a determination letter from the Commissioner indicating that Plan O is qualified.

(c) Based upon such a letter, absent facts to the contrary, a plan administrator may reasonably conclude that Plan O is qualified and that the amount paid as a direct rollover is an eligible rollover distribution.

Example 2. (a) Same facts as *Example 1*, except that Employee A elects to receive the distribution from Plan O and wishes to make a rollover contribution described in section 402 rather than a direct rollover.

(b) When making the rollover contribution, Employee A certifies that, to the best of Employee A's knowledge, Employee A is entitled to the distribution as an employee and not as a beneficiary, the distribution from Plan O to be contributed to Plan M is not one of a series of periodic payments, the distribution from Plan O was received by Employee A not more than 60 days before the date of the rollover contribution, and the entire amount of the rollover contribution would be includible in gross income if it were not being rolled over.

(c) As support for these certifications, Employee A provides the plan administrator of Plan M with two statements from Plan O. The first is a letter from the plan administrator of Plan O, as described in *Example 1*, stating that Plan O has received a determination letter from the Commissioner indicating that Plan O is qualified. The second is the distribution statement that accompanied the distribution check. The distribution statement indicates that the distribution is being made by Plan O to Employee A, indicates the gross amount of the distribution, and indicates the amount withheld as Federal income tax. The amount withheld as Federal income tax is 20 percent of the gross amount of the distribution. Employee A contributes to Plan M an amount not greater than the gross amount of the distribution stated in the letter from Plan O and the contribution is made within 60 days of the date of the distribution statement from Plan O.

(d) Based on the certifications and documentation provided by Employee A, absent facts to the contrary, a plan administrator may reasonably conclude that Plan O is qualified and that the distribution otherwise satisfies the requirements of section 402(c) for treatment as a rollover contribution.

Example 3. (a) The facts are the same as in *Example 2*, except that, rather than contributing the distribution from Plan O to Plan M, Employee A contributes the distribution from Plan O to IRA P, an individual retirement account described in section 408(a). After the contribution of the distribution from Plan O to IRA P, but before the year in which Employee A attains age 70 1/2, Employee A requests a distribution from IRA P and decides to contribute it to Plan M as a rollover contribution. To make the rollover contribution, Employee A endorses the check received from IRA P as payable to Plan M.

(b) In addition to providing the certifications described in *Example 2* with respect to the distribution from Plan O, Employee A certifies that, to the best of Employee A's knowledge, the contribution to IRA P was made not more than 60 days after the date Employee A received the distribution from Plan O, no amount other than the distribution from Plan O has been contributed to IRA P, and the distribution from IRA P was received not more than 60 days earlier than the rollover contribution to Plan M.

(c) As support for these certifications, in addition to the two statements from Plan O described in *Example 2*, Employee A provides copies of statements from IRA P. The statements indicate that the account is identified as an IRA, the account was established within 60 days of the date of the letter from Plan O informing Employee A that an amount had been distributed, and the opening balance in the IRA does not exceed the amount of the distribution described in the letter from Plan O. There is no indication in the statements that any additional contributions have been made to IRA P since the account was opened. The date on the check from IRA P is less than 60 days before the date that Employee A makes the contribution to Plan M.

(d) Based on the certifications and documentation provided by Employee A, absent facts to the contrary, a plan administrator may reasonably conclude that Plan O is qualified and that the contribution by Employee A is a rollover contribution described in section 408(d)(3)(A)(ii) that satisfies the other requirements of section 408(d)(3) for treatment as a rollover contribution.

Par. 3. Section 1.402(c)–2 is amended by adding a sentence to the end of A–11 to read as follows:

§ 1.402(c)–2 Eligible rollover distributions; questions and answers.

* * * * *

A–11. * * * See § 1.401(a)(31)–1, Q&A–14, for guidance concerning the qualification of a plan that accepts a rollover contribution.

* * * * *

Michael P. Dolan,
Acting Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on September 18, 1996, 8:45 a.m., and published in the issue of the Federal Register for September 19, 1996, 61 F.R. 49279)

Notice of Proposed Rulemaking and Notice of Public Hearing

Classification of Certain Transactions Involving Computer Programs

REG–251520–96

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations relating to the tax treatment of certain transactions involving the transfer of computer programs. The proposed regulations provide rules for classifying such transactions as sales, licenses, leases, or the provision of services or of know-how under certain provisions of the Internal Revenue Code and tax treaties. This document also provides notice of a public hearing on the proposed regulations.

DATES: Comments must be received by February 11, 1997. Requests to speak (with outlines of oral comments) at a public hearing scheduled for March 19, 1997, at 10 a.m. must be submitted by February 26, 1997.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–251520–96), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–251520–96), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternately, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http:\\www.irs.ustreas.gov\prod\tax_regs\comments.html. The public hearing will be held in the NYU Classroom, room 2615, Internal Rev-

enue Building, 1111 Constitution Avenue NW, Washington, DC.

SUPPLEMENTARY INFORMATION:

Background

These regulations are proposed to clarify the treatment under certain provisions of the Internal Revenue Code (Code) and tax treaties of income from transactions involving computer programs.

I. Introduction

Computer programs are generally protected by copyright law. Typically the protection afforded by copyright law is a principal source of the value of a computer program to the owner of the copyright. Conversely, the principal source of the value of a computer program to the purchaser of a copy of the program is not the protection afforded by copyright law, but the right to use or sell the copy. In this regard, computer programs are similar to other copyrighted works such as books, records, motion pictures, etc. For example, when a copy of a book is purchased, the purchaser does not thereby also acquire any copyright rights. Accordingly, the proposed regulations generally distinguish between transactions in a copyright and in the subject of the copyright.

In developing regulations addressing the treatment of computer programs, the IRS and Treasury generally have been guided by the following principles: (i) the rules should take into account the special features of computer programs, such as the ability to deliver copies electronically as well as physically, and to make perfect copies at little or no cost, and (ii) wherever possible, transactions that are functionally equivalent should be treated similarly. For example, a transaction that involves the transfer for internal use only of fifty copies of a computer program should generally be treated the same as a transfer of one copy (for internal use) with the right to make forty-nine other copies all for internal use. Similarly, if the right to use a computer program is limited in time, the transaction should generally be treated the same irrespective of whether, at the end of the period of permitted use, a disk containing the computer program must be returned, or the program automatically deactivates itself.

II. Copyright Law Principles

Distinguishing between transactions in a copyright and in the subject of the copyright requires an examination of U.S. and foreign copyright law (e.g. EC Directive on Legal Protection of Computer Programs, 1991 (91/250/EEC); and the Berne Convention (Paris Text, July 24, 1971)). An overview of U.S. copyright law as it relates to computer programs is set forth below. However, the IRS and the Treasury do not purport in these regulations to interpret U.S. copyright law and these proposed regulations should not be taken as an expression of the legal or policy views of the U.S. Copyright Office.

The Copyright Act of 1976, as amended (17 U.S.C. 101 et seq.), provides protection against infringement of the exclusive rights of the owner of a copyright in original works of authorship, fixed in any tangible medium of expression, including literary works. (17 U.S.C. 102.) The term *literary works* is defined to include: ". . . numbers, or other verbal or numerical symbols or indicia, regardless of the nature of the material objects, such as books, periodicals, manuscripts, phonorecords, film, tapes, disks, or cards, in which they are embodied." (17 U.S.C. 101.) Thus, computer programs are literary works for purposes of the Copyright Act.

The Copyright Act grants five exclusive rights to a copyright owner. Of these, three are most relevant in the case of computer programs: the right to reproduce copies of the copyrighted work (17 U.S.C. 106(1)); the right to prepare derivative works, which may themselves be separately copyrighted, based upon the copyrighted work (17 U.S.C. 103 and 106(2)); and the right to distribute copies of the copyrighted work to the public by sale or other transfer of ownership, or by rental, lease or lending (17 U.S.C. 106(3)). Additionally, in certain circumstances, the right to publicly perform the copyrighted work (17 U.S.C. 106(4)) and the right to publicly display the copyrighted work may also be relevant (17 U.S.C. 106(5)).

Thus, under U.S. copyright law, the user of a computer program who does not possess any of those five rights (or parts of them) has obtained only rights to use the copyrighted article it possesses. Generally, that user is treated only as having received a copy of the copyrighted work. Under U.S. copyright law, a copy is a material object in which a work is fixed by any method now known or later developed, and from which the work can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device (17 U.S.C. 101.). In these proposed regulations a copy is also referred to as a "copyrighted article." The distinction between copies and copyrights is made most clearly in section 202 of the Copyright Act which provides:

> Ownership of a copyright, or of any of the exclusive rights under a copyright, is distinct from ownership of any material object in which the work is embodied. Transfer of ownership of any material object, including the copy or phonorecord in which the work is first fixed, does not of itself convey any rights in the copyrighted work embodied in the object; nor, in the absence of an agreement, does transfer of ownership of a copyright or of any exclusive rights under a copyright convey property rights in any material object.

Certain rights pass to the purchaser of a copy of a computer program. The most important of these is the right to sell (but not, without permission, to lease, rent or lend) the copy to another person. (17 U.S.C. 109.) Additionally, the owner of a copy of a computer program has the right to make a copy of that copy as an essential step in the utilization of the program (e.g., copying to the memory of the computer) and may also make a copy for archival purposes. (17 U.S.C. 117.) If, however, the owner of the copy sells that copy, all copies made pursuant to the 17 U.S.C. 117 right must be destroyed. III. The Proposed Regulations and Copyright Law Principles

Although the proposed regulations are guided by copyright law principles in determining whether a copyright right or copyrighted article has been transferred, the regulations depart in some cases from a strict reliance on copyright law in order to take into account the special nature of computer programs and to treat functionally equivalent transactions in the same way. For example, the proposed regulations do not treat the transfer of a right to copy as the transfer of a copyright right, unless it is accompanied by the right to distribute the copies to the public.

Thus, where a corporation obtains the right, under an agreement, to make fifty copies of a program for use by its employees at one location (a site license) the transaction is not, for all practical purposes, any different from a transaction in which fifty individual disks are purchased. Accordingly, the proposed regulations treat the transac-

tion as the transfer of a copyrighted article, rather than of a copyright right, despite a copyright law requirement that the corporation receive a "license" to make those fifty copies. Similarly, under the proposed regulations, the transfer of a computer program in perpetuity for internal use only on a single disk or set of disks in return for a one-time payment, in a transaction styled as a license of copyright rights (a so-called shrink wrap license), is treated as the sale of a copyrighted article and not the transfer of a copyright right. Therefore, such a transfer is classified solely as the sale of a copyrighted article for the purposes of the proposed regulations.

IV. Explanation of Provisions

Section 1.861–18(a)(1) of the proposed regulations describes the scope of the proposed regulations. These proposed regulations provide rules for classifying transfers of computer programs for the purposes of subchapter N of chapter 1 of the Internal Revenue Code, sections 367, 404A, 482, 551, 679, 1057, 1059A, chapter 3, chapter 5, sections 842 and 845 (to the extent involving a foreign person), and transfers to foreign trusts not covered by section 679.

Section 1.861–18(a)(2) describes the categories of transactions relating to computer programs. In particular, a transfer of a copyright right may be either a sale or license of that right and a transfer of a copyrighted article may be either a sale or lease of that copyrighted article. Section 1.861– 18(a)(3) defines the term *computer program.*

Section 1.861–18(b)(1) provides that a transaction involving the transfer of a computer program will be classified as either the transfer of a copyright right, the transfer of a copyrighted article, the provision of services relating to the development of a computer program, or the provision of know-how.

Section 1.861–18(b)(2) provides that a transaction involving computer programs which consists of more than one of the categories in paragraph (b)(1), is treated as separate transactions. Any resulting transaction that is de minimis, however, taking into account all facts and circumstances, will not be treated as a separate transaction.

Section 1.861–18(c)(1)(i) provides that the transfer of a computer program will be classified as the transfer of a copyright right if the transferee acquires one or more of the rights set forth in paragraph (c)(2).

Section 1.861–18(c)(1)(ii) provides that if such rights are not transferred and the transaction does not involve, or involves to only a de minimis extent, the provision of services or know- how, then the transaction will be classified solely as the transfer of a copyrighted article.

Section 1.861–18(c)(2) identifies those rights that will be treated as copyright rights for purposes of the proposed regulations. This list differs from the list of rights set out in the Copyright Act to take into account the special nature of computer programs. Specifically, the copyright law right to copy will only be treated as a copyright right for the purposes of the proposed regulations if it is accompanied by the right to distribute such copies to the public. The copyright rights that apply for purposes of this section are, in addition to the right to copy and distribute to the public, the right to prepare derivative computer programs, the right to make a public performance of the computer program, and the right to publicly display the computer program. The list of rights contained in § 1.861–18(c)(2) rather than those contained in the Copyright Act will apply for the purposes of the proposed regulations.

Section 1.861–18(c)(3) defines a copyrighted article as a copy of a computer program from which the work can be perceived, reproduced or otherwise communicated.

Section 1.861–18(d) of the proposed regulations provides rules for determining whether a transaction involving a newly- developed or modified computer program will be treated as the provision of services or another transaction described in paragraph (b)(1) of this section. The determination is based on all facts and circumstances, including how risk of loss is allocated and the intent of the parties as to ownership of the copyright. See, e.g., *Boulez v. Commissioner*, 83 T.C. 584 (1984); Rev. Rul. 74–555 (1974–2 C.B. 202); Rev. Rul. 84–78 (1984–1 C.B. 173).

Section 1.861–18(e) provides rules for determining whether a transfer of information related to a computer program will be considered the provision of know-how. A provision of know-how will not be considered to occur unless a party transfers information that (i) relates to computer programming techniques, (ii) is not capable of being copyrighted, and (iii) is protected by trade secret protection.

Under § 1.861–18(f)(1), if a transfer involves copyright rights, it will be further classified as either a sale or a license of copyright rights. This classification will be made by examining whether, taking into account all facts and circumstances, all substantial rights, under the principles of sections 1222 and 1235, have passed to the transferee.

Under § 1.861–18(f)(2), if a transfer involves a copyrighted article, it will be further classified as either a sale or a lease of a copyrighted article. This classification will be made by examining whether the benefits and burdens of ownership have passed to the transferee. See, e.g., *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1237–38 (1981); *Torres v. Commissioner*, 88 T.C. 702, 720–27 (1987); *Estate of Thomas v. Commissioner*, 84 T.C. 412, 431–40 (1985).

Under § 1.861–18(f)(3), the determination of the classification of a transfer involving a copyright right or copyrighted article must appropriately consider the special nature of computer programs in transactions that take advantage of those characteristics. For example, a transaction in which a person acquires a copyrighted article on disk subject to a requirement that the disk be destroyed after a specified period is generally the equivalent of a requirement that the disk be returned after such period. Similarly, a transaction in which the program deactivates itself after a specified period may also be treated as the equivalent of returning the copy.

Section 1.861–18(g) of the proposed regulations provides certain additional rules of operation. Section 1.861–18(g)(1) provides that neither the form adopted by the parties to a transaction nor the classification of a transaction under copyright law are determinative for tax purposes. Therefore, as illustrated in Example 1, a transfer of a computer program on a disk subject to a shrink-wrap license will generally be a sale of a copyrighted article.

Section 1.861–18(g)(2) provides that the method of transferring the computer program, for example by disk or electronically, shall not be relevant in determining whether a copyright right or a copyrighted article has been transferred.

The foregoing rules are illustrated by a number of examples contained in § 1.861–18(h).

Under § 1.861–18(i), these regulations are proposed to apply to all transactions occurring on or after the date that is 60 days after the date the final

regulations are published in the **Federal Register**. No inference should be drawn from the proposed effective date concerning the treatment of transactions involving computer programs entered into before the regulations are applicable.

The application of these rules for purposes of the affected Internal Revenue Code sections may result in a change in the method of accounting for certain transactions involving computer programs by certain taxpayers. If the final regulations are adopted, the IRS will consider issuing an automatic change revenue procedure to address the situation where the taxpayer is required to change its method of accounting to comport with the new regulations.

Special Analyses

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

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely (in the manner described in the ADDRESSES caption) to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for March 19, 1997, at 10 a.m. in the NYU Classroom, room 2615, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit comments by February 11, 1997, and submit an outline of the topics to be discussed and the time to be devoted to each topic (in the manner described in the ADDRESSES caption) by February 26, 1997.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

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Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.861–18 is added to read as follows:

§ 1.861–18 Classification of transactions involving computer programs.

(a) *General*—(1) *Scope.* This section provides rules for classifying transactions relating to computer programs for purposes of subchapter N of chapter 1 of the Internal Revenue Code, sections 367, 404A, 482, 551, 679, 1057, 1059A, chapter 3, chapter 5, sections 842 and 845 (to the extent involving a foreign person), and transfers to foreign trusts not covered by section 679.

(2) *Categories of transactions.* This section generally requires that such transactions be treated as being solely within one of four categories (described in paragraph (b)(1) of this section) and provides certain rules for categorizing such transactions. In the case of a transfer of a copyright right, this section provides rules for determining whether the transaction should be classified as either a sale or exchange, or a license generating royalty income. In the case of a transfer of a copyrighted article, this section provides rules for determining whether the transaction should be classified as either a sale or exchange, or a lease generating rental income.

(3) *Computer program.* For purposes of this section, a computer program is a set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result. For purposes of this paragraph (a)(3), a computer program includes any data base or similar item if the data base or similar item is incidental to the operation of the computer program.

(b) *Categories of transactions*—(1) *General.* Except as provided in paragraph (b)(2) of this section, a transaction involving the transfer of, or the provision of services or of know-how with respect to, a computer program (collectively, a transfer of a computer program) is treated as being solely one of the following—

(i) A transfer of a copyright right in the computer program;

(ii) A transfer of a copy of the computer program (a copyrighted article);

(iii) The provision of services for the development or modification of the computer program; or

(iv) The provision of know-how relating to computer programming techniques.

(2) *Transactions consisting of more than one category.* Any transaction involving computer programs which consists of more than one of the transactions described in paragraph (b)(1) of this section shall be treated as separate transactions, with the appropriate provisions of this section being applied to each such transaction. However, any transaction that is de minimis, taking into account the overall transaction and the surrounding facts and circumstances, shall not be treated as a separate transaction, but as part of another transaction.

(c) *Transfers involving both a copyright right and a copyrighted article*—(1) *Classification*—(i) *Transfers treated as transfers of copyright rights.* A transfer of a computer program is classified as a transfer of a copyright right if, as a result of the transaction, a person acquires any one or more of the rights described in paragraphs (c)(2)(i) through (iv) of this section. For example, if a person receives a disk containing a copy of a computer program which enables it to exercise, in relation to that program, a non-de minimis right described in paragraphs (c)(2)(i) through (iv) of this section (and the transaction does not involve, or involves only a de minimis provision of services as described in paragraph (d) of this section or of know-how as described in paragraph (e) of this section), then, under paragraph (b)(2) of this section, the transfer is classified solely as a transfer of a copyright right.

(ii) *Transfers treated solely as transfers of copyrighted articles.* If a person

acquires a copy of a computer program but does not acquire any of the rights described in paragraphs (c)(2)(i) through (iv) of this section (and the transaction does not involve, or involves only a de minimis provision of services as described in paragraph (d) of this section or of know-how as described in paragraph (e) of this section), the transfer of the copy of the computer program is classified solely as a transfer of a copyrighted article.

(2) *Copyright rights.* The copyright rights referred to in paragraph (c)(1) of this section are as follows—

(i) The right to make copies of the computer program for purposes of distribution to the public by sale or other transfer of ownership, or by rental, lease or lending;

(ii) The right to prepare derivative computer programs based upon the copyrighted computer program;

(iii) The right to make a public performance of the computer program; or

(iv) The right to publicly display the computer program.

(3) *Copyrighted article.* A copyrighted article is a copy of a computer program from which the work can be perceived, reproduced or otherwise communicated, either directly or with the aid of a machine or device. The copy of the program may be fixed in the magnetic medium of a floppy disk or in the main memory or hard drive of a computer.

(d) *Provision of services.* The determination of whether a transaction involving a newly developed or modified computer program is treated as either the provision of services or another transaction described in paragraph (b)(1) of this section is based on all the facts and circumstances of the transaction, including, as appropriate, the intent of the parties (as evidenced by their agreement and conduct) as to which party is to own the copyright rights in the computer program and how the risks of loss are allocated between the parties.

(e) *Provision of know-how.* The provision of information with respect to a computer program will not be treated as the provision of know-how for the purposes of this section unless the information is—

(1) Information relating to computer programming techniques;

(2) Not capable itself of being copyrighted; and

(3) Subject to trade secret protection.

(f) *Further classification of transfers involving copyright rights and copyrighted articles*—(1) *Transfers of copyright rights.* The determination of whether a transfer of a copyright right is a sale or exchange of property is made on the basis of whether, taking into account all facts and circumstances, there has been a transfer of all substantial rights in the copyright. A transaction that does not constitute a sale or exchange because not all substantial rights have been transferred will be classified as a license generating royalty income. For this purpose, the principles of sections 1222 and 1235 shall apply.

(2) *Transfers of copyrighted articles.* The determination of whether a transfer of a copyrighted article is a sale or exchange is made on the basis of whether, taking into account all facts and circumstances, the benefits and burdens of ownership have been transferred. A transaction that does not constitute a sale or exchange because insufficient benefits and burdens of ownership of the copyrighted article have been transferred, such that a person other than the transferee is properly treated as the owner of the copyrighted article, will be classified as a lease generating rental income.

(3) *Special circumstances of computer programs.* In connection with determinations under this paragraph (f), consideration must be given as appropriate to the special characteristics of computer programs in transactions that take advantage of these characteristics (such as the ability to make perfect copies at minimal cost). For example, a transaction in which a person acquires a copy of a computer program on disk subject to a requirement that the disk be destroyed after a specified period is generally the equivalent of a transaction subject to a requirement that the disk be returned after such period. Similarly, a transaction in which the program deactivates itself after a specified period is generally the equivalent of returning the copy.

(g) *Rules of operation*—(1) *Term applied to transaction by parties.* Neither the form adopted by the parties to a transaction, nor the classification of the transaction under copyright law, shall be determinative. Therefore, for example, if there is a transfer of a computer program on a single disk for a one-time payment with restrictions on transfer and reverse engineering, which the parties characterize as a license (generally referred to as a shrink-wrap license), application of the rules of paragraphs (c) and (f) of this section may nevertheless result in the transaction being classified as the sale of a copyrighted article.

(2) *Means of transfer not to be taken into account.* The rules of this section shall be applied irrespective of the physical or electronic medium used to effectuate a transfer of a computer program.

(h) *Examples.* The provisions of this section may be illustrated by the following examples. All of the following examples assume that all parties are unrelated to each other:

Example 1. (i) *Facts.* Corp A, a U.S. corporation, owns the copyright in a computer program, Program X. It copies Program X on to disks. The disks are placed in boxes covered with a wrapper on which is printed what is generally referred to as a shrink-wrap license. The license is stated to be perpetual. Under the license no reverse engineering of the computer program is permitted. The transferee receives, first, the right to use the program on two of its own computers (for example, a laptop and a desktop) provided that only one copy is in use at any one time, and, second, the right to make one copy of the program on each machine as an essential step in the utilization of the program. The transferee is permitted by the shrink-wrap license to sell the copy so long as it destroys any other copies it has made and imposes the same terms and conditions of the license on the purchaser of its copy. These disks are made available for sale to the general public in Country Z. In return for valuable consideration, P, a Country Z resident, receives one such disk.

(ii) *Analysis.* (A) Under paragraph (g)(1) of this section, the label license is not determinative. None of the copyright rights described in paragraph (c)(2) of this section have been transferred in this transaction. P has received a copy of the program, however, and, therefore, under paragraph (c)(1)(ii) of this section, P has acquired solely a copyrighted article.

(B) Taking into account all of the facts and circumstances, P is properly treated as the owner of a copyrighted article. Therefore, under paragraph (f)(2) of this section, there has been a sale of a copyrighted article rather than the grant of a lease.

Example 2. (i) *Facts.* The facts are the same as those in Example 1, except that instead of selling disks, Corp A, the U.S. corporation, decides to make Program X available, for a fee, on a World Wide Web home page on the Internet. P, the Country Z resident, in return for payment made to Corp A, downloads Program X (via modem) onto the hard drive of his computer. As part of the electronic communication, P signifies his assent to a license agreement with terms identical to those in Example 1, except that in this case P may make a back-up copy of the program on to a disk.

(ii) *Analysis.* (A) None of the copyright rights described in paragraph (c)(2) of this section have passed to P. Although P did not buy a physical copy of the disk with the program on it, paragraph (g)(2) of this section provides that the means of transferring the program is irrelevant. Therefore, P has acquired a copyrighted article.

(B) As in *Example 1*, P is properly treated as the owner of a copyrighted article. Therefore, under paragraph (f)(2) of this section, there has been a sale of a copyrighted article rather than the grant of a lease.

Example 3. (i) *Facts.* The facts are the same as those in Example 1, except that Corp A only

allows P, the Country Z resident, to use Program X for one week. At the end of that week, P must return the disk with Program X on it to Corp A. P must also destroy any copies made of Program X. If P wishes to use Program X for a further period he must enter into a new agreement to use the program for an additional charge.

(ii) *Analysis.* (A) Under paragraph (c)(2) of this section, P has received no copyright rights. Because P has received a copy of the program under paragraph (c)(1)(ii) of this section, he has, therefore, received a copyrighted article.

(B) Taking into account all of the facts and circumstances, P is not properly treated as the owner of a copyrighted article. Therefore, under paragraph (f)(2) of this section, there has been a lease of a copyrighted article rather than a sale. Taking into account the special characteristics of computer programs as provided in paragraph (f)(3) of this section, the result would be the same if P were required to destroy the disk at the end of the one week period instead of returning it since Corp A can make additional copies of the program at minimal cost.

Example 4. (i) *Facts.* The facts are the same as those in Example 2, where P, the Country Z resident, receives Program X from Corp A's home page on the Internet, except that P may only use Program X for a period of one week at the end of which an electronic lock is activated and the program can no longer be accessed. Thereafter, if P wishes to use Program X, it must return to the home page and pay Corp A to send an electronic key to reactivate the program for another week.

(ii) *Analysis.* (A) As in *Example 3*, under paragraph (c)(2) of this section, P has not received any copyright rights. P has received a copy of the program, and under paragraph (g)(2) of this section, the means of transmission is irrelevant, P has, therefore, under paragraph (c)(1)(ii) of this section, received a copyrighted article.

(B) As in *Example 3*, P is not properly treated as the owner of a copyrighted article. Therefore, under paragraph (f)(2) of this section, there has been a lease of a copyrighted article rather than a sale. While P does retain Program X on its computer at the end of the one week period, as a legal matter P no longer has the right to use the program (without further payment) and, indeed, cannot use the program without the electronic key. Functionally, Program X is no longer on the hard drive of P"s computer. Instead, the hard drive contains only a series of numbers which no longer perform the function of Program X. Although in *Example 3*, P was required to physically return the disk, taking into account the special characteristics of computer programs as provided in paragraph (f)(3) of this section, the result in this *Example 4* is the same as in *Example 3*.

Example 5. (i) *Facts.* Corp A, a U.S. corporation, transfers a disk containing Program X to Corp B, a Country Z corporation, and grants Corp B an exclusive license for the remaining term of the copyright to copy and distribute an unlimited number of copies of Program X in the geographic area of Country Z, prepare derivative works based upon Program X, make public performances of Program X, and publicly display Program X. Corp B will pay Corp A a royalty of $y a year for three years, which is the expected period during which Program X will have commercially exploitable value.

(ii) *Analysis.* (A) Although Corp A has transferred a disk with a copy of Program X on it to Corp B, under paragraph (c)(1)(i) of this section because this transfer is accompanied by a copyright right identified in paragraph (c)(2)(i) of this section, this transaction is a transfer solely of copyright rights, not of copyrighted articles. For purposes of paragraph (b)(2) of this section, the disk containing a copy of Program X is a de minimis component of the transaction.

(B) Applying the all substantial rights test under paragraph (f)(1) of this section, Corp A will be treated as having sold copyright rights to Corp B. Corp B has acquired all of the copyright rights in Program X, has received the right to use them exclusively within a geographic area, and has received the rights for the remaining life of the copyright in Program X. Under paragraph (g)(1) of this section, the fact that the agreement is labelled a license is not controlling (nor is the fact that Corp A receives a sum labelled a royalty). (This would also be the case if the copy of Program X to be used for the purposes of reproduction were transmitted electronically to Corp B, as a result of the application of the rule of paragraph (g)(2) of this section.)

Example 6. (i) *Facts.* Corp A, a U.S. corporation, transfers a disk containing Program X to Corp B, a Country Z corporation, and grants Corp B the non exclusive right to reproduce and distribute for sale to the public an unlimited number of disks at its factory in Country Z in return for a payment related to the number of disks copied and sold. The term of the agreement is two years, which is less than the remaining life of the copyright.

(ii) *Analysis.* (A) As in *Example 5*, the transfer of the disk containing the copy of the program does not constitute the transfer of a copyrighted article under paragraph (c)(1) of this section because Corp B has also acquired a copyright right under paragraph (c)(2)(i) of this section. For purposes of paragraph (b)(2) of this section, the disk containing Program X is a de minimis component of the transaction.

(B) Taking into account all of the facts and circumstances, there has been a license of Program X to Corp B, and the payments made by Corp B are royalties. Under paragraph (f)(1) of this section, there has not been a transfer of all substantial rights in the copyright to Program X because Corp A has the right to enter into other licenses with respect to the copyright of Program X, including in Country Z (or even to sell that copyright, subject to Corp B's interest). Corp B has acquired no right itself to license the copyright rights in Program X. Finally, the term of the license is for less than the remaining life of the copyright in Program X.

Example 7. (i) *Facts.* Corp C, a distributor in Country Z, enters into an agreement with Corp A, a U.S. corporation, to purchase as many copies of Program X on disk as it may from time- to-time request. Corp C will then sell these disks to retailers. The disks are shipped in boxes covered by shrink-wrap licenses (identical to the license described in *Example 1*).

(ii) *Analysis.* (A) Corp C has not acquired any copyright rights under paragraph (c)(2) of this section with respect to Program X. It has acquired individual copies of Program X, which it may sell to others. The use of the term license is not dispositive under paragraph (g)(1) of this section. Under paragraph (c)(1)(ii) of this section, Corp C has acquired copyrighted articles.

(B) Taking into account all of the facts and circumstances, Corp C is properly treated as the owner of copyrighted articles. Therefore, under paragraph (f)(2) of this section, there has been a sale of copyrighted articles.

Example 8. (i) *Facts.* Corp A, a U.S. corporation, transfers a disk containing Program X to Corp D, a foreign corporation engaged in the manufacture and sale of personal computers in Country Z. Corp A grants Corp D the non-exclusive right to copy Program X onto the hard drive of computers which it manufactures, and to distribute those copies (on the hard drive) to the public. The term of the agreement is two years, which is less than the remaining life of the copyright in Program X. Corp D pays Corp A an amount based on the number of copies of Program X it loads on to computers.

(ii) *Analysis.* The analysis is the same as in *Example 6.* Under paragraph (c)(2)(i) of this section, Corp D has acquired a copyright right enabling it to exploit Program X by copying it on to the hard drives of the computers that it manufactures and then sells. For purposes of paragraph (b)(2) of this section, the disk containing Program X is a de minimis component of the transaction. Taking into account all of the facts and circumstances, Corp D has not, however, acquired all substantial rights in the copyright to Program X (for example, the term of the agreement is less than the remaining life of the copyright). Under paragraph (f)(1) of this section, this transaction is, therefore, a license of Program X to Corp D rather than a sale and the payments made by Corp D are royalties.

Example 9. (i) *Facts.* The facts are the same as in Example 8, except that Corp D, the Country Z corporation, receives physical disks. The disks are shipped in boxes covered by shrink-wrap licenses (identical to the licenses described in *Example 1*). Corp D uses each individual disk only once to load a single copy of Program X onto each separate computer. Corp D transfers the disk with the computer when it is sold.

(ii) *Analysis.* (A) As in *Example 7* (unlike *Example 8*) no copyright right identified in paragraph (c)(2) of this section has been transferred. Corp D acquires the disks without the right to reproduce and distribute publicly further copies of Program X. This is therefore the transfer of copyrighted articles under paragraph (c)(1)(ii) of this section.

(B) Taking into account all of the facts and circumstances, Corp D is properly treated as the owner of copyrighted articles. Therefore, under paragraph (f)(2) of this section, the transaction is classified as the sale of a copyrighted article.

Example 10. (i) *Facts.* Corp A, a U.S. corporation, transfers a disk containing Program X to Corp E, a Country Z corporation, and grants Corp E the right to load Program X onto 50 individual workstations for use only by Corp E employees at one location in return for a one-time per-user fee (generally referred to as a site license). If additional workstations are subsequently introduced, Program X may be loaded on to those machines for additional one-time per-user fees. The license which grants the rights to operate Program X on 50 workstations also prohibits Corp E from selling the disk (or any of the 50 copies) or reverse engineering the program. The term of the license is stated to be perpetual.

(ii) *Analysis.* (A) The grant of a right to copy, unaccompanied by the right to distribute those copies to the public, is not the transfer of a copyright right under paragraph (c)(2) of this section. Therefore, under paragraph (c)(1)(ii) of this section, this transaction is a transfer of copyrighted articles (50 copies of Program X).

(B) Taking into account all of the facts and circumstances, Corp E is properly treated as the owner of a copyrighted article. Therefore, under paragraph (f)(2) of this section, there has been a sale of copyrighted articles rather than the grant of a lease. Notwithstanding the restriction on sale, other factors such as, for example, the risk of loss

and the right to use the copies in perpetuity outweigh, in this case, the restrictions placed on the right of alienation.

Example 11. (i) *Facts.* The facts are the same as in Example 10, except that Corp E, the Country Z corporation, acquires the right to make Program X available to workstation users who are Corp E employees by way of a local area network (LAN). The number of users that can use Program X on the LAN at any one time is limited to 50. Corp E pays a one-time fee for the right to have up to 50 employees use the program at the same time.

(ii) *Analysis.* Under paragraph (g)(2) of this section the mode of transmission is irrelevant. Therefore, as in *Example 10*, under paragraph (c)(2) of this section, no copyright right has been transferred and thus, under paragraph (c)(1)(ii) of this section, this transaction will be classified as the transfer of a copyrighted article. Under the benefits and burdens test of paragraph (f)(2) of this section, this transaction is a sale of copyrighted articles.

Example 12. (i) *Facts.* The facts are the same as in *Example 11*, except that Corp E pays a monthly fee to Corp A, the U.S. corporation, calculated with reference to the permitted maximum number of users (which can be changed) and the computing power of Corp E's server. In return for this monthly fee, Corp E receives the right to receive upgrades of Program X when they become available. The agreement may be terminated by either party at the end of any month. When the disk containing the upgrade is received, or if the contract is terminated, Corp E must return the disk containing the earlier version of Program X to Corp A, and delete (or otherwise destroy) any copies made of the current version of Program X. The agreement specifically provides that Corp E has not thereby been granted an option to purchase Program X.

(ii) *Analysis.* (A) Corp E has received no copyright rights under paragraph (c)(2) of this section. Under paragraph (d) of this section, based on all the facts and circumstances of the transaction, Corp A has not provided services to Corp E. Therefore, under paragraph (c)(1)(ii) of this section, the transaction is a transfer of a copyrighted article.

(B) Taking into account all facts and circumstances, under the benefits and burdens test Corp E is not properly treated as the owner of the copyrighted article. Corp E does not receive the right to use Program X in perpetuity, but only for so long as it continues to make payments. Corp E does not have the right to purchase Program X on advantageous (or, indeed, any) terms once a certain amount of money has been paid to Corp A or a certain period of time has elapsed (which might indicate a sale). Once the agreement is terminated, Corp E will no longer possess any copies of Program X, current or superseded. Therefore under paragraph (f)(2) of this section there has been a lease of a copyrighted article.

Example 13. (i) *Facts.* The facts are the same as in *Example 12*, except that while Corp E must return copies of Program X as new upgrades are received, if the agreement terminates, Corp E may keep the latest version of Program X (although Corp E is still prohibited from selling or otherwise transferring any copy of Program X).

(ii) *Analysis.* For the reasons stated in *Example 10*, the transfer of the program will be treated as a sale of a copyrighted article rather than as a lease.

Example 14. (i) *Facts.* Corp G, a Country Z corporation, enters into a contract with Corp A, a U.S. corporation, for Corp A to modify Program X so that it can be used at Corp G's facility in Country Z. Under the contract, Corp G is to acquire one copy of the program on a disk and the right to use the program on 5,000 workstations. The contract requires Corp A to rewrite elements of Program X so that it will conform to Country Z accounting standards. The services required to perform this task are de minimis taking into account the facts and circumstances of this transaction. The agreement between Corp A and Corp G is otherwise identical as to rights and payment terms as the agreement described in *Example 10.*

(ii) *Analysis.* (A) As in *Example 10*, no copyright rights are being transferred under paragraph (c)(2) of this section. Under paragraph (b)(2) of this section, the services provided are de minimis. This transaction will be classified, therefore, as a transfer of copyrighted articles under paragraph (c)(1)(ii) of this section.

(B) Taking into account all facts and circumstances, Corp G is properly treated as the owner of copyrighted articles. Therefore, under paragraph (f)(2) of this section, there has been the sale of a copyrighted article rather than the grant of a lease.

Example 15. (i) *Facts.* Corp H, a Country Z corporation, enters into a license agreement for a modified version of Program X only if Corp A, a U.S. corporation, makes substantial modifications to the program. Only the core idea of Program X will be used and a considerable amount of labor will be expended in rewriting Program X, which under applicable copyright law as a derivative work will be a separate, new program. Corp A and Corp H agree that Corp A is modifying Program X for Corp H and that, when modified Program X is completed, the copyright in the modified program will belong to Corp H. Corp H gives instructions to Corp A programmers regarding program specifications. Corp H agrees to pay Corp A a fixed monthly sum during development of the program. If Corp H is dissatisfied with the development of the program it may cancel the contract at the end of any month. In the event of termination, Corp A will retain all payments, while any procedures, techniques or copyrightable interests will be the property of Corp H. All of the payments are labelled royalties. There is no provision in the agreement for any continuing relationship between Corp A and Corp H, such as the furnishing of updates of the program, after completion of the modification work.

(ii) *Analysis.* Taking into account all of the facts and circumstances, Corp A is treated as providing services to Corp H. Under paragraph (d) of this section, Corp A is treated as providing services to Corp H because Corp H bears all of the risks of loss associated with the development of modified Program X and is the owner of all copyright rights in modified Program X. Under paragraph (g)(1) of this section, the fact that the agreement is labelled a license is not controlling (nor is the fact that Corp A receives a sum labelled a royalty).

Example 16. (i) *Facts.* Corp A, a U.S. corporation, and Corp I, a Country Z corporation, agree that a development engineer employed by Corp A will travel to Country Z to provide know-how relating to certain techniques which are not generally known to computer programmers which will enable Corp I to more efficiently create computer programs. These techniques represent the product of experience gained by Corp A from working on many computer programming projects. Such information is not capable of being copyrighted, but it is subject to trade secret protection.

(ii) *Analysis.* This transaction contains the elements of know-how specified in paragraph (e) of this section. Therefore, this transaction will be classified as the provision of know-how.

(i) *Effective date.* This section applies to transactions occurring on or after the date that is sixty days after the date final regulations are published in the **Federal Register.**

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on November 7, 1996, 3:11 p.m., and published in the issue of the Federal Register for November 13, 1996, 61 F.R. 58152)

Announcement of the Disbarment, Suspension, and 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 suspended from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants, enrolled agents, and enrolled actuaries to identify practitioners under consent suspension from practice before the Internal Revenue Service, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been suspended from such practice, their designation as attorney, certified public accountant, enrolled agent, or enrolled actuary and date or period of suspension. This announcement will appear in the weekly Bulletin at the earliest practicable date after such action and will continue to appear in the weekly Bulletins for five successive weeks or for as many weeks as is practicable for each attorney, certified public accountant, enrolled agent, or enrolled actuary so suspended and will be consolidated and published in the Cumulative Bulletin.

The following individuals have been placed under consent suspension from practice before the Internal Revenue Service:

Name	Address	Designation	Date of Suspension
Bruender, Lawrence	Lesueur, MN	Attorney	Indefinite from April 18, 1996
Pallman, James J.	New Haven, CT	CPA	April 19, 1996 to October 18, 1996
Pribble Jr., William C.	Minneapolis, MN	Attorney	Indefinite from May 1, 1996
Pyburn, Richard E.	Downers Grove, IL	CPA	May 1, 1996 to October 31, 1997
Scalise, James J.	New Britain, CT	Attorney	May 1, 1996 to July 31, 1996
Kieldaisch, Dale W.	Manteno, IL	CPA	May 1, 1996 to October 31, 1996
Ogorek, Charolotte F.	Park Ridge, IL	CPA	May 3, 1996 to July 2, 1996
Korman, Steven B.	Mulford, CT	CPA	May 3, 1996 to February 2, 1997
Myers, Donald L.	Olney, MD	CPA	May 7, 1996 to May 6, 1998
Sharrett, William R.	Paradise, CA	Enrolled Agent	May 8, 1996 to November 7, 1996
Cornwell, Douglas S.	Norwalk, CT	CPA	May 10, 1996 to November 9, 1996
Chang, Sun Kun	McLean, VA	Enrolled Agent	May 13, 1996 to July 12, 1996
Cariveau, Stewart	Minneapolis, MN	CPA	May 30, 1996 to August 29, 1996
Carter, Gary E.	Ashdown, AR	CPA	June 1, 1996 to August 31, 1996
Underwood, Wendell L.	Sedalia, MO	CPA	June 1, 1996 to July 31, 1996
Candiloro, James A.	Glastonbury, CT	CPA	June 1, 1996 to November 30, 1996
Schwartz, Leonard J.	Danbury, CT	Enrolled Agent	June 1, 1996 to February 28, 1997
Forrester, Donald F.	Fairfield, OH	CPA	Indefinite from June 4, 1996
Shade, Stephen E.	Clearwater, FL	Enrolled Agent	June 8, 1996 to May 7, 1997
Woods, James G.	Huntington, CT	CPA	July 1, 1996 to June 30, 1997
Grove, Michael J.	Alliance, OH	CPA	July 1, 1996 to June 30, 1997
Jenkins, Frank	Montgomery, AL	CPA	July 1, 1996 to December 31, 1996
Brewton III, George W.	Greenville, MS	CPA	July 1, 1996 to September 30, 1996
Fischer, Randall E.	Lombard, IL	CPA	July 1, 1996 to September 30, 1996
Rhoney, Brian	Wheaton, IL	CPA	July 1, 1996 to December 31, 1996
Devereux, Michael J.	Florissant, MO	CPA	July 1, 1996 to March 31, 1997
Cranston, Robert S.	Saugerties, NY	CPA	July 1, 1996 to December 31, 1996
Miller, Dwight W.	Overland Pk, KS	CPA	July 1, 1996 to June 30, 1997

Name	Address	Designation	Date of Suspension
Beck, Clyde E.	Salina, KS	CPA	July 1, 1996 to October 31, 1996
Seal, Ernest E.	Cleveland, MS	CPA	August 1, 1996 to July 31, 1998
Dicker, Joseph W.	Minneapolis, MN	Attorney	August 1, 1996 to October 31, 1996
Berry, James R.	Columbus, MO	CPA	June 5, 1996 to December 4, 1997
Rohner Jr., Richard E.	Burr Ridge, IL	CPA	June 10, 1996 to June 9, 1997
Bova, Robert J.	Tampa, FL	CPA	June 10, 1996 to March 9, 1997
Rines, Robert L.	Concord, NH	Attorney	June 17, 1996 to December 16, 1998
Kimball, Randy	Rancho Cucamonga, CA	CPA	July 1, 1996 to December 31, 1996
Cole, Sherman	Oklahoma City, OK	CPA	July 1, 1996 to March 31, 1997
Barretta, Samuel N.	Southfield, MI	Attorney	August 1, 1996 to December 31, 1999
Harris, Luis F.	Orlando, FL	CPA	August 1, 1996 to October 31, 1996
Vourvoulias, James	Park Ridge, IL	CPA	August 1, 1996 to October 31, 1996
Swan, Roy E.	Salem, OR	CPA	August 1, 1996 to January 31, 1997
Hamilton, Barry K.	Twins Falls, ID	CPA	August 1, 1996 to September 30, 1996
Horton, Greta	Richland, VA	CPA	Indefinite from August 2, 1996
Addabbo, Marie P.	Manchester, CT	Enrolled Agent	September 1, 1996 to May 31, 1997
Crouch Jr., Richard E.	Miss'nViejo, CA	CPA	September 1, 1996 to February 28, 1999
Sanders Jr., Wilfred A.	Orlando, FL	CPA	September 1, 1996 to August 31, 1998
Perkins, Nancy F.	Apple Valley, MN	CPA	September 1, 1996 to November 30, 1996
Nichols, Oliver R.	Meriden, CT	CPA	September 1, 1996 to May 31, 1997
Winiemko, Ronald C.	Sterl'g Hts, MI	Attorney	September 1, 1996 to February 28, 1999
Pallman, William F.	Guilford, CT	CPA	September 30, 1996 to January 29, 1997
Gannon, Martin C.	Wallingford, CT	CPA	September 30, 1996 to December 29, 1996
Andrews, Craig A.	Hicksville, OH	CPA	September 30, 1996 to September 29, 1997
Lamb, Gordon W.	Pullman, WA	CPA	September 1, 1996 to January 31, 1997
Anderson, Randall S.	Arlington Hgts, IL	CPA	September 1, 1996 to February 28, 1998
Broderick, William J.	Farmington Hills, MI	CPA	September 1, 1996 to November 30, 1996
Ruggiero, John M.	Rutland, VT	Attorney	September 1, 1996 to October 31, 1996
Eklund, Mark	Portland, OR	CPA	September 1, 1996 to February 28, 1997
Stayner, G. Craig	Salt Lake City, UT	CPA	September 15, 1996 to June 14, 1997
Allen, Lehman D.	Lubbock, TX	CPA	September 20, 1996 to September 19, 1998
Hardgrove, David L.	Amarillo, TX	CPA	September 21, 1996 to June 20, 1997
Trader, John H.	Kansas City, MO	Attorney	September 30, 1996 to March 29, 1997
Schmertz, Carl D.	Wilmette, IL	CPA	October 1, 1996 to March 31, 1999
Bengston, Wessel	Chicago, IL	CPA	October 15, 1996 to April 14, 1997
Sherman, Richard M.	Crystal Lake, IL	CPA	October 18, 1996 to July 17, 1997
Hunter, Lewis	Jacksonville, FL	CPA	October 25, 1996 to January 24, 1997
Hisken, Donald	Red Bluff, CA	CPA	November 1, 1996 to March 31, 1997
Byrne, Steven P.	Arcadia, CA	Attorney	November 1, 1996 to January 31, 1997
Mulrey, Robert M.	Milton, MA	CPA	November 1, 1996 to October 31, 1997
Edwards, Ronald A.	Plymouth, MI	CPA	November 1, 1996 to April 30, 1998
Hart Jr., Charles E.	Wilmington, OH	Attorney	November 1, 1996 to October 31, 1998
Willner, Peter D.	Stowe, VT	CPA	November 1, 1996 to April 30, 1997
May, Gary	Madison, WI	Attorney	November 1, 1996 to October 31, 1998

Name	Address	Designation	Date of Suspension
Josephson, Elliott	Northbrook, IL	CPA	November 1, 1996 to October 31, 1998
Capwill Jr., James A.	Solon, OH	CPA	November 1, 1996 to February 28, 1997
Hazel, John J.	Ridgefield, CT	Enrolled Agent	November 1, 1996 to January 31, 1997
Jacobs, Patrick	St. Paul, MN	CPA	November 1, 1996 to December 31, 1996
Lau, William	Crete, IL	CPA	November 1, 1996 to June 30, 1997
Franklin, Gene L.	Lees Summit, MO	Enrolled Agent	November 1, 1996 to January 31, 1997
Winterhalter, Charles L.	Cincinnati, OH	CPA	November 1, 1996 to April 30, 1998
Cremer, Patricia L.	Roundup, MT	CPA	November 5, 1996 to May 4, 1997
Gardner, Stephen A.	Dallas, TX	Attorney	November 7, 1996 to May 6, 1999
Masini, David	Wheat Ridge, CO	CPA	November 12, 1996 to November 11, 1997
Cunningham, Michael	Lafayette, IN	CPA	November 12, 1996 to August 11, 1997
Smith, Robert	Chicago, IL	CPA	January 1, 1997 to December 31, 1997

Under 31 Code of Federal Regulations, Part 10, an enrolled agent 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 resignation from such practice. The Director of Practice, in his discretion, may suspend an enrolled agent 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 enrolled agent who has resigned from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants, enrolled agents, and enrolled actuaries to identify former enrolled agents who have resigned from practice before the Internal Revenue Service, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of former enrolled agents who have resigned from such practice, and date of resignation. 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 enrolled agent who has resigned, and will be consolidated and published in the Cumulative Bulletin.

The following individual has offered his resignation as an enrolled agent:

Name	Address	Date of Resignation
Marchioli, Anthony	Dallas, TX	July 12, 1996

Under title 31 of the Code of Federal Regulations, section 10.76, the Director of Practice is authorized to immediately suspend from practice before the Internal Revenue Service any practitioner who, within five years, from the date the expedited proceeding is instituted, (1) has had a license to practice as an attorney, certified public accountant, or actuary suspended or revoked for cause; or (2) has been convicted of any crime under title 26 of the United States Code or, of a felony under title 18 of the United States Code involving dishonesty or breach of trust.

Attorneys, certified public accountants, enrolled agents, and enrolled actuaries are prohibited in any Internal Revenue Service matter from directly or indirectly employing, accepting assistance from, being employed by, or sharing fees with, any practitioner disbarred or suspended from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants, enrolled agents, and enrolled actuaries to identify practitioners under expedited suspension from practice before the Internal Revenue Service, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been suspended from such practice, their designation as attorney, certified public accountant, enrolled agent, or enrolled actuary, and date or period of suspension. This announcement will appear in the weekly Bulletin at the earliest practicable date after such action and will continue to appear in the weekly Bulletins for five successive weeks or for as many weeks as is practicable for each attorney, certified public accountant, enrolled agent, or enrolled actuary so suspended and will be consolidated and published in the Cumulative Bulletin.

The following individuals have been placed under suspension from practice before the Internal Revenue Service by virtue of the expedited proceeding provisions of the applicable regulations:

Name	Address	Designation	Date of Suspension
Bower, Lewis H.	Tampa, FL	CPA	Indefinite from May 30, 1996
Reiss, Irvin L.	Newton, PA	CPA	Indefinite from June 4, 1996

Name	Address	Designation	Date of Suspension
Reynolds, Mark E.	Brownsburg, IN	Attorney	Indefinite from July 1, 1996
Moore, Philip J.	Rome, GA	CPA	Indefinite from July 10, 1996
Broek, Kevin J.	Omaha, NE	CPA	Indefinite from July 10, 1996
Bein, William	Beachwood, OH	Attorney	Indefinite from August 1, 1996
Henry, Gregory	Bradford, PA	Attorney	Indefinite from August 1, 1996
Sadler, George A.	Houston, TX	Attorney	Indefinite from August 1, 1996
Fuhr IV, John Henry	Dallas, TX	CPA	Indefinite from August 1, 1996
Rakov, Harris J.	Mahwah, NJ	Attorney	Indefinite from August 1, 1996
Perkell, Mark E.	S. Burlington, VT	Attorney	Indefinite from August 1, 1996
Darrah, Robert J.	Neola, IA	CPA	Indefinite from August 21, 1996
Constantino, Enrico J.	Bay Shore, NY	Attorney	Indefinite from August 27, 1996
VanLoan, Jonathan A.	Frazer, PA	Attorney	Indefinite from August 27, 1996
Bennett, John J.	Milford, CT	Attorney	Indefinite from August 27, 1996
Lavin-Munch, Carole A.	Merrionette Pk, IL	CPA	Indefinite from August 27, 1996
Alleva, Donald	Mount Vernon, NY	Enrolled Agent	Indefinite from September 5, 1996
Rose, Robert M.	Dallas, TX	Attorney	Indefinite from September 5, 1996
McGrath, Gregory	New Smyrna Bch, FL	CPA	Indefinite from September 8, 1996
Finch Jr., Kenneth L.	Pelham, AL	CPA	Indefinite from September 8, 1996
Pacchiana, Paul	Chappaqua, NY	Attorney	Indefinite from October 9, 1996
Rosenberger, David H.	Centerville, OH	Enrolled Agent	Indefinite from October 21, 1996
Gudes, Gerald	W. Bloomfield, MI	CPA	Indefinite from October 22, 1996
Donnelly, Richard S.	Asheville, NC	CPA	Indefinite from October 22, 1996
Burrows, William D.	Dallas, TX	Attorney	Indefinite from November 13, 1996
Klausner, Julius	Scarsdale, NY	CPA	Indefinite from November 13, 1996
Glessner, Randy	Omak, WA	CPA	Indefinite from November 13, 1996
Aspland, Frieda R.	Greenville, SC	CPA	Indefinite from November 13, 1996

Under Section 330, Title 31 of the United States Code, the Secretary of the Treasury, after due notice and opportunity for hearing, is authorized to suspend or disbar from practice before the Internal Revenue Service any person who has violated the rules and regulations governing the recognition of attorneys, certified public accountants, enrolled agents, or enrolled actuaries to practice before the Internal Revenue Service.

Attorneys, certified public accountants, enrolled agents, and enrolled actuaries are prohibited in any Internal Revenue Service matter from directly or indirectly employing, accepting assistance from, being employed by, or sharing fees with, any practitioner disbarred or under suspension from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants, enrolled agents, and enrolled actuaries to identify such disbarred or suspended practitioners, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been suspended from such practice, their designation as attorney, certified public accountant, enrolled agent, or enrolled actuary, and the date of disbarment or period of suspension. This announcement will appear in the weekly Bulletin for five successive weeks or as long as it is practicable 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	Effective Date
Bushta, Patrick C.	Sacramento, CA	CPA	April 18, 1996
Hart, Joel S.	Beaumont, TX	CPA	April 19, 1996
Riggs, Patricia A.	Stockton, CA	Enrolled Agent	April 19, 1996
Hammontree, Richard F.	Ogunquit, ME	CPA	April 27, 1996

Name	Address	Designation	Effective Date
Otto, Judith M.	Tucson, AZ	Enrolled Agent	May 18, 1996
Styvaert, Richard	San Diego, CA	CPA	July 5, 1996
Davis Jr., George L.	Washington, DC	Enrolled Agent	August 15, 1996

Index

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

Automatic extensions for Forms W–2 (RP 57) 389

Levy:

Table, exempt from levy on wages, salary, and other income (Notice 56) 223

Modification of RP 84–77 (RP 60) 399

Proposed regulations:

26 CFR 301.9100–1T—301.9100–3T and intermediary sections, added; extensions of time to make elections (IA–29–96) 483

Railroad retirement:

Rate determination, quarterly (July 1, 1996) 162; (October 1, 1996 and January 1, 1997) 162

Regulations:

26 CFR 301.9100–1T—301.9100–3T and intermediary sections, added; extensions of time to make elections (TD 8680) 194

Social security contribution and benefit base (1997) 434

ESTATE AND GIFT TAX ADMINISTRATIVE

Gift of checks (RR 56) 161

Proposed regulations:

26 CFR 20.2041–3, 20.2056(d)–2, 25.2511–1, 25.2514–3, 25.2518–1, –2, amended; 20.2041–3, added; disclaimer of interests and powers (REG–208215–91) 491

ESTATE AND GIFT TAX ADMINISTRATIVE—Continued

Proposed regulations—Continued

26 CFR 301.9100–1T—301.9100–3T and intermediary sections, added; extensions of time to make elections (IA–29–96) 483

ESTATE TAX

Proposed regulations:

26 CFR 20.2041–3(d)(6)(i), amended; 20.2041–3(d)(6)(iii), added; 20.2056(d)–2, amended; disclaimer of interests and powers (REG–208215–91) 491

Qualified domestic trust (RP 54) 386

Regulations:

26 CFR 301.9100–1T—301.9100–3T and intermediary sections, added; extensions of time to make elections (TD 8680) 194

26 CFR 20.2056A–0, revised; 20.2056A–2(d), added; 20.2056A–2T, removed; qualified domestic trusts; requirements to ensure estate tax collection (TD 8686) 152

EXCISE TAXES

Exempt organizations:

Excess benefit transactions engaged in (Notice 46) 212

Foreign insurance taxes (Ct.D 2060) 163

Proposed regulations:

26 CFR 2652–1, amended; generation-skipping transfer tax (PS–22–96) 491

Regulations:

26 CFR 40.6011(a)–1, –2(b)(2), 40.6302(c)–1, –2, –3, –4, 40.9999–1, 48.4082–2(a), 48.4083–1, 48.6715(a); amended; Subpart F of 49.4291–1, added; 40.6302(c)–5T, 48.6427–7, 301.6156–1, 301.6206–1, 301.6415–1—6421–1 and intermediary sections, 301.6423–1, 301.6675–1, removed; 48.6714–1, redesignated, excise tax deposits (TD 8685) 174

GIFT TAX

Gift of checks (RR 56) 161

Proposed regulations:

26 CFR 25.2511–1, 25.2514–3, 25.2518–1, –2, amended; disclaimer of interests and powers (REG–208215–91) 491

INCOME TAX

Accounting methods (Notice 40) 210

Advance pricing agreement (RP 53) 375

Bankruptcy; validity of liens (Ct.D 2059) 179

Base period T-bill rate for 1996 (RR 55) 57

Bonds:

Qualified mortgage bonds:

Mortgage credit certificates:

National median gross income (RP 37) 299

Claiming a refund, U.S. v. IBM (Notice 37) 208

Cost-of-living adjustments, 1997 (RP 59) 392

Covered compensation tables; 1997 (RR 53) 34

CPI adjustment for below-market loans for 1997 (RR 64) 199

Credits against tax:

Low-income housing (RP 46) 338; (RP 51) 370

Satisfactory bond, "bond factor" amounts for the period July through September 1996 (RR 45) 4; October—December 1996 (RR 59) 5

Damages for personal injuries or sickness (RR 65) 6

Educational assistance after termination of employment (RR 41) 8

Educational assistance program, section 127 (Notice 68) 236

Electronic filing program for Form 1040 series, 1997 (RP 61) 401

Employees attaining age 70 1/2 in 1996 (Notice 67) 235

Employee plans:

Funding:

Full funding limitations, weighted average interest rate, June 1996 (Notice 36) 208; July 1996 (Notice 38) 209; August 1996, (Notice 43) 211; September 1996 (Notice 45) 212; October 1996 (Notice 54) 222; November 1996 (Notice 59) 226; December 1996 (Notice 66) 235

Limit on contributions and benefits; cost-of-living adjustments (Notice 55) 222

Nondiscrimination and coverage, rollover (RR 48) 31

Participant consent, significant detriment (RR 47) 35

Qualification (RP 55) 387

Requests for comments on proposed guidance for section 457 plans (Notice 63) 228

Section 414(u); retirement plans; model amendments (RP 49) 369

Tax-sheltered annuities; correction program; extension (RP 50) 370

Exempt organizations:
Group letter exemption (RP 40) 301
Private inurement expressly prohibited (Notice 47) 213
Information returns, copies to the public and increases to certain penalties (Notice 48) 214
Forms:
Paper substitutes, Forms 1096, 1098, 1099 series, 5498, and W–2G (RP 42) 306
Substitute printed, computer-prepared, and computer-generated tax forms and schedules (RP 48) 339
Fringe benefits aircraft valuation formula (RR 58) 6
Governmental plans (Notice 64) 229
Guidance for acceptance agent program (RP 52) 372
Income:
Controlled foreign corporation, partnership, subpart F income (Notice 39) 209
Indian tribal casinos, information reporting (Notice 57) 225
Inflation-adjusted numbers for 1997 (RR 63) 83
Inflation adjustment factor for 1996 (Notice 41) 211
Inflation-indexed debt instruments (Notice 51) 216
Information reporting:
Discharge of indebtedness (Notice 61) 227
Insurance companies:
Differential earnings rate (RR 42) 45
Loss reserves, discounting unpaid losses (RP 44) 330
Discounting estimated salvage recoverable (RP 45) 336
Interest:
Investment:
Federal short-term, mid-term, and long-term rates, July 1996 (RR 34) 75; August 1996 (RR 37) 77; September 1996 (RR 43) 78; October 1996 (RR 49) 79; November 1996 (RR 52) 81; December 1996 (RR 57) 82
Rates, underpayments and overpayments beginning October 1, 1996 (RR 44) 187; (RP 61) 401

INCOME TAX—Continued

Inventories:
LIFO:
Price indexes, department stores, May 1996 (RR 36) 38; June 1996 (RR 39) 39; July 1996 (RR 46) 40; August 1996 (RR 50) 41; September 1996 (RR 54) 42; October 1996 (RR 60) 43
Low income housing credit:
Bond factor amounts, April–June 1996 (RR 33) 3
FEMA (RR 35) 4
Marginal production rates for 1996 (Notice 42) 211
Medical savings accounts (Notice 53) 219
Offers in compromise; substitute Forms 656 (RP 38) 300
On-line filing program for Form 1040 series, 1997 (RP 62) 412
Optional standard mileage rates, 1997 (RP 63) 420
Penalty provisions, filing requirements (Notice 60) 227
Per diem allowances (RP 64) 427
Pooled income fund; community trust; maintenance requirement (RR 38) 44
Proposed regulations:
26 CFR 1.61–8(b), revised; 1.451–1(g), added; 1.467–1, amended; 1.467–4, amended; 1.467–0 through –8, added; rental agreements (IA–292–84) 462
26 CFR 1.61–12(c), 1.163–7(c), 1.171–1—1.171–4, 1.1016–5(b), revised; 1.163–13, 1.171–5, added; 1.1016–9, removed; amortizable bond premium (FI–48–95) 449
26 CFR 1.148–5(d)(6)(iv)—(viii) and intermediary sections; 1.148–5(e)(2)(iv), added; arbitrage restrictions on tax-exempt bonds (FI–28–96) 458
26 CFR 1.166–3(a)(3), added; bad debts modifications and dealer assignments of notional principal contracts (FI–59–94) 442
26 CFR 1.280B–1, added; structure, definition (PS–39–93) 489
26 CFR 1.367(e)–1, 1.6038B–1(b)(2)(i); section 355 distributions of stock and securities by domestic corporations to foreign persons (REG–209827–96) 507

INCOME TAX—Continued

Proposed regulations—Continued
26 CFR 1.382–5, –8, added; 1.382–2(a)(1)(iv), revised; consolidated returns, short taxable years for controlled groups (CO–26–96) 440
26 CFR 1.401(a)(31)–1; 1.402(c)–2, amended; relief from disqualification of plans accepting rollovers (REG–245562–96) 509
26 CFR 1.475(b)–1, –2, –4, 1.475(c)–1, –2, 1.475(e)–1, revised; mark-to-market equity interests in related parties and dealer-customer relationship (FI–32–95) 443
26 CFR 1.671–1(g), (h), 1.671–2(f), 1.1297–4, added; application of the grantor trust rules to nonexempt employees' trusts (REG–209826–96) 498
26 CFR 1.861–8(e)(7)(iii), 1.865–1, –2, 1.904–4(c)(2)(ii)(A) and (B), added; 1.904–0, amended; stock disposition loss allocation (INTL–4–95) 484
26 CFR 1.861–18, added; classification of certain transactions involving computer programs (REG 251520–96) 511
26 CFR 1.1059(e)–1, added; extraordinary dividends; distributions to corporate shareholders (CO–9–96) 436
26 CFR 1.1202–0, –2, added; qualified small business stock (IA–26–94) 479
26 CFR 1.1502–15, –21, –22, –23, added; consolidated returns, limitations on the use of certain losses and deductions (CO–24–96) 437
26 CFR 1.1502–90T—1.1502–99T and intermediary sections, added; consolidated group, net operating loss carryforwards and built-in losses and credits following ownership change, limitation (CO–25–96) 439
26 CFR 1.6045–1, –2, 301.6011–2, revised; magnetic media filing requirements for information returns (REG–209803–95) 497
26 CFR 1.6662–0, –3, amended; 1.6662–4(d)(2), –7(d), revised; 1.6664–0, amended; definition of reasonable basis (IA–42–95) 481
26 CFR 301.9100–1T—301.9100–3T and intermediary sections, added; extensions of time to make elections (IA–29–96) 483
Qualified State Tuition Program (Notice 58) 226

Recommendation letters for nonsuit settlements (Del. Order 155, Rev. 4) 208
Refund claims; Tax Court; return not filed (Ct.D. 2058) 181
Regulated investment companies, preferential dividends (RP 47) 338
Regulations:
26 CFR 1.110–3, added; debt instruments modifications (TD 8675) 60
26 CFR 1.163–7(a), added; 1.446–4, amended; 1.483–2T, removed; 1.483–4, added; 1.1001–1, revised; 1.1012–1(g), revised; 1.1271–0(b), amended; 1.1272–1(c)(7), added; 1.1274–2(g), revised; 1.1274–2(i) and (j), added; 1.1275–2(g), (h), (i), (j), added; 1.1275–2T, removed; 1.1275–4, added; 1.1275–5(a)(5), (6), added; 1.1275–5(c)(1), (5), revised; 1.1275–6, added; debt instruments with original issue discount, contingent payments, anti-abuse rule (TD 8674) 84
26 CFR 1.166–3T, 1.1001–4T, added; bad debts modifications and dealer assignments of notional principal contracts (TD 8676) 9
26 CFR 1.367(e)–0; 1.367(e)–1, removed; 1.367(e)–0T, –1T, added; section 355 distributions of stock and securities by domestic corporations to foreign persons (TD 8682) 12
26 CFR 1.382–5T, –8T, –2T(f)(1)(i)—(iii) and intermediary sections, added; 1.382–2, –2T, removed; consolidated groups, short taxable years for controlled groups (TD 8679) 25

Regulations—Continued
26 CFR 1.863–0, –1(e), –3, added; 1.863–1(a), (b), (c), –2, –4, revised; 1.863–5, removed; source of income from sales of inventory and natural resources produced in one jurisdiction and sold in another jurisdiction (TD 8687) 47
26 CFR 1.1254–2(d)(1)(ii), –3(b)(1)(i) and (ii), –3(d)(1)(i) and (ii), revised; 1.1254–4, –6, amended; treatment of gain from disposition of interest in certain natural resource recapture property by S corps and their shareholders (TD 8684) 70
26 CFR 1.1394–0, –1, added; enterprize zone facility bonds (TD 8673) 112
26 CFR 1.1502–0, –1, –2, –11, –21A, –22A, –23A, –41A, revised; 1.1502–15, –21, redesignated, 1.1502–21T, –23T, –79A, added; 1.1502–79, amended; consolidated returns, limitations on the use of certain losses and deductions (TD 8677) 119
26 CFR 1.1502–90T through –99T and intermediary sections, added; consolidated groups, net operating loss carryforwards and built-in losses and credits following ownership change, limitations (TD 8678) 134
26 CFR 1.6045–1(q), –2, amended; 1.6045–1T, –2T, 301.6011–2T, added; magnetic media filing requirements for information returns (TD 8683) 169
26 CFR 301.6355–1, amended; sale of seized property (GL–7–96) 460

Regulations—Continued
26 CFR 301.7503–1, amended; time for performance of acts where last day falls on Saturday, Sunday, or legal holiday (TD 8681) 192
26 CFR 301.9100–1T—301.9100–3T and intermediary sections, added; extensions of time to make elections (TD 8680) 194
Returns:
Magnetic media reporting, Forms 1098, 1099, 5498, and W–2G (RP 36) 237
Section 355 de minimis limitation (RP 43) 330
Section 355 No Rule (RP 39) 300
Section 457 "no rule" rev. proc. (RP 56) 389
Statements required by brokers; correction (Notice 50) 216
Substitute Forms 1099; logos (Notice 62) 228
Tax conventions:
Fiji, 202
Jordan, 202
Luxembourg, 203
Russia, 205
Taxes, accrual of deduction (RR 51) 36
Tax-exempt bonds; arbitrage (RR 41) 8; (Notice 49) 215
Tax treatment of partnership items correction (Notice 44) 212
Training costs; business expenses (RR 62) 9
Trust treatment, domestic or foreign by PL 104–188 (Notice 65) 232
Work opportunity tax credit (Notice 52) 218

*U.S. G.P.O.:1997-418-361:40015