Internal Revenue

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1990–2

July-December

Department of the Treasury
Internal Revenue Service

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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 1990-2 is a consolidation of all items of permanent nature published in the weekly Bulletins 1990-27 through 1990-53 for the period of July 1 through December 31, 1990.

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

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

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

Definition of Terms

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

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

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

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

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

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

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

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

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

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

Abbreviations

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

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

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Cumulative List of Announcements Relating to Decisions of the Tax Court Published in the Internal Revenue Bulletin from January 1, 1990 thru December 31, 1990

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

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

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

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

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

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

The Commissioner ACQUIESCES in the following decisions:

Taxpayer	Docket No.	*Report* Volume	Page
Casanova Co [1]	25468-84	87	214
Davis, Ronald, et ux [2]	7717-87	92	351
DiMarco, Est. of Anthony F., Joan M. DiMarco, Personal Representative [3]	18965-83	87	653
Fisher Companies, Inc. [4]	16064-83	84	1319
Frontier Savings Association & Subs. [5]	16209-81) 24559-83)	87	665
Illinois Grain Corp. [6]	6332-84	87	435
Illinois Power Co. [7]	28136-84	87	1417
Laureys, Frank J., Jr., et ux [8]	23490-85	92	101
Lucky Stores, Inc. [9]	35251-86) 47728-86)	92	1151
Matthews, David W., et ux [2]	4254-87	92	351
Neisen, Est. of Leander, Elizabeth Neisen, Personal Rep. [10]	4909-86	89	939
Perkins, James W. [11]	14968-87	92	749
Sierracin Corp. [12]	28569-83	90	341
Smith, Est. of Frederick R., Frederick D. Smith & Kay A. Hemingway, personal representatives [13]	30821-88	94	872

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Taxpayer	Docket No.	*Report* Volume	Page
Egger, Est. of Luis G., James H. Powell, Executor [14]	39777-86	92	1079
Fisher Companies, Inc. [15]	16064-83	84	1319
Illinois Grain Corp. [16]	6332-84	87	435
Laureys, Frank J., et ux [17]	23490-85	92	101
Lucky Stores, Inc. [18]	35251-86) 47728-86)	92	1151
Marcor, Inc. & Sub. [19]	13037-82) 29876-82)	89	181

[1] Acquiescence relating to whether petitioner was required to withhold income tax at the source on interest paid to Laatam, N.V., a Netherlands Antilles corporation pursuant to sections 1441 and 1442 of the Code, and/or applicable treaty provisions.

[2] Acquiescence relating to whether the court correctly concluded that petitioners should be entitled to rely upon the receipt of a refund by another taxpayer as IRS acceptance of their position.

[3] Acquiescence in result relating to whether a survivor's income benefit is taxable as a gift where (1) decedent is automatically covered by the benefit

plan and has no control over its terms; (2) decedent's employer retains the right to modify the plan; and (3) decedent's death is the event which first causes the value of the benefit to be ascertainable. Acquiescence "in result" means acceptance of the Court but disagreement with some or all the reasons assigned for the decision.

[4] Acquiescence relating to whether a violation is a "related violation" within the meaning of section 162(g) of the Code where there is no injunction against the taxpayer accompanying the guilty *nolo contendere* plea in the criminal proceeding.

[5] Acquiescence relating to whether any member bank receiving a stock dividend from a Federal Home Loan Bank has an election to receive stock or property within the meaning of section 305(b)(1) of the Code.

[6] Acquiescence in result in part relating to whether barge rental income a non-exempt cooperative received was patronage- or nonpatronage-sourced income.

[7] Acquiescence in result relating to whether a transfer of nuclear fuel by petitioner to Illinois Power Fuel Co. (IPF) which was cast as a sale-leaseback was in reality a financing arrangement and whether petitioner is entitled to deduct the liability it accrued for "lease" charges in connection with the transfer of the fuel. Acquiescence "in result" means acceptance of the Court but disagreement with some or all the reasons assigned for the decision.

[8] Acquiescence relating to whether petitioner's transactions were entered into primarily for profit.

[9] Acquiescence relating to whether the WIN credit available for tax years beginning prior to 1982 is allowable with respect to employees not certified as eligible at the time their employment began.

[10] Acquiescence in result relating to whether a decedent's will contained a formula bequest within the meaning of section 403(e)(3) of the Economic Recovery Tax Act of 1981, which precludes petitioner from qualifying for an unlimited marital deduction under section 2056 of the Code. Acquiescence "in result" means acceptance of the Court but disagreement with some or all of the reasons assigned for the decision.

[11] Acquiescence in result relating to whether a petitioner can pay interest on a determined deficiency which is before the Tax Court for redetermination without either paying at least a portion of the deficiency or consenting to its assessment. Acquiescence "in result" means acceptance of the Court but disagreement with some or all the reasons assigned for the decision.

[12] Acquiescence in the issue relating to whether petitioner was entitled to use the completed contract method of accounting in reporting income from certain multi-unit manufacturing contracts based on the rationale that the products manufactured under such contracts were "unique" items within the meaning of section 1.451-3(b)(1)(ii) of the regulations. Acquiescence in result in the issue relating to whether such contracts should be severed by delivery pursuant to section 1.451-3(e) of the regulations in order to clearly reflect income. Acquiescence "in result" means acceptance of the Court but disagreement with some or all the reasons assigned for the decision.

[13] Acquiescence relating to whether the Commissioner, after increasing the value of "adjusted taxable gifts" for estate tax purposes under section 2001(b)(1)(B) of the Code when the time in which to assess a deficiency in gift tax stemming from such gifts has expired under section 2504(c) and section 6501, should adjust the amount of the gift tax subtraction under section 2001(b)(2) to reflect the increase in value.

[14] Nonacquiescence relating to whether, on remand to the Tax Court, the Tax Court should vacate its earlier decision solely in order to enter a new decision that takes into account additional administration expenses and interest accruing on the deficiency that were not claimed when the case was previously before the Tax Court.

[15] Nonacquiescence relating to if a lump sum payment in settlement of a civil suit is for a period during which there was a violation described in section 162(g) of the Code and this period is contained in the period described in the civil suit, is the payment required to be allocated in proportion to the length of time of each to these periods.

[16] Nonacquiescence in part relating to whether interest income a nonexempt cooperative received on short-term investments was patronage- or nonpatronage-sourced income.

[17] Nonacquiescence relating to whether offsetting positions in stock options constitute a guarantee, stop loss agreement, or similar arrangement within the meaning of section 465(b)(4) of the Code.

[18] Nonacquiescence relating to whether the WIN credit available for years prior to 1982 is allowable with respect to employees employed less than 30 hours per week.

[19] Nonacquiescence relating to whether the costs of providing installation, preparation and fabrication services are includable in total contract price used in calculating deferred gross profit from installment sales pursuant to the provisions of section 453 of the Code.

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 1991 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." See Rev. Proc. 90-64, page 674.

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

Section 25.—Interest on Certain Home Mortgages

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

Average area purchase price safe harbor limitations for Guam and Puerto Rico are added to the list in Rev. Proc. 89-59, 1989-2 C.B. 771. See Rev. Proc. 90-51, page 625.

Subpart B.—Foreign Tax Credit, Etc.

Section 29.—Credit for Producing Fuel from a Nonconventional Source

Credit for producing fuel from a nonconventional fuel source. For the purposes of section 29 of the Code, a well is "drilled" before January 1, 1991, if continual drilling of the well is commenced by spudding the well before January 1, 1991.

Rev. Rul. 90-70

ISSUE

For purpose of the credit for producing fuel from a nonconventional source under section 29 of the Internal Revenue Code, is a well "drilled" before January 1, 1991, if continual drilling of the well is commenced by "spudding in" of the well before that date?

FACTS

X is involved in the exploration, development, drilling, production, and marketing of natural gas and oil, as well as extraction and sale of natural gas liquids. *X* intends to drill several wells in Devonian shale formations during 1990. *X* expects that on January 1, 1991, it will be in the process of drilling wells that were "spudded in" prior to January 1, 1991, and that drilling operations on these wells will continue until each well's productive horizon is reached.

Some of the steps involved in drilling an oil or gas well include the following. Once a specific well location has been selected, the site is prepared by building roads, constructing a level drill site, and digging mud pits. When the drill site has been prepared, a drilling rig is moved in and assembled, and the drilling activities are begun with the initial boring of the hole. This initial drilling is known as "spudding in" the well.

As drilling continues, fresh water sources may be found that must be protected from possible contamination by oil or gas from deeper formations. Casing, which is heavy steel pipe, is run into the well and cemented. Once the cement is hardened, the drilling proceeds until the targeted formation is reached. During this drilling process, information is obtained about the formations that are being penetrated. If a hydrocarbon formation is encountered, a formation test is run to determine the producing characteristics of the formation.

Once a well is drilled to its intended depth, a decision must be made whether to run casing into the well and complete it for production or to abandon the well. This is known as the "casing point." If a decision is made to complete it, production casing is run into the well.

LAW AND ANALYSIS

Section 29(a) of the Code provides an income tax credit for certain qualified fuels produced and sold by the taxpayer. The credit is an incentive to drill wells that otherwise might not be economically feasible to drill. The credit is allowed per barrel-of-oil equivalent of qualified fuels produced and sold by January 1, 2001. With respect to qualified fuels produced from wells, section 29(f)(1)(A)(i) states that the credit is allowed for the production of qualified fuels from wells drilled after December 31, 1979, but before January 1, 1991. However, the Code does not define the term "drilled."

The date on which a well is spudded is a readily established date. The use of such date will facilitate the administration of these rules for taxpayers and the Service.

Accordingly, a well will be considered to have been drilled if it is "spudded in" before January 1, 1991, and if there is continual drilling to the productive horizon. For this purpose, the suspension of drilling operations that occurs just above the production horizon under the so-called "open-hole completion" method will not be considered a termination of continual drilling. Drilling will be considered to be continual even when delays occur if those delays result from factors that are beyond a taxpayer's control. Delays caused by the need to make mechanical repairs, the presence of unusually severe weather conditions, or the operation of any federal or state law are examples of delays ordinarily caused by factors that are beyond the taxpayer's control. Unavailability of drilling rigs will not be treated as a factor beyond the taxpayer's control.

HOLDING

If a well is "spudded in" before January 1, 1991, and there is continual drilling until the productive horizon is reached, then the well is considered to have been "drilled" before January 1, 1991, for purposes of section 29(f)(1)(A)(i) of the Code.

Subpart C.—Refundable Credits

Section 32.—Earned Income

26 CFR 1.43-2: Earned income credit for taxable years beginning after December 31, 1978.

The Service is providing inflation adjustments to the earned income credit amounts (including the supplemental young child credit and the health insurance credit) for taxable years beginning in 1991. See Rev. Proc. 90-64, page 674.

Subpart D.—Business Related Credits

Section 42.—Low-Income Housing Credit

Low-income housing credit; satisfactory bond. Guidance is provided

on the amount of bond considered satisfactory by the Secretary and the period of the bond required by the Secretary under section 42(j)(6) of the Code. Also monthly "bond factor" amounts to be used by taxpayers who dispose of low-income housing buildings or interests therein, during calendar years 1987, 1988, 1989, and the first seven months of calendar year 1990 are announced.

Rev. Rul. 90-60

Section 42(a) of the Internal Revenue Code allows a 10-year tax credit for investment in qualified low-income buildings placed in service after December 31, 1986. Section 7108 of the Revenue Reconciliation Act of 1989, 1990-1 C.B. 210, 217, extended the credit and amended certain provisions of section 42. The amount of the low-income housing credit for any tax year in the credit period is an amount equal to the product of the applicable percentage and the qualified basis of each qualified low-income building.

If, at the close of any tax year in the compliance period, the amount of the qualified basis of any building with respect to the taxpayer is less than the amount of the qualified basis at the close of the preceding tax year, section 42(j)(1) of the Code provides that the taxpayer's tax for the tax year shall be increased by the credit recapture amount under section 42(j)(2). However, under section 42(j)(6), a taxpayer that disposes of a qualified low-income building or an interest therein may defer or avoid recapture by furnishing a bond to the Secretary in an amount satisfactory to, and for the period required by, the Secretary if it is reasonably expected that the building will continue to be operated as a qualified low-income building for the remainder of the building's compliance period.

The taxpayer's obligation under the bond must be secured by a surety, and the company acting as surety on the bond must hold a Certificate of Authority from the Department of the Treasury, Financial Management Service. These companies are listed in Treasury Department Circular 570, Companies Holding Certificates of Authority as Acceptable Sureties on Federal Bonds and as Acceptable Reinsuring Companies.

The purpose of the bond is to secure the taxpayer's liability for credit recapture under section 42(j) of the Code with respect to the taxpayer's disposition of an interest in a qualified low-income building during the compliance period. If a taxpayer furnishes a bond under section 42(j)(6) with respect to the disposition of an interest in a qualified low-income building, the taxpayer will be treated, solely for purposes of applying section 42(j) with respect to the disposition, as if the taxpayer had not disposed of the interest. Instead, the taxpayer's recapture (if any) with respect to the disposed-of interest will be determined under the rules of section 42(j) by deeming the taxpayer to continue to own the disposed-of interest and by determining the qualified basis for the deemed interest in accordance with the rules of section 42(c). The taxpayer will not, however, be treated as claiming any additional low-income housing credit with respect to the disposed-of interest for any period following the disposition.

If the qualified basis with respect to the taxpayer's deemed interest in a qualified low-income building decreases after a disposition of the taxpayer's interest in the qualified low-income building, the bond may be forfeited in whole or in part. If a bond is forfeited only in part (i.e., the taxpayer's qualified basis in the deemed interest decreases, but is not eliminated), the nonforfeited portion of the bond remains subject to forfeiture in the event of subsequent decreases in qualified basis with respect to the taxpayer's deemed interest. For example, the Government could call a portion of a bond during the bond's term due to a decrease in qualified basis with respect to the taxpayer's deemed interest and could later call an additional portion of the bond due to a further decrease in qualified basis with respect to the taxpayer's deemed interest. Forfeiture could also result if the building ceases to be a qualified low-income building because such a cessation reduces to zero the qualified basis with respect to the taxpayer's deemed interest in the building.

In the event of a decrease in qualified basis, the amount of the bond forfeited generally will be (i) the credit recapture amount computed under section 42(j) of the Code with respect to the deemed interest (including interest at the overpayment rate through the date the return is due, without regard to extensions, for the year in which the event giving rise to forfeiture occurs), plus (ii) interest accruing on such amount as described under section 6621(a)(2) from the date the return is due, without regard to extensions, for the year in which the event giving rise to forfeiture occurs, through the date the Government collects the proceeds of the bond. It is the responsibility of the taxpayer to provide any documentation necessary to compute the credit recapture amount under section 42(j).

The Secretary has determined that a bond furnished under section 42(j)(6) of the Code must be maintained for a period that ends no sooner than the date that is 58 months after the last day of the compliance period for the building. The Secretary will publish in the Internal Revenue Bulletin a table of "bond factor" amounts for dispositions occurring during each calendar month. In general, taxpayers can ascertain the minimum bond that the Secretary considers satisfactory for qualified low-income buildings or interests therein that are disposed of during that calendar month by using the bond factor amount that corresponds to the month of disposition and the first year of the building's credit period—either the year the building was placed in service or the succeeding calendar year if the section 42(f)(1) election was made.

The minimum required bond amount is generally the product of (1) the total credits that the taxpayer has claimed (as well as any additional credits the taxpayer anticipates claiming for any year or portion thereof preceding the date of disposition), (2) the appropriate bond factor amount pertaining to the month in the compliance period during which the disposition occurred and the first year of the building's credit period, and (3) the percentage of the taxpayer's total interest in the qualified low-income building disposed of by the taxpayer, taking into account the de minimis rule described below. (It is not necessary for the taxpayer to calculate the amount of credits claimed on an accelerated basis, as the bond factor

amount takes this into account.) The term "total credits" includes any carrybacks and carryforwards that have been deferred. However, the term "total credits" does not include credit amounts previously recaptured, credit amounts with respect to which a bond was previously posted by the taxpayer, or credits taken on additions to qualified basis that are not subject to recapture because they are not claimed on an accelerated basis. In the event a taxpayer that has furnished a bond files an amended return claiming credits in excess of those included in the calculation of the bond factor amount, that taxpayer is subject to recapture with regard to the excess credits claimed unless the taxpayer furnishes an additional bond with respect to such excess credits.

For administrative convenience, the Service intends to issue regulations adopting a de minimis rule pursuant to which a taxpayer who is a partner in a partnership owning an interest in a qualified low-income building (other than a partnership described in section 42(j)(5)(B) of the Code) may elect to avoid or defer recapture by reason of dispositions of interests in the partnership without furnishing a bond until the taxpayer has, in the aggregate, disposed of more than 33-1/3 percent of that taxpayer's greatest total interest in the qualified low-income building through the partnership at any point in time. Once dispositions aggregate more than 33-1/3 percent, the de minimis rule will no longer be available and further deferral with respect to those dispositions will be possible only if the taxpayer furnishes a bond. The taxpayer that defers recapture by reason of the disposition of an interest under the de minimis rule will remain subject to recapture under section 42(j) with respect to that interest. Regulations containing the de minimis rule will be forthcoming and may modify the rules set forth above.

After the publication of this revenue ruling, the previous 50 percent de minimis rule mentioned in the instructions to Schedule A of Form 8609 is no longer available. A taxpayer, other than a taxpayer in a partnership relying on the 33-1/3 percent de minimis rule, may avoid or defer recapture with respect to a disposition of an interest in a qualified low-income building only if the taxpayer furnishes a bond with respect to such disposition.

However, in the case of taxpayers (other than taxpayers in partnerships relying on the 33-1/3 percent de minimis rule) that disposed of less than 50 percent of their interest (direct or indirect) in a qualified low-income building before the publication of this ruling but have neither furnished a bond nor paid recapture with respect to such dispositions, a special rule applies. Those taxpayers may continue to defer recapture by reason of their prior dispositions, without furnishing a bond with respect to those dispositions, until the date they dispose of any additional interest, direct or indirect, in the qualified low-income building. This rule is intended to apply to those taxpayers who previously relied on the 50 percent de minimis rule mentioned in the instructions to Schedule A of Form 8609. For purposes of this rule, a written binding contract to dispose of an interest in a qualified low-income building is deemed to constitute a disposition as of the date the contract is entered into.

Taxpayers that disposed of 50 percent or more of their interest (direct or indirect) in a qualified low-income building before the publication of this revenue ruling but have neither furnished a bond nor paid recapture with respect to such dispositions may continue to defer recapture by reason of their prior dispositions only by furnishing a bond securing their liability for recapture with respect to those dispositions. This bond must be furnished in accordance with the provisions of this revenue ruling within 6 months after publication of this revenue ruling.

The bond factor amounts for calculating a disposition bond under section 42(j)(6) of the Code for dispositions occurring during calendar years 1987, 1988, 1989 and the first seven months of 1990 are contained in the accompanying table.

Rev. Rul. 90-60

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
January 1987	150.72%	0.00%	0.00%	0.00%
February 1987	150.72	0.00	0.00	0.00
March 1987	150.72	0.00	0.00	0.00
April 1987	150.72	0.00	0.00	0.00
May 1987	150.72	0.00	0.00	0.00
June 1987	150.72	0.00	0.00	0.00
July 1987	150.72	0.00	0.00	0.00
August 1987	150.72	0.00	0.00	0.00
September 1987	150.72	0.00	0.00	0.00
October 1987	150.72	0.00	0.00	0.00
November 1987	150.72	0.00	0.00	0.00
December 1987	150.72	0.00	0.00	0.00
January 1988	149.68	151.51	0.00	0.00
February 1988	148.78	151.51	0.00	0.00

Rev. Rul. 90-60

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
March 1988	148.00	151.51	0.00	0.00
April 1988	147.32	151.51	0.00	0.00
May 1988	146.72	151.51	0.00	0.00
June 1988	146.18	151.51	0.00	0.00
July 1988	145.70	151.51	0.00	0.00
August 1988	145.27	151.51	0.00	0.00
September 1988	144.88	151.51	0.00	0.00
October 1988	144.53	151.51	0.00	0.00
November 1988	144.21	151.51	0.00	0.00
December 1988	143.91	151.51	0.00	0.00
January 1989	143.09	150.35	150.76	0.00
February 1989	142.34	149.36	150.76	0.00
March 1989	141.64	148.49	150.76	0.00
April 1989	140.98	147.74	150.76	0.00
May 1989	140.38	147.07	150.76	0.00
June 1989	139.81	146.48	150.76	0.00
July 1989	139.29	145.95	150.76	0.00
August 1989	138.79	145.47	150.76	0.00
September 1989	138.33	145.04	150.76	0.00
October 1989	137.89	144.65	150.76	0.00
November 1989	137.47	144.29	150.76	0.00
December 1989	137.08	143.96	150.76	0.00
January 1990	136.40	143.14	149.65	150.76
February 1990	135.75	142.38	148.71	150.76
March 1990	135.13	141.68	147.89	150.76
April 1990	134.54	141.03	147.17	150.76
May 1990	133.99	140.42	146.54	150.76
June 1990	133.46	139.86	145.97	150.76
July 1990	132.95	139.33	145.47	150.76

The Service will provide additional guidance concerning procedural aspects of furnishing and forfeiting bonds under section 42(j)(6) of the Code, including guidance with respect to the time, place, and form in which bonds are to be furnished. Furthermore, regulations will be forthcoming to explain the proper calculation of qualified basis and credit amounts subject to recapture under section 42(j). The Service solicits suggestions for alternative methods of satisfying the requirements in section 42(j)(6).

Low-income housing credit; satisfactory bond; "bond factor" amounts for August and September 1990. This revenue ruling announces the monthly "bond factor" amounts to be used by taxpayers who dispose of qualified low-income buildings or interests therein during the months of August and September 1990. It also modifies Rev. Rul. 90-60, page [illegible] this Bulletin, to state that the Service will timely publish a monthly figure but may do so less frequently than monthly. Rev. Rul. 90-60 modified and supplemented.

Rev. Rul. 90-67

In Rev. Rul. 90-60, page 3, this Bulletin, the Internal Revenue Service announced the bond factor amounts for calculating a bond under section 42(j)(6) of the Internal Revenue Code with respect to a disposition of a qualified low-income building or interest therein occurring during calendar years 1987, 1988, 1989, and the first seven months of 1990. It further announced that the Secretary would publish in the Internal Revenue Bulletin a table of "bond factor" amounts for dispositions occurring during each subsequent calendar month.

This revenue ruling provides in the accompanying table the bond factor amounts for calculating a bond under section 42(j)(6) of the Code with respect to dispositions occurring during August and September of 1990.

Rev. Rul. 90-67

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
August 1990	132.47%	138.83%	145.02%	150.76%
September 1990	132.00	138.36	144.61	150.76

Rev. Rul. 90-60 indicated that the Service would publish in the Internal Revenue Bulletin each month the applicable monthly bond factors. The Service will publish timely monthly factors but may do so less frequently than monthly. Accordingly, this revenue ruling modifies Rev. Rul. 90-60 by revising the second sentence of the 7th paragraph of the revenue ruling to read as follows: "The Secretary will publish in the Internal Revenue Bulletin a table of "bond factor" amounts for dispositions occurring during each calendar month."[1]

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 90-60 is modified and supplemented.

[1]Rev. Rul. 90-60, page 3, this Bulletin, reflects this modification.

Low-income housing credit; satisfactory bond; "bond factor" amounts for October, November, and December 1990. This ruling announces the monthly "bond factor" amounts to be used by taxpayers that dispose of qualified low-income buildings or interests therein during the months of October, November, and December 1990, and also restates all the bond factor amounts applicable to dispositions during calendar year 1990.

Rev. Rul. 90-88

In Rev. Rul. 90-60, page 3, this Bulletin, 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 section 42(j)(6) of the 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 a bond under section 42(j)(6) of the Code with respect to dispositions occurring during October, November, and December of 1990. Table 2 restates all the bond factor amounts applicable to dispositions during calendar year 1990. These bond factor amounts were previously published in Rev. Rul. 90-60 and Rev. Rul. 90-67, page 6, this Bulletin.

Table 1
Rev. Rul. 90-88

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
October 1990	131.56 %	137.92 %	144.24 %	150.76 %
November 1990	131.14	137.51	143.90	150.76
December 1990	130.73	137.12	143.58	150.76

Table 2
Rev. Rul. 90-88

Monthly Bond Factor Amounts for Dispositions During 1990 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
January 1990	136.40	143.14	149.65	150.76
February 1990	135.75	142.38	148.71	150.76
March 1990	135.13	141.68	147.89	150.76
April 1990	134.54	141.03	147.17	150.76
May 1990	133.99	140.42	146.54	150.76
June 1990	133.46	139.86	145.97	150.76
July 1990	132.95	139.33	145.47	150.76
August 1990	132.47	138.83	145.02	150.76
September 1990	132.00	138.36	144.61	150.76
October 1990	131.56	137.92	144.24	150.76
November 1990	131.14	137.51	143.90	150.76
December 1990	130.73	137.12	143.58	150.76

(Also Section 142.)

Low-income housing credit; minimum set-aside requirements. For purposes of determining whether a building meets the minimum set-aside requirements of section 42(g)(1) of the Code, the combined income of all occupants of an apartment, whether or not legally related, is compared to the appropriate percentage of the median family income for a family with the same number of members.

Rev. Rul. 90-89

ISSUE

For purposes of determining whether a building meets the minimum set-aside requirements of section 42(g)(1) of the Internal Revenue Code, how is the appropriate percentage of the area median gross income determined for occupants of an apartment when those occupants are not legally related?

FACTS

The owner of a newly constructed building wants to qualify the building for the low-income housing credit under section 42(a) of the Code. The owner has elected to qualify under the 40-60 minimum set-aside requirement of section 42(g)(1)(B), under which 40 percent or more of the building's aggregate residential rental units must be occupied by individuals with incomes of 60 percent or less of the area median gross income.

A and *B* are unrelated individuals who want to rent a two-bedroom apartment in the building. *A* and *B* each has income that does not exceed 60 percent of the area median gross income for one individual. However, *A* and *B*'s combined income exceeds 60 percent of the area median gross income for a two-individual family.

LAW AND ANALYSIS

Section 38(a) of the Code provides for a general business credit against tax that includes the amount of the current year business credit. Section 38(b)(5) provides that the amount of the current year business credit includes the low-income housing credit determined under section 42(a).

Section 42(a) of the Code provides that, for purposes of section 38, the amount of the low-income housing credit determined under section 42 for any tax year in the credit period shall be an amount equal to the "applicable percentage" of the qualified basis of each qualified low-income building.

Section 42(c)(2) of the Code defines the term "qualified low-income building" as any building: (A) that is part of a qualified low-income housing project at all times during the period (i) beginning on the first day in the compliance period on which the building is part of such a project, and (ii) ending on the last day of the compliance period with respect to the building, and (B) to which the amendments made by section 201(a) of the Tax Reform Act of 1986 apply.

Section 42(g)(1) of the Code defines the term "qualified low-income housing project" as any project for residential rental property if the project meets the requirements of subparagraphs (A) or (B), whichever the taxpayer elects. The election is irrevocable. The project meets the requirements of section 42(g)(1)(A) if 20 percent or more of the residential units in the project are both rent-restricted and occupied by individuals whose income is 50 percent or less of area median gross income. The project meets the requirements of section 42(g)(1)(B) if 40 percent or more of the residential units in the project are both rent-restricted and occupied by individuals whose income is 60 percent or less of area median gross income. This rule is known as the "minimum set-aside" requirement. 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-92 (1986), 1986-3 (Vol. 4) C.B. 92.

Section 42(g)(4) of the Code provides, in part, that section 142(d)-(2)(B) applies for purposes of determining whether any project is a low-income housing project and whether any unit is a low-income unit. Section 142(d)(2)(B) states that the income of

individuals and area median gross income shall be determined in a manner consistent with determinations of lower income families and area median gross income under section 8 of the United States Housing Act of 1937 (or, if the program is terminated, under the program as in effect immediately before such termination). Determinations of area median gross income under the preceding sentence are adjusted for family size. The determination of an individual's or family's income for purposes of section 8 of the Housing Act of 1937 may differ materially from that individual's or family's income for federal income tax purposes.

In order to satisfy the minimum set-aside requirements of section 42(g)(1) of the Code, a specified percentage of apartments in a low-income housing project must be occupied by low-income tenants who meet the income limits of section 42(g)(1). Under sections 42(g)(1) and 142(d)-(2)(B), tenants are considered low-income by reference to the area median gross income as adjusted for family size. These sections require that the income of all individuals in a family that share an apartment be aggregated and compared to the area median gross income for a family of the same size to determine if the minimum set-aside requirement is satisfied. Similarly, the income of all unrelated individuals who share an apartment should be aggregated and compared to the area median gross income for a family of the same size to determine if the minimum set-aside requirement is satisfied.

In this case, if *A* and *B* rent the apartment, that apartment does not count towards satisfying the minimum set-aside requirement of section 42(g)(1)(B) because *A* and *B*'s combined income exceeds 60 percent of the area median gross income for a two-individual family.

HOLDING

For purposes of determining whether a building meets the minimum set-aside requirements of section 42(g)(1) of the Code, the combined income of all occupants of an apartment, whether or not legally related, is compared to the appropriate percentage of the median family income for a family with the number of members.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1990. See Rev. Rul. 90-52, page 192.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1990. See. Rev. Rul. 90-66, page 194.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1990. See Rev. Rul. 90-75, page 195.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1990. See Rev. Rul. 90-81, page 196.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1990. See Rev. Rul. 90-92, page 198.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1990. See Rev. Rul. 90-99, page 199.

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

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Section 48.—Definitions; Special Rules

26 CFR 1.48-1: Definition of section 38 property.

Costs of replanting timber tree seedlings that die because of an abnormal drought may be section 38 property and qualify for the investment credit. See Rev. Rul. 90-61, page 39.

Part VI.—Alternative Minimum Tax

Section 56.—Adjustments in Computing Alternative Minimum Taxable Income

26 CFR 1.56-0: Table of contents to §1.56-1, adjustment for book income of corporations.

T.D. 8307

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

Corporate Alternative Minimum Tax Book Income Adjustment

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations on computing the alternative minimum tax adjustment for the book income of corporations under section 56(f) of the Internal Revenue Code of 1986 (the Code). This document also contains final regulations relating to the installment payment of estimated tax by corporations, taking into account the alternative minimum tax and the environmental tax. Changes to the applicable law were made by the Tax Reform Act of 1986, the Superfund Amendments and Reauthorization Act of 1986, the Omnibus Budget Reconciliation Act of 1987, and the Technical and Miscellaneous Revenue Act of 1988. These regulations affect corporate taxpayers and provide them with guidance necessary to determine their alternative minimum tax liability and their estimated tax liability.

EFFECTIVE DATE: The regulations are effective for taxable years beginning after December 31, 1986, and before January 1, 1990.

SUPPLEMENTARY INFORMATION

Paperwork Reduction Act

The collection of information requirements contained in this final regulation have been reviewed and approved by the Office of Management and Budget in accordance with the requirements of the Paperwork Reduction Act (44 U.S.C. 3504(h)) under control number 1545-0123. The estimated average collection burden per respondent varies from 15 minutes to 30 minutes, depending on individual circumstances, with an estimated average of 20 minutes.

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

Comments concerning the accuracy of this burden estimate should be directed to the Internal Revenue Service, Attn: IRS Reports Clearance Officer T:FP, Washington, D.C. 20224, and to the Office of Management and Budget, Paperwork Reduction Project, Washington, D.C. 20503.

Background

On April 28, 1987, and April 28, 1988, the Federal Register published Notices of Proposed Rulemaking (52 F.R. 15305 [T.D. 8138, 1987-1 C.B. 3], and 53 F.R. 15200 [T.D. 8197, 1988-1 C.B. 18], respectively) by cross reference to temporary regulations published on the same days under section 56 of the Internal Revenue Code of 1986. A number of public comments were received concerning these regulations and a public hearing was held on September 1, 1987. After consideration of the written comments and those presented at the hearing, the proposed regulations are adopted as revised by this Treasury Decision.

Explanation of Provisions

Section 701 of the Tax Reform Act of 1986 (Pub. L. 99-514, 100 Stat. 2320) [1986-3 C.B. (Vol. 1) 1, 237], as amended by section 516 of the Superfund Amendments and Reauthorization Act of 1986 (Pub. L. 99-499, 100 Stat. 1770) and section 1007 of the Technical and Miscellaneous Revenue Act of 1988 (Pub. L. 100-647, 102 Stat. 3373) [1988-3 C.B. 1, 88], enacted a new adjustment for corporations in computing their alternative minimum tax. This adjustment is based on the financial statement income of corporate taxpayers. These final regulations provide taxpayers with guidance necessary to determine the adjustment for book income in computing their alternative minimum tax liability.

Public Comment

I. *Amendments to §1.56-1T(b).*

A. *No adjustments to net book income allowed except those specified.*

Section 56(f)(2)(A) defines adjusted net book income as the net income or loss of the taxpayer as set forth on its applicable financial statement, adjusted as provided in section 56(f)(2). The statute enumerates specific adjustments for the following: taxes, related corporations, applicable financial statements covering different periods, cooperatives, dividends from possessions (section 936) corporations, Alaska Native Corporations, life insurance companies, stock-for-debt swaps of insolvent companies, and adjustments to prevent the omission or duplication of any item.

The only adjustment with respect to which the Secretary has a specific grant of regulatory authority is the last one—to prevent the omission or duplication of any item. The proposed regulations specify certain adjustments that are permitted to prevent the omission or duplication of items and prohibit any adjustments that are not so specified. Many commenters requested a broad omission and duplication rule designed to address any circumstance in which a taxpayer believes an omission or duplication of items of income or expense might occur. Because Congress considered and rejected a number of adjustments that would be permissible if a broad rule were adopted, the final regulations continue the approach adopted in the proposed regulations. Thus, §1.56-1(b)(1) of the final regulations provides that, except as provided in the regulations or in published guidance, a taxpayer may not adjust net book income to prevent the omission or duplication of any item. The final regulations, however, expand the list of permitted adjustments.

B. *Use of current earnings and profits to compute the adjusted net book income of a consolidated group.*

Section 1.56-1T(b)(5)(i) of the proposed regulations provides that, for taxpayers eligible to compute net book income using current earnings and profits, net book income is equal to the taxpayer's current earnings and profits for its taxable year. Generally, current earnings and profits is computed under the rules of section 312 and the regulations thereunder. Current earnings and profits is not reduced by distributions to shareholders. Section 1.56-1T(b)(5)(ii) of the proposed regulations defines the current earnings and profits of a consolidated group as the current earnings and profits of each member of the group, after making adjustments to exclude earnings and profits attributable to intercompany transactions as defined in §1.1502-33(a). Section 1.56-1T(d)(4)(iii) of the proposed regulations provides that all the adjustments described in §1.1502-33(a) apply except the adjustments to earnings and profits described in §1.1502-33(c)-(4)(ii)(*a*) to reflect increases or decreases in the stock basis of a subsidiary.

Commenters indicated that the adjustments in §1.1502-33(c)(1) for intercompany dividends should also be disregarded in order to prevent earnings associated with intercompany dividends from being included twice in the adjusted net book income of a consolidated group that uses current earnings and profits to compute net book income. Section 1.56-1(d)(4)(iii) of the final regulations incorporates this change. In addition, the provision relating to adjustments attributable to intercompany transactions is moved to §1.56-1(d)(4)(iii) of the final regulations because it is an adjustment to prevent omission or duplication.

II. *Amendments to §1.56-1T(c).*

A. *Substantial non-tax use of applicable financial statement.*

Section 1.56-1T(c)(4) of the proposed regulations provides that in certain circumstances a taxpayer must "reasonably anticipate" that users of the financial statement will rely on it for a substantial non-tax purpose. Several commenters requested that the final regulations adopt a presumption of substantial non-tax use. The legislative history, however, states that actual substantial non-tax use is required. S. Rep. No. 99-313, 99th Cong., 2d Sess., 531 (1986). The final regulations retain the requirement that the taxpayer reasonably anticipate that users of its financial statement will rely on it for a substantial non-tax purpose.

B. *Consolidated group's election to use current earnings and profits to determine net book income.*

Section 1.56-1T(c)(5)(i) of the proposed regulations provides that the applicable financial statement of a consolidated group is the highest priority financial statement of the common parent of the group. A taxpayer may use current earnings and profits to compute its net book income if (1) it has no applicable financial statement or (2) it has only a category (iv) applicable financial statement and it properly elects to use current earnings and profits. Ordinarily, the common parent is the sole agent for each member of the group for making all but a few specified tax elections. Section 1.1502-77. The proposed regulations do not specifically address

whether the common parent may make this election for the entire group if one or more members are ineligible to make the election (for example, as a result of having a category (i) applicable financial statement). In addition, the proposed regulations do not address whether an election by the common parent, assuming it is itself eligible to make the election, will bind all the members of the group, including those otherwise ineligible to make the election.

Section 1.56-1(c)(2)(iv) of the final regulations clarifies the rules regarding the election by the common parent of a consolidated group to use current earnings and profits to determine its net book income by (1) permitting the common parent to make the election on behalf of the group if the common parent itself is eligible to make the election, and (2) providing that the election binds all members of the group, including those otherwise not eligible to make the election. Determining the test for eligibility for the group at the level of the common parent is consonant with the rule of §1.56-1T(c)(5)(i)(A) of the proposed regulations that the applicable financial statement of a consolidated group is the highest priority financial statement of the common parent. Requiring that the election bind all members of the group, including those otherwise not eligible to make the election, avoids the complexity that would result if some members of the group used an applicable financial statement and other members of the group used current earnings and profits.

Because some taxpayers may have treated an election by a common parent as covering only those members of the group that were themselves eligible to make the election, the final regulations grant relief under section 7805(b) for those taxpayers who properly applied a separate company approach. The regulations also allow (but do not require) taxpayers to make the correct election on an amended return.

C. *Eligibility to use current earnings and profits to determine net book income.*

Section 1.56-1T(c)(2) of the proposed regulations allows a taxpayer to elect to use its current earnings and profits to compute its net book income if it has only a category (iv) applicable financial statement. Under the proposed regulations, the election is revocable only with the consent of the District Director and the taxpayer must make the election in the first year in which it is "eligible" to do so.

Section 1.56-1(c)(2)(iii) of the final regulations provides that the first year a taxpayer is "eligible" to make the election is the first year the taxpayer (1) has a category (iv) applicable financial statement, (2) has an excess of adjusted net book income over pre-adjustment alternative minimum taxable income, and (3) has an excess of the tentative minimum tax over the regular tax or is liable for the environmental tax under section 59A of the Code.

Similar eligibility requirements are also provided in §1.56-1(b)(4)(iii) of the final regulations regarding the election to compute adjusted net book income based on the financial statement for an accounting year ending within the taxable year.

The final regulations allow a taxpayer who has not previously made either of these elections to make them on an amended return for the first taxable year in which it is eligible to make the election. The final regulations also allow a taxpayer who made either election before its first eligible year, determined under §1.56-1(c)(2)-(iii) or §1.56-1(b)(4)(iii) of the final regulations, to revoke the election on an amended return. The final regulations specify the time within which taxpayers must make or revoke the election on an amended return.

III. *Amendments to §1.56-1T(d).*

A. *Adjustment for foreign income taxes.*

Section 1.56-1T(d)(3)(i) of the proposed regulations requires that net book income be adjusted to disregard any income, war profits or excess profits taxes imposed by the United States, any of its possessions or any foreign country, that are directly or indirectly taken into account on the taxpayer's applicable financial statement. Section 1.56-1T(d)(3)(ii) of the proposed regulations does not require an adjustment for any foreign income taxes if the taxpayer chooses not to use the benefits of section 901 (relating to the foreign tax credit).

Many commenters indicated that the language in the proposed regulations is unclear. Section 1.56-1(d)(3)-(ii) of the final regulations is clarified to provide that no adjustment is made for any foreign income taxes that cannot be credited against the taxpayer's United States income tax liability because of section 245(a)(8) (no deemed-paid credit for the U.S.-source portion of a dividend received from a 10-percent owned foreign corporation), section 901(j) (no foreign tax credit for income taxes paid or accrued to any country with which the United States has severed diplomatic relations), section 907(b) (limitations on the creditability of taxes on certain foreign oil-related income), or section 908 (reduction of foreign tax credit for participation in international boycotts). Foreign income taxes not creditable against the United States income tax liability because of the limitations of section 904 of the Code are not included in this list and therefore increase net book income pursuant to §1.56-1(d)(3)(i) of the final regulations.

B. *Certain valuation adjustments.*

Section 1.56-1T(d)(3)(i) of the proposed regulations provides that net book income must be adjusted to disregard any Federal or foreign income tax expense that is directly or indirectly taken into account on the taxpayer's applicable financial statement. Section 1.56-1T(d)(3)(iii) of the proposed regulations provides that income tax expense includes the effect of valuation adjustments such as the valuation adjustments related to purchase accounting described in Accounting Principles Board (APB) Opinion No. 16, paragraph 89. In the case of a business combination accounted for as a purchase, APB 16 requires that the book value of the assets acquired be adjusted for the tax effect associated with the difference between the appraised value and the tax basis of the assets acquired.

The proposed regulations also refer to Example (6) of §1.56-1T(d)(3)(iv). In this example, an asset the book value of which has been reduced in accordance with APB 16 is sold for an amount that produces Federal income tax expense and, under the example, this expense is taken into account as an adjustment in computing adjusted net book income. Many commenters stated that the valuation adjustment under APB 16 should be disregarded in determining adjusted net book income.

Section 1.56-1(d)(3)(iii) of the final regulations contains a clarification of

the treatment of valuation adjustments that conforms this provision with Example (6) of §1.56-1(d)(3)(iv). The APB 16 adjustment to an asset's value on the acquisition of the asset for financial accounting purposes is not the same as a direct or indirect tax expense. Thus, the valuation adjustment on the acquisition of the asset is not treated as a tax expense that increases or decreases adjusted net book income under §1.56-1(d)(3)-(i) of the final regulations. Under §1.56-1(d)(3)(i), however, income tax expense does include the full tax expense reflected on the applicable financial statement that is associated with any gain or loss on the sale or other disposition of an asset the basis of which was adjusted under paragraph 89 of APB 16.

C. *Adjustment for timing differences.*

Numerous commenters stated that the proposed regulations inappropriately prohibit an adjustment for timing differences. A timing difference exists when an item of income or deduction is recognized in different periods for purposes of pre-adjustment alternative minimum taxable income and financial statement income. Timing differences arise because tax accounting and financial accounting principles treat certain items as accruing in different periods.

For example, tax accounting principles may require the immediate recognition of advance payments as income, while financial accounting principles may require the income to be recognized in a later period. In this case, pre-adjustment alternative minimum taxable income includes an item in an earlier taxable period and the taxpayer pays either regular tax or alternative minimum tax on the item in that period. If the item is recognized in a later period for financial accounting purposes (assuming no other adjustments or preferences), the taxpayer may have a book income adjustment attributable to the item, and may again pay tax on that item.

The final regulations provide no adjustment for timing differences. The specific grant of authority to the Secretary under section 56(f)(2)(J) to make adjustments to prevent the omission or duplication of any item was intended to prevent the omission of any item from adjusted net book income and the duplication of any item in adjusted net book income. Because income resulting from a timing difference is reported in adjusted net book income only once, there is no duplication of adjusted net book income to be adjusted under section 56(f)(2)(J).

Further, any imposition of alternative minimum tax resulting from timing differences is mitigated by the minimum tax credit of section 53 of the Code. Thus, a taxpayer that has paid alternative minimum tax because of a book income adjustment will have a minimum tax credit, with an indefinite carryforward, available to offset any future regular tax liability.

D. *Adjustment for items previously taxed as subpart F income.*

Section 1.56-1T(b)(2)(iv) of the proposed regulations includes the earnings of another corporation in the net book income of the taxpayer when (1) the two corporations are not members of a consolidated group, and (2) the taxpayer must include dividends or other amounts with respect to the earnings of the other corporation in its gross income. This rule applies to amounts included in gross income under section 951. For example, assume a taxpayer includes in its taxable income the subpart F income of another corporation in a year in which no actual distributions are made. Under the general rule of §1.56-1T(b)(2)(iv) of the proposed regulations, the amount of the subpart F inclusion is included in adjusted net book income. If in the next year a distribution qualifying under section 959 as previously taxed income is made, the applicable financial statement of the taxpayer will report this dividend as income (assuming consolidated financial statements are not filed). Absent an appropriate adjustment, the same income will be included twice in the adjusted net book income of the taxpayer: first, as subpart F income under section 1.56-1T(b)(2)(iv) of the proposed regulations; and again, as an actual dividend reported on the applicable financial statement. The final regulations provide an adjustment to prevent this duplication to the extent section 959 applies.

E. *Adjustment for acquisitions accounted for as poolings of interests.*

The proposed regulations do not provide an adjustment to net book income for acquisitions accounted for as a pooling of interests under Opinion 16 of the Accounting Principles Board. When a business combination is accounted for as a pooling of interests, the income of the acquired corporation is reflected on its final financial statement. In addition, the financial statement of the acquiring company will reflect both the pre- and post-acquisition income of the acquired company for the year of the combination. The final regulations provide an appropriate adjustment under §1.56-1(d)(4)(vi) to prevent this duplication of income items in the net book income of two taxpayers.

F. *Adjustment for certain deferred foreign taxes.*

Section 1.56-1T(d)(3)(i) of the proposed regulations requires net book income to be adjusted to disregard any Federal income taxes or any income, war profits, or excess profits taxes imposed by any foreign country or possession of the United States, that are directly or indirectly taken into account on the taxpayer's applicable financial statement. Taxes taken into account on the applicable financial statement include both current and deferred income tax. Section 1.56-1T(d)(3)(ii) of the proposed regulations provides that net book income is not adjusted for taxes imposed by a foreign country or possession of the United States if the taxpayer chooses to deduct rather than to take a foreign tax credit with respect to these taxes. The taxes that are not added back are limited to the amount of foreign taxes the taxpayer deducts in the current taxable year under section 164(a).

Some commenters were concerned about the treatment of deferred foreign taxes that are deducted on the applicable financial statement and are therefore added back in computing adjusted net book income. The commenters stated that there should be a corresponding adjustment reducing net book income if, in the year these taxes are actually paid, the taxpayer deducts the taxes, rather than taking them as a foreign tax credit. Thus, §1.56-1(d)(4)(vii) of the final regulations allows a deduction from net book income for foreign taxes that the taxpayer deducts in the current year under section 164(a) to the extent that these taxes were added back

to net book income in computing the book income adjustment for a prior year.

G. *Adjustment for taxpayers subject to section 512.*

Section 1007(a)(2) of the Technical and Miscellaneous Revenue Act of 1988 amended section 55(b)(2) of the Code to provide that if a taxpayer is subject to regular tax on an income base other than taxable income, then that taxpayer also must determine its alternative minimum tax on that income base. A taxpayer subject to section 512 determines its regular tax based on its unrelated business taxable income (UBTI), as defined in section 512(a) of the Code.

Section 1.56-1(d)(8) of the final regulations therefore provides that the adjusted net book income of an organization subject to tax under subchapter F of chapter 1 of the Code (sections 501 through 528) shall exclude all items of income other than those defined as UBTI in section 512(a) of the Code, and all items of deduction and expense other than those associated with income items included in UBTI.

IV. *Other Issues.*

When the proposed regulations were published, the Internal Revenue Service invited public comments on the proposed regulations and any other issues arising under section 56(f). Although not all of the comments that were received are discussed in this preamble, all comments were considered in drafting these regulations. The Service appreciates the submission of those comments.

Special Analyses

The Commissioner of Internal Revenue has determined that this final rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis therefore is not required.

Although a notice of proposed rulemaking was issued, the Internal Revenue Service concluded when the notice was issued that the regulations are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 did not apply. Accordingly, the final regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. Chapter 6).

* * * * *

Adoption of amendments to the regulation

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

Paragraph 1. The authority for Part 1 is amended by

(a) removing the following citation: "Section 1.56-1T is also issued under 26 U.S.C. 56(f)(2)(H)" and

(b) adding the following citation: Authority: 26 U.S.C. 7805 * * * "Section 1.56-1 is also issued under 26 U.S.C. 56(f)(2)(H)".

Paragraph 2. 26 CFR Part 1 is amended by redesignating §1.56-0T as 1.56-0 and removing the word "(temporary)" from the end of the section heading.

Paragraph 3. Section 1.56-0 (as redesignated) is revised to read as follows:

§1.56-0 Table of contents to §1.56-1, adjustment for book income of corporations.

(a) Computation of the book income adjustment.
  (1) In general.
  (2) Taxpayers subject to the book income adjustment.
  (3) Consolidated returns.
  (4) Examples.
(b) Adjusted net book income.
  (1) In general.
  (2) Net book income.
    (i) In general.
    (ii) Measures of net book income.
    (iii) Tax-free transactions and tax-free income.
    (iv) Treatment of dividends and other amounts.
  (3) Additional rules for consolidated groups.
    (i) Consolidated adjusted net book income.
    (ii) Consolidated net book income.
    (iii) Consolidated pre-adjustment alternative minimum taxable income.
    (iv) Cross references.
  (4) Computation of adjusted net book income when taxable year and financial accounting year differ.
    (i) In general.
    (ii) Estimating adjusted net book income.
    (iii) Election to compute adjusted net book income based on the financial statement for the year ending within the taxable year.
      (A) In general.
      (B) Time of making election.
      (C) Eligibility to make and manner of making election.
      (D) Election or revocation of election made on an amended return.
    (iv) Quarterly statement filed with the Securities and Exchange Commission (SEC).
  (5) Computation of net book income using current earnings and profits.
    (i) In general.
    (ii) Current earnings and profits of a consolidated group.
  (6) Additional rules for computation of net book income of a foreign corporate taxpayer.
    (i) Adjusted net book income of a foreign taxpayer.
    (ii) Effectively connected net book income of a foreign taxpayer.
      (A) In general.
      (B) Certain exempt amounts.
    (iii) Computation of net book income of a foreign taxpayer using current earnings and profits.
  (7) Examples.
(c) Applicable financial statement.
  (1) In general.
    (i) Statement required to be filed with the Securities and Exchange Commission (SEC).
    (ii) Certified audited financial statement.
    (iii) Financial statement provided to a government regulator.
    (iv) Other financial statements.
    (v) Required use of current earnings and profits.
  (2) Election to treat net book income as equal to current earnings and profits for the taxable year.
    (i) In general.
    (ii) Time of making election.
    (iii) Eligibility to make and manner of making election.
    (iv) Election by common parent of consolidated group.
    (v) Election or revocation of election made on an amended return.
  (3) Priority among statements.
    (i) In general.
    (ii) Special priority rules for use of certified audited financial statements and other financial statements.
    (iii) Priority among financial statements provided to a gov-

ernment regulator.
(iv) Statements of equal priority.
(A) In general.
(B) Exceptions to the general rule in paragraph (c)(3)(iv)-(A).
(4) Use of financial statement for a substantial non-tax purpose.
(5) Special rules.
(i) Applicable financial statement of related corporations.
(A) Applicable financial statement of a consolidated group.
(B) Special rule for statements of equal priority.
(C) Special rule for related corporations.
(D) Anti-abuse rule.
(ii) Applicable financial statement of a foreign corporation with a United States trade or business.
(A) In general.
(B) Special rules for applicable financial statement of a trade or business of a foreign taxpayer.
(C) Special rule for statements of equal priority.
(D) Anti-abuse rule.
(iii) Supplement or amendment to an applicable financial statement.
(A) Excluding a restatement of net book income.
(B) Restatement of net book income.
(6) Examples.
(d) Adjustments to net book income.
(1) In general.
(2) Definitions.
(i) Historic practice.
(ii) Accounting literature.
(3) Adjustments for certain taxes.
(i) In general.
(ii) Exception for certain foreign taxes.
(iii) Certain valuation adjustments.
(iv) Examples.
(4) Adjustments to prevent omission or duplication.
(i) In general.
(ii) Special rule for depreciating an asset below its cost.
(iii) Consolidated group using current earnings and profits.
(iv) Restatement of a prior year's applicable financial statement.
(A) In general.
(B) Reconciliation of owner's equity in applicable financial statements.
(C) Use of different priority applicable financial statements in consecutive taxable years.
(D) First successor year defined.
(E) Exceptions.
(v) Adjustment for items previously taxed as subpart F income.
(vi) Adjustment for pooling of interests.
(vii) Adjustment for certain deferred foreign taxes.
(viii) Examples.
(5) Adjustments resulting from disclosure.
(i) Adjustment for footnote disclosure or other supplementary information.
(A) In general.
(B) Disclosures not specifically authorized in the accounting literature.
(ii) Equity adjustments.
(A) In general.
(B) Definition of equity adjustment.
(iii) Amount disclosed in an accountant's opinion.
(iv) Accounting method changes that result in cumulative adjustments to the current year's applicable financial statement.
(A) In general.
(B) Exception.
(v) Examples.
(6) Adjustments applicable to related corporations.
(i) Consolidated returns.
(A) In general.
(B) Corporations included in the consolidated Federal income tax return but excluded from the applicable financial statement.
(C) Corporations included in the applicable financial statement but excluded from the consolidated tax return.
(ii) Adjustment under the principles of section 482.
(iii) Adjustment for dividends received from section 936 corporations.
(A) In general.
(B) Treatment as foreign taxes.
(C) Treatment of taxes imposed on section 936 corporations.
(iv) Adjustment to net book income on sale of certain investments.
(v) Examples.
(7) Adjustments for foreign taxpayers with a United States trade or business.
(i) In general.
(ii) Example.
(8) Adjustment for corporations subject to subchapter F.
(e) Special rules.
(1) Cooperatives.
(2) Alaska Native Corporations.
(3) Insurance companies.
(4) Estimating the net book income adjustment for purposes of estimated tax liability.

Paragraph 4. 26 CFR Part 1 is amended by redesignating §1.56-1T as §1.56-1 and removing the word "(temporary)" from the end of the section heading.

Paragraph 5. Section 1.56-1 (as redesignated) is revised to read as follows:

1.56-1 Adjustment for the book income of corporations

(a) *Computation of the book income adjustment*—(1) *In general.* For taxable years beginning in 1987, 1988, and 1989, the alternative minimum taxable income of any taxpayer is increased by the book income adjustment described in this paragraph (a)(1). The book income adjustment is 50 percent of the excess, if any, of—

(i) The adjusted net book income (as defined in paragraph (b) of this section) of the taxpayer, over

(ii) The pre-adjustment alternative minimum taxable income for the taxable year.

For purposes of this section, pre-adjustment alternative minimum taxable income is alternative minimum taxable income, determined without regard to the book income adjustment or the alternative tax net operating loss determined under section 56(a)(4). See paragraph (a)(4) of this section for examples relating to the computation of the book income adjustment.

(2) *Taxpayers subject to the book income adjustment.* The book income adjustment is applicable to any corporate taxpayer that is not an S corporation, regulated investment company (RIC), real estate investment trust (REIT), or real estate

mortgage investment company (REMIC).

(3) *Consolidated returns.* In the case of a taxpayer that is a consolidated group, the book income adjustment equals 50 percent of the amount, if any, by which its consolidated adjusted net book income (as defined in paragraph (b)(3)(i) of this section) exceeds its consolidated pre-adjustment alternative minimum taxable income (as defined in paragraph (b)(3)(iii) of this section). See paragraph (a)(4), Example (4) of this section. For purposes of this section, with respect to any taxable year the term "consolidated group" has the same meaning as in §1.1502-1T. See paragraph (d)(6) of this section for rules relating to adjustments attributable to related corporations.

(4) *Examples.* The provisions of this paragraph may be illustrated by the following examples.

Example 1. Corporation A has adjusted net book income of $200 and pre-adjustment alternative minimum taxable income of $100. A must increase its pre-adjustment alternative minimum taxable income by $50 (($200 − $100) × .50).

Example 2. Corporation B has adjusted net book income of $200 and pre-adjustment alternative minimum taxable income of $300. B does not have a book income adjustment for the taxable year because its adjusted net book income does not exceed its pre-adjustment alternative minimum taxable income.

Example 3. Corporation C has adjusted net book income of negative $200 and pre-adjustment alternative minimum taxable income of negative $300. C must increase its pre-adjustment alternative minimum taxable income by $50 ((−$200 − (−$300)) × .50). Thus, C's alternative minimum taxable income determined after the book income adjustment, but without regard to the alternative tax net operating loss, is negative $250 (−$300 + $50).

Example 4. Corporations D and E are a consolidated group for tax purposes. D and E do not have a consolidated financial statement. On their separate financial statements D and E have adjusted net book income of $100 and $50 respectively, and pre-adjustment alternative minimum taxable income of $50 and $80 respectively. Assuming there are no intercompany transactions, DE's consolidated adjusted net book income (as defined in paragraph (b)(3)(i) of this section) is $150 and its consolidated pre-adjustment alternative minimum taxable income (as defined in paragraph (b)(3)(iii) of this section) is $130. DE must increase its consolidated pre-adjustment alternative minimum taxable income by $10 (($150 − $130) × .50).

(b) *Adjusted net book income*—(1) *In general.* "Adjusted net book income" means the net book income (as defined in paragraph (b)(2) of this section) adjusted as provided in paragraph (d) of this section. Except as provided in paragraph (d) of this section, a taxpayer may not make any adjustments to net book income.

(2) *Net book income*—(i) *In general.* "Net book income" means the income or loss of a taxpayer reported in the taxpayer's applicable financial statement (as defined in paragraph (c) of this section). Net book income must take into account all items of income, expense, gain and loss for the taxable year, including extraordinary items, income or loss from discontinued operations, and cumulative adjustments resulting from accounting method changes. Net book income is not reduced by any distributions to shareholders. See paragraph (b)(5)(i) of this section for a similar rule for corporations using current earnings and profits to compute net book income.

(ii) *Measures of net book income.* Except as described in paragraph (b)(5) of this section, net book income is disclosed on the income statement included in a taxpayer's applicable financial statement. Such income statement must reconcile with the balance sheet, if any, that is included in the applicable financial statement and must be used in computing changes in owner's equity reflected in the applicable financial statement. See paragraph (c) of this section for the definition of an applicable financial statement.

(iii) *Tax-free transactions and tax-free income.* Net book income includes income or loss that is reported on a taxpayer's applicable financial statement regardless of whether such income or loss is recognized, realized or otherwise taken into account for other Federal income tax purposes. See paragraph (b)(7), Examples (1), (2) and (3) of this section.

(iv) *Treatment of dividends and other amounts.* The adjusted net book income of a taxpayer shall include the earnings of other corporations not filing a consolidated Federal income tax return with the taxpayer only to the extent that amounts are required to be included in the taxpayer's gross income under chapter 1 of the Code with respect to the earnings of such other corporation (*e.g.*, dividends received from such corporation and amounts included under subpart A). See paragraph (b)(7), Examples (4) and (5) of this section.

(3) *Additional rules for consolidated groups*—(i) *Consolidated adjusted net book income.* "Consolidated adjusted net book income" means the consolidated net book income (as defined in paragraph (b)(3)(ii) of this section), after taking into account the adjustments under the rules of paragraph (d) of this section.

(ii) *Consolidated net book income.* Consolidated net book income is the income or loss of a consolidated group as reported on its applicable financial statement as defined in paragraph (c)(5) of this section.

(iii) *Consolidated pre-adjustment alternative minimum taxable income.* Consolidated pre-adjustment alternative minimum taxable income is the taxable income of the consolidated group for the taxable year, determined with the adjustments provided in sections 56 and 58 (except for the book income adjustment and the alternative tax net operating loss determined under section 56(a)(4)) and increased by the preference items described in section 57.

(iv) *Cross references.* See paragraph (c)(5) of this section for rules relating to the applicable financial statement of related corporations and paragraph (d)(6) of this section for rules relating to adjustments attributable to related corporations.

(4) *Computation of adjusted net book income when taxable year and financial accounting year differ*—(i) *In general.* If a taxpayer's applicable financial statement is prepared on the basis of a financial accounting year that differs from the year that the taxpayer uses for filing its Federal income tax return, adjusted net book income must be computed either—

(A) By including a pro rata portion of the adjusted net book income for each financial accounting year that includes any part of the taxpayer's taxable year (see paragraph (b) (7), Example (6) of this section), or (B) In accordance with the election described in paragraph (b) (4) (iii) of this section.

(ii) *Estimating adjusted net book income.* If a taxpayer is using the pro rata approach described in paragraph (b)(4)(i)(A) of this section and an applicable financial statement for part of the taxpayer's taxable year is not available when the taxpayer files its Federal income tax return, the taxpayer must make a reasonable esti-

mate of adjusted net book income for the pro rata portion of the taxable year. If the actual pro rata portion of adjusted net book income that results from the taxpayer's applicable financial statement for the financial accounting year exceeds the estimate of adjusted net book income used on the original tax return and results in additional tax liability, the taxpayer must file an amended Federal income tax return reflecting such additional liability. The amended return must be filed within 90 days of the date the previously unavailable applicable financial statement is available.

(iii) *Election to compute adjusted net book income based on the financial statement for the year ending within the taxable year*—(A) *In general.* If a taxpayer's accounting year ends five or more months after the end of its taxable year, the taxpayer may elect to compute adjusted net book income based on the net book income reported on the applicable financial statement prepared for the financial accounting year ending within the taxpayer's taxable year. See paragraph (b)(7), Examples (7) and (8) of this section. For purposes of this paragraph (b)(4)(iii)(A), if a taxpayer uses a 52-53 week year for financial accounting or Federal income tax purposes, the last day of such year shall be deemed to occur on the last day of the calendar month ending closest to the end of such year.

(B) *Time of making election.* An election under this paragraph (b)(4)(iii) is made by attaching the statement described in paragraph (b)(4)(iii)(C) of this section to the taxpayer's Federal income tax return for the first taxable year in which the taxpayer is eligible to make the election. An election under this paragraph (b)(4)(iii) that is made prior to the first taxable year in which the taxpayer is eligible to make the election (as determined under paragraph (b)(4)(iii)(C) of this section) is valid unless revoked pursuant to paragraph (b)(4)(iii)(D) of this section.

(C) *Eligibility to make and manner of making election.* A taxpayer is eligible to make the election specified in paragraph (b)(4)(iii)(A) of this section in the first taxable year beginning after 1986 in which

(*1*) The taxpayer has an accounting year ending five or more months after the end of its taxable year,

(*2*) The use of the pro rata approach described in paragraph (b)(4)(i)(A) of this section produces an excess of adjusted net book income over pre-adjustment alternative minimum taxable income, as defined in paragraph (a)(1) of this section, and

(*3*) The taxpayer has an excess of tentative minimum tax over regular tax for the taxable year, as defined in section 55(a), or is liable for the environmental tax imposed by section 59A.

Thus, a taxpayer is not required to evaluate the merits of an election to compute its adjusted net book income based on the applicable financial statement prepared for the financial accounting year ending within the taxpayer's taxable year unless the taxpayer, when using the pro rata approach described in paragraph (b)(4)(i)(A) of this section, either has an excess of tentative minimum tax over its regular tax or is liable for the environmental tax imposed by section 59A. The election statement must set forth the electing taxpayer's name, address, taxpayer identification number, taxable year and financial accounting year. An election under this paragraph (b)(4)(iii) will apply for the taxable year when initially made and for all subsequent years until revoked with the consent of the District Director.

(D) *Election or revocation of election made on an amended return.* An election under paragraph (b)(4)(iii) of this section may be made by attaching the statement described in paragraph (b)(4)(iii)(C) to an amended return for the first taxable year in which the taxpayer is eligible to make the election. An election under paragraph (b)(4)(iii) of this section that was made prior to the first taxable year in which the taxpayer was eligible to make the election, as determined under paragraph (b)(4)(iii)(C) of this section, may be revoked by filing an amended return for the taxable year in which the election was initially made. However, an election made or revoked on an amended return under paragraph (b)(4)(iii) of this section will be allowed only if the amended return is filed no later than December 14, 1990.

(iv) *Quarterly statement filed with the Securities and Exchange Commission (SEC).* A taxpayer with different financial accounting and taxable years that is required to file both annual and quarterly financial statements with the SEC may not aggregate quarterly statements filed with the SEC in order to obtain a statement covering the taxpayer's taxable year. See paragraph (b)(7), Example (9) of this section. See paragraph (c)(3)(iv)-(B)(*1*) of this section for priority rules relating to statements required to be filed with the SEC.

(5) *Computation of net book income using current earnings and profits*—(i) *In general.* If a taxpayer does not have an applicable financial statement, or only has a statement described in paragraph (c)(1)(iv) of this section and makes the election described in paragraph (c)(2) of this section, net book income for purposes of this section is equal to the taxpayer's current earnings and profits for its taxable year. Generally, a taxpayer's current earnings and profits is computed under the rules of section 312 and the regulations thereunder. Current earnings and profits therefore is reduced by Federal income tax expense and any foreign tax expense for foreign taxes eligible for the foreign tax credit under section 27 of the Code. Current earnings and profits is then adjusted as described in paragraph (d) of this section to arrive at adjusted net book income. No adjustment is made under paragraph (d) of this section, however, for any adjustment that is already reflected in current earnings and profits. See paragraph (d)(3) of this section for adjustments to net book income with respect to certain taxes. For purposes of this section, current earnings and profits is not reduced by any distribution to shareholders. See paragraph (d)(3)(iv), Example (5) of this section.

(ii) *Current earnings and profits of a consolidated group.* For purposes of this paragraph (b)(5), the current earnings and profits of a consolidated group is the aggregate of the current earnings and profits of each member of the group, as determined pursuant to paragraph (d)(4)(iii) of this section.

(6) *Additional rules for computation of net book income of a foreign corporate taxpayer*—(i) *Adjusted net book income of a foreign taxpayer.*

Adjusted net book income of a foreign corporate taxpayer ("foreign taxpayer") means the effectively connected net book income (as defined in paragraph (b)(6)(ii) of this section) of the foreign taxpayer, after taking into account the adjustments under the rules of paragraph (d) of this section.

(ii) *Effectively connected net book income of a foreign taxpayer*—(A) *In general.* Effectively connected net book income of a foreign taxpayer is the income or loss reported in its applicable financial statement (as defined in paragraph (c)(5)(ii) of this section), but only to the extent that such amount is attributable to items of income or loss that would be treated as effectively connected with the conduct of a trade or business in the United States by the foreign taxpayer as determined under either the principles of section 864(c) and the regulations thereunder, or any other applicable provision of the Internal Revenue Code of 1986. Thus, if for tax purposes an item of income or loss is treated as effectively connected with the conduct of a trade or business in the United States, then the income or loss reported on the foreign taxpayer's applicable financial statement attributable to such item is effectively connected net book income. See paragraph (b)(7), Examples (11), (12) and (13) of this section.

(B) *Certain exempt amounts.* Effectively connected net book income does not include any amount attributable to an item that is exempt from United States taxation under sections 883, 892, 894 or 895 of the Internal Revenue Code of 1986. See paragraph (b)(7), Examples (14) and (15) of this section.

(iii) *Computation of net book income of a foreign taxpayer using current earnings and profits.* If a foreign taxpayer does not have an applicable financial statement or only has a statement described in paragraph (c)(1)(iv) of this section and makes the election described in paragraph (c)(2) of this section, net book income for purposes of this section is equal to the foreign taxpayer's current earnings and profits that are attributable to income or loss that is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States. Effectively connected current earnings and profits are computed under the rules of section 884(d) and the regulations thereunder, relating to effectively connected earnings and profits for purposes of computing the branch profits tax, but without regard to the exceptions set forth under section 884(d)(2)(B) through (E). For purposes of this section, effectively connected current earnings and profits are not reduced by any remittances or distributions. Effectively connected current earnings and profits takes into account Federal income tax expense and any foreign tax expense; however, see paragraph (d)(3) of this section for adjustments to net book income with respect to certain taxes.

(7) *Examples.* The provisions of this paragraph may be illustrated by the following examples.

Example 1. Corporation A owns 100 percent of corporation B and the AB affiliated group files a consolidated Federal income tax return. AB uses a calendar year for both financial accounting and tax purposes. During 1987, A transfers all of its stock in B for stock of an acquiring corporation in a transaction described in section 368(a)(1)(B). Although AB recognizes no taxable gain on the transfer pursuant to section 354, gain from the transfer is reported on AB's 1987 applicable financial statement. Pursuant to paragraph (b)(2)(iii) of this section, AB's net book income includes the book gain attributable to the transfer.

Example 2. Corporation C uses a calendar year for both financial accounting and tax purposes. C adopted a plan of liquidation prior to August 1, 1986. On June 1, 1987, C makes a bulk sale of all of its assets subject to liabilities and completely liquidates. Pursuant to section 633(c) of the Tax Reform Act of 1986 (the Act), section 337, as in effect prior to its amendment by the Act, applies. Thus, C will generally not recognize taxable gain upon the bulk sale. However, C's applicable financial statement for the period January 1, 1987, through June 1, 1987, reports net book income of $500, $400 of which is attributable to the bulk sale of assets on June 1, 1987. Pursuant to paragraph (b)(2)(iii) of this section, C's net book income includes the amount attributable to the bulk sale. Thus, assuming C has no other adjustments to net book income, its adjusted net book income for the period January 1, 1987, through June 1, 1987, is $500.

Example 3. Corporation Z has a large inventory of marketable securities. On its applicable financial statement, Z marks these securities to market, i.e., as they appreciate in value, Z restates their value on its balance sheet to their fair market value, and increases the income on its income statement by that amount. Pursuant to paragraph (b)(2)(iii) of this section, the adjusted net book income of Z includes the income from the valuation adjustment.

Example 4. Corporation D owns 100 percent of E, a controlled foreign corporation as defined in section 957. Both D and E use a calendar year for financial accounting and tax purposes. D's applicable financial statement includes E. Pursuant to section 951, D includes $100 of E's subpart F income in its gross income for 1987. Although D's applicable financial statement is adjusted to eliminate E's income, pursuant to paragraph (b)(2)(iv) of this section, D's adjusted net book income for 1987 includes the $100 of gross income included under section 951.

Example 5. Corporation F owns 20 percent of G, a foreign corporation. Both F and G use a calendar year for financial accounting and tax purposes. During 1987, G pays F a $100 dividend. F's applicable financial statement accounts for F's investment in G by the equity method. F is eligible for a deemed paid foreign tax credit of $30 with respect to the dividend from G and must include the $130 in gross income pursuant to section 78 of the Code. Although F's applicable financial statement is adjusted to eliminate F's income from G under the equity method, pursuant to paragraph (b)(2)(iv) of this section, F's adjusted net book income for 1987 includes the $130 of gross income recognized with respect to the dividend from G.

Example 6. Corporation H files its Federal income tax return on a calendar year basis. However, its applicable financial statement is based on a fiscal year ending June 30. H does not make the election described in paragraph (b)(4)(iii) of this section. Pursuant to paragraph (b)(4)(i) of this section, H's adjusted net book income for calendar year 1987 is computed by adding 50 percent of adjusted net book income from the applicable financial statement for the year ending June 30, 1987, and 50 percent of adjusted net book income from the applicable financial statement for the year ending June 30, 1988.

Example 7. Corporation J files its Federal income tax returns for 1987, 1988, and 1989 on a calendar year basis. However, its applicable financial statement is based on a year ending May 31. Pursuant to paragraph (b)(4)(iii) of this section, J elects in 1987 to compute its adjusted net book income by using the applicable financial statement for the fiscal year ending May 31, 1987. Unless the District Director consents to revocation of the election, for calendar year 1988 or 1989, J's adjusted net book income for 1988 and 1989 is determined from its applicable financial statements for the years ending May 31, 1988, and May 31, 1989, respectively.

Example 8. The facts are the same as in Example (7), except that J's applicable financial statement is based on a year ending April 30. Since April 30 is less than 5 months after December 31, the end of J's taxable year, J is not permitted to make the election described in paragraph (b)(4)(iii) of this section.

Example 9. The facts are the same as in Example (8), except H files quarterly and annual financial statements with the Securities and Exchange Commission (SEC). The fourth quarter statement is included as a footnote to the annual statement that it files with the SEC. Pursuant to paragraph (b)(4)(iv) of this section, H may not determine its net book income by aggregating its four quarterly statements for 1987. Thus, H's net book income is computed as described in Example (8).

Example 10. Corporation I is a United States corporation with a 100 percent owned subsidiary, J, a foreign sales corporation (FSC). I uses a calendar year for both financial account-

ing and tax purposes. Income from J is consolidated in I's applicable financial statement. I and J do not file a consolidated tax return. In 1987, J pays a dividend to I of $100 out of J's earnings and profits. For purposes of this example, it is assumed that the distribution is made out of the profits attributable solely to foreign trade income determined through use of the administrative pricing rules of section 925(a)(1) and (2). Accordingly, the distribution is eligible for the 100 percent dividends received deduction under section 245(c). Although I's applicable financial statement is adjusted to eliminate income or loss attributable to J, the entire amount of the dividend distribution must be included in I's adjusted net book income pursuant to paragraph (b)(2)(iv) of this section.

Example 11. Corporation K is a foreign corporation incorporated under the laws of country X. K uses a calendar year for both financial accounting and tax purposes. In 1987, K actively conducts a real estate business, L, in the United States. The financial statement that is used as K's applicable financial statement (as determined under paragraph (c)(5)(ii) of this section) discloses total net income of $150. Of this amount, $100 is attributable to L's real estate business and $50 is attributable to dividends paid to L from its investment in certain securities. The securities investment is not connected with L's real estate business. Under the rules of section 864, only $100 is effectively connected to the conduct of a trade or business in the United States. Thus, K's effectively connected net book income for 1987 equals $100.

Example 12. Assume the same facts as in Example (11) except that K's applicable financial statement also discloses $75 attributable to investment real property located in the United States, so that the net income amount reported on the financial statement equals $225. The $75 of income is not effectively connected with the conduct of a trade or business in the United States. K, for regular tax purposes, makes an election under section 882(d) to treat this income as effectively connected with the conduct of a trade or business in the United States. As a result, K's effectively connected net book income for 1987 equals $175 ($100 + $75).

Example 13. Corporation M is a foreign corporation that actively conducts a manufacturing business, N, in the United States. M is a calendar year taxpayer for both financial accounting and tax purposes. In 1987, the financial statement that is used as M's applicable financial statement (as determined under paragraph (c)(5)(ii) of this section) reflects an anticipated loss from the sale of a division of N. For Federal income tax purposes the loss is not recognized in 1987, but rather is recognized in 1988 when M sells the division. In determining M's effectively connected net book income for 1987, the anticipated loss reported on M's 1987 applicable financial statement is taken into account because the reported loss is effectively connected to the conduct of a trade or business in the United States under the principles of section 864.

Example 14. Corporation O is a foreign corporation that is engaged in the international shipping business. O is incorporated under the laws of X. O is a calendar year taxpayer for both financial accounting and tax purposes. In 1987, O actively conducts a shipping business, P, within the United States. The statement that is used in 1987 as O's applicable financial statement (as determined under paragraph (c)(5)(ii) of this section) discloses income of $100 that is attributable to P's operation of ships in international traffic. Under section 864, $50 is effectively connected with the conduct of a trade or business in the United States. However, the United States income tax treaty with X exempts from United States income tax any income derived by a resident of X from the operation of ships in international traffic. Thus, pursuant to paragraph (b)(6)(ii)(B) of this section, no amount of P's income is includible in O's effectively connected net book income.

Example 15. Assume the same facts as in Example (14) except that there is no United States income tax treaty with X. However, X by statute exempts United States citizens and United States corporations from tax imposed by X on gross income derived from the operation of a ship or ships in international traffic. Under section 883(a), P's income of $50 that is effectively connected with the conduct of a trade or business in the United States is exempt from United States taxation. Thus, pursuant to paragraph (b)(6)(ii)(B) of this section, no amount of P's income is includible in O's effectively connected net book income.

(c) *Applicable financial statement*—(1) *In general.* A taxpayer's applicable financial statement is the statement described in this paragraph (c)(1) that has the highest priority, as determined under paragraph (c)(3) of this section. Generally, an applicable financial statement includes an income statement, a balance sheet (listing assets, liabilities, and owner's equity including changes thereto), and other appropriate information. An income statement alone may constitute an applicable financial statement for purposes of this section if the other materials described in this paragraph are not prepared or used by the taxpayer. However, an income statement that does not reconcile with financial materials otherwise issued will not qualify as an applicable financial statement. For purposes of determining the book income adjustment, the following may be considered applicable financial statements (subject to the rules relating to priority among statements under paragraph (c)(3) of this section)—

(i) *Statement required to be filed with the Securities and Exchange Commission (SEC).* A financial statement that is required to be filed with the Securities and Exchange Commission.

(ii) *Certified audited financial statement.* A certified audited financial statement that is used for credit purposes, for reporting to shareholders or for any other substantial nontax purpose. Such a statement must be accompanied by the report of an independent (as defined in the American Institute of Certified Public Accountants Professional Standards, Code of Professional Conduct, Rule 101 and its interpretations and rulings) Certified Public Accountant or, in the case of a foreign corporation, a similarly qualified and independent professional who is licensed in any foreign country. A financial statement is "certified audited" for purposes of this section if it is—

(A) Certified to be fairly presented (an unqualified or "clean" opinion),

(B) Subject to a qualified opinion that such financial statement is fairly presented subject to a concern about a contingency (a qualified "subject to" opinion),

(C) Subject to a qualified opinion that such financial statement is fairly presented, except for a method of accounting with which the accountant disagrees (a qualified "except for" opinion), or

(D) Subject to an adverse opinion, but only if the accountant discloses the amount of the disagreement with the statement.

Any other statement or report, such as a review statement or a compilation report that is not subject to a full audit is not a certified audited statement. See paragraph (c)(3)(iv)(B)-*(2)* of this section for a special rule for a statement accompanied by a review report when there are statements of equal priority. See also paragraph (d)(5)(iii) of this section for rules relating to adjustments for information disclosed in an accountant's opinion to a certified audited statement.

(iii) *Financial statement provided to a government regulator.* A financial statement that is required to be provided to the Federal government or any agency thereof (other than the Securities and Exchange Commission), a state government or any agency thereof, or a political subdivision of a state or any agency thereof. An income tax return, franchise tax return or other tax return prepared for the purpose of determining any tax liability that is filed with a Federal, state or local government or agency cannot be an applicable financial statement.

(iv) *Other financial statements.* A financial statement that is used for

credit purposes, for reporting to shareholders, or for any other substantial non-tax purpose, even though such financial statement is not described in paragraphs (c)(1)(i) through (c)(1)(iii) of this section.

(v) *Required use of current earnings and profits.* If a taxpayer does not have a financial statement described in paragraphs (c)(1)(i) through (c)(1)(iv) of this section, the taxpayer does not have an applicable financial statement. In that case, net book income for the taxable year will be treated as being equal to the taxpayer's current earnings and profits for the taxable year. See paragraph (b)(5) of this section for rules relating to the computation of current earnings and profits for the taxable year. See paragraph (c)(4) of this section for rules relating to use of a financial statement for a substantial non-tax purpose.

(2) *Election to treat net book income as equal to current earnings and profits for the taxable year*—(i) *In general.* If a taxpayer's only financial statement is a statement described in paragraph (c)(1)(iv) of this section, the taxpayer may elect to treat net book income as equal to the taxpayer's current earnings and profits for all taxable years in which the taxpayer is eligible to make the election.

(ii) *Time of making election.* An election under this paragraph (c)(2) is made by attaching the statement described in paragraph (c)(2)(iii) of this section to the taxpayer's Federal income tax return for the first taxable year the taxpayer is eligible to make the election. An election under this paragraph (c)(2), which is made prior to the first taxable year in which the taxpayer is eligible to make the election, as determined under paragraph (c)(2)(iii) of this section, is valid unless revoked pursuant to paragraph (c)(2)(iv) of this section.

(iii) *Eligibility to make and manner of making election.* A taxpayer is eligible to make the election in the first taxable year in which

(A) The taxpayer has an applicable financial statement described in paragraph (c)(1)(iv) of this section;

(B) The use of this applicable financial statement produces an excess of adjusted net book income over pre-adjustment alternative minimum taxable income, as defined in paragraph (a)(1) of this section, and

(C) The taxpayer has, as determined under section 55(a), an excess of tentative minimum tax over regular tax for the taxable year, or is liable for the environmental tax imposed by section 59A.

Thus, a taxpayer is not required to evaluate the merits of an election to use its current earnings and profits as its net book income unless the taxpayer, when using an applicable financial statement described in paragraph (c)(1)(iv) of this section, has an excess of tentative minimum tax over its regular tax or is liable for the environmental tax imposed by section 59A. The election statement must set forth the electing taxpayer's name, address and taxpayer identification number, state that the election is being made under the provisions of section 56(f)(3)(B), and state that the only financial statement of the taxpayer is a financial statement described in paragraph (c)(1)(iv) of this section. An election under this paragraph (c)(2) is effective for every taxable year in which the taxpayer does not have a financial statement described in paragraphs (c)(1)(i) through (c)(1)(iii) of this section and may be revoked only with the consent of the District Director. See paragraph (c)(6), Example (1) of this section.

(iv) *Election or revocation of election made on an amended return.* An election under paragraph (c)(2) of this section may be made by attaching the statement described in paragraph (c)(2)(iii) to an amended return for the first taxable year in which the taxpayer is eligible to make the election. An election under paragraph (c)(2) of this section that was made prior to the first taxable year in which the taxpayer was eligible to make the election, as determined under paragraph (c)(2)(iii) of this section, may be revoked by filing an amended return for the taxable year in which the election was initially made. However, an election made or revoked on an amended return will be allowed only if the amended return is filed no later than December 14, 1990.

(v) *Election by common parent of consolidated group.* The election by the common parent of a consolidated group to treat net book income as equal to current earnings and profits shall bind all members of the group. This rule shall not apply in the case of any taxpayer that first, has made the election on a return filed before August 16, 1990, second, applied the election only to those members of the group that are themselves eligible to make the election, and third, properly consolidated the adjusted net book income of the group. In order to change its election to apply to all members of the group, a taxpayer must attach a statement to an amended return for the first taxable year the taxpayer is eligible to make the election. However, an election made on an amended return under this paragraph (c)(2)(iv) will be allowed only if the amended return is filed no later than December 14, 1990. See paragraph (b)(5)(ii) of this section regarding the current earnings and profits of a consolidated group. See paragraph (d)(4)(iii) of this section for adjustments that apply when a consolidated group uses current earnings and profits to compute its net book income.

(3) *Priority among statements*—(i) *In general.* If a taxpayer has more than one financial statement described in paragraph (c)(1)(i) through (c)(1)(iv) of this section, the taxpayer's applicable financial statement is the statement with the highest priority. Priority is determined in the following order—

(A) A financial statement described in paragraph (c)(1)(i) of this section.

(B) A certified audited statement described in paragraph (c)(1)(ii) of this section.

(C) A financial statement required to be provided to a Federal or other government regulator described in paragraph (c)(1)(iii) of this section.

(D) Any other financial statement described in paragraph (c)(1)(iv) of this section.

For example, corporation A, which uses a calendar year for both financial accounting and tax purposes, prepares a financial statement for calendar year 1987 that is provided to a state regulator and an unaudited financial statement that is provided to A's creditors. The statement provided to the state regulator is A's financial statement with the highest priority

and thus is A's applicable financial statement.

(ii) *Special priority rules for use of certified audited financial statements and other financial statements.* In the case of financial statements described in paragraphs (c)(1)(ii) and (c)(1)(iv) of this section, within each of these categories the taxpayer's applicable financial statement is determined according to the following priority—

(A) A statement used for credit purposes,

(B) A statement used for disclosure to shareholders, and

(C) Any other statement used for other substantial non-tax purposes.

For example, corporation B uses a calendar year for both financial accounting and tax purposes. B prepares a financial statement for calendar year 1987 that it uses for credit purposes and prepares another financial statement for calendar year 1987 that it uses for disclosure to shareholders. Both financial statements are unaudited. The statement used for credit purposes is B's financial statement with the highest priority and thus is B's applicable financial statement.

(iii) *Priority among financial statements provided to a government regulator.* In the case of two or more financial statements described in paragraph (c)(1)(iii) of this section (relating to financial statements required to be provided to a Federal or other governmental regulator) that are of equal priority, the taxpayer's applicable financial statement is determined according to the following priority—

(A) A statement required to be provided to the Federal government or any of its agencies,

(B) A statement required to be provided to a State government or any of its agencies, and

(C) A statement required to be provided to any subdivision of a state or any agency of a subdivision.

(iv) *Statements of equal priority*—(A) *In general.* Except as provided in paragraph (c)(3)(iv)(B) and paragraph (c)(5)(i)(B) of this section, if a taxpayer has two or more financial statements of equal priority (determined under paragraphs (c)(3)(i), (c)(3)(ii) and (c)(3)(iii) of this section), the taxpayer's applicable financial statement is the statement that results in the greatest amount of adjusted net book income.

(B) *Exceptions to the general rule in paragraph (c)(3)(iv)(A)—(1)* In the case of two or more financial statements described in paragraph (c)(1)(i) of this section (relating to financial statements required to be filed with the SEC) that are of equal priority, a certified audited financial statement has a higher priority than an unaudited financial statement.

(*2*) In the case of two or more financial statements described in paragraph (c)(1)(iv) of this section (relating to other financial statements) that are of equal priority, a financial statement accompanied by an auditor's "review report" has a higher priority than another financial statement of otherwise equal priority. For purposes of this section, an auditor's review report is defined in the American Institute of Certified Public Accountant Professional Standards, AR section 100.32. See paragraph (c)(6), Examples (2) and (3) of this section.

(4) *Use of financial statement for a substantial non-tax purpose.* In order to be an applicable financial statement for purposes of computing the book income adjustment, a financial statement described in paragraph (c)(1)(ii) or (c)(1)(iv) must be used by the taxpayer for credit purposes, for disclosure to shareholders, or for any other substantial non-tax purpose. A financial statement is used by a taxpayer if the taxpayer reasonably anticipates that users of the statement will rely on it for non-tax purposes. Thus, a financial statement used for the purpose of computing the book income adjustment is not an applicable financial statement even if it is provided to shareholders or creditors, unless the taxpayer reasonably anticipates that users of the statement will rely on it for non-tax purposes. See paragraph (c)(6), Examples (4), (5), (19) and (20) of this section.

(5) *Special rules*—(i) *Applicable financial statement of related corporations*—(A) *Applicable financial statement of a consolidated group.* The applicable financial statement of a consolidated group (as defined in paragraph (a)(3) of this section) is the financial statement of the common parent (within the meaning of section 1504(a)(1)) of the consolidated group that has the highest priority under the rules of paragraphs (c)(3)(i), (c)(3)(ii) and (c)(5)(i)(B) of this section. See paragraph (d)(6)(i) of this section for rules relating to adjustments to net book income of a consolidated group. See paragraph (c)(6), Example (7) of this section. See paragraph (c)(2)(iv) of this section for rules relating to the election by the common parent of a consolidated group to use current earnings and profits to compute net book income.

(B) *Special rule for statements of equal priority.* If a consolidated group has two or more financial statements of equal priority (determined under paragraphs (c)(3)(i) and (c)(3)(ii) of this section and this paragraph (c)(5)), the consolidated group's applicable financial statement is determined under either paragraph (c)(5)(i)(B)(*1*) or (*2*), whichever is applicable.

(*1*) Two or more financial statements reporting on the same corporations. If two or more financial statements of equal priority report on the same corporations, the consolidated group's applicable financial statement is determined under the rules of paragraph (c)(3)(iv) of this section. Thus, the financial statement that results in the greatest consolidated adjusted net book income is the consolidated group's applicable financial statement.

(*2*) *Two or more financial statements reporting on different corporations.* If two or more financial statements of equal priority report on different corporations, the consolidated group's applicable financial statement is—

(*i*) The statement that reflects the greatest amount of gross receipts attributable to members of the consolidated group, or

(*ii*) The statement that reflects the greatest amount of gross receipts (including gross receipts attributable to corporations that are not members of the consolidated group), but only if the consolidated group has financial statements of equal priority after applying the rules of paragraph (c)(5)(i)(B)(*2*)(*i*).

If after applying the rules of paragraphs (c)(5)(i)(B)(*2*)(*i*) and (*ii*) of this section, the consolidated group still has financial statements of equal priority, the rules of paragraph (c)(3)(iv) of this section apply. See paragraph

(c)(6), Examples (7) and (8) of this section.

(C) *Special rule for related corporations.* If any portion of the net book income of a corporation (the "first corporation") is included on the applicable financial statement of a second corporation, but the first and second corporations are not members of the same consolidated group, the applicable financial statement of the second corporation is disregarded when determining the applicable financial statement of the first corporation. Thus, the applicable financial statement of the first corporation is the financial statement of highest priority determined under the rules of paragraph (c)(3) of this section without regard to the financial statement of the second corporation. Pursuant to paragraph (c)(1)(iv) of this section, if a separate financial statement is not prepared by the first corporation, the rules of paragraph (b)(5) (relating to current earnings and profits) apply. See paragraph (c)(6), Examples (9) and (10) of this section.

(D) *Anti-abuse rule.* The special rules of this paragraph (c)(5)(i) will not apply if the taxpayer rearranges its corporate structure or modifies its financial reporting and the principal purpose of such action is to use the special rules of this paragraph (c)(5)(i) to reduce the amount of the book income adjustment. In such cases, the District Director may, based upon all the facts and circumstances, determine the taxpayer's applicable financial statement. See paragraph (c)(6), Examples (13) and (14) of this section.

(ii) *Applicable financial statement of a foreign corporation with a United States trade or business*—(A) *In general.* The applicable financial statement of a foreign taxpayer conducting one or more trades or businesses in the United States is the financial statement prepared by any such trade or business (or attributable to more than one such trades or businesses) that has the highest priority as determined under paragraph (c)(3) of this section. See paragraph (c)(6), Example (15) of this section.

(B) *Special rules for applicable financial statement of a trade or business of a foreign taxpayer—(1) Financial statement prepared under foreign generally accepted accounting principles.* Subject to the rules of this section, a financial statement prepared by a United States trade or business using generally accepted accounting principles of a foreign country may be an applicable financial statement under this paragraph (c). See paragraph (c)(6), Example (16) of this section.

(2) Financial statement denominated in United States dollars. Except as provided in paragraph (c)(5)(ii)(D) of this section, the financial statement of a United States trade or business must be denominated in United States dollars in order to be considered the applicable financial statement of the foreign taxpayer under this paragraph (c). See paragraph (c)(6), Example (17) of this section.

(C) *Special rule for statements of equal priority.* If a foreign taxpayer has two or more financial statements of equal priority (determined under paragraphs (c)(3)(i) and (c)(3)(ii) of this section and this paragraph (c)(5)(ii)), the foreign taxpayer's applicable financial statement is determined under either paragraph (c)(5)(ii)(C)*(1)* or *(2)* of this section, whichever is applicable.

(1) Two or more financial statements reporting on the same trades or businesses. If two or more financial statements of equal priority report on the same United States trades or businesses, the applicable financial statement of the foreign taxpayer is determined under the rule of paragraph (c)(3)(iv) of this section. In applying this rule, adjusted net book income (as defined under paragraph (b)(6) of this section) shall be used. Thus, the financial statement that results in the greatest amount of adjusted net book income is the foreign taxpayer's applicable financial statement.

(2) Two or more financial statements reporting on different trades or businesses. If two or more financial statements of equal priority report on different United States trades or businesses, the foreign taxpayer's applicable financial statement is—

(i) The financial statement that reflects the greatest amount of gross receipts attributable to United States trades or businesses, or

(ii) If after applying the rules of paragraph (c)(5)(ii)(C)*(2)(i)* of this section, the foreign taxpayer still has financial statements of equal priority, the financial statement determined under the rules of paragraph (c)(3)(iv) of this section (using effectively connected adjusted net book income).

See paragraph (c)(6), Example (18) of this section.

(D) *Anti-abuse rule.* The special rules of this paragraph (c)(5)(ii) will not apply if a trade or business conducted in the United States by a foreign taxpayer modifies its financial reporting and the principal purpose of such action is to reduce the amount of the book income adjustment. In such cases, the District Director may, based upon all the facts and circumstances, determine the taxpayer's applicable financial statement. See paragraph (c)(6), Example (21), of this section.

(iii) *Supplement or amendment to an applicable financial statement*—(A) *Excluding a restatement of net book income.* An applicable financial statement includes any supplement or amendment thereto (excluding a restatement of net book income) for the taxable year that is prepared and used for a substantial non-tax purpose (within the meaning of paragraph (c)(4) of this section) prior to the date the taxpayer's Federal income tax return for the taxable year would be due if the time for filing were extended under section 6081. For example, a calendar year taxpayer's applicable financial statement includes any supplement or amendment prepared and used prior to September 15 of the year immediately following its taxable year. If a taxpayer files its Federal income tax return before the issuance of a supplement or amendment to the applicable financial statement and before the extended due date for filing under section 6081, the taxpayer must file an amended Federal income tax return reporting any additional tax that results from treating the supplement or amendment as part of the applicable financial statement. A supplement or amendment (excluding restatements of net book income) to an applicable financial statement after the date specified in section 6081 is disregarded for purposes of the book income adjustment.

(B) *Restatement of net book income.* If a taxpayer restates net book income in what otherwise would have been its applicable financial statement (its "original financial statement"), referred to in this section as a "restatement of net book income," prior

to the date that the taxpayer's Federal income tax return for such taxable year would be due if the time for filing were extended under section 6081, then—

(*1*) If the financial statement that includes the restated net book income is of a higher priority than the original financial statement, the restated financial statement is the taxpayer's applicable financial statement.

(*2*) If the financial statement that includes the restated net book income is of equal priority to the original financial statement and—

(*i*) The restatement is attributable to an error (as described in Accounting Principles Board Opinion No. 20, paragraph 13), the restated financial statement is the taxpayer's applicable financial statement, or

(*ii*) The restatement is not attributable to an error, the original and restated financial statements will be considered of equal priority, and paragraph (c)(3)(iv) will apply. Thus, the taxpayer's applicable financial statement is the financial statement that results in the greatest amount of adjusted net book income.

See paragraph (d)(4)(iv) of this section for rules that apply to restatements occurring after the due date (including the extension under section 6081) of the return for the taxable year to which the applicable financial statement relates. See paragraph (c)(6), Examples (11) and (12) of this section.

(6) *Examples.* The provisions of this paragraph may be illustrated by the following examples.

Example 1. In 1987, Corporation A only has a financial statement described in paragraph (c)(1)(iv) of this section and elects to treat net book income as equal to its current earnings and profits. In 1988, A has a certified audited financial statement (as described in paragraph (c)(1)(ii) of this section). In 1989, A only has a statement described in paragraph (c)(1)(iv) of this section. In 1988, A's certified audited financial statement is its applicable financial statement. However, in 1989, A is bound by the election it made in 1987 (unless revoked with the consent of the District Director) and must treat net book income as equal to its current earnings and profits.

Example 2. Corporation B prepares two unaudited financial statements. Both statements are distributed to creditors and are used for substantial non-tax purposes. The first financial statement is accompanied by an auditor's review report while the second statement has no auditor's review report. B has no other financial statement. Pursuant to paragraph (c)(3)(iv)(B)(*2*) of this section, the financial statement accompanied by the auditor's review report is B's applicable financial statement.

Example 3. Assume the same facts as in Example (2), except the financial statement accompanied by an auditor's review report is distributed to shareholders while the other statement is distributed to creditors, and both statements are used for substantial non-tax purposes. Pursuant to paragraph (c)(3)(ii) of this section, B's applicable financial statement is the statement distributed to its creditors. Paragraph (c)(3)(iv)(B)(*2*) of this section does not apply because the two statements are not of equal priority after applying paragraphs (c)(3)(i) and (ii) of this section.

Example 4. Corporation C is a closely held corporation with two shareholders. Both shareholders participate in the business on a day-to-day basis and are aware of the financial status of the business. C prepares a financial statement that is used by C's two shareholders to calculate bonuses. The financial statement prepared by C is used for a substantial non-tax purpose.

Example 5. Corporation D prepares a financial statement that it only sends to banks with which D is neither currently doing business nor negotiating. D does not reasonably anticipate that the financial statement will be relied on by the banks for any non-tax purpose, and therefore, for purposes of computing net book income, the financial statement is not used for a substantial non-tax purpose. The result would be the same if D sent the statement to a bank whose only relationship to D is that it holds a mortgage on D's property and D's rights and obligations under the mortgage are not affected by changes in its financial condition. The result would also be the same if D sent the statement to a bank with which D is doing business, and the statement is not reasonably expected to come to the attention of the bank's employees who are responsible for D's account.

Example 6. Corporation E and its subsidiaries, F and G are a consolidated group. Certified audited financial statements are prepared by EF and by FG. Both statements are used for substantial non-tax purposes. Pursuant to paragraph (c)(5)(i)(A) of this section, the financial statement that is prepared by EF is the applicable financial statement of the consolidated group. However, pursuant to paragraph (d)(6)(i)(B) of this section, an adjustment will be required to include the adjusted net book income attributable to G. The result would be the same even if the financial statement prepared by FG is of higher priority (under the rules of paragraph (c)(3) of this section) than the statement prepared by E and F.

Example 7. Corporation H and its subsidiaries I, J and K are a consolidated group. Certified audited financial statements are prepared by H and I and by H, J and K. Both statements are used for substantial non-tax purposes. The financial statement prepared by H, J, and K includes the greater amount of gross receipts attributable to members of the consolidated group and thus, pursuant to paragraph (c)(5)(i)(B)(*2*)(*i*) of this section, it is the consolidated group's applicable financial statement.

Example 8. Corporation L and its subsidiary M are a consolidated group. Corporation L also owns 100 percent of N, a foreign corporation that is not part of the consolidated group. A certified audited financial statement prepared by L M and N discloses gross receipts of $200, of which $150 is attributable to L and M, and a separate certified audited financial statement prepared by L and M discloses gross receipts of $150. Both statements are used for substantial non-tax purposes. Pursuant to paragraph (c)(5)(i)(B) of this section, the consolidated group's applicable financial statement is the statement prepared by L, M and N.

Example 9. Corporation O is 60 percent owned by corporation P and 40 percent owned by corporation Q. Both P and Q prepare financial statements that are required to be filed with the SEC reflecting their respective interests in O. O also separately prepares a certified audited financial statement, or uses a summary of its books and records for credit purposes. Under paragraph (c)(5)(i)(C), O's separate statement is its applicable financial statement.

Example 10. Assume the same facts as in Example (9) except that O does not prepare a separate financial statement or a summary of its books and records for credit purposes. Pursuant to paragraph (c)(5)(i)(C) of this section, O must treat its net book income as equal to its current earnings and profits.

Example 11. Corporation R uses a calendar year for both financial accounting and tax purposes. Initially, R issues its calendar year 1987 financial statement on March 1, 1988. R's adjusted net book income resulting from this statement is $80. This would be R's applicable financial statement for 1987, but for the restatement described in the next sentence. On September 1, 1988, R restates its 1987 financial statement to correct an error (as described in Accounting Principles Board Opinion No. 20, paragraph 13). The restated financial statement is of the same priority as the initial financial statement. The restatement results in adjusted net book income for calendar year 1987 of $50. Pursuant to paragraph (c)(5)(iii)(B)(*2*)(*i*) of this section, the restated financial statement is treated as R's 1987 applicable financial statement.

Example 12. Assume the same facts as in Example (11), except that R restates its financial statement in order to reflect a change in accounting method. Since the restatement does not result from an error, paragraph (c)(5)(iii)(B)(*2*)(*i*) of this section does not apply. Pursuant to paragraph (c)(5)(iii)(B)(*2*)(*ii*) of this section, R's 1987 applicable financial statement is the financial statement for 1987 that results in the greater amount of adjusted net book income. Thus, R's March 1, 1988 financial statement is treated as its 1987 applicable financial statement.

Example 13. Corporation S, which is not a member of an affiliated group, uses a calendar year for both financial accounting and tax purposes. S's 1987 applicable financial statement is a certified audited financial statement. On January 1, 1988, S transfers all of its assets subject to liabilities to T, a newly created subsidiary that is 100 percent owned by S. The principal purpose of the transfer is to use the special rules of paragraph (c)(5)(i) of this section to reduce the adjusted net book income of S. For calendar year 1988, T prepares and uses a certified audited financial statement. Since S's only asset is its investment in T, S does not prepare a financial statement for calendar year 1988. In addition, since S is only a holding company, T's 1988 certified audited financial statement reports the same net book

income that would have been reported on a consolidated ST financial statement. If paragraph (c)(5)(i)(D) of this section does not apply, ST's 1988 applicable financial statement is the financial statement of S (the parent of the consolidated group) with the highest priority. Under paragraph (c)(1) of this section, since S does not have a financial statement in 1988, the net book income of the ST consolidated group is ordinarily deemed to equal the aggregate earnings and profits of the members of the consolidated group. However, given these facts, the District Director may determine that the 1988 certified audited financial statement of T is the 1988 applicable financial statement of the ST consolidated group.

Example 14. The facts are the same as in Example 13, except that S has owned 100 percent of T for several years prior to calendar year 1987. In addition, prior to 1987, ST prepared a consolidated certified audited financial statement. For calendar year 1987, ST does not prepare a consolidated certified audited financial statement. Instead, T prepares and uses a certified audited financial statement while S does not prepare a financial statement. The principal purpose of the change in financial reporting is to use the special rules of paragraph (c)(5)(i) of this section to reduce the adjusted net book income of the ST consolidated group. Given these facts, the District Director may determine that the 1987 certified audited financial statement of T is the 1987 applicable financial statement of the ST consolidated group.

Example 15. Corporation U is a foreign corporation incorporated in A. U is a calendar year taxpayer for both financial accounting and tax purposes. U actively conducts three real estate businesses, X, Y and Z, in the United States. In 1987, X prepares a certified audited financial statement that it provides to its United States creditor. In addition, in 1987, X, Y and Z each prepare unaudited financial statements that they provide to U for incorporation in U's worldwide financial statement. Under paragraph (c)(5)(ii)(A) of this section, U's applicable financial statement is the certified audited financial statement prepared by X. However, pursuant to paragraph (d)(7) of this section, an adjustment is required to include any of U's effectively connected net book income that is not included in X's certified audited financial statement (*i.e.*, the effectively connected net book income attributable to Y and Z).

Example 16. Corporation A is a foreign corporation incorporated in Z. A is a calendar year taxpayer for both financial accounting and tax purposes. A actively conducts a real estate business, B, in the United States. B prepares a certified audited financial statement for 1987 using the accounting principles of Z that it provides to A for incorporation into A's worldwide financial statement. In addition, B prepares a review statement for 1987 using United States generally accepted accounting principles that it provides to its United States creditors. Both the certified statement and the review statement are denominated in United States dollars. Under paragraphs (c)(5)(ii)(A) and (c)(5)(ii)(B)(*1*) of this section, the financial statement prepared under the accounting principles of Z is the applicable financial statement.

Example 17. Assume the same facts as in Example (16) except that amounts are reported on B's certified audited financial statement in the currency of Z and amounts are reported on B's review statement in United States dollars. Since the review statement is denominated in United States dollars, under paragraph (c)(5)(ii)(B)(*2*) of this section, it is the applicable financial statement.

Example 18. Corporation C is a foreign corporation incorporated in Z. C is a calendar year taxpayer for both financial accounting and tax purposes. C actively conducts two real estate businesses, D and E, in the United States. D and E each separately prepare a certified audited financial statement for 1987 that they provide to their United States creditors. D's financial statement reports gross receipts of $100. E's financial statement reports gross receipts of $200. Under paragraph (c)(5)(ii)(C)(*2*) of this section, E's certified audited financial statement is the applicable financial statement and must be adjusted under the rules of paragraph (d)(7) of this section to include effectively connected book income attributable to D.

Example 19. F is a foreign corporation incorporated in X. F is a calendar year taxpayer for both financial accounting and tax purposes. F actively conducts a banking business, G, in the United States. G has been engaged in business in the United States since 1977. For the years 1977 through 1986, G did not prepare a separate financial statement. However, each year G provided F with its books, records and other raw financial data. F used this data in preparing its worldwide financial statement. G provides F with its 1987 books and records on January 5, 1988, in accordance with its historic practice. On February 15, 1988, G prepares an unaudited financial statement for calendar year 1987 that it provides to F. The principal purpose of creating this financial statement is to reduce net book income. Under these facts, the financial statement provided by G is not intended to be reasonably relied upon by F in preparing its worldwide financial statement. Therefore, for purposes of computing net book income, G's financial statement has not been used for a substantial non-tax purpose.

Example 20. Assume the same facts as in Example (19) except that for purposes of preparing F's 1987 worldwide financial statement, G does not provide F with any raw financial data, and G only provides F with an audited financial statement that is prepared for a substantial non-tax purpose. Under these facts, the financial statement provided by G is intended to be relied upon by F in preparing its worldwide financial statement. Therefore, for purposes of computing net book income, G's financial statement has been used for a substantial non-tax purpose.

Example 21. Corporation H is a foreign corporation incorporated in I. H is a calendar year taxpayer for both financial accounting and tax purposes. H actively conducts a real estate business, J, in the United States. For the years 1976 through 1986, J prepared a certified audited financial statement using United States dollars that it provided to H. In 1987, J prepares a certified audited financial statement using the currency of I. The principal purpose of the modification of J's financial reporting is to reduce the amount of the book income adjustment. Given these facts, the District Director may determine that J's 1987 certified audited financial statement prepared in the currency of I is J's applicable financial statement for 1987, and such statement must be converted into United States dollars based upon the translation used to prepare the certified audited financial statement in the currency of I. Accordingly, the effectively connected net book income of J for 1987 is the effectively connected net book income reported on the financial statement that has been converted into United States dollars.

(d) *Adjustments to net book income*—(1) *In general.* Adjusted net book income is computed by making the adjustments described in this paragraph (d) to net book income (as defined in paragraph (b)(2) of this section). No adjustment may be made to net book income except as provided in this paragraph (d).

(2) *Definitions*—(i) *Historic practice.* For purposes of this paragraph (d), historic practice is defined as an accounting practice that—

(A) Was used consistently by the taxpayer for each of the 2 years immediately preceding its first taxable year beginning after 1986, and

(B) Was used on the financial statement that would have been the taxpayer's applicable financial statement (as determined under paragraph (c) of this section) for each of the 2 years immediately preceding its first taxable year beginning after 1986 if section 56(f), as amended by the Tax Reform Act of 1986, had been in effect.

Thus, in order for a calendar year corporation to have an historic practice in 1987, the corporation must have used the accounting practice in its 1985 and 1986 financial statements. However, to be treated as used for purposes of this paragraph, an accounting practice must have been used prior to April 23, 1987. For example, an accounting practice that is first used after April 23, 1987, in a restatement of a taxpayer's 1985 and 1986 financial statements is not the taxpayer's historic practice.

(ii) *Accounting literature.* For purposes of this paragraph (d), the term "accounting literature" means—

(A) Generally accepted accounting principles (GAAP) as defined in the American Institute of Certified Public Accountants Professional Standards, AU Sections 411.05, paragraphs (a) through (c), and

(B) Pronouncements by the SEC including, but not limited to, Regulation S-X, SEC Financial Reporting Releases, and SEC Staff Accounting Bulletins,

that are effective for the accounting

period covered by the applicable financial statement.

(3) *Adjustments for certain taxes*—(i) *In general.* Net book income for purposes of this paragraph (d) must be adjusted to disregard (for example, by adding back) any Federal income taxes or income, war profits, or excess profits taxes imposed by any foreign country or possession of the United States that are directly or indirectly taken into account on the taxpayer's applicable financial statement. No adjustment is made for taxes not described in the preceding sentence. Taxes directly or indirectly taken into account consist of the taxpayer's total income tax expense that includes both current and deferred income tax expense. In addition, items of income and expense, including extraordinary items that are stated net of tax, must be adjusted to disregard the taxes described in this paragraph (d)(3)(i). See paragraph (d)(4)(vii) of this section for an adjustment for certain deferred foreign taxes.

(ii) *Exception for certain foreign taxes.* Net book income is not adjusted to disregard taxes imposed by a foreign country or possession of the United States if the taxpayer does not choose to take the benefits of section 901 (relating to the foreign tax credit) with respect to these taxes for the taxable year. The rule in the preceding sentence only applies to the amount of taxes the taxpayer deducts in the current taxable year under section 164(a). See paragraph (d)(3)(iv), Example (4) of this section. Net book income also is not adjusted to disregard foreign taxes that cannot be claimed as a credit (other than by virtue of a foreign tax credit limitation). Thus, a taxpayer does not add back to net book income any taxes it is not allowed to claim as a credit against its United States income tax liability because of sections 245(a)(8), 901(j), 907(b) or 908 of the Code.

(iii) *Certain valuation adjustments.* Income tax expense under paragraph (d)(3)(i) of this section does not include valuation adjustments such as the valuation adjustments related to purchase accounting described in Accounting Principles Board (APB) Opinion No. 16, paragraph 89. However, income tax expense does include the tax associated with any gain or loss on the sale or other disposition of any asset the basis of which was adjusted under paragraph 89 of Opinion 16. See paragraph (d)(3)(iv), Example (6) of this section.

(iv) *Examples.* The provisions of this paragraph may be illustrated by the following examples.

Example 1. Corporation A has $120 of net book income. In calculating net book income, A has deducted $20 of state income tax expense and $60 of Federal income tax expense. Assuming there are no other adjustments to net book income, A's adjusted net book income is $180 ($120 of net book income + $60 of Federal income tax expense). Pursuant to paragraph (d)(3)(i) of this section, no adjustment is made for the state income tax expense.

Example 2. Assume the same facts as in Example (1), except that A also has a net extraordinary item of $40. Thus, A has net book income of $160 ($120 + $40). The $40 net extraordinary item is composed of a $70 gross extraordinary item less $30 of Federal income tax expense. Assuming there are no other adjustments to net book income, A's adjusted net book income is $250 ($160 of net book income + $60 of Federal income tax expense on book income other than the extraordinary item + $30 of Federal income tax expense on the extraordinary item).

Example 3. Assume the same facts as in Example (1), except that in calculating A's $120 of net book income, A has $50 of Federal income tax expense and $10 of foreign income tax expense. The $10 of foreign income tax expense results from a foreign branch and is composed of $7 of current foreign income tax expense and $3 of deferred foreign income tax expense. A chooses to take the benefits of the foreign tax credit under section 901 for the current taxable year. Assuming there are no other adjustments to net book income, A's adjusted net book income is $180 ($120 of net book income + $50 of Federal income tax expense + $10 of foreign income tax expense).

Example 4. Assume the same facts as in Example (3), except that A does not choose to take the benefits of the foreign tax credit in the current taxable year and instead deducts the $7 of current foreign income tax paid. Pursuant to paragraph (d)(3)(ii) of this section, net book income is not adjusted for the $7 of current foreign income tax expense. However, net book income is adjusted for the $3 of deferred foreign income tax expense. Thus, assuming there are no other adjustments to net book income, D's adjusted net book income is $173 ($120 of net book income + $50 of Federal income tax expense + $3 of deferred foreign income tax expense).

Example 5. In 1987, corporation B only has a financial statement described in paragraph (c)(1)(iv) of this section. B elects pursuant to paragraph (c)(2) of this section to treat net book income as equal to its current earnings and profits. B's current earnings and profits in 1987 is $60, after reduction for $40 of Federal income tax (see paragraph (b)(5)(i) of this section). Pursuant to paragraph (d)(3) of this section, B must make a $40 adjustment to net book income. Thus, assuming no other adjustments to net book income, B's 1987 adjusted net book income is $100 ($60 of net book income + $40 adjustment for Federal income taxes).

Example 6. Corporation A acquires assets from corporation B in a transaction where the tax basis of B's assets will carry over to A. For financial accounting purposes, A will account for the acquisition in accordance with Accounting Principles Board (APB) Opinion No. 16. One of the assets acquired from B has an appraised value of $10,000. However, because the tax basis of B's assets will carry over to A, A's tax basis in the asset is only $7,000. Given these facts, APB Opinion No. 16, paragraph 89 requires that the asset be recorded at $10,000 less the tax effect of the difference between the appraised value and the tax basis. Assuming a 30 percent tax rate for A, the asset would be recorded at $9,100 ($10,000 appraised value—($3,000 difference between the appraised value and the tax basis x 30 percent)). If A sells the asset for $10,000, A will recognize a book gain of $900 with respect to the sale (assuming the asset is not amortized for book purposes). However, A will also have income tax expense of $900 (($10,000 sales proceeds—$7,000 tax basis) x 30 percent) with respect to the sale. Thus, A will have no net book income from the sale. Pursuant to paragraph (d)(3)(iii) of this section, A's income tax expense includes the $900 of income tax expense attributable to the effects of the valuation adjustment made in accordance with APB Opinion No. 16, paragraph 89. As a result, A's adjusted net book income with respect to its asset sale is $900 ($0 of net book income + $900 adjustment for income tax expense).

(4) *Adjustments to prevent omission or duplication*—(i) *In general.* In order to prevent omissions or duplications, net book income must be adjusted for the items described in paragraph (d)(4)(ii) through (d)(4)(vii) of this section and for such other items as approved or required by the Commissioner in published guidance. Except as provided in this paragraph (d), a taxpayer may not adjust net book income to prevent omission or duplication of items. See paragraph (d)(4)(viii), Example (1) of this section.

(ii) *Special rule for depreciating an asset below its cost.* Net book income must be adjusted to exclude depreciation or amortization expense to the extent such expense exceeds the asset's financial accounting historical cost ("excess depreciation"). However, no adjustment is required if excess depreciation has been the taxpayer's historic practice (as defined in paragraph (d)(2)(i) of this section) or if the excess depreciation is properly attributable to negative salvage value (*i.e.*, where the cost of removal or clean-up exceeds the salvage value).

(iii) *Consolidated group using current earnings and profits.* In the case of a consolidated group that uses its aggregate current earnings and profits as net book income (as determined

under the rules of paragraph (b)(5)(ii) of this section), the current earnings and profits of the group is the aggregate of the current earnings and profits of each member of the group. In determining aggregate current earnings and profits, the adjustments described in §1.1502-33 apply except for the adjustment for intercompany distributions with respect to stock and obligations of members of the group described in §1.1502-33(c)(1) and the investment adjustment described in §1.1502-33(c)(4)(ii)(*a*).

(iv) *Restatement of a prior year's applicable financial statement*—(A) *In general.* If a taxpayer restates an applicable financial statement and as a result, the net book income for a taxable year is restated after the last date that the taxpayer could have filed its Federal income tax return for such taxable year (if it had obtained an extension of time under section 6081 of the Code), net book income for the first successor year (as defined in paragraph (d)(4)(iv)(D) of this section) must be adjusted by that part of the cumulative effect of the restatement on net book income attributable to taxable years beginning after 1986. To the extent that the cumulative effect of the restatement on net book income includes a tax component, paragraph (d)(3) of this section may apply. See paragraph (c)(5)(iii) of this section for rules relating to the restatement of an applicable financial statement prior to the date the taxpayer's return for the taxable year would be due if the time for filing the return is extended.

(B) *Reconciliation of owner's equity in applicable financial statements.* If—

(*1*) The beginning balance of owner's equity on the taxpayer's applicable financial statement for the current taxable year is different than the ending balance of owner's equity on the taxpayer's applicable financial statement for the preceding taxable year, and

(*2*) The taxpayer is not otherwise subject to the restatement rules in paragraph (d)(4)(iv)(A) of this section,

the taxpayer will be deemed to have restated its applicable financial statement for the preceding year and paragraph (d)(4)(iv)(A) of this section will apply.

(C) *Use of different priority applicable financial statements in consecutive taxable years.* If the priority of a taxpayer's applicable financial statement (as determined under the rules of paragraph (c)(3) of this section) for the current taxable year is different than the priority of the taxpayer's applicable financial statement for the preceding taxable year, the taxpayer shall be required to adjust net book income to the extent required under the rules of either paragraph (d)(4)(iv)(A) or (B) of this section.

(D) *First successor year defined.* The "first successor year" is the first taxable year for which the taxpayer could have timely filed a return if it had obtained an extension of time under section 6081 of the Code after the restatement occurs. For example, if a calendar year corporation restates and uses its 1987 applicable financial statement between September 16, 1988, and September 15, 1989, any adjustment resulting from the restatement will be made in the taxpayer's 1988 Federal income tax return. If the restatement occurs prior to September 15, 1988, the rules of paragraph (c)(5)(iii) of this section will apply.

(E) *Exceptions.* (*1*) No adjustment is made under paragraph (d)(4)(iv)(A) of this section for a restatement prepared in accordance with APB Opinion No. 16, paragraph 53, requiring restatements of financial statements to reflect the combined operation of corporations combined in a pooling transaction.

(*2*) In order to prevent duplication of an adjustment, an adjustment otherwise required under paragraph (d)(4)(iv)(A) of this section may be decreased to take into account an adjustment previously made under the disclosure rules described in paragraph (d)(5) of the section. See paragraph (d)(4)(viii), Example (3) of this section.

(v) *Adjustment for items previously taxed as subpart F income.* Net book income does not include any item excluded from regular taxable income under section 959 if the item was included in adjusted net book income in a prior taxable year under the provisions of paragraph (b)(2)(iv) of this section and due to section 951. A taxpayer may not adjust net book income under this paragraph (d)(4)(v) to the extent any portion of the subpart F income was recognized during taxable years beginning before 1987. See example (5) of paragraph (d)(4)(viii) of this section.

(vi) *Adjustment for pooling of interests.* In a business combination accounted for as a pooling of interests under paragraph 50 of APB Opinion 16, net book income does not include the income of a separate corporation for that part of the taxable year preceding the combination of that corporation with the taxpayer, to the extent the separate corporation included this income in its net book income for the taxable year preceding the business combination. A taxpayer may not adjust net book income under this paragraph (d)(4)(vi) to the extent the separate corporation's income is attributable to taxable years beginning before 1987.

(vii) *Adjustment for certain deferred foreign taxes.* In the case of deferred foreign taxes that were previously added back to net book income in accordance with paragraph (d)(3) of this section, a deduction is allowed in computing adjusted net book income for the taxable year in which the deferred foreign taxes are deducted under section 164(a). A taxpayer may not adjust net book income under this paragraph (d)(4)(vii) to the extent the foreign taxes were deferred during taxable years beginning before 1987.

(viii) *Examples.* The provisions of this paragraph may be illustrated by the following examples.

Example 1. Corporation A uses a calendar year for both financial accounting and tax purposes. In 1986, A's financial statement included a $100 financial accounting loss for a plant shutdown. A could not deduct the loss on its 1986 Federal income tax return. In 1987, A deducts the loss from the 1986 plant shutdown in its 1987 Federal income tax return. As a result, A's 1987 adjusted net book income exceeds its 1987 pre-adjustment alternative minimum taxable income by $100 (an amount equal to the deduction for the 1986 plant shutdown). Pursuant to paragraph (d)(4)(i) of this section, A cannot make an adjustment to net book income.

Example 2. Corporation B uses a calendar year for both financial accounting and tax purposes. B issues its calendar year 1987 applicable financial statement on March 1, 1988. The applicable financial statement reports net book income for the calendar years 1985 through 1987 of $50, $70, and $80, respectively. On March 1, 1989, when it issues its calendar year 1988 applicable financial statement, B restates its 1985, 1986 and 1987 applicable financial statements. The restatement results from a change in accounting method that is made during calendar year 1988. After restatement, B's net book income for 1985, 1986, and 1987 is $60, $80, and $90,

respectively. Based upon these facts, the cumulative effect of the restatement on B's net book income for years prior to 1988 is $30. However, since $20 of the cumulative effective is attributable to years beginning before 1987, B's 1988 net book income is increased by only $10 ($30—$20). If the cumulative effect includes a tax adjustment, see paragraph (d)(3) of this section.

Example 3. Assume the same facts for Corporation B as in Example (2), except that B's 1987 net book income of $80 is increased by $10 for purposes of B's 1987 Federal income tax return. The $10 adjustment is made pursuant to paragraph (d)(5)(iii) of this section relating to disclosure in the accountant's opinion. Specifically, the accountant's opinion on B's 1987 applicable financial statement disclosed that if D had used a certain accounting method, B's 1987 net book income would have been $90 rather than $80. The restatement of B's 1987 applicable financial statement on March 1, 1988, results entirely from B changing to the accounting method referred to in the 1987 accountant's opinion. Pursuant to paragraph (d)(4)(iv)(E)(*2*) of this section, no adjustment is made to B's 1988 net book income as a result of the restatement of B's 1987 applicable financial statement.

Example 4. Assume the same facts as in Example (1), except that when A issues its 1987 applicable financial statement it also restates the net book income reported on its 1986 financial statement to exclude the $100 loss attributable to the plant shutdown. Furthermore, the $100 loss from the plant shutdown is included in A's 1987 net book income as reported on its 1987 applicable financial statement. Pursuant to paragraph (d)(4) of this section, no adjustment is made to A's 1987 net book income as a result of the restatement of A's 1986 net book income.

Example 5. Corporation D is a domestic corporation. D owns ten percent of the issued and outstanding stock of corporation F, a foreign corporation. D and F file separate financial statements and federal income tax returns, both on a calendar-year basis. F is a controlled foreign corporation as defined in section 957. In 1987, D includes ten percent of F's subpart F income in its income under section 951. F makes no actual distributions to D in that year, and D's applicable financial statement includes the earnings of F only when actual distributions are made. See paragraph (d)(6)(i)(A) of this section. In 1987, D must adjust its net book income under paragraph (b)(2)(iv) of this section to include ten percent of F's subpart F income. In 1988, F makes an actual distribution to D which qualifies for the exclusion of section 959. D includes this actual distribution as income on its applicable financial statement for 1987. Pursuant to paragraph (d)(4)(v) of this section, D must adjust its net book income for 1988 to exclude the actual distribution from F.

(5) *Adjustments resulting from disclosure*—(i) *Adjustment for footnote disclosure or other supplementary information*—(A) *In general.* Except as described in this paragraph (d)(5)(i), net book income must be increased by any amount disclosed in a footnote or other supplementary information to the applicable financial statement if the disclosure supports a calculation of a net book income amount that would be greater than the net book income reported on the taxpayer's applicable financial statement. However, net book income will not be increased if the disclosure—

(*1*) Is specifically authorized by the accounting literature described in paragraph (d)(2)(ii) of this section, or

(*2*) Is in accordance with the taxpayer's historic practice as defined in paragraph (d)(2)(i) of this section.

See paragraph (d)(5)(v), Examples (1) and (2) of this section.

(B) *Disclosures not specifically authorized in the accounting literature.* The following footnote or other supplementary disclosures will not be considered specifically authorized in the accounting literature—

(*1*) Disclosure of what the taxpayer's net book income would have been if GAAP had been used in preparing the applicable financial statement instead of tax accounting rules (or disclosure of the adjustment necessary to determine net book income on a GAAP basis), and

(*2*) Disclosure of what the taxpayer's net book income would have been if the accrual method had been used in preparing the applicable financial statement instead of the cash method (or disclosure of the adjustment necessary to determine net book income on the accrual method).

(ii) *Equity adjustments*—(A) *In general.* Except as described in this paragraph (d)(5)(ii), net book income must be increased by the amount of any equity adjustment (as defined in paragraph (d)(5)(ii)(B) of this section) included in the applicable financial statement if the equity adjustment increases owner's equity as reported on the taxpayer's applicable financial statement and the increase is attributable to the taxpayer or a member of the taxpayer's consolidated group. However, net book income will not be increased if the equity adjustment—

(*1*) Is specifically authorized by the accounting literature described in paragraph (d)(2)(ii) of this section, or

(*2*) Is in accordance with the taxpayer's historic practice, as defined in paragraph (d)(2)(i) of this section.

See paragraph (d)(5)(v), Examples (3) and (4) of this section.

(B) *Definition of equity adjustment.* An equity adjustment is any reconciling item between beginning and ending owner's equity as reported on the taxpayer's applicable financial statement for the current taxable year. However, if properly accounted for, the following reconciling items are not considered equity adjustments and do not require adjustment under paragraph (d)(5)(ii)(A) of this section—

(*1*) Net book income,

(*2*) Non-liquidating dividend distributions, and

(*3*) Contributions to capital.

(iii) *Amounts disclosed in an accountant's opinion.* Net book income must be increased by the amount of any item disclosed in the accountant's opinion (as described in paragraphs (c)(1)(ii)(C) and (c)(l)(ii)(D) of this section) if the disclosure supports a calculation of a net book income amount that would be greater than the net book income reported on the taxpayer's applicable financial statement. However, net book income will not be increased if the disclosure is in accordance with the taxpayer's historic practice, as defined in paragraph (d)(2)(i) of this section.

(iv) *Accounting method changes that result in cumulative adjustments to the current year's applicable financial statement*— (A) *In general.* If net book income for the current taxable year includes a cumulative adjustment attributable to an accounting method change and the amount of the cumulative adjustment may be determined upon review of the applicable financial statement (including footnotes) or other supplementary disclosure, net book income for the current taxable year shall be adjusted to exclude that portion of the cumulative adjustment attributable to taxable years beginning before 1987. To the extent the cumulative adjustment is reported net of a tax, paragraph (d)(3) of this section may apply. See paragraph (d)(5)(v), Example (5) of this section. If an accounting method change results in a restatement of an applicable financial statement, paragraphs (c)(5)-(iii) or (d)(4)(iv)(A) of this section may apply.

(B) *Exception.* In order to prevent

duplication of an adjustment, the adjustment required under paragraph (d)(5)(iv)(A) of this section may be decreased to take into account any adjustment for the accounting method change previously made under the rules described in paragraph (d)(5) of this section (relating to adjustments resulting from disclosure).

(v) *Examples.* The provisions of this paragraph may be illustrated by the following examples.

Example 1. Corporation A uses a calendar year for both financial accounting and tax purposes. For calendar years 1984 through 1986, A used the cash method of accounting on its financial statement and disclosed in a footnote the net income or loss that would have resulted if the accrual method of accounting had been used. A's 1987 net book income, as reported on its 1987 applicable financial statement, is $100 and is calculated on the cash method of accounting. In addition, a footnote in A's 1987 applicable financial statement states that A's 1987 net book income would have been $30 greater had the accrual method of accounting been used. Pursuant to paragraph (d)(5)(i)(B)(2) of this section, A's 1987 footnote disclosure is not considered specifically authorized by the accounting literature. However, since A made such disclosure for calendar years 1985 and 1986, the 1987 disclosure is in accordance with A's historic practice, as defined in paragraph (d)(2)(i) of this section. Since A satisfies the exception described in paragraph (d)(5)(i)(A)(*2*) of this section, no adjustment is made to A's 1987 net book income for the footnote disclosure.

Example 2. Assume the same facts for corporation B as in Example (1), except that B's 1985 and 1986 financial statements did not disclose the amount of income or loss that would result if the accrual method of accounting (rather than the cash method of accounting) were used. Since B does not satisfy either of the exceptions described in paragraph (d)(5)(i)(A) of this section, B's 1987 adjusted net book income is $130 ($100 of net book income plus $30 adjustment for footnote disclosure).

Example 3. Corporation C uses a calendar year for both financial accounting and tax purposes. C's 1987 net book income, as reported on its 1987 applicable financial statement, is $200. However, as specifically authorized in FASB Statement of Standards No. 52, C's 1987 applicable financial statement also includes a $50 equity adjustment (as defined in paragraph (d)(5)(ii)(B) of this section) for foreign currency translation gains. Since the equity adjustment is specifically authorized in the accounting literature, C satisfies the exception described in paragraph (d)(5)(ii)(A)(*1*) of this section, and no adjustment is made to C's 1987 net book income for the $50 equity adjustment.

Example 4. Assume the same facts for corporation D as in Example (3), except that D's equity adjustment is for foreign currency transaction gains instead of foreign currency translation gains. Pursuant to FASB Statement of Financial Accounting Standards No. 52, foreign currency transaction gains (as compared with foreign currency translation gains) are included in the income statement rather than in equity. In addition, in 1985 and 1986, D included foreign currency transaction gains in its income statement. Since D does not satisfy either of the exceptions described in paragraph (d)(5)(ii)(A) of this section, D's 1987 adjusted net book income is $250 ($200 of net book income plus $50 equity adjustment).

Example 5. Corporation E uses a calendar year for both financial accounting and tax purposes. E's net book income for 1988 is $100. The $100 of net book income includes $30 of financial accounting loss attributable to a cumulative adjustment as of January 1, 1988, resulting from a change in E's accounting method. The $30 cumulative loss is disclosed in E's 1988 applicable financial statement. If E had made the accounting method change in calendar year 1987, the cumulative loss as of January 1, 1987 would have been $20. Based upon the above facts, E must increase net book income by $20 to disregard that portion of the cumulative adjustment attributable to years beginning before 1987. Thus, assuming no other adjustments to net book income, E's adjusted net book income for 1988 is $120 ($100 plus $20).

(6) *Adjustments applicable to related corporations*—(i) *Consolidated returns*—(A) *In general.* Pursuant to paragraphs (a)(3) and (b)(3) of this section, the book income adjustment with respect to a consolidated group (as described under paragraph (a)(3) of this section) is computed based on the consolidated adjusted net book income (as defined in paragraph (b)(3)(i) of this section). In the case of any corporation that is not included in the consolidated group, consolidated adjusted net book income of the consolidated group shall include only the sum of the dividends received from such other corporation and other amounts includible in gross income under this chapter with respect to the earnings of such other corporation. See paragraph (d)(6)(v), Example (4) of this section.

(B) *Corporations included in the consolidated Federal income tax return but excluded from the applicable financial statement—(1) In general.* Consolidated net book income reported on the applicable financial statement (as determined under paragraph (c)(5) of this section) shall be adjusted to include net book income attributable to a corporation that is included in the consolidated group but is not included in the applicable financial statement. Net book income for the corporation not included in the applicable financial statement of the consolidated group is the net book income reported on such corporation's applicable financial statement (determined under the rules of paragraph (c) of this section and adjusted under the rules of this paragraph (d)). The adjusted net book income of such corporation must be consolidated with the adjusted net book income of other members of the consolidated group and appropriate adjustments, including consolidating elimination entries, must be made.

(*2*) *Adjustments to net book income for minority interests.* Consolidated net book income must be adjusted to include income or loss allocated to minority interests in members of the consolidated group. Failure to include income or loss allocated to minority interests shall be treated as an omission of net book income. See paragraph (d)(6)(v), Example (1) of this section.

(*3*) *Corporations included in the consolidated group that are accounted for under the equity method of accounting.* No adjustment is required to consolidated net book income for income or loss of a member of the consolidated group that is reported in the applicable financial statement under the equity method of accounting (as described in APB Opinion No. 18, paragraph (6)). However, consolidated adjusted net book income (as defined in paragraph (b)(3)(i) of this section) must include 100 percent of the net book income attributable to such member. See paragraph (d)(6)(i)-(B)(*2*) of this section. For example, if consolidated net book income (as defined in paragraph (b)(3)(ii) of this section) only includes 85 percent of the equity income attributable to a member of the consolidated group, an adjustment will be required to include the 15 percent of equity income excluded from consolidated net book income. In addition, to the extent the equity income reflects an adjustment for tax expense or benefit, paragraph (d)(3) may apply. See paragraph (d)(6)(v), Examples (2) and (3) of this section.

(C) *Corporations included in the applicable financial statement but excluded from the consolidated tax return.* Net book income or consolidated net book income must be adjusted to eliminate the income or loss of a corporation that is included in the applicable financial statement, but is not included in the consolidated group. When net book income attributable to a corporation that is not a member of the consolidated group is removed from the computation of net book income in the applicable finan-

cial statement, consolidating elimination entries attributable to the excluded member must also be removed.

(ii) *Adjustment under the principles of section 482.* In order to fairly allocate items relating to intercompany transactions between corporations that are owned or controlled directly or indirectly by the same interests but are not members of a consolidated group, adjustments must be made to the net book income reported on the applicable financial statement of each corporation under the principles of section 482 and the regulations thereunder (relating to allocation of income and deductions among related taxpayers). For example, assume corporation A owns 100 percent of F, a foreign subsidiary, but A and F are not members of a consolidated group. However, A and F prepare a consolidated financial statement. In adjusting A's applicable financial statement to eliminate the net book income attributable to F, A must apply the principles of section 482. If a corporation fails to make appropriate adjustments to its applicable financial statement under the rules of this paragraph (d)(6)(ii), the District Director may make such adjustments under the principles of section 482 and the regulations thereunder.

(iii) *Adjustment for dividends received from section 936 corporations*—(A) *In general.* Any dividend received from a corporation eligible for the credit provided by section 936 (relating to the possession tax credit) shall be included in adjusted net book income. For example, assume corporation A owns 100 percent of B, a section 936 corporation, and B pays a $100 dividend to A. Furthermore, assume that of the $100 dividend, $15 of withholding tax is paid to a possession of the United States, so that A only receives $85 from the dividend. Given these facts, A's adjusted net book income includes $100 with respect to the dividend from B.

(B) *Treatment as foreign taxes.* Fifty percent of any withholding tax paid to a possession of the United States with respect to dividends referred to in paragraph (d)(6)(iii)(A) of this section may be treated for purposes of the alternative minimum foreign tax credit as a tax paid to a foreign country by the corporation receiving the dividend. However, if the aggregate of these dividends exceeds the excess referred to in paragraph (a)(1) of this section, the amount treated as a tax paid to the foreign country shall not exceed 50 percent of the aggregate amount of the tax withheld multiplied by a fraction,

(*1*) the numerator of which is the excess referred to in paragraph (a)(1) of this section; and

(*2*) the denominator of which is the aggregate amount of these dividends.

(C) *Treatment of taxes imposed on section 936 corporations.* Taxes paid by any corporation eligible for the credit provided under section 936 shall be treated as a withholding tax paid with respect to any dividend paid by such corporation, and thus subject to the rules of this paragraph (d)(6)(iii), but only to the extent such taxes would be treated as paid by the corporation receiving the dividend under rules similar to the rules of section 902.

(iv) *Adjustment to net book income on sale of certain investments.* If a taxpayer accounts for an investment under any method equivalent to the equity method of accounting (as described in APB Opinion No. 18, paragraph 6) and pursuant to paragraphs (b)(2)(iv) or (d)(6)(i) of this section the taxpayer excludes net book income attributable to that investment, the taxpayer must adjust its net book income in the year the investment is sold (or partially sold). The adjustment equals the amount of net book income previously excluded under paragraphs (b)(2)(iv) or (d)(6)(i)(A) of this section). See paragraph (d)(6)(v), Example (4) of this section.

(v) *Examples.* The provisions of this paragraph may be illustrated by the following examples.

Example 1. Corporation A and its 100 percent owned subsidiary B and its 90 percent owned subsidiary C are a consolidated group. A also owns 100 percent of D, a foreign corporation. ABC's applicable financial statement is a certified audited financial statement that includes A, B, C and D. The net book income reported on the statement excludes $10 of C's net book income that is attributable to the 10 percent minority interest in C held outside of the consolidated group. Pursuant to paragraph (d)(6)(i)(B)(*2*) of this section, net book income of the consolidated group must be adjusted to include the $10 of net book income attributable to the minority interest in C. In addition, pursuant to paragraph (d)(6)(i)(C) of this section, net book income shown on the applicable financial statement must be adjusted to eliminate the net book income attributable to D.

Example 2. Corporation E owns 100 percent of F, a finance subsidiary, and EF are a consolidated group. Since F is a finance subsidiary, E's applicable financial statement accounts for F under the equity method of accounting. F also prepares a separate financial statement that is of equal or higher priority than E's applicable financial statement. In 1987, E's applicable financial statement includes $60 of equity income from F. The $60 of equity income reflects a reduction for $40 of Federal income tax expense. Thus, E's equity income from F prior to the reduction for Federal income tax expense, is $100 ($60 + $40). Since E's applicable financial statement includes E's equity income in F, F's separate financial statement is not relevant for determining the adjusted net book income of the EF consolidated group. However, pursuant to paragraphs (d)(3) and (d)(6)(i)(B)(*3*) of this section, E is required to adjust its equity income in F by the $40 of Federal income tax expense attributable to F. Thus, assuming there are no other adjustments, E's adjusted net book income with respect to F is $100.

Example 3. The facts are the same as Example (2), except that E reports its equity income in F without reduction for F's Federal income tax expense. The $40 of Federal income tax expense attributable to F is combined with E's Federal income tax expense. Assuming no other adjustments, E's adjusted net book income with respect to F is $100. Thus, E's adjusted net book income with respect to F will be the same regardless of whether E's equity income in F is reported before or after taxes.

Example 4. A, a domestic corporation, uses a calendar year for both financial accounting and tax purposes. On January 1, 1987, A purchases 100 percent of F, a foreign corporation, for $100. F does not file a Federal income tax return and A does not recognize any taxable income with respect to F under section 951 (relating to controlled foreign corporations). In its applicable financial statement, A accounts for its investment in F under the equity method of accounting. Thus, A's initial investment in F is $100. During calendar year 1987, F has $50 of net book income but makes no dividend payments to A. Under the equity method of accounting, A's net book income includes the $50 of net book income attributable to A's net book investment in F. Thus, A's investment in F is increased to $150. Pursuant to paragraph (d)(6)(i)(C) of this section, A's net book income is adjusted to eliminate the $50 of net book income attributable to F. On January 1, 1988, A sells F for $150. Since A's investment in F under the equity method of accounting is $150, A's net book income for 1988 will not include any gain on the sale of F. However, pursuant to paragraph (d)(6)(iv), A's 1988 net book income must be increased by $50, the amount of net book income previously eliminated with respect to A's investment in F. The result would be the same if instead of accounting for its investment in F under the equity method of accounting, A and F prepare a consolidated financial statement.

(7) *Adjustments for foreign taxpayers with a United States trade or business*—(i) *In general.* Pursuant to

paragraph (b)(6) of this section, the book income adjustment with respect to a foreign taxpayer with a United States trade or business is computed based on the effectively connected net book income of the foreign taxpayer (as defined in paragraph (b)(6)(ii) of this section). The net book income amount reported on the applicable financial statement of the foreign taxpayer (as determined under paragraph (c)(5)(ii) of this section) must be adjusted to—

(A) Include effectively connected net book income attributable to a trade or business conducted in the United States by the foreign taxpayer that is not reported on the applicable financial statement. Such amounts shall be determined from a financial statement (determined under paragraph (c) of this section and adjusted under the rules of this paragraph (d)) that would have qualified as an applicable financial statement of such excluded trade or business or upon effectively connected earnings and profits (if the rules of section (b)(6)(iii) of this section apply), and

(B) Exclude any amount reported on such applicable financial statement that does not qualify as effectively connected net book income.

See the example in paragraph (d)(7)(ii) of this section.

(ii) *Example.* The provisions of this paragraph may be illustrated by the following example.

Example. Foreign corporation A, a calendar year taxpayer for financial accounting and tax purposes, is incorporated in X. A actively conducts two real estate businesses, B and C, in the United States. B prepares a certified audited financial statement that it provides to its United States creditor. C does not prepare a financial statement. The certified audited financial statement prepared by B is treated as A's applicable financial statement under paragraph (c)(5)(ii) of this section. B's certified audited financial statement, in addition to amounts related to the conduct of its real estate business, also reports income received from its investment in United States securities, unrelated to its conduct of business in the United States that does not qualify as effectively connected net book income. In order to determine A's effectively connected net book income from the net book income reported on the applicable financial statement, such statement must be adjusted to exclude amounts attributable to the securities. In addition, book income or loss attributable to C, to the extent effectively connected to its business in the United States, must be included in the effectively connected net book income reported on B's financial statement. Since C does not have a financial statement, C's effectively connected net book income is determined by computing its effectively connected earnings and profits under paragraph (b)(6)(iii) of this section.

(8) *Adjustment for corporations subject to subchapter F.* A corporation subject to tax under subchapter F of chapter 1 of the Code shall adjust its book income to exclude all items of income, loss or expense other than those relating to the calculation of unrelated business taxable income for purposes of section 512(a).

(e) *Special rules*—(1) *Cooperatives.* For purposes of computing the book income adjustment, net book income of a cooperative to which section 1381 applies is reduced by patronage dividends and per-unit retain allocations under section 1382(b) that are paid by the cooperative to the extent such amounts are deductible for regular income tax and general alternative minimum tax purposes under section 1382, and not otherwise taken into account in determining adjusted net book income.

(2) *Alaska Native Corporations.* In computing the net book income of an Alaska Native Corporation, cost recovery and depletion are computed using the asset basis determined under section 21(c) of the Alaska Native Claims Settlement Act (43 U.S.C. 1620(c)). In addition, net book income is reduced by expenses payable under either section 7(i) or section 7(j) of the Alaska Native Claims Settlement Act (43 U.S.C. 1606(i) and (j)) only when deductions for such expenses are allowed for tax purposes.

(3) *Insurance companies.* In the case of an insurance company whose applicable financial statement is a statement described in paragraph (c)(1)(iii) of this section (relating to statements provided to a government regulator), net book income for purposes of the book income adjustment is the net income or loss from operations, after reduction for dividends paid to policyholders, but without reduction for Federal income taxes.

(4) *Estimating the book income adjustment for purposes of the estimated tax liability.* See §1.6655-7 for special rules for estimating the corporate alternative minimum tax book income adjustment under the annualization exception.

Paragraph 6. 26 CFR part 1 is amended as follows:

(a) Section 1.6655-7T is redesignated as §1.6655-7 and the word "(Temporary)" is removed at the end of the section heading.

(b) Section 1.6655-7 (as redesignated) is revised to read as follows:

§1.6655-7 Special rules for estimating the corporate alternative minimum tax book income adjustment under the annualization exception.

(a) *In general.* For purposes of section 6655(e) (relating to the "annualization exception") a corporate taxpayer must take into account the tax imposed by section 55 (relating to the alternative minimum tax) and the tax imposed by section 59A (relating to the environmental tax). Thus, a taxpayer using the annualization exception must estimate alternative minimum taxable income, including the book income adjustment, for the period of the taxable year that is annualized (the "annualization period").

(b) *Estimating the book income adjustment.* The book income adjustment for the annualization period is determined in accordance with the rules of §1.56-1, except as otherwise provided in this section.

(c) *Applicable financial statement for the annualization period*—(1) *In general.* A taxpayer's applicable financial statement for an annualization period is the financial statement of highest priority described in section 56(f)(3)(A) and §1.56-(c) that is prepared for such annualization period by the date the installment payment is due. However, if a taxpayer reasonably expects to have a financial statement of higher priority for such period no later than 30 days after the date the installment payment is due, the taxpayer shall make a reasonable estimate of the adjusted net book income that will result from such statement, and such estimate shall be used as the taxpayer's adjusted net book income for that annualization period. If the date that is 30 days after the due date of the installment falls on a Saturday, Sunday or legal holiday, the 30-day period is extended to the immediately following day that is not a Saturday, Sunday or legal holiday. For example, an event arising subsequent to the installment due date that causes the taxpayer's estimate of net book income to be understated will not result in a recomputation of the book income adjustment for the annualization period, if, based

on all the facts and circumstances at the time the installment payment was made, it was not reasonably foreseeable that the subsequent event would occur.

(2) *Example.* The provisions of this paragraph may be illustrated by the following example:

Example. A is a public corporation that is a calendar year taxpayer. A's first installment payment of estimated tax is due April 15. A uses the annualization exception under section 6655(e) in order to determine whether it is liable for an addition to tax due to an underpayment of estimated tax. In the case of the first installment, the applicable annualization period is the first three months of the taxable year. On April 15, A has an unaudited financial statement for the first three-month period that is used for credit purposes. By May 15, A will file a quarterly report, Form 10-Q, with the Securities and Exchange Commission. Since the financial statement filed with the SEC has higher priority than the unaudited statement and A can reasonably expect to have such statement no later than 30 days after the installment due date, A must make a reasonable estimate of the adjusted net book income that will result from such statement. This estimate shall be used as A's adjusted net book income for the annualization period.

(d) *Earnings and profits*—(1) *In general.* If an applicable financial statement is not available by the date a payment is due for an annualization period or reasonably expected to be available no later than 30 days after the payment is due under the rules of paragraph (c) of this section, current earnings and profits for the applicable annualization period must be used in lieu of net book income. See §1.56-1(b)(5) for rules relating to computing current earnings and profits for purposes of computing the book income adjustment.

(2) *Election to use earnings and profits*—(i) *In general.* A taxpayer may elect to use current earnings and profits for the applicable annualization period if the taxpayer has only a statement for such period that is described in section 56(f)(3)(A)(iv) and §1.56-1(c)(1)(iv) and the taxpayer has elected under the rules of section 56(f)(3)(B)(ii) and §1.56-1(c)(2) to use current earnings and profits to compute the book income adjustment for purposes of filing its annual Federal income tax return. Once the election has been made, current earnings and profits must be used for any annualization period for which the taxpayer has only an applicable financial statement described in section 56(f)(3)(A)-(iv) and §1.56-1(c)(1)(iv).

(ii) *Election during 1987 taxable year.* During its taxable year beginning in 1987, a taxpayer may elect to use current earnings and profits for an applicable annualization period even if the taxpayer has not elected to use current earnings and profits for purposes of computing its annual Federal income tax liability under section 56(f)(3)(B)(ii) and §1.56-1(c)(2). In addition, a taxpayer electing in 1987 to use current earnings and profits for purposes of its installment payments of estimated tax is not required to use current earnings and profits to compute the book income adjustment when filing its annual Federal income tax return. However, unless an annual election under section 56(f)(3)(B)(ii) is made when filing the taxpayer's 1987 Federal income tax return, the election to use current earnings and profits for purposes of computing its estimated tax liability in taxable years beginning after 1987 is terminated.

(iii) *Manner of making election.* If a taxpayer elects to use current earnings and profits for the applicable annualization period under the rules of this section, the taxpayer must attach a statement to its Federal income tax return for the taxable year in which the election was made. The statement must include the electing taxpayer's name, address and taxpayer identification number, identify the election and indicate that it was made under the provisions of §1.6655-7, state that the only financial statement of the taxpayer available for the annualization period is described in §1.56-1(c)(1)(iv).

Paragraph 7. The authority for Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805

Paragraph 8. The table of OMB control numbers in §602.101(c) is amended as follows: The entry reading: "1.56-1T. . .1545-0123" is revised to read: "1.56-1. . .1545-0123", and the entry reading: "1.6655-7T. . . 1545-0123" is revised to read: "1.6655-7. . .1545-0123".

Michael J. Murphy,
Acting Commissioner of Internal Revenue.

Approved July 27, 1990.

Kenneth W. Gideon,
Assistant Secretary of the Treasury.

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Section 57.—Items of Tax Preference

(Also Section 170; 1.170A-1.)

Items of tax preference; appreciated property charitable deduction preference; carryover of excess contribution. A carryover of an excess charitable contribution of tangible personal property made in 1991 will not generate an item of tax preference under section 57(a)(6) of the Code in any succeeding taxable year to which the excess may be carried under the rules of section 170.

Rev. Rul. 90-111

ISSUE

If, in a taxable year beginning in 1991, a taxpayer makes a charitable contribution of tangible personal property that constitutes capital gain property within the meaning of section 170(b)(1)(C)(iv) of the Internal Revenue Code and the charitable deduction for that property is limited by the percentage rules of section 170(b), does a carryover of the excess charitable contribution that is deducted under the rules of section 170 in a succeeding taxable year generate an item of tax preference under section 57(a)(6) in that succeeding year?

FACTS

In 1991, *A*, an individual who is a calendar year taxpayer, makes a charitable contribution (as defined in section 170(c) of the Code) of a work of art. The donee is Museum *X*, an organization described in section 170(b)(1)(A). *X*'s use of the property will be related to its purpose and function as a museum. Thus, the amount of the contribution is not reduced by the rules of section 170(e)(1)(B).

At the time of the contribution, *A*'s basis in the art work is $250*x*, the fair market value of the art work is $1,000*x*, and the art work is tangible personal property that is capital gain property as defined in section 170(b)(1)(C)(iv) of the Code. *A* makes no other charitable contributions in 1991 and has no charitable contribu-

tion carryovers from earlier years. *A* does not elect under section 170(b)(1)(C)(iii) to deduct the basis rather than the fair market value of contributed capital gain property. *A*'s 1991 contribution base (determined under section 170(b)(1)(F)) is $2,000*x*. Accordingly, although the amount of *A*'s charitable contribution is the $1,000*x* fair market value of the art work, *A* may deduct only $600*x* ($2,000*x* times 30%) in 1991 on account of the "30 percent limitation" imposed by section 170(b)(1)(C)(i).

In 1992, *A* makes no charitable contributions, has no other carryover of charitable contributions, and has a contribution base of $2,000*x* for that year. Accordingly, *A* may deduct the $400*x* excess 1991 charitable contribution as a carryover contribution in 1992 under section 170(b)(1)(C)(ii) of the Code.

LAW AND ANALYSIS

Section 170(a) of the Code allows a deduction for any charitable contribution (as defined in section 170(c)) payment of which is made within the taxable year.

Section 170(b)(1)(C)(i) of the Code provides that the deduction for charitable contributions of capital gain property to organizations described in section 170(b)(1)(A) is limited to 30 percent of an individual taxpayer's contribution base for the year. Under section 170(b)(1)(F), an individual taxpayer's contribution base is adjusted gross income, computed without regard to any net operating loss carryback to the taxable year.

Section 170(b)(1)(C)(ii) of the Code provides that if charitable contributions of capital gain property to organizations described in section 170(b)(1)(A) are in excess of 30 percent of the taxpayer's contribution base for the year, such excess shall be treated, in a manner consistent with the rules of section 170(d)(1), as a contribution of capital gain property to which the 30 percent limitation applies in each of the 5 succeeding taxable years in order of time.

Section 170(b)(1)(C)(iv) of the Code provides that the term "capital gain property" means, with respect to any contribution, any capital asset the sale of which at its fair market value at the time of contribution would have resulted in gain that would have been long-term capital gain.

Section 55 of the Code imposes an alternative minimum tax on taxpayers. In determining alternative minimum tax, taxpayers must compute alternative minimum taxable income, which is taxable income determined with the adjustments provided in sections 56 and 58, and increased by the items of tax preference provided in section 57. Section 57(a)(6) provides that the amount by which the deduction allowable under section 170 or section 642(c) would be reduced if all capital gain property were taken into account at its adjusted basis shall be treated as an item of tax preference. Section 57(a)(6)(B) defines the term "capital gain property" to have the same meaning as in section 170(b)(1)(C)(iv), subject to certain exceptions.

Section 11344 of the Revenue Reconciliation Act of 1990, Pub. L. No. 101-503 (the "Act"), added the following sentence to section 57(a)(6)(B) of the Code: "In the case of any taxable year beginning in 1991, such term [capital gain property] shall not include any tangible personal property." The purpose of this amendment was to provide an additional incentive for taxpayers to donate certain tangible personal property (such as works of art and manuscripts) to charitable and educational institutions. *See generally* Senate Comm. on Finance, 101st Cong., 2d Sess., *Explanatory Material Concerning Committee on Finance 1990 Reconciliation Submission Pursuant to House Concurrent Resolution 310*, 136 Cong. Rec. S15632, S15711 (Daily ed. October 18, 1990) (report language submitted to the Senate Comm. on the Budget). The Conference Report relating to section 11344 of the Act states that the amendment to section 57(a)(6)(B) "applies only to contributions made during taxable years beginning in 1991." H.R. Rep. No. 964, 101st Cong., 2d Sess. 1033 (1990). Not explicitly addressed, however, is whether the amendment applies to a deduction for a charitable contribution made in a taxable year beginning in 1991 that is carried over to a succeeding taxable year.

Section 57(a)(6)(B) of the Code looks to section 170 for its definition of "capital gain property." For purposes of section 170, once property is characterized as capital gain property, that characterization is applied consistently in carryover years. *See* section 170(b)(1)(C)(ii) and (b)(1)(D)(ii); *see also* section 1.170A-10(c) of the regulations. Conversely, if property is characterized as other than capital gain property, it retains that character in carryover years. *See* section 170(d)(1); *see also* section 1.170A-10(b). Under section 57(a)(6)(B), these character rules apply for purposes of determining the character of a contribution under section 57(a)(6) in a carryover year. Thus, if property is not characterized under section 57(a)(6) as capital gain property in the year of contribution, it will not be characterized as capital gain property for alternative minimum tax purposes in carryover years. Conversely, if property is characterized as capital gain property in the year of contribution, the property will retain that character in carryover years.

In the present case, the contribution made by *A* in 1991 consists of art work that does not constitute capital gain property for purposes of section 57(a)(6) of the Code, as amended by the Act for taxable years beginning in 1991. Thus, *A*'s contribution does not generate an item of tax preference in 1991. Further, the remaining portion of *A*'s charitable contribution that is carried over to 1992 will not generate an item of tax preference in that carryover year because the art work contributed by *A* in 1991 will retain its character as other than capital gain property for alternative minimum tax purposes in 1992.

Conversely, if *A* had contributed the art work in 1990 instead of 1991, the art work would have constituted capital gain property for purposes of section 57(a)(6) of the Code and would have generated an item of tax preference in 1990. If any portion of this charitable contribution were carried over to 1991 (or any subsequent year), it would similarly generate an item of tax preference in the carryover year. The art work contributed in 1990 would retain its 1990 character as capital gain property for alternative minimum tax purposes in the carryover year because the Act's amendment to section 57(a)(6) does not apply to contributions made in taxable years beginning prior to 1991. *See* H.R. Rep. No. 964, at 1033 (the amendment "applies only to contributions made during taxable years beginning in 1991").

HOLDING

If, in a taxable year beginning in 1991, a taxpayer makes a charitable contribution of tangible personal property that constitutes capital gain property within the meaning of section 170(b)(1)(C)(iv) of the Code and the charitable deduction for that property is limited by the percentage rules of section 170(b), a carryover of the excess charitable contribution that is deducted under the rules of section 170 in a succeeding taxable year will not generate an item of tax preference under section 57(a)(6) in that succeeding taxable year.

Subchapter B.—Computation of Taxable Income
Part I.—Definition of Gross Income, Adjusted Gross Income, Taxable Income, etc.

Section 61.—Gross Income Defined

Whether the value of lodging furnished to a "principal representative" of the U.S. is excludable from the gross income of the principal representative under section 119(a)(2) of the Code. Also, whether amounts deducted from the salary of the principal representative to pay for usual household expenses that must be borne personally by the representative are excludable from the gross income of the principal representative or allowable as a deduction. See Rev. Rul. 90-64, page 35.

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26 CFR 1.61-12: Income from discharge of indebtedness.
(Also Section 108; 1.108(a)-1.)

Preferred stock and the stock-for-debt exception. Where a debtor corporation that is under the jurisdiction of a court in a case under title 11 of the U.S. Code issues preferred stock in exchange for its outstanding indebtedness, the stock-for-debt exception can apply only to the extent of the redemption price and liquidation preference of the preferred stock.

Rev. Rul. 90-87

ISSUE

To what extent, if any, does the common law stock-for-debt exception apply to a debtor corporation that is under the jurisdiction of a court in a case under title 11 of the United States Code when it issues, in exchange for its outstanding indebtedness, preferred stock with a redemption price and liquidation preference that are less than the amount of the indebtedness.

FACTS

Z is a corporation that is under the jurisdiction of the bankruptcy court in a case under title 11 of the United States Code. Z owes $500,000 to C, an unrelated creditor. Pursuant to a plan of reorganization approved by the court, Z issues preferred stock that has a redemption price of $300,000 and that is limited and preferred as to liquidation proceeds ("liquidation preference") to the extent of $300,000 to C in exchange for the indebtedness. The payment of the indebtedness would not have given rise to a deduction.

LAW AND ANALYSIS

Section 61(a)(12) of the Code provides that gross income includes income from discharge of indebtedness. A taxpayer may realize income by discharging its indebtedness for less than the amount owed. *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931); Section 1.61-12(a) and (c)(3) of the Income Tax Regulations.

Section 108(a)(1) of the Code provides that gross income does not include any amount that would otherwise be includible in gross income by reason of the discharge, in whole or in part, of indebtedness of the taxpayer if (A) the discharge occurs in a title 11 case, (B) the discharge occurs when the taxpayer is insolvent, but only to the extent of the insolvency, or (C) the indebtedness discharged is qualified farm indebtedness. If an amount is excluded from gross income under section 108(a)(1), the taxpayer must reduce its tax attributes in accordance with sections 108(b) and 1017.

For purposes of section 108 of the Code, the term "title 11 case" means a case under title 11 of the United States Code, but only if the taxpayer is under the jurisdiction of the court in such case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court. Section 108(d)(2).

Under certain circumstances, a corporation that issues stock to its creditors in exchange for its outstanding indebtedness does not realize discharge of indebtedness income because of the judicially developed "stock-for-debt exception." The stock-for-debt exception is based on the theory that there has been a substitution of a capital stock liability for the indebtedness. *Tower Building Corp. v. Commissioner*, 6 T.C. 125 (1946), *acq.* 1947-1 C.B. 4. *See also Colonial Savings Association v. Commissioner*, 85 T.C. 855, 863 (1985), *aff'd*, 854 F.2d 1001 (7th Cir. 1988), *cert. denied*, 109 S.Ct. 1556 (March 30, 1989).

In 1984, Congress enacted section 108(e)(10) of the Code, which limits the scope of the stock-for-debt exception. Section 108(e)(10)(A) provides that, for purposes of determining income of a debtor from discharge of indebtedness, if a debtor corporation transfers stock to a creditor in satisfaction of its indebtedness, the corporation is treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock. Section 108(e)(10)(B) provides that section 108(e)(10)(A) does not apply in the case of a debtor in a title 11 case or to the extent the debtor is insolvent. Thus, section 108(e)(10) does not limit the stock-for-debt exception if a debtor is in a title 11 case or to the extent the debtor is insolvent.

Congress has also restricted the application of the stock-for-debt exception through the enactment of section 108(e)(8) of the Code. Section 108(e)(8) provides that, for purposes of determining income of the debtor from discharge of indebtedness, the stock-for-debt exception does not apply (A) to the issuance of nominal or token shares, or (B) with respect to an unsecured creditor, where the ratio of the value of the stock received by such unsecured creditor to the amount of its indebtedness canceled or exchanged for stock in the workout is less than 50 percent of a similar ratio computed for all unsecured creditors participating in the workout.

In this case, because the exchange of the preferred stock for the indebtedness occurs in a title 11 case, section 108(e)(10)(A) of the Code does not apply. Therefore, subject to section 108(e)(8), the stock-for-debt exception applies to the exchange of preferred stock for the indebtedness.

Under the stock-for-debt exception, Z is considered to have substituted a capital stock liability for the indebtedness. Because the redemption price and liquidation preference of the preferred stock are limited, however, the amount of the substitution is limited. *See Commissioner v. Capento Securi-*

ties Corp., 47 B.T.A. 691 (1942), *nonacq.*, 1943 C.B. 28, *aff'd*, 140 F.2d 382 (1st Cir. 1944) (retirement of indebtedness solely in exchange for preferred stock). Accordingly, assuming section 108(e)(8) of the Code does not apply to restrict the availability of the stock-for-debt exception, the stock-for-debt exception applies only to the extent of the $300,000 redemption price and liquidation preference of the preferred stock.

As to the amount of the indebtedness forgiven, because the discharge occurred in a title 11 case under section 108(a)(1)(A) of the Code, the discharge of indebtedness income is not included in Z's gross income. However, Z must reduce its tax attributes in accordance with sections 108(b) and 1017.

Although the amount of discharge of indebtedness income upon issuance of the preferred stock for the indebtedness is measured by reference to the stock's redemption price and liquidation preference, these amounts are not relevant to the determination of the preferred stock's issue price. *See*, e.g., Rev. Rul. 83-119, 1983-2 C.B. 57.

HOLDING

Where a debtor corporation that is under the jurisdiction of a court in a case under title 11 of the United States Code issues preferred stock in exchange for its outstanding indebtedness, the stock-for-debt exception can apply only to the extent of the redemption price and liquidation preference of the preferred stock.

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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 noncommercial flights on employer-provided aircraft, the Standard Industry Fare Level (SIFL) cents-per-mile rates and the terminal charges in effect for 1990 are set forth. Rev. Rul. 90-43 modified.

Rev. Rul. 90-104

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) of the regulations sets forth 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 revised semi-annually.

The following chart sets forth the applicable terminal charges and SIFL mileage rates for 1990:

Period During Which the Flight Was Taken	*Terminal Charge*	*SIFL Mileage Rates*
1/1/90-6/30/90	$30.45	Up to 500 miles = $.1666 per mile 501-1500 miles = $.1270 per mile Over 1500 miles = $.1221 per mile
7/1/90-12/31/90	$32.31	Up to 500 miles = $.1767 per mile 501-1500 miles = $.1348 per mile Over 1500 miles = $.1296 per mile

EFFECT ON OTHER REVENUE RULING

Rev. Rul. 90-43, 1990-1 C.B. 13, is modified.

Section 62.—Adjusted Gross Income Defined

26 CFR 1.62-1T: Adjusted gross income (temporary).
(Also Sections 67, 3121, 7701; 1.67-1T, 31.3121(d)-1, 301.7701-1.)

Expenses of statutory employees. A full-time life insurance salesman described in section 3121(d)(3) of the Code is not an employee for purposes of sections 62 and 67.

Rev. Rul. 90-93

ISSUE

Is a full-time life insurance salesman who is treated as an employee for purposes of the Federal Insurance Contributions Act ("FICA") under section 3121(d)(3) of the Internal Revenue Code an employee for purposes of sections 62 and 67 of the Code?

FACTS

A is a full-time life insurance salesman and is not an employee under the common law rules for distinguishing between employees and independent contractors. The commissions earned by *A* were reported on Form W-2, Wage and Tax Statement, as "wages" for purposes of the FICA. No income tax was withheld from the amounts paid to *A*. In computing net profit or loss on Schedule C, *A* deducted the trade or business expenses incurred by *A* in doing business as a full-time life insurance salesman.

LAW AND ANALYSIS

Section 62(a) of the Code provides that the term "adjusted gross income" means, in the case of an individual, gross income minus certain deductions, including allowable deductions attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee.

Section 67(a) of the Code provides that, in computing taxable income, miscellaneous itemized deductions for any taxable year shall be allowed to an individual only to the extent that the aggregate of those deductions exceeds 2 percent of adjusted gross income. Section 67(b) provides that the term "miscellaneous itemized deductions" means all itemized deductions other than certain deductions enumerated in that section. Business expenses under section 162 are an itemized deduction that is not enumerated in section 67(b), and thus such a deduction is included in the term "miscellaneous itemized deductions."

Section 3121(d) of the Code describes four separate categories of individuals who are treated as employees for purposes of applying the FICA tax provisions. These four categories include (1) officers of a corporation, (2) common law employees, (3) individuals in specified occupational groups who are not common law employees, and (4) certain nonfederal governmental workers. Employees in the third category are commonly referred to as "statutory employees." Full-time life insurance salesmen who are not common law employees are expressly included in this third category. A full-time life insurance salesman is one whose entire or principal business activity is devoted to the solicitation of life insurance or annuity contracts, or both, primarily for one life insurance company. *See* section 31.3121(d)-1(d)(3)(ii) of the regulations.

Section 3121(d)(3) of the Code also provides that the term "employee" includes anyone who performs services for remuneration for any person as an agent-driver or commission-driver, as a home worker, or as a traveling or city salesman, under the conditions stated in the section.

Section 7701(a)(20) of the Code provides that for the purpose of applying certain enumerated sections of the Code, the term "employee" includes a full-time life insurance salesman who is considered an employee for FICA purposes. Sections 62 and 67 are not among the sections of the Code enumerated.

The provisions cited above operate to treat individuals described in section 3121(d)(3) of the Code as statutory employees only for purposes of certain specified provisions of the Code. No statutory or regulatory provision, however, treats these statutory employees as employees for purposes of sections 62 and 67.

Thus, *A*, who is a statutory employee under section 3121(d)(3) of the Code, is not an employee for purposes of sections 62 and 67. Therefore, *A* may use Schedule C of the Form 1040 to determine *A*'s net profit or loss from doing business as a full-time life insurance salesman. Further, *A*'s trade or business expenses related to being a full-time life insurance salesman are not subject to the 2-percent floor for miscellaneous itemized deductions.

HOLDING

A full-time life insurance salesman described in section 3121(d)(3) of the Code is not an employee for purposes of sections 62 and 67.

This holding also applies to all other statutory employees described in section 3121(d)(3) of the Code in connection with the expenses they incur in the conduct of their trades or businesses.

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26 CFR 1.62-2T: Reimbursements and other expense allowance arrangements (temporary).

The revenue procedure provides a special method for determining the amount of ordinary and necessary expenses of an employee or self-employed individual in the transportation industry for meal and incidental expenses incurred while traveling away from home that will be deemed substantiated for purposes of section 1.274-5T of the temporary regulations. See Rev. Proc. 90-38, page 363.

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

Rules are set forth under which an arrangement providing mileage reimbursement or other expense allowance arrangement 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. 90-59, page 644.

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

Rules are set forth for the deemed substantiation of the amount of ordinary and necessary business expenses of an employee for lodging, meal, and/or 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. 90-60, page 651.

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 to the standard deduction amounts (including the $500 limitation in the case of certain dependents, and $600 or $750 additional standard deduction for the aged or blind) for taxable years beginning in 1991. See Rev. Proc. 90-64, page 674.

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

26 CFR 1.67-1T: 2-percent floor on miscellaneous itemized deductions (temporary).

Is a full-time life insurance salesman who is an employee within the meaning of section 3121(d)(3) of the Code, an employee for purposes of sections 62 and 67? See Rev. Rul. 90-93, page 33.

Part III.—Items Specifically Excluded from Gross Income

Section 103.—Interest on State and Local Bonds

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

Average area purchase price safe harbor limitations for Guam and Puerto Rico are added to the list in Rev. Proc. 89-59, 1989-2 C.B. 771. See Rev. Proc. 90-51, page 625.

Section 108.—Income from Discharge of Indebtedness

26 CFR 1.108(a)-1: Income from discharge of indebtedness.

Where a debtor corporation that is under the jurisdiction of a court in a case under title 11 of the U.S. Code issues preferred stock in exchange for its outstanding indebtedness, the stock-for-debt exception can apply only to the extent of the redemption price and liquidation preference of the preferred stock. See Rev. Rul. 90-87, page 32.

Section 115.—Income of States, Municipalities, Etc.

Risk-sharing pools of local governments. The income of an organization formed, operated and funded by political subdivisions to pool their casualty risks, or other risks arising from their obligations concerning public liability, workers' compensation, or employees' health is excluded from gross income under section 115(1) of the Code if private interests do not participate in the organization or benefit more than incidentally from the organization.

Rev. Rul. 90-74

ISSUE

If political subdivisions of a state create, fund, and operate an organization to pool the casualty risks of the participating political subdivisions, is the income of the organization excluded from gross income under section 115(1) of the Internal Revenue Code?

FACTS

X is a non-profit organization incorporated under the laws of State *A*. County governments may, under the laws of State *A*, form and become members of *X* to pool the casualty risks of the participating counties. The governing body of each county must authorize the county to join *X* and must designate an individual to represent the county at meetings of *X*. The board of directors, elected by and from the representatives of the counties, controls *X*.

Each member appropriates funds from its general revenues to pay to *X* an initial deposit and an annual fee based upon its size and its actuarially determined level of risk. *X* also receives investment income. *X* reimburses its members for any casualty losses. In the event of dissolution, *X* will distribute its assets to its members.

LAW AND ANALYSIS

Section 115(1) of the Code provides that gross income does not include income derived from the exercise of any essential governmental function and accruing to a state or political subdivision.

The determination whether a function is an essential governmental function depends on the facts and circumstances of each case. Rev. Rul. 77-261, 1977-2 C.B. 45, concludes that the income of a fund, established under a written declaration of trust to pool the temporary investments of the state and its political subdivisions, is excludable from gross income under section 115(1) of the Code. The fund was authorized by state statute, managed by the state treasurer, and benefited only the state and its political subdivisions. The ruling states that the investment of funds is a necessary incident of the power of governmental entities to raise revenue and meet expenses.

Political subdivisions insure against casualty risks and other risks arising from employee negligence, workers' compensation statutes, and employee health obligations. Insuring against these risks satisfies governmental obligations. Any private benefit to employees from insuring against these various risks is incidental to the public benefit.

Pooling casualty risks through *X* instead of purchasing commercial insurance fulfills the obligations of the political subdivisions to protect their financial integrity. *X* is created under authority granted by the governing body of each participating county and State *A*. Except for the incidental benefit to employees of the participating political subdivisions described in the preceding paragraph, no private interests participate in or benefit from the operation of *X*. Accordingly, *X* performs an essential governmental function.

Section 115(1) of the Code also requires that the income accrue to a state or a political subdivision. In Rev. Rul. 77-261, a state and the participating political subdivisions had an unrestricted right to receive a proportionate share of the income earned by a joint investment fund. The ruling states that section 115(1) does not require that the income in question accrue only to a state or a single political subdivision and concludes that the income accrues under section 115(1), even though more than one governmental entity participated in the fund.

The income of *X* is used to reimburse casualty losses incurred by the counties or to reduce the annual fees that the member counties would otherwise be required to pay to the organization. The income of *X* does not benefit private interests. Furthermore, upon dissolution, *X* will distribute its assets to its members. Therefore, the income of *X* accrues to a political subdivision within the meaning of section 115(1) of the Code.

HOLDING

The income of an organization formed, operated, and funded by political subdivisions to pool their casualty risks is excluded from gross income under section 115(1) of the Code. Similarly, the income of an organization formed, operated, and funded by one or more political subdivisions (or by a state and one or more political subdivisions) to pool their risks in lieu of purchasing insurance to cover their public liability, workers' compensation, or employees' health obligations is also excluded under section 115(1) if private interests do not, except for incidental benefits to employees of the participating state and political subdivisions, participate in or benefit from the organization.

Section 119.—Meals or Lodging Furnished for the Convenience of the Employer

26 CFR 1.119-1: Meals and lodging furnished for the convenience of the employer.
(Also Sections 61, 262, 912.)

Lodging furnished to U.S. Government employee. The value of lodging furnished to a U.S. Government employee who is a "principal representative" of the U.S. serving in a foreign country is excludable from the representative's gross income. However, amounts deducted from the salary of the principal representative to pay for usual household expenses that must be borne personally by the representative are not excludable from gross income. Rev. Rul. 84-86 modified and superseded.

Rev. Rul. 90-64

ISSUES

1. Whether the value of lodging furnished to a "principal representative" of the United States is excludable from the gross income of the principal representative under section 119(a)(2) of the Internal Revenue Code.

2. Whether amounts deducted from the salary of a "principal representative" of the United States to pay for usual household expenses that must be borne personally by the representative are excludable from the gross income of the principal representative or allowable as a deduction.

FACTS

A, an individual, is a principal representative of the United States stationed in a foreign country. The government provides the principal representative, without cost to him, an official residence, including heat, fuel, and light, in a government owned or rented building. Under section 411(a) of the Standardized Regulations (Government Civilians, Foreign Areas) issued by the Department of State (hereafter "Std. Regs."), a principal representative is a senior official of the U.S. Government serving in a foreign country who occupies a position of such importance that

the government should defray the unusual expenses incident to the operation and maintenance of his official residence.

Section 22 of the Administrative Expenses Act of 1946 (Pub.L. 86-707, section 311(a)) provides, in part, that under such regulations as the President may prescribe, funds available to an agency for administrative expenses may be allotted to posts in foreign countries to defray the unusual expenses incident to the operation and maintenance of official residences suitable for 1) the chief representatives of the United States at the posts, and 2) such other senior officials of the Government of the United States as the President may designate. These unusual expenses are commonly known as official residence expenses or "ORE."

In accordance with section 22 of the Administrative Expenses Act of 1946, section 411(c) of the Std. Regs. provides that official residence expenses are those unusual expenses which a principal representative is obliged to incur in the operation and maintenance of a suitable office residence. These expenses must be in excess of the usual expenses incident to the operation and maintenance of the residence he would occupy if he were serving at the post in any other capacity.

Section 412 of the Std. Regs. provides that the defraying of official residence expenses is intended to make possible the operation and maintenance of official residences in which principal representatives can properly represent the United States abroad by extending official (as distinct from personal) hospitality to foreign dignitaries and important visitors, by receiving official deputations and callers, and by holding requisite and appropriate ceremonies smoothly and with dignity. Also, payment of official residence expenses is intended to keep the official residences staffed and in operation, to the extent necessary, even during intervals between the departure of an officer because of recall, transfer, or some other reason, and his return or the arrival of his successor.

Sections 450-453 of the Std. Regs. provide that government paid or reimbursed official residence expenses include expenses such as the following: wages and maintenance of household servants; transportation of servants; rent, installation, repair, upkeep, and removal of furnishings, equipment, and appliances; services to renovate and redecorate the premises for use as an official residence; general house cleaning, dry cleaning, laundry, trash removal and window washing; certain telephone costs; expendable household supplies such as cleaning supplies, paper, light bulbs, linen, nails, and wire; and supplies worth $10 or less such as electrical equipment, kitchenware, plumbing supplies, and tools.

Section 440 of the Std. Regs. provides that the amount of annual usual household expenses that must be borne personally by a principal representative regardless of rank or grade is generally five percent of salary subject to certain additions and exclusions.

Since official residence expenses include only the unusual expenses of operating and maintaining an official residence, section 440 of the Std. Regs. serves as a method of separating unusual expenses from usual expenses. The government pays for residence expenses that include both usual and unusual, but then subtracts five percent from the principal representative's salary to defray the cost of usual expenses that must be borne personally.

A has met the three tests contained in section 1.119-1(b) of the Income Tax Regulations for exclusion from gross income of lodging furnished to an employee by an employer.

LAW AND ANALYSIS

Section 61(a) of the Internal Revenue Code provides that gross income means all income from whatever source derived, including (but not limited to) compensation for services, including fees, commissions, fringe benefits and similar items.

Section 1.61-2(d)(3) of the regulations provides that the value of living quarters that an employee receives in addition to the employee's salary constitutes gross income unless it is furnished for the convenience of the employer and meets the conditions specified in section 119 of the Code.

Section 119(a)(2) of the Code provides that there shall be excluded from the gross income of an employee the value of any lodging furnished the employee, the employee's spouse, or any of the employee's dependents by or on behalf of the employer for the convenience of the employer, but only if the employee is required to accept such lodging on the employer's business premises as a condition of employment.

Section 1.119-1(b) of the regulations provides that the value of lodging furnished to an employee by the employer is excludable from the employee's gross income if three tests are met:

(1) The lodging is furnished on the business premises of the employer,

(2) The lodging is furnished for the convenience of the employer, and

(3) The employee is required to accept such lodging as a condition of employment. The requirement of subparagraph (3) is met where the employee is required to accept the lodging in order to enable the employee to properly perform the duties of his or her employment.

Section 1.119-1(b) of the regulations further provides that if the employer furnishes the employee lodging for which the employee is charged an unvarying amount irrespective of whether the employee accepts the lodging, the amount of the charge made by the employer for such lodging is not, as such, part of the compensation includible in the gross income of the employee. Whether the value of the lodging is excludable from the employee's gross income is determined under the other rules of section 119 of the Code.

Rev. Rul. 68-579, 1968-2 C.B. 61, holds that lodging furnished an employee for the convenience of the employer includes the value of any necessary utilities also furnished by the employer. *See also Inman v. Commissioner*, T.C.M. 1970-264.

Rev. Rul. 84-86, 1984-1 C.B. 26, holds, among other things, that the amounts described above that are deducted from the salary of a principal representative and applied against the household expenses of the official residence furnished to the principal representative by the government are excludable from the principal representative's gross income under section 119(a)(2) of the Code.

Section 262 of the Code provides that, except as otherwise provided by law, no deduction shall be allowed

for personal, living, or family expenses.

Section 912(1)(D) of the Code provides, in part, that in the case of civilian officers and employees of the Government of the United States, amounts received as allowances or otherwise (but not amounts received as post differentials) under subsection (e) or (f) of the first section of the Administrative Expenses Act of 1946, as amended, or section 22 of such Act, are excludable from the gross income of the recipient.

The official residence expenses of operating the official residence occupied by the principal representative are defined by law as those unusual expenses which a principal representative is obliged to incur in the operation and maintenance of a suitable official residence that exceed the usual expenses that would be incurred in operation and maintenance of the residence that he would occupy if he were serving at the post in any other capacity. The five percent of salary that is paid toward household expenses by the principal representative is not a charge for those unusual expenses, nor is it a charge for lodging. Instead, the five-percent salary deduction is designed to cover ordinary day-to-day expenses of living, such as household supplies, house cleaning, laundry, dry cleaning, and trash removal, that might be incurred by any individual. Thus, the five-percent salary deduction merely represents a payment for usual household expenses that must be borne personally by the principal representative. In contrast to official residence expenses, these day-to-day household expenses are nondeductible personal, living or family expenses that are not excludable under either section 119 or section 912 of the Code.

HOLDINGS

1. The value of the lodging furnished *A* by the United States is excludable from *A*'s gross income under section 119(a)(2) of the Code.

2. While amounts paid by the government as authorized by section 22 of the Administrative Expenses Act of 1946 to defray unusual expenses incident to the operation and maintenance of an official residence are excludable from gross income under section 912(1)(D) of the Code, the five percent of salary paid by the principal representative, through payroll deduction, for the usual expenses incident to the operation and maintenance of the official residence is not a charge for lodging, but rather a payment for ordinary, everyday living expenses, and is not excludable from gross income.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 84-86, 1984-1 C.B. 26, is modified and superseded.

PROSPECTIVE APPLICATION

Under the authority granted by section 7805(b) of the Code, this revenue ruling is effective for payments received on or after October 1, 1990.

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

The Service is providing inflation adjustments to the limitation on the exclusion of income from United States savings bonds for taxpayers who pay qualified higher education expenses for taxable years beginning in 1991. See Rev. Proc. 90-64, page 674.

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

Subpart A.—Private Activity Bonds

Section 142.—Exempt Facility Bond

For purposes of determining whether a building meets the minimum set-aside requirements of section 42(g)(1) of the Code, the combined income of all occupants of an apartment, whether or not legally related, is compared to the appropriate percentage of the median family income for a family with the same number of members. See Rev. Rul. 90-89, page 8.

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

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

Average area purchase price safe harbor limitations for Guam and Puerto Rico are added to the list in Rev. Proc. 89-59, 1989-2 C.B. 771. See Rev. Proc. 90-51, page 625.

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

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Section 149.—Bonds Must be Registered to be Tax Exempt; Other Requirements

26 CFR 1.149(b)(3)-1T: Permitted investments.

T.D. 8313

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Exception from the Prohibition of Federal Guarantees—Permitted Investments of Tax-Exempt Bond Proceeds

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to the prohibition of federal guarantees with respect to bonds the interest on which is excludable from gross income. The Tax Reform Act of 1984 changed the applicable law and, with certain exceptions, provides that interest on a bond issued by a state or local government unit is not excludable from gross income if payment of the bond's principal or interest is directly or indirectly guaranteed by the United States (or any agency or instrumentality thereof). These temporary regulations provide that investments in obligations issued by the Resolution Funding Corporation pursuant to the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 are excepted from the prohibition of federal guarantees. The text of the temporary regulations set forth in this document also serves as the text of the proposed regulations cross-referenced in *** [FI-84-90, page 739, this Bulletin].

EFFECTIVE DATE: These temporary regulations are effective for investments made on or after October 2, 1990.

SUPPLEMENTARY INFORMATION:

Background

This document adds temporary regulations to the Income Tax Regulations (26 CFR Part 1) under section 149(b) of the Internal Revenue Code. The provisions currently found in section 149(b) were added to the Code by section 622 of the Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, 918-21 [1984-3 C.B. (Vol. 1) 1, 426].

Explanation of Provisions

Under section 149(b) of the Code, if a state or local bond is federally

guaranteed, interest on the bond is not excludable from gross income under section 103(a). A bond is federally guaranteed if (a) the payment in whole or in part of the bond's interest or principal is guaranteed by the United States (or any agency or instrumentality thereof), (b) a significant portion of the bond's proceeds are used to make federally guaranteed loans, (c) a significant portion of the bond's proceeds are invested in federally insured deposits in financial institutions, or (d) the payment of the bond's principal or interest is otherwise indirectly guaranteed in whole or in part by the United States (or any agency or instrumentality thereof). Without this provision, a federally guaranteed state or local bond would be more attractive than either taxable federal securities or other state and local bonds lacking federal guarantees, because the bond would have the backing and safety of a federal obligation plus the federal tax exemption of a state or local obligation.

Section 149(b)(3)(B) of the Code lists four specific exceptions to the prohibition of a federal guarantee. It also allows as exceptions other investments permitted in regulations. These temporary regulations except investments in obligations issued by the Resolution Funding Corporation from the prohibition of federal guarantees. The regulations are effective for investments made on or after October 2, 1990.

Special Analyses

It has been determined that these rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. 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 final Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations will be submitted to the Administrator 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—[AMENDED]

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

Authority: 26 U.S.C. 7805 *** §1.149(b)(3)-1T also issued under 26 U.S.C. §149(b)(3)(B)(v).

Par. 2. The following new section 1.149(b)(3)-1T is added in the appropriate place:

§1.149(b)(3)-1T Permitted Investments.

(a) *Exception under authority of section 149(b)(3)(B)(v).* Section 149(b)(1) does not apply to investments in obligations issued pursuant to §21B(d)(3) of the Federal Home Loan Bank Act, as amended by §511(a) of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, or any successor provision to §21B(d)(3) of the Federal Home Loan Bank Act as so amended.

(b) *Effective date.* This section applies to investments made on or after October 2, 1990.

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

Fred T. Goldberg, Jr.,
Commissioner of Internal Revenue.

Approved October 5, 1990.

Kenneth W. Gideon,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on October 10, 1990, 11:51 a.m., and published in the issue of the Federal Register for October 15, 1990, 55 F.R. 41664)

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 to the personal exemption for taxable years beginning in 1991. See Rev. Proc. 90-64, page 674.

Part VI.—Itemized Deductions for Individuals and Corporations

Section 162.—Trade Or Business Expense

26 CFR 1.162-1: Business expenses.

An administrative procedure is provided whereby certain life insurance companies may expeditiously obtain the consent of the Commissioner to change their method of accounting for ceding commissions to comply with the principles of Rev. Rul. 82-69 and the Supreme Court decision in *Colonial American Life Insurance Co.* See Rev. Proc. 90-36, page 357.

26 CFR 1.162-3: Cost of materials.

Economically recoverable precious metal fabricated into items used in a taxpayer's trade or business are not depreciable if their cost is more than half the total cost of the item into which they are fabricated. See Rev. Rul. 90-65, page 41.

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

The revenue procedure provides a special method for determining the amount of ordinary and necessary expenses of an employee or self-employed individual in the transportation industry for meal and incidental expenses incurred while traveling away from home that will be deemed substantiated for purposes of section 1.274-5T of the temporary regulations. See Rev. Proc. 90-38, page 363.

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

The rules for the substantiation of expenditures for ordinary and necessary expenses of transportation whether or not traveling away from home that most nearly represent present reasonable limits in light of current costs are set forth. See Rev. Proc. 90-59, page 644.

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

Rules are set forth for the deemed substantiation of the amount of ordinary and necessary business expenses of an employee for lodging, meal, and/or 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. 90-60, page 651.

Section 163.—Interest

Do Alaska Permanent Fund Dividends constitute investment income as defined in section 163(d)(4)(B) of the Code? See Rev. Rul. 90-56, page 102.

Section 165.—Losses

26 CFR 1.165-1: Losses.
(Also Sections 48, 194, 611, 1231; 1.48-1, 1.194-1, 1.611-3, 1.1231-1.)

Loss from death of tree seedlings. Greater than normally anticipated failure of planted tree seedlings because of an abnormal drought results in a deductible loss under section 165 of the Code. The deductible loss, allowable for the year in which the seedlings died, is in an amount equal to previously capitalized reforestation costs that had to be duplicated on replanting. The loss is treated as a loss from an involuntary conversion of property under section 1231(a)(4)-(B). Rev. Rul. 81-2 distinguished; Rev. Rul. 87-59 amplifed.

Rev. Rul. 90-61

ISSUE

If abnormal drought causes the death of tree seedlings planted for use in a taxpayer's business, is there a deductible loss under section 165 of the Internal Revenue Code? If so, what is the timing, amount, and character of the deductible loss?

FACTS

The taxpayer, which files its federal income tax returns on a calendar-year basis, owns forested lands in the southeastern United States and manages them to yield timber on a continuous basis for use in the business of manufacturing lumber.

During November 1985, having previously harvested the timber on 200 acres of its lands by clearcutting, the taxpayer reforested the cutover area by planting nursery-grown tree seedlings. Reforestation practices vary, depending, among other factors, on the particular site and on the species of tree being grown. For the site and species that was planted in this case, the taxpayer's method is to plant 600 well-spaced seedlings per acre. Because of the vulnerability of newly planted seedlings, the taxpayer's normal practice is to examine planted areas at the end of the second growing season to determine whether the number and spacing of the surviving seedlings are sufficient to produce a satisfactory stand of timber and thus use the productive capability of the land economically. As a rule, if fewer than 300 well-spaced seedlings per acre survive, the reforestation is unsatisfactory, and the taxpayer replants the understocked areas. In normal years, replanting is required on not more than 5 percent of the acreage inspected.

In this instance, however, during the spring and summer of 1986, the planted area was subject to a drought of unexpected and unusual severity. By the time drought conditions subsided in the fall of 1986, stocking was still adequate on the area of the reforested tract that was located near water. On the remaining 60 percent of the tract, however, only 50 or fewer seedlings per acre (less than 10 percent) had survived the drought. Because more than 90 percent of the seedlings on the understocked acreage had died in 1986, the planting on this acreage was worthless, and complete replanting of this understocked acreage was required. (The failure of 60 percent of the planting is greatly in excess of the normally anticipated failure of 5 percent or less.) During January 1987, the understocked acreage was replanted by machine with 600 well-spaced seedlings per acre.

The seedling deaths were attributable to the drought and were not sudden enough to qualify as a loss due to casualty under section 1231(a)(4)(C) of the Code. They were not covered by any type of insurance. The taxpayer continued to use the area for growing timber for eventual use in the taxpayer's lumber-manufacturing facilities.

The costs of the initial reforestation during November 1985 included site preparation expenditures (for example, costs of windrowing of logging slash and brush, preparing seedling beds with disc equipment, and depreciation on equipment) and planting expenditures (for example, seedling costs, labor expense, tool expense, and depreciation on equipment). For federal income tax purposes, the taxpayer capitalized both the site preparation and the planting expenditures into a plantation, or deferred reforestation, account representing the costs attributable to the seedlings (immature timber) on the 200-acre tract. This plantation account, along with other plantation accounts and a merchantable timber account, is part of a larger account that consists of the costs attributable to all the timber on 50,000 acres of the taxpayer's lands, including the 200-acre tract. When the planted trees reach merchantable size, the amounts in the plantation account are transferred to the merchantable timber account and eventually recovered through a depletion deduction as the timber is cut, processed, and sold as lumber.

Except for the extraordinary nature of the cause for the replanting, the facts in the present situation do not differ substantially from those in Rev. Rul. 81-2, 1981-1 C.B. 78.

LAW AND ANALYSIS

Section 165(a) of the Code provides the general rule that there shall be allowed as a deduction any loss sustained during the tax year and not compensated for by insurance or otherwise.

Section 1.165-1(b) of the Income Tax Regulations provides that to be allowable as a deduction, a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and, except as otherwise provided (such as in section 165(i) of the Code), actually sustained during the tax year.

Section 165(b) of the Code provides that the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property. Section 1.165-1(c) of the regulations provides that the amount of loss allowable under section 165(a) shall not exceed the amount prescribed by section 1.1011-1 as the adjusted basis of the property involved.

Section 165(i) of the Code provides that any loss attributable to a disaster in an area determined by the President of the United States to warrant assistance under the Disaster Relief and Emergency Assistance Act (prior to November 23, 1988, the Disaster Relief Act of 1974) may be taken into account for the preceding tax year at the election of the taxpayer.

Section 611(a) of the Code provides that in the case of timber there shall

be allowed as a deduction a reasonable allowance for depletion under regulations prescribed by the Secretary.

Section 1.611-3(c) of the regulations requires every taxpayer claiming or expecting to claim a deduction for depletion of timber property to establish accounts in which to record the basis of the timber, including allowable capital additions.

Section 1.611-3(a) of the regulations provides that amounts paid or incurred in connection with the planting of timber shall be capitalized and shall be recoverable through depletion allowances.

Section 1.611-3(b) of the regulations, in general, provides that the allowable depletion for a year is determined by dividing the adjusted basis in an account by the total number of units of merchantable timber in the account, and multiplying the resulting "depletion unit" by the number of units cut.

With respect to merchantable timber, section 1.611-3(e) of the regulations describes circumstances in which the units of timber in a depletion account are to be adjusted without a corresponding basis adjustment. It provides that if, as the result of the growth of timber, of changes in standards of utilization, of losses not otherwise accounted for, of abandonment of timber, or of operations or development work, it is ascertained that there remain available for utilization more or fewer units of timber than remain in the timber account on the basis of the original estimate, then the original estimate (but not the basis for depletion) shall be revised.

Section 165(f) of the Code provides that losses from the sale or exchange of a capital asset shall be allowed only to the extent allowed in sections 1211 and 1212. Under section 1231, the character of gains and losses from sales, exchanges, and conversions of specified types of assets depends on the outcome of computations netting such gains and losses for the tax year. In these computations, losses on the destruction of qualifying assets are regarded as losses from an involuntary conversion. The precise treatment of these losses depends on whether they arise from casualty. *See* section 1231(a)(4)(B) and (C).

In Rev. Rul. 81-2, the taxpayer grew timber for business use. As did the taxpayer in the present case, the taxpayer in Rev. Rul. 81-2 planted a cutover tract with 600 seedlings per acre. Following its normal practice, the taxpayer examined the planted area at the end of the second growing season to determine whether stocking was satisfactory or whether some replanting would be necessary. The examination showed that some of the tract was not satisfactorily reforested, and the taxpayer therefore replanted the understocked portions. The seedling deaths were not due to casualty. Rev. Rul. 81-2 holds that the taxpayer did not sustain any deductible loss attributable to the seedlings that died, even though portions of the tract had to be replanted. That ruling also holds that the replanting costs, as well as the original planting costs, must be capitalized in accordance with section 1.611-3(a) of the regulations.

In Rev. Rul. 87-59, 1987-2 C.B. 59, the taxpayer lost timber used in the taxpayer's trade or business. An unexpected and unusual insect attack on a stand of merchantable pine trees caused the death of the trees but did not appreciably damage the wood. The death of the trees rendered them vulnerable to wood-destroying organisms that gradually caused the deterioration and worthlessness of the uncut timber. That revenue ruling holds that the loss was not sudden enough to constitute a casualty loss. However, the loss of the timber from the combined effects of the tree-killing insects and the wood-destroying organisms was unexpected and unusual. The ruling holds that this distinguishes the loss from normal and expected physical losses that occur in growing timber and that properly are recoverable through depletion under section 1.611-3(e) of the regulations. The taxpayer's loss of timber from an unexpected and unusual cause gives rise to an allowable business loss deduction under section 165(a) of the Code in the tax year when the loss of the timber in the trees was realized, which in that ruling was when the timber became worthless and was bulldozed and burned. Because the loss did not arise from a casualty, it was required to be netted with other noncasualty section 1231 gains and losses.

The regulations under section 611 of the Code generally require that the costs of acquiring or establishing a stand of timber be capitalized and recovered through a deduction for depletion as the timber is cut and the products produced are sold. To achieve this purpose, both merchantable and immature timber, as well as the related costs, are aggregated in accounts that reflect the taxpayer's basis in the timber.

With respect to merchantable timber, section 1.611-3(e) of the regulations requires that a taxpayer adjust the quantity, but not the basis, of timber in a depletion account for such factors as growth of timber, abandonment of timber, and losses not otherwise accounted for. This regulation contemplates two distinct ways to account for losses involving timber. First, some capitalized costs that could be associated with lost timber remain in the account and are recovered by the standard depletion mechanism, even though the quantity of timber in the account available for depletion is adjusted. Second, as is indicated by the reference to losses "not otherwise accounted for," some capitalized costs are recoverable as a current loss, with a corresponding adjustment to basis as well as quantity, prior to the time that the cost would have been otherwise recovered through depletion.

Which method is appropriate to account for timber losses depends on the facts of the case considered in the light of the role of capitalization, which is to match expenses with associated income. The first method is applicable with respect to normal, expected physical changes in the quantity of timber that occur in growing timber for the production of income on harvest. These changes, including losses of timber resulting from mortality of trees from normal expected causes, are accounted for by an adjustment in the quantity of timber in the depletion account without a corresponding adjustment in basis. Such an adjustment reflects the fact that no gain or loss is currently recognized for changes in the quantity of timber that reflect growth and yield expectations in the income-producing operation. In contrast, if identifiable timber losses are due to casualty or, although not sudden in nature, are from unexpected and unusual causes, then the timber losses give rise to a current loss deduction, with a corre-

sponding downward adjustment to the basis as well as to the quantity in the depletion account. *See* Rev. Rul. 87-59.

With respect to immature timber, a similar analysis applies. When a cutover tract is planted, seedling mortality within a certain range, possibly requiring some replanting, is considered normal. The timber grower takes such mortality into account at the outset by planting more than enough seedlings to stock the area satisfactorily and by planning to inspect the area and replant where necessary. The benefit of these activities survives the foreseeable death of some of the seedlings. Accordingly, such anticipated seedling deaths, including deaths attributable to normal cyclical drought conditions, do not give rise to losses deductible under section 165 of the Code. *See* Rev. Rul. 81-2.

In the present case, the seedling deaths due to the abnormal drought were unexpected, unusual, and identifiable. The seedling deaths here are thus distinguishable from those that occurred in Rev. Rul. 81-2, and a loss deduction is allowable under section 165 of the Code if the requirements of that provision are otherwise met. Because the loss was incurred in a trade or business, it need not result from casualty to be deductible under section 165. *See* Rev. Ruls. 77-490, 1977-2 C.B. 64, and 87-59.

With respect to the timing of the deduction, the seedlings died, thereby becoming worthless, during 1986. There is no reasonable prospect of reimbursement for the loss through insurance or otherwise. Because the tract is not within a declared drought-related disaster area for 1986 (see Rev. Rul. 86-151, 1986-2 C.B. 29, for a listing of declared disaster areas), the taxpayer cannot elect under section 165(i) of the Code to deduct the loss in the preceding year. The taxpayer's loss is therefore deductible in 1986.

The amount of the deduction for the taxpayer's loss is limited to the adjusted basis in the lost property for determining gain or loss from its sale or other disposition. Section 165(b) of the Code and section 1.165-1(c)(1) of the regulations. In the present case, the adjusted basis of the lost property, and thus the deductible amount, consists of that portion of the initial planting and site preparation expenditures in the plantation account allocable to the acreage that had to be replanted, excluding any costs incurred in the initial planting effort that did not have to be duplicated on replanting, such as the cost of windrowing of logging slash and brush. *See* section 1.612-1(a) (providing for allocation of basis if part of a timber property is sold).

The taxpayer's basis in the plantation account must be reduced by the amount of the loss deduction, to prevent the equivalent of a double deduction. See sections 1.612-1(a) and 1.1016-6(a) of the regulations.

The loss of the tree seedlings in the present situation qualifies as an "involuntary conversion" of property resulting from "destruction" within the meaning of section 1231(a)(4)(B) of the Code but does not arise from "other casualty" under section 1231(a)(4)(C). If the tree seedlings qualify as assets described in section 1231, the netting computations required by section 1231 will determine whether the loss will be an ordinary loss or a capital loss. If it is a capital loss, it will be subject to the limitations described in sections 165(f) and 1211.

The costs of replanting must be capitalized. They may be subject to amortization under section 194 of the Code and to investment credit under sections 48(a)(1)(F) and 49(b)(3). *See* Rev. Rul. 81-2. For the types of costs subject to capitalization, see Rev. Rul. 75-467, 1975-2 C.B. 93.

HOLDING

The taxpayer sustained a loss deductible for 1986 under section 165 of the Code, in an amount equal to the portion of the basis in the taxpayer's plantation account properly attributable to the seedlings on the area that had to be replanted as a result of the abnormal drought. The deductible amount includes only those previously capitalized reforestation costs that had to be duplicated on replanting.

The deduction is subject to the limitations in sections 165(f) and 1211 of the Code if the loss is deemed to be a capital loss as a result of the computations required by section 1231.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 81-2 is distinguished, and, to the extent it implies that a deduction is never allowable for a loss of seedlings unless the loss is due to casualty, it is modified. The holdings in Rev. Rul. 81-2 with respect to capitalization of replanting costs, amortization, and investment credit remain valid.

Rev. Rul. 87-59 is amplified.

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26 CFR 1.165-1: Losses.

Can an individual U.S. citizen offset the gain (or loss) realized from the sale of a personal residence with a loss (or gain) realized from the repayment of a nonfunctional currency denominated mortgage loan used to finance the purchase of the residence? See Rev. Rul. 90-79, page 187.

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26 CFR 1.165-2: Obsolescence of nondepreciable property.

For a revenue procedure that describes three alternative methods of accounting for package design costs and provides the exclusive procedure for taxpayers to obtain consent from the Commissioner to change to each of the alternative methods. See Rev. Proc. 90-63, page 664.

Section 167.—Depreciation

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

An administrative procedure is provided whereby certain life insurance companies may expeditiously obtain the consent of the Commissioner to change their method of accounting for ceding commissions to comply with the principles of Rev. Rul. 82-69 and the Supreme Court decision in *Colonial American Life Insurance Co.* See Rev. Proc. 90-36, page 357.

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26 CFR 1.167(a)-2: Tangible property.
(Also Sections 162, 263A; 1.162-3, 1.263A-1T.)

Depreciable versus non-depreciable; precious metals. Economically recoverable precious metal fabricated into items used in a taxpayer's trade or business are not depreciable if their cost is more than half the total cost of the item into which they are fabricated. Rev. Rul. 69-55 revoked; Rev. Rul. 75-491 amplified.

Rev. Rul. 90-65

ISSUE

If economically recoverable precious metals are physically or chemically fabricated into an item of prop-

erty used in a taxpayer's trade or business and the cost of those metals represents more than half of the cost of the item, are the metals accounted for separately or as part of the item into which they are fabricated?

FACTS

Situation 1—Individual *A* is a contract jeweler who fabricates jewelry to customers' specifications, using gold supplied by the customers. *A* does not maintain an inventory of gold or completed jewelry, but to assist customers *A* fabricates and maintains gold sample jewelry showing currently available styles. *A*'s samples are not held for sale. The cost of the gold used in each item of sample jewelry represents more than 50 percent of the total cost of the item. Every 3 years, *A* melts down the sample jewelry, recovering 100 percent of the gold content of the jewelry. For *A*'s purposes, the recovered gold is indistinguishable from gold that has not previously been used in sample jewelry, and *A* reuses it in fabricating new sample jewelry.

For federal income tax purposes, *A* sought to depreciate over three years the full cost of the sample jewelry, including the cost of the gold and the costs allocable to fabrication.

Situation 2—Corporation *Z* is a petroleum refiner. As part of its refining operation, *Z* uses a catalyst called prills, made by fabricating platinum salt solutions and other chemicals onto the surfaces of small alumina pellets. *Z* purchases the platinum in elemental form and then delivers it to a contractor for fabricating in accordance with *Z*'s specifications. The prills are placed in reactor vessels, where they perform as a catalyst for the production of high-octane gasoline. The cost of the platinum fabricated into the prills represents more than half of the cost of the prills.

During the production of high-octane gasoline, the prills are contaminated through the build up of coke and other chemicals on their surfaces. The prills, therefore, must be periodically regenerated by burning off the coke. Some of the chemicals cannot be removed by the regenerating process, and after several years the prills are considered spent and must be replaced. Approximately 15 to 20 percent of the platinum is lost during use as a catalyst. The spent catalyst is sent to a reclaimer, where approximately 80 to 85 percent of the platinum initially contained in the prills is recovered and refabricated into prills.

For federal income tax purposes, *Z* sought to depreciate the cost of the platinum over the life of the reactor vessel.

LAW AND ANALYSIS

Section 162(a) of the Internal Revenue Code allows a deduction for the ordinary and necessary expenses paid or incurred during the tax year in carrying on any trade or business. Section 1.162-1(a) of the Income Tax Regulations defines business expenses deductible from gross income to include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except items that are used as the basis for a deduction or a credit under provisions of law other than section 162. No such item shall be included in business expenses, however, to the extent that it is used by the taxpayer in computing the cost of property included in its inventory or used in determining the gain or loss basis of its plant, equipment, or other property.

Section 1.162-3 of the regulations requires taxpayers carrying materials and supplies on hand to include in expenses the charges for materials and supplies only in the amount that they are actually consumed and used in operations during the tax year for which the return is made, provided that the costs of such materials and supplies have not been deducted in determining the net income or loss or taxable income for any previous year.

Section 263A of the Code sets forth the general rules for the capitalization and inclusion in inventory costs of certain expenditures. Section 263A applies to property produced for sale or for use in the taxpayer's trade or business and to property acquired for resale. Section 1.263A-1T(b)(2)(ii) of the temporary regulations provides for the capitalization of indirect costs. Certain examples of indirect materials and supplies are identified by section 1.263A-1T(b)(2)(iii) as indirect costs that must be capitalized.

Section 167 of the Code sets forth the general rules for depreciation. Depreciation is designed to compensate a taxpayer for the loss of utility of property. Section 1.167(a)-2 of the regulations limits the depreciation allowance in the case of tangible property to that part of the property subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence. Thus, if an identifiable part of property used in a trade or business is recoverable—and is reasonably expected to be recovered—without loss of utility, the cost of that part is economically recoverable and does not enter into the depreciation allowance. In such a case, the nonwasting part is accounted for separately from the wasting part.

Section 446(b) of the Code requires that computation of income be made under a method of accounting that clearly reflects income. Section 1.446-1(a)(1) of the regulations explains that the taxpayer's method of accounting includes the accounting treatment of any item.

In Rev. Rul. 69-55, 1969-1 C.B. 26, a glass manufacturer used platinum in its fabricated furnace linings, electrodes, and other equipment necessary for manufacturing glass products. These fabricated items had useful lives that varied from 6 months to 3 years, after which time the items were refined and the platinum was recovered and reused in fabricating new items. The ruling states that platinum in its sponge (raw) form did not depreciate by reason of exhaustion, wear and tear, or obsolescence. It further states, however, that fabricated items containing platinum with a useful life of over 1 year take on the characteristics of depreciable property. The ruling concludes that because none of the fabricated platinum items had a useful life to the taxpayer of 4 years or more, the taxpayer was not entitled to investment tax credit under section 38 of the Code.

In Rev. Rul. 75-491, 1975-2 C.B. 19, a manufacturer of flat glass used molten tin as a frictionless surface on which glass moved through the float process of glass manufacturing. The ruling concludes that the tin was not depreciable property because it retained its identity as tin in its elemental state rather than serving as a material of construction that became part of a depreciable property. The ruling states that, although a portion of the tin (approximately 9 percent)

was consumed and used in the manufacturing operation, the portion that remained had not diminished in value to the taxpayer by reason of its use. The ruling concludes that the cost of tin consumed is deductible under section 162 of the Code as an expense of operation, subject to being included as a production cost in the inventoriable cost of producing the glass.

In *Arkla, Inc. v. United States*, 765 F.2d 487 (5th Cir. 1985), *cert. denied*, 475 U.S. 1064 (1986), the taxpayer owned a gas reservoir and maintained "cushion gas" in the reservoir to regulate the pressure. The cushion gas was indistinguishable from the gas the taxpayer sold to its customers. At the end of the reservoir's useful life, the taxpayer could recover some, but not all, of the cushion gas. The recoverable cushion gas was indistinguishable from the nonrecoverable cushion gas. The taxpayer was allowed investment credit and depreciation only for the nonrecoverable cushion gas. Similarly, in Rev. Rul. 75-233, 1975-1 C.B. 95, natural gas was injected into a reservoir for storage and later withdrawal and sale. For federal income tax purposes, that ruling divides the injected gas into the portion that is recoverable and the portion that remains in the reservoir and is unrecoverable. The cost of the unrecoverable portion is a capital expenditure subject to depreciation. *See also* Rev. Rul. 70-354, 1970-2 C.B. 50, as modified by Rev. Rul. 73-469, 1973-2 C.B. 84, in which liquified petroleum gas injected into a well to improve production is divided for tax purposes into a recoverable and an unrecoverable portion. The cost of the unrecoverable portion is a capital expenditure subject to depreciation in contrast to the cost of the recoverable portion, which is an offset against proceeds arising in future sales.

If a part of an item of property represents more than half of the total cost of the item and that part is economically recoverable for reuse without a loss of utility, separate accounting treatment is, in the Commissioner's opinion, necessary to clearly reflect income even though the recoverable part may have been "fabricated" (either by itself or with other materials) into an item of property with a determinable service life. Notwithstanding the fabrication, the taxpayer's ability to recover the part economically and reuse it without a loss in its utility indicates that the part is not subject to wear and tear. Moreover, allowing depreciation deductions in such a case would fail to clearly reflect income. Accordingly, the cost of the recoverable part is not depreciable. Section 1.167(a)-2 of the regulations. (By contrast, the platinum in a car's catalytic converter is not accounted for separately because its cost does not represent more than half of the total cost of the car.)

Situation 1—*A*'s costs associated with acquiring the gold and the fabrication of the jewelry are required to be capitalized under section 263A of the Code. The capitalized cost of the gold represents more than half of the total cost of the sample jewelry. It is economically feasible to recover the gold from the sample jewelry, and, once recovered, the gold is usable in *A*'s business in a manner that is indistinguishable from the use of gold that had never been fabricated, used, and recovered. The utility of the gold does not diminish as a result of its fabrication into sample jewelry. Accordingly, it is not subject to exhaustion, wear and tear, or obsolescence, and is not depreciable.

A may depreciate other capitalized costs allocable to fabricating the sample jewelry. Because the sample jewelry has a limited period of utility in *A*'s business, the asset represented by its fabrication cost is subject to obsolescence and may be depreciated. Similarly, the capitalized costs of any physical portions of the jewelry that are reasonably expected either not to be economically recoverable or to be recoverable only with diminished utility for *A* may be depreciated. In such cases, the utility of that portion ends with the utility of the item of property into which it has been incorporated, and the capitalized costs allocable to that portion are depreciable as part of the cost of the item.

Situation 2—As costs of producing an asset used in *Z*'s trade or business, the costs of acquiring the platinum and the costs incurred by *Z* in having the catalyst (the prills) fabricated under contract for use in *Z*'s trade or business are required to be capitalized under section 263A of the Code.

The capitalized costs of the platinum contained in the catalyst are to be accounted for separately from the capitalized costs of the remainder of the catalyst. The cost of the platinum represents more than half of the total cost of the prills, and the platinum, like the gold in *Situation 1*, is economically recoverable for reuse in the taxpayer's business with no loss of utility. The fact that a portion of the platinum is lost during its use as a catalyst does not affect this conclusion.

It makes no difference that, on the one hand, *A*'s gold is used in its elemental state and is subject only to physical fabrication while, on the other hand, *Z*'s platinum undergoes a chemical change when it is fabricated into prills and a second, reverse chemical change when it is recovered. The critical fact is not the physical or chemical nature of the fabrication process but whether the platinum can be economically recovered without loss of utility.

Because *Z*'s platinum is economically recoverable for reuse in *Z*'s business with no loss of utility, the capitalized platinum is not depreciable. The cost of any platinum not recovered is a material or supply expense under section 162 of the Code during the periods the prills are in use and is further capitalized under section 263A as an indirect material or supply cost of producing the gasoline. *See* section 1.263A-1T(b)(2)(iii) of the temporary regulations.

Also, as in Situation 1, the fabrication process creates a wasting asset. Thus, given the multi-year useful life of the prills, the capitalized cost of fabricating the prills and the nonplatinum materials of the prills are depreciable. The depreciation allowance, however, is itself further capitalized under section 263A of the Code as a cost of the gasoline.

In neither of the two situations can the taxpayer avoid a separate accounting for precious metals by including the cost of the precious metals and the fabrication costs in a single depreciation account. In these cases, such a single-account method does not, in the opinion of the Commissioner, clearly reflect income. In each case, the cost of the precious metal represents more than half of the cost of the item into which it is fabricated. Thus, if a single precious metal account were to include the cost of the precious metal along with the costs of fabrication and all such costs were treated as subject to a

depreciation allowance, the majority of the costs in that account would receive treatment that is fundamentally different from the more precise treatment that they receive if accounted for separately. A taxpayer must therefore use a multiple-account method because, in the Commissioner's opinion, only such a method clearly reflects income. *See* section 446(b) of the Code.

The same result obtains if the taxpayer does not fabricate the items containing precious metals, but buys them already fabricated and, at the end of the items' useful lives, resells them to the fabricator or some other party. So long as recovery with undiminished utility is economically feasible, the fact that the taxpayer benefits from the recovery by resale rather than refabrication is irrelevant. The taxpayer must use a multiple-account method to account separately for the precious metal content of the items.

HOLDING

If economically recoverable precious metals are physically or chemically fabricated into an item of property used in a taxpayer's trade or business and the cost of those metals represents more than half of the cost of the object, the costs of the precious metals are nondepreciable and are accounted for separately from the item into which they are fabricated.

APPLICATION

Any change in the taxpayer's method of accounting to conform with the holding of this revenue ruling is a change in method of accounting to which the provisions of sections 446 and 481 of the Code and the regulations thereunder apply. Section 446(e) requires a taxpayer who changes a method of accounting to secure the prior consent of the Commissioner. Section 1.446-1(e)(3)(i) of the regulations provides, in part, that a taxpayer may secure the Commissioner's consent by filing with the Commissioner a Form 3115, *Application for Change in Accounting Method*, within 180 days after the beginning of the tax year in which the change is to occur. See section 5.02 of Rev. Proc. 84-74, 1984-2 C.B. 736, for late applications. Section 481(a) requires that those adjustments necessary to prevent amounts from being duplicated or omitted be taken into account when the taxpayer's taxable income is computed under a method of accounting different from the method used to compute taxable income for the preceding tax year. *See* Rev. Proc. 84-74.

This ruling is identified as a designated "B" ruling pursuant to section 5.12(2) of Rev. Proc. 84-74. Accordingly, if a taxpayer files a Form 3115 requesting a change from an accounting method that capitalizes and depreciates precious metals, then the section 481(a) adjustment period determined under section 5.06(1)(e) of Rev. Proc. 84-74 shall not exceed 6 tax years. If, however, the use of the method is raised as an issue during an examination and the taxpayer thereafter files a Form 3115 more than 2 years after the date of publication of this revenue ruling in the Internal Revenue Bulletin, then the section 481(a) adjustment period shall not exceed 3 tax years pursuant to section 5.12(2) of Rev. Proc. 84-74.

Any change in the taxpayer's method of accounting to conform with the holding of this revenue ruling shall be made as specified above. If the taxpayer has been capitalizing and depreciating precious metals used in its trade or business, any change in the taxpayer's method shall be made without regard to the change in method of accounting procedures set out in section 1.263A-1T(e) of the temporary regulations and in Notice 88-78, 1988-2 C.B. 394.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 69-55 is revoked.

Rev. Rul. 75-491 is amplified. The principles stated in that ruling apply not only when a recoverable element is used in its elemental state, but also when an economically recoverable precious metal is fabricated physically or chemically into items of property used in the taxpayer's trade or business and it is necessary, in order to clearly reflect income, to account for the precious metals separately.

PROSPECTIVE APPLICATION

Pursuant to the authority contained in section 7805(b) of the Code, relief will be extended to any taxpayer covered by the implication in Rev. Rul. 69-55 that the cost of precious metals fabricated into an item of property with a useful life of more than one year is depreciable. For such a taxpayer, this revenue ruling will not be applied adversely for tax years beginning before August 13, 1990, the date of publication of this revenue ruling.

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26 CFR 1.167(a)-3: Intangibles.

For a revenue procedure that describes three alternative methods of accounting for package design costs and provides the exclusive procedure for taxpayers to obtain consent from the Commissioner to change to each of the alternative methods. See Rev. Proc. 90-63, page 664.

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26 CFR 1.167(h)-1: Life tenants and beneficiaries of trust and estates.
(Also Section 643; 1.643(b)-1.)

Trust depreciation deduction allocation; mortgaged property. A trust that holds mortgaged property and that charges payments of principal on the mortgage note against trust income in determining amounts to be distributed to the trust's beneficiaries must allocate a portion of the depreciation deduction attributable to the mortgaged property to the trust.

Rev. Rul. 90-82

ISSUE

If a trust holds mortgaged property, and if the trustee, in accordance with the terms of the trust's governing instrument, charges the payments of principal on the mortgage note against the trust's income in determining the amounts to be distributed to the trust's beneficiaries, then should the depreciation deduction attributable to the mortgaged property be allocated, in part, to the trust?

FACTS

G, a grantor, established an irrevocable trust, *TR*, by executing a trust instrument and by conveying property to *T* as trustee. The trust instrument provides that *T* is to pay trust income to *B* for *B*'s life, and after *B*'s death, *T* is to distribute the entire trust principal to *C*. *G* did not retain any power over or interest in *TR* that would cause *G* to be treated as an owner of *TR* under the grantor trust provisions of the Internal Revenue Code (sections 671 through 679).

The trust instrument of *TR* directs *T*, as trustee, to distribute at least annually to *B* all income realized by

TR during the taxable year. For this purpose, the trust instrument defines income to include all income (other than capital gains) minus certain specified expenses, including both interest and principal on any mortgage indebtedness.

The Revised Uniform Principal and Income Act provides that, unless the governing instrument provides otherwise, a trustee is to charge against trust principal the payments of principal on an indebtedness. Rev. Unif. Principal and Income Act section 13(c)(2), 78 U.L.A. 177 (1962). *TR* is subject to the laws of a state that has adopted the Revised Uniform Principal and Income Act.

In accordance with discretion granted to it under the terms of the trust instrument, *T* purchased on behalf of *TR* income-producing real estate. The purchase price of the real estate was $1,100*x*. *T* paid $100*x* cash to the seller, and gave a mortgage to the seller for the $1,000*x* balance. The mortgage required equal quarterly payments of principal and interest for a period of 15 years.

For its first full taxable year, *TR* realized $140*x* of rental income. During that year, *T*, as trustee, paid $130*x* on the mortgage, and of that amount, $100*x* represented interest and $30*x* represented principal. In accordance with the terms of *TR*'s governing instrument, *T* charged the entire $130*x* of mortgage payments against *TR*'s income, and distributed $10*x* to *B*.

For *TR*'s first full taxable year, the allowable depreciation deduction attributable to the mortgaged real estate was $40*x*. *TR* had no other items of income or deduction. *T* did not establish a reserve for depreciation.

LAW AND ANALYSIS

Section 642(e) of the Code provides that a trust shall be allowed the deduction for depreciation only to the extent that it is not allowable to the beneficiaries under section 167(h).

Section 167(h) of the Code and the related regulations provide that, if the trustee does not maintain a reserve for depreciation, deductions for depreciation are apportioned between the income beneficiaries of the trust and the trustee in the same proportion that trust income is allocable to each. Section 1.167(h)-1(b)(2) of the Income Tax Regulations specifically states that no effect is to be given to any allocation of the depreciation deduction that gives any beneficiary or the trustee a share of such deduction greater than that person's prorata share of trust income, irrespective of any provision in the trust instrument other than a provision that requires or allows the trustee to establish a reserve for depreciation.

Section 643(b) of the Code and the related regulations provide that the term "income," when not preceded by the words "distributable net," "undistributed net," or "gross," means the amount of income of the trust for the taxable year determined under the terms of its governing instrument and applicable local law. Section 1.643(b)-1 of the regulations states, however, that trust provisions that depart fundamentally from concepts of local law in determining trust income are not recognized for federal income tax purposes. The example set out in section 1.643(b)-1 indicates that if a trust instrument directs a trustee to distribute all income currently, but allocates ordinary dividends and interest to principal, the trust would not be considered one that is required to distribute all its income currently. In other words, the trust provision defining income and principal is ignored, and, for federal income tax purposes, the crediting of dividends and interest to principal is considered an accumulation of income for the benefit of the remainderman.

Generally, payment of the principal portion of an outstanding mortgage is charged against trust principal and is not, therefore, taken into account in determining "trust income" as that term is defined in section 643(b) of the Code. *See* Rev. Unif. Principal and Income Act section 13(c)(2), 7B U.L.A. 177 (1962); Unif. Principal and Income Act section 12, 7B U.L.A. 191 (1931); G. Bogert, *The Law of Trusts and Trustees*, sections 603, 808 (rev. 2d ed., 1981); *Restatement (Second) of Trusts* section 233; Annot., 68 A.L.R.3d 811 (1976). The rationale for this general rule is that the reduction of the principal balance on an outstanding mortgage increases the equity held by the trust in the encumbered real estate, and therefore the remainder beneficiary suffers no loss through application of trust principal to such payments. *See* G. Bogert, *supra*, section 808; Annot., 68 A.L.R.3d at 813. Rather, by charging mortgage principal payments against trust principal, the trustee merely decreases the trust's investment in one asset (*e.g.*, principal cash), and increases the trust's investment in the encumbered real estate. If, however, a trustee charges mortgage principal payments against income, the amount available for distribution to the income beneficiary is diminished, and the amount available for the remainder beneficiary is increased because the value of trust principal is enhanced by the amount of the payment. *See* G. Bogert, *supra*, section 808; Annot., 68 A.L.R.3d at 814.

Charging mortgage principal payments against trust income produces the same result that occurs if items normally considered to be trust income, such as interest and dividends, are allocated to trust principal. In both situations, amounts that would be included in trust income, but for provisions of the governing instrument that depart from general concepts of local law, are added to trust principal for the benefit of the remainderman. In this case, therefore, consistent with the example set out in section 1.643(b)-1 of the regulations, the provision in the trust instrument directing the trustee to charge mortgage principal payments against income is ignored for federal income tax purposes.

Accordingly, for its first full taxable year, *TR* is to compute trust income for purposes of section 643(b) of the Code as follows:

Rental Income	$140*x*
Minus interest on mortgage	$100*x*
Income computed under section 643(b)	$ 40*x*

Because the provision in the trust instrument directing the trustee to charge mortgage principal payments against trust income is disregarded for federal income tax purposes, that amount is not deducted in determining trust income under section 643(b).

Although the provision of the trust instrument directing the trustee to charge mortgage principal payments against income is disregarded for federal income tax purposes, the trustee must follow that direction in determining the amount of income to be

distributed to *B*. Consequently, *T* could distribute only $10*x* of income to *B* ($140*x* rental income − $130*x* interest and principal on the mortgage). Because that amount represents one-fourth of total trust income computed under section 643(b) of the Code, *B* may deduct one-fourth of the $40*x* depreciation attributable to the mortgaged real estate, or $10*x*. The balance of the depreciation deduction, $30*x*, is allocated to *TR* because it retained three-fourths of total trust income computed under section 643(b).

HOLDING

If a trust holds mortgaged property, and if the trustee, in accordance with the terms of the trust instrument, charges payments of mortgage principal against trust income in determining the amount to be distributed to the trust's beneficiaries, a portion of the depreciation deduction attributable to the mortgaged property must be allocated to the trust. By charging mortgage principal payments against income, the trustee, in effect, accumulates income for the benefit of the remainderman, and, under section 167(h) of the Code, depreciation is to be allocated between the trust and the beneficiaries based on the amount of income allocable to each. The portion of the depreciation allocated to the trust, therefore, is determined by multiplying the total allowable depreciation by a fraction, the numerator of which is the amount of income accumulated, and the denominator of which is the total trust income computed under section 643(b).

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

Ct. D. 2049

SUPREME COURT OF THE UNITED STATES

No. 89-98

HAROLD DAVIS, ET UX., PETITIONERS v. UNITED STATES [—U.S.—]

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

May 21, 1990

Syllabus

Section 170 of the Internal Revenue Code of 1954 permits a taxpayer to claim a charitable contribution deduction only if the contribution is made "to or for the use of" a qualified organization. Petitioner husband and wife, who are members of the Church of Jesus Christ of Latter-day Saints, claimed such deductions for funds transferred to their sons while they were serving as full-time, unpaid missionaries for the Church. The Church requested the payments, set their amounts, and, through written guidelines, instructed that they be used exclusively for missionary work. In accordance with the guidelines, petitioners' sons used the money primarily to pay for rent, food, transportation, and personal needs while on their missions. When the Internal Revenue Service denied petitioners' claim, they filed suit in the District Court. The court ruled in favor of the Government, holding that the payments were not "for the use of" the Church under §170 because the Church lacked sufficient possession and control of the funds. The court also rejected petitioners' alternative claim that the payments were deductible under Treas. Reg. 1.170A-1(g)—which allows the deduction of "unreimbursed expenditures made incident to the rendition of services to an organization contributions to which are deductible"—on the ground that petitioners were not themselves performing donated services. The Court of Appeals affirmed.

Held: 1. The funds transferred by petitioners to their sons were not donated "for the use of" the Church within the meaning of §170.

(a) In choosing the phrase "for the use of," Congress was most likely referring to donations made to a legally enforceable trust or a similar legal arrangement. Although, on its face, the quoted phrase could support any number of meanings, the history of the statute indicates that Congress added the phrase to §170 in 1921 for the purpose of overruling the Government's prior interpretation that a gift to a trust for a charitable purpose was not deductible. Construing the phrase as referring to a trust or similar arrangement comports with the accepted meaning in 1921 of "use" as synonymous with the term "trust."

(b) Thus, the Service's contemporaneous and longstanding interpretation that the phrase "for the use of" is intended to convey a similar meaning as "in trust for" is consistent with the statutory language, fully implements Congress' apparent purpose in adopting it, and must be accepted.

(c) There is no evidence to support petitioners' contentions that Congress intended the phrase "for the use of" to be interpreted as referring to fiduciary relationships in general or as referring to a type of relationship that gives a qualified organization a reasonable ability to supervise the use of contributed funds.

(d) The record does not support a finding that petitioners transferred the funds to their sons "in trust for," or through a similarly enforceable legal arrangement for the benefit of, the Church. There is no evidence that petitioners took any steps normally associated with creating a trust or similar legal arrangement; that the sons had any legal obligation to comply with their promise to use the money in accordance with the Church's guidelines; or that the Church might have a legal entitlement to the money or to a civil cause of action against missionaries using such money for purposes not approved by the Church.

2. The transfer of funds by petitioners to their sons was not a contribution "to" the Church under Treas. Reg. 1.170A-1(g). The regulation's plain language indicates that taxpayers may claim deductions only for "unreimbursed expenditures" incurred in connection with their own "rendition of services to [a qualified] organization."

861 F. 2d 558, affirmed.

O'CONNOR, J., delivered the opinion for a unanimous Court.

JUSTICE O'CONNOR delivered the opinion of the Court.

We are called upon in this case to determine whether the funds petitioners transferred to their two sons while they served as full-time, unpaid missionaries for the Church of Jesus Christ of Latter-day Saints are deductible as charitable contributions "to or for the use of" the Church, pursuant to 26 U.S.C. §170.

I

Petitioners, Harold and Enid Davis, and their sons, Benjamin and Cecil, are members of the Church of Jesus Christ of Latter-day Saints. According to the stipulated facts, the Church operates a worldwide missionary program involving 25,000 persons each year. Most of these missionaries are young men between the ages of 19 and 22. If the Church determines that a candidate is qualified to become a missionary, the president of the Church sends a letter calling the candidate to missionary service in a specified geographical location. A follow-up letter from the Missionary Department lists the items of clothing the missionary will need, provides specific information relating to the mission, and sets forth the estimated amount of money needed to support the missionary service. This amount varies according to the location of the mission, and reflects an estimate of the amount the missionary will actually need.

The missionary's parents generally provide the necessary funds to support their son or daughter during the period of missionary service. If they are unable to do so, the Church will locate another donor from the local congregation or use money donated to the Church's general missionary funds. The Church believes that having individual donors send the necessary funds directly to the missionary benefits the Church in several important ways. Specifically, it "fosters the

Church doctrine of sacrifice and consecration in the lives of its people" as well as reducing the administrative and bookkeeping requirements which would otherwise be imposed upon the Church. App. to Pet. for Cert. 32a.

After accepting the call, the missionary candidate receives priesthood ordinances to serve as an official missionary and minister of the Church. During the missionary service, the Mission President (leader of the mission) controls many aspects of the missionaries' lives, including the manner of dress and grooming. Missionaries are required to conform to a daily schedule which calls for at least 10 hours per day of actual missionary work in addition to study time, mealtime and planning time. Mission rules forbid dating, movies, plays, certain sports, and other activities; missionaries are not allowed to take vacations or travel for personal purposes.

Missionaries receive some supervision over their use of funds. The Missionary Handbook instructs missionaries that "[t]he money you receive for your support is sacred and should be spent wisely and only for missionary work. Keep expenses at a minimum. . . .Keep a financial record of all expenditures." App. 13. The Mission Presidents give similar instructions to the missionaries under their supervision. Although missionaries are not required to obtain advance approval of each expenditure they make from their personal checking account, they do submit weekly reports to their group leader listing the amount of time spent in Church service, the type of missionary work accomplished, and a report of the total expenses for the week and month to date. If a missionary begins to accumulate surplus funds, he is expected to take action to reduce the amount of donations sent to him. The Mission President may alter his estimates of the amounts required each month to take into account changing circumstances.

Benjamin and Cecil Davis both applied to become missionaries. In 1979, the Church notified Benjamin by letter that he had been called to missionary service at the New York Mission. A second letter informed him of the estimated amount of money which would be needed to support his service. In 1980, Cecil Davis was notified that he had been called to missionary service at the New Zealand-Cook Island Mission. Cecil also received a second letter informing him about the mission and the amount of money he would need. Petitioners notified their bishop that they would provide the funds requested by the Church to meet their sons' mission expenses. According to petitioners, both sons made a commitment with them to use the money only in accordance with the Church's instructions.

Petitioners transferred to Benjamin's personal checking account, on which he was the sole authorized signatory, $3,480.89 in 1980 and $4,135 in 1981. During 1981, petitioners transferred $1,518 to Cecil's personal checking account, on which he was the sole authorized signatory. Benjamin and Cecil used this money primarily to pay for rent, food, transportation, and personal needs while on their missions. Benjamin also spent approximately $20 per month to purchase religious tracts and other materials used during his missionary work. Neither Benjamin nor Cecil was required to or sought specific approval of each expenditure made from his personal checking account. However, each week Benjamin and Cecil submitted a report of the total expenses for the week and month to date. At the end of their service, Cecil had no money remaining in his account; Benjamin had $150 which he used to purchase a camera. (Petitioners do not claim a deduction for this amount.)

In their joint tax returns filed in 1980 and 1981, petitioners claimed their sons as dependents, but did not claim a charitable contribution deduction under 26 U.S.C. §170 for the funds sent their sons during their missionary service. On April 16, 1984, petitioners filed an amended income tax return for the years 1980 and 1981, claiming additional charitable contributions of the $3,480.89 and $4,882 paid to their sons during the missionary service. In January 1985, the Internal Revenue Service disallowed the refunds. Petitioners filed a refund suit in the United States District Court for the District of Idaho. In September 1986, petitioners filed a second set of amended returns, limiting their charitable deductions to the amounts indicated by the Church and correcting the number of dependents claimed for each year.

In District Court, petitioners and the United States both moved for summary judgment. 664 F. Supp. 468 (Idaho 1987). Petitioners argued that the payments they made to support their sons' missionary services were charitable contributions "for the use of" the Church. Alternatively, they claimed the payments were deductible under Treas. Reg. 1.170A-1(g), 26 CFR §1.170A-1(g) (1989), which allows the deduction of "unreimbursed expenditures made incident to the rendition of services to an organization contributions to which are deductible." The District Court ruled in favor of the United States. It rejected petitioners' claimed deduction for unreimbursed expenditures because petitioners were not themselves performing donated services and it held that petitioners' payments to their sons were not "for the use of" the Church because the Church lacked sufficient possession and control of the funds. 664 F. Supp., at 471–472.

The Court of Appeals for the Ninth Circuit affirmed. 861 F. 2d 558 (1988). The Court of Appeals rejected petitioners' claim that the transferred funds were deductible contributions because they conferred a benefit on the Church. Id., at 561. Instead, the Court of Appeals held that contributions are deductible only when the recipient charity exercises control over the donated funds. Id., at 562. The Court of Appeals reasoned that the beneficiary of a charitable contribution must be indefinite, see Russell v. Allen, 107 U.S. 163, 167 (1883), and that this requirement cannot be met when the taxpayer makes a contribution directly to the intended beneficiary. In this case, the Court of Appeals concluded that the Church lacked actual control over the disposition of the funds and thus they were not deductible. 861 F. 2d at 562. The Court of Appeals agreed with the District Court that §1.170A-1(g) did not apply to petitioners, as the regulation permits a deduction for unreimbursed expenses only by the taxpayer who performed the charitable service. 861 F. 2d, at 564.

Because the Court of Appeals' decision conflicted with White v. United States, 725 F. 2d 1269, 1270–1272 (CA10 1984), and Brinley v. Commissioner, 782 F. 2d 1326, 1336 (CA5 1986), we granted certiorari,

____ U.S. ____ (1990), and now affirm.

II

Under §170 of the Internal Revenue Code of 1954, 68A Stat. 58, as amended, 26 U.S.C. §170 (1982 ed.), a taxpayer may claim a deduction for a charitable contribution only if the contribution is made "to or for the use of" a qualified organization. This section provides, in pertinent part:

"(a) Allowance of deduction.

"(1) General rule.—There shall be allowed as a deduction any charitable contribution (as defined in subsection (c)) payment of which is made within the taxable year. A charitable contribution shall be allowable as a deduction only if verified under regulations prescribed by the Secretary.

* * * * *

"(c) Charitable contribution defined.—For purposes of this section, the term 'charitable contribution' means a contribution or gift to or for the use of—

* * * * *

"(2) A corporation, trust, or community chest, fund, or foundation—

* * * * *

"(B) organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes. . . ." (Emphasis added.)

Petitioners contend that the funds they transferred to their sons' accounts are deductible as contributions "for the use of" the Church. Alternatively, petitioners claim these funds are unreimbursed expenditures under Treasury Regulation §1.170A-1(g), and therefore are deductible as contributions "to" the Church.* We first consider whether the payments at issue here are "for the use of" the Church within the meaning of §170.

On its face, the phrase "for the use of" could support any number of different meanings. See, e.g., Webster's New International Dictionary (2d ed. 1950) ("use" defined in general usage as "to convert to one's service"; "to employ"; or, in law, "use imports a trust" relationship). Petitioners contend that the phrase "for the use of" must be given its broadest meaning as describing "the entire array of fiduciary relationships in which one person conveys money or property to someone else to hold or employ in some manner for the benefit of a third person." Brief for Petitioners 17. Under this reading, no legally enforceable relationship need exist between the recipient of the donated funds and the qualified donee; in effect, any intermediary may handle the funds in any way that would arguably benefit a charitable organization, regardless of how indirect or tangential the benefit might be. Petitioners also advance a second, somewhat narrower interpretation, specifically that a contribution is "for the use of" a qualified organization within the meaning of §170 so long as the donee has "a reasonable ability to ensure that the contribution primarily serves the organization's charitable purposes." Brief for Petitioners 26. In this case, petitioners argue that their payments at least meet this second interpretation. They point to the Church's role in requesting the funds, setting the amount to be donated, and requiring weekly expense sheets from the missionaries. The Service, on the other hand, has historically defined "for the use of" as conveying "a similar meaning as 'in trust for.' " See e.g., I.T. 1867, II-2 Cum. Bull. 155 (1923).

Although the language of §170 would support the interpretation of either the Service or petitioners, the events leading to the enactment of the 1921 amendment adding the phrase "for the use of" to §170 indicate that Congress had a specific meaning of "for the use of" in mind. The original version of §170, promulgated in the War Revenue Act of 1917, ch. 63, §1201(2), 40 Stat. 330, did not allow deductions for gifts "for the use of" a qualified donee. Rather, it allowed individuals to deduct only "[c]ontributions or gifts. . .to corporations or associations organized and operated exclusively for religious, charitable, scientific, or educational purposes. . . ." In interpreting this provision in the Act (and in the subsequent Revenue Act of 1918, ch. 18 §214(a)(11), 40 Stat. 1068), the Bureau of Internal Revenue stated that "[c]ontributions to a trust company (a corporation) in trust to invest and disburse them for a charitable purpose are not allowable deductions under [§170]." O.D. 669, 3 Cum. Bull 187 (1920). In hearings before the Senate Committee on Finance on the proposed Revenue Act of 1921, representatives of charitable foundations requested an amendment making gifts to trust companies and similar donees deductible even though a trustee, rather than a charitable organization, held legal title to the funds. Hearings on Proposed Revenue Act of 1921 before the Senate Committee on Finance, 67th Cong., 1st Sess., 521 (1921). Testimony before the Committee indicated that numerous communities had established charitable trusts, charitable foundations, or community chests so that individuals could donate money to a trustee who held, invested, and reinvested the principal, and then turned the principal over to a committee that distributed the funds for charitable purposes. Id., at 522-526; see also H.R. Rep. No. 350, 67th Cong., 1st Sess., 12 (1921) (House Comm. on Ways and Means) (amendments "would allow the deduction, under proper restriction, of contributions or gifts to a community chest fund or foundation"); S. Rep. No. 275, 67th Cong., 1st Sess., 18 (1921). Responding to these concerns, Congress overruled the Service's interpretation of §170 [then §214(a)(11)] by adding the phrase "for the use of. . .any corporation, or community chest, fund, or foundation. . ." to the charitable deduction provision of the Revenue Act of 1921, ch. 136, §214(a)(11), 42 Stat. 241. In light of these events, it can be inferred that Congress' use of the phrase "for the use of" related to its purpose in amending §170 of allowing taxpayers to deduct contributions made to trusts, foundations, and similar donees. An interpretation of "for the use of" as conveying a similar meaning as "in trust for" would be consistent with this goal.

It would have been quite natural for Congress to use the phrase "for the use of" to indicate its intent of allowing deductions for donations in trust, as this phrase would have suggested a trust relationship to the members of the 67th Congress. From

*The Commissioner has adopted the holding in Rockefeller v. Commissioner, 676 F. 2d 35, 42 (CA2 1982) that unreimbursed expenses are contributions "to" the Church rather than "for the use of" the Church. See Rev. Rul. 84-61, 1984-1 Cm. Bull. 40.

the dawn of English common law through the present, the word "use" has been employed to refer to various forms of trust arrangements. See 1 G. Bogert, Trusts and Trustees §2, p. 9 (1935); Black's Law Dictionary 1382 (5th ed. 1979) ("Use and trusts are not so much different things as different aspects of the same subject. A use regards principally the beneficial interest; a trust regards principally the nominal ownership"). In the early part of this century, the word "use" was technically employed to refer to a passive trust, but less formally used as a synonym for the word "trust." See Bogert, supra, at 9 ("The words 'use' and 'trust' are employed as synonyms frequently by writers and judges"); 1 R. Baldes, Perry on Trusts and Trustees §298 (7th ed. 1929) ("A use, a trust and a confidence is one and the same thing. . . ."); 1 Restatement of Trusts §§67-72 (Effect of Statute of Uses) (1935). The phrases "to the use of" or "for the use of" were frequently used in describing trust arrangements. See, e.g., United States v. Bowling, 256 U.S. 484, 486 (1921); Blanset v. Cardin, 256 U.S. 319, 321 (1921); Rand v. United States, 249 U.S. 503, 508 (1919). Given that this meaning of the word "use" precisely corresponded with Congress' purpose for amending the statute, it appears likely that in choosing the phrase "for the use of" Congress was referring to donations made in trust or in a similar legal arrangement.

This understanding is confirmed by the Service's initial interpretation of the phrase. It is significant that almost immediately following the amendment of §170, the Commissioner interpreted the phrase "for the use of" as "intended to convey a similar meaning as 'in trust for.' " I.T. 1867, II-2 Cum. Bull. 155 (1923). Rejecting a taxpayer's claim that a gift to a volunteer fire company was deductible as a contribution for the use of the municipality, the Service noted that "[i]t does not appear that the municipality in any way has any control over the property of the incorporated volunteer fire company or that it has any voice in the manner in which such property should be used. Upon dissolution of the company, the property would not escheat to the State. A right of appropriation or enjoyment of the property of the fire company does not rest in the municipality." Ibid. The Service adhered to its interpretation that "for the use of" conveys "a similar meaning as 'in trust for' " in subsequent rulings permitting taxpayers to deduct the value of gifts irrevocably transferred to a trust for the benefit of qualified organizations. See, e.g., Rev. Rul. 55-275, 1955-1 Cum. Bull. 295; Rev. Rul. 194, 1953-2 Cum. Bull. 128; I.T. 3707, 1945 Cum. Bull. 114. Numerous judicial decisions have relied on this interpretation. See, e.g., Rockefeller v. Commissioner, 676 F. 2d 35, 40 (CA2 1982); Orr v. United States, 343 F. 2d 553, 557-558 (CA5 1965); Thomason v. Commissioner, 2 T.C. 441, 444 (1943); Danz v. Commissioner, 18 T.C. 454, 464 (1952), aff'd on other grounds, 231 F. 2d 673 (CA9 1955), cert. denied, 352 U.S. 828 (1956). Congress' reenactment of the statute in 1954, using the same language, indicates its apparent satisfaction with the prevailing interpretation of the statute. See Cammarano v. United States, 358 U.S. 498, 510 (1959); McCaughn v. Hershey Chocolate Co., 283 U.S. 488, 492-493 (1931).

The Commissioner's interpretation of "for the use of" thus appears to be entirely faithful to Congress' understanding and intent in using that phrase. Moreover, the Commissioner's interpretation is consistent with the purposes of §170 as a whole. In enacting §170, "Congress sought to provide tax benefits to charitable organizations, to encourage the development of private institutions that serve a useful public purpose or supplement or take the place of public institutions of the same kind." Bob Jones University v. United States, 461 U.S. 574, 588 (1983). The Commissioner's interpretation of "for the use of" assures that contributions will in fact foster such development because it requires contributions to be made in trust or in some similar legal arrangement. A defining characteristic of a trust arrangement is that the beneficiary has the legal power to enforce the trustee's duty to comply with the terms of a trust. See, e.g., 3 W. Fratcher, Scott on Trusts §200 (4th ed. 1988); 1 Restatement of Trusts §200 (1935). A qualified beneficiary of a bona fide trust for charitable purposes would have both the incentive and legal authority to ensure that donated funds are properly used. If the trust contributes funds to a range of charitable organizations so that no single beneficiary could enforce its terms, the trustee's duty can be enforced by the Attorney General under the laws of most States. See 4A W. Fratcher, Scott on Trusts §391 (4th ed. 1989); G. Bogert Trusts and Trustees §411 (2d ed. 1977). Although the Service's interpretation does not require that the qualified organization take actual possession of the contribution, it nevertheless reflects that the beneficiary must have significant legal rights with respect to the disposition of donated funds.

Petitioners argue that any interpretation of "for the use of" that requires a qualified donee to have the same degree of control over contributed funds as a beneficiary would have over a trust res, would make "for the use of" redundant, meaning no more than "to." We disagree. When Congress amended §170, it was fully aware of the Service's ruling that the original statutory deduction for contributions "to" a qualified organization could not be claimed contributions made in trust for the organization. See O.D. 669, 3 Cum. Bull. 187 (1920). Accordingly, Congress amended the statute specifically to overcome this interpretation. Moreover, a contribution made in trust for a charity does not give the charity immediate possession and control, as does a donation directly to a charity. Unlike a contribution that must go "to" a qualified organization, a contribution "for the use of" a donee may go to a trustee with the discretion to select among a number of qualified donees to whom the funds may be disbursed. See, e.g., Bowman v. Commissioner, 16 B.T.A. 1157, 1163-1164 (1929). Furthermore, a taxpayer may generally claim an immediate deduction for a gift to a trustee, even though receipt of the gift by the charity is delayed. Recognizing this characteristic of gifts in trust, Congress further amended §170 in 1964 in order to encourage donations "to" a charity, because donations "in trust for" a charity "often do not find their way into operating philanthropic endeavors for extended periods of time." S. Rep. No. 830, 88th Cong., 2d Sess., 59-60 (1964).

Although the Service's interpretive rulings do not have the force and

effect of regulations, see Bartels v. Birmingham, 332 U.S. 126, 132 (1947), we give an agency's interpretations and practices considerable weight where they involve the contemporaneous construction of a statute and where they have been in long use. See, e.g., Norwegian Nitrogen Products Co. v. United States, 288 U.S. 294, 315 (1933). Under the circumstances presented here, we think there is good reason to accept the Service's interpretation of "for the use of." The denial of deductions for donations in trust that prompted Congress to amend §170, the accepted meaning of "use" as synonymous with the term "trust," and the Service's contemporaneous and longstanding construction of §170 constitutes strong evidence in favor of this interpretation.

Although the language of the statute may also bear petitioners' interpretation, they have failed to establish that their interpretation is compelled by the statutory language. To the contrary, there is no evidence that Congress intended the phrase "for the use of" to be interpreted as referring to fiduciary relationships in general or as referring to a type of relationship that gives a qualified organization a reasonable ability to supervise the use of contributed funds. Rather, as noted above, there are strong indications that Congress intended a more specific meaning. Moreover, petitioners' interpretations would tend to undermine the purposes of §170 by allowing taxpayers to claim deductions for funds transferred to children or other relatives for their own personal use. Because a recipient of donated funds need not have any legal relationship with a qualified organization, the Service would face virtually insurmountable administrative difficulties in verifying that any particular expenditure benefitted a qualified donee. Cf. §170(a)(1). Although there is no suggestion whatsoever in this case that the transferred funds were used for an improper purpose, it is clear that petitioners' interpretation would create an opportunity for tax evasion that others might be eager to exploit. See, e.g., Scialabba, Kurtzman, Steinhart, Mail-Order Ministries Under the Section 170 Charitable Contribution Deduction: The First Amendment Restrictions, the Minister's Burden of Proof, and the Effect of TRA '86, 11 Campbell L. Rev. 1 (1988); Note, "I Know It When I See It": Mail-Order Ministry Tax Fraud and the Problem of a Constitutionally Acceptable Definition of Religion, 25 Am. Crim. L. Rev. 113 (1987). We need not determine whether petitioners' interpretation of "for the use of" would have been a permissible one had the Service decided to adopt it, though we note that the Service may retain some flexibility to adopt other interpretations in the future. It is sufficient to decide this case that the Service's longstanding interpretation is both consistent with the statutory language and fully implements Congress' apparent purpose in adopting it. Accordingly, we conclude that a gift or contribution is "for the use of" a qualified organization when it is held in a legally enforceable trust for the qualified organization or in a similar legal arrangement.

Viewing the record here in the light most favorable to petitioners, as we must after a grant of summary judgment for the United States, we discern no evidence that petitioners transferred funds to their sons "in trust for" the Church. It is undisputed that petitioners transferred the money to their sons' personal bank accounts on which the sons were the sole authorized signatories. Nothing in the record indicates that petitioners took any steps normally associated with creating a trust or similar legal arrangement. Although the sons may have promised to use the money "in accordance with Church guidelines," see App. to Pet. for Cert. 36a, they did not have any legal obligation to do so; there is no evidence that the guidelines have any legally binding effect. Nor does the record support the assertion, see Tr. Oral Arg. 19-20, that the Church might have a legal entitlement to the money or a civil cause of action against missionaries who used their parents' money for purposes not approved by the Church. We conclude that, because petitioners did not donate the funds in trust for the Church, or in a similarly enforceable legal arrangement for the benefit of the Church, the funds were not donated "for the use of" the Church for purposes of §170.

III

Petitioners contend, in the alternative, that their transfer of funds into their sons' account was a contribution "to" the Church under Treas. Reg. §1.170A-1(g), 26 CFR §1.17A-1(g) (1989), which provides:

> "Contributions of services. No deduction is allowable under section 170 for a contribution of services. However, unreimbursed expenditures made incident to the rendition of services to an organization contributions to which are deductible may constitute a deductible contribution. For example, the cost of a uniform without general utility which is required to be worn in performing donated services is deductible. Similarly, out-of-pocket transportation expenses necessarily incurred in performing donated services are deductible. Reasonable expenditures for meals and lodging necessarily incurred while away from home in the course of performing donated services are also deductible. For the purposes of this paragraph, the phrase 'while away from home' has the same meaning as that phrase is used for purposes of section 162 and the regulations thereunder."

Petitioners assert that this regulation allows them to claim deductions for their sons' unreimbursed expenditures incident to their sons' contribution of services. We disagree. The plain language of §1.170A-1(g) indicates that taxpayers may claim deductions only for expenditures made in connection with their own contributions of service to charities. Unless there is a specific statutory provision to the contrary, a taxpayer ordinarily reports his own income and takes his own deductions. See, e.g., Commissioner v. Culbertson, 337 U.S. 733, 739-740 (1949) ("[T]he first principle of income taxation [is] that income must be taxed to him who earns it."); New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440-441 (1934) ("[T]axpayer who sustain[s] the loss is the one to whom the deduction shall be allowed"). Section 1.170A-1(g) is thus most naturally read as referring to the individual taxpayer, who may deduct only those "unreimbursed expenditures" incurred in connection with the taxpayer's own "rendition of services to [a

qualified] organization." This interpretation of the regulation is consistent with the Revenue Ruling that was the precursor to §1.170A-1(g). See Rev. Rul. 55-4, 1955-1 Cum. Bull. 291 ("A taxpayer who gives his services gratuitously to an association, contributions to which are deductible under [§170] and who incurs unreimbursed traveling expenses. . .may deduct the amount of such unreimbursed expenses in computing his net income. . ."). It would strain the language of the regulation to read it, as petitioners suggest, as allowing a deduction for expenses made incident to a third party's rendition of services rather than to the taxpayer's own contribution of services. Similarly, the taxpayer is clearly intended to be the subject of the other provisions in the regulation. For example, it is most natural to read the regulation as referring to a taxpayer who incurs expenditures for meals and lodging while away from his home, not while a third party is away from his home.

Petitioners' interpretation not only strains the language of the statute, but would also allow manipulation of §1.170A-1(g) for tax evasion purposes. See Note, Does Charity Begin at Home? The Tax Status of a Payment to an Individual as a Charitable Deduction, 83 Mich. L. Rev. 1428, 1434-1435 (1985); Brinley v. Commissioner, 782 F. 2d, at 1338 (Hill, J. dissenting). For example, parents might be tempted to transfer funds to their children in amounts greater than needed to reimburse reasonable expenses incurred in donating services to a charity. Parents and children might attempt to claim a deduction for the same expenditure. Controlling such abuses would place a heavy administrative burden on the Service, which would not only have to monitor the taxpayer's records, but also correlate them with the records of the third party. To the extent petitioners' interpretation lessens the likelihood that claimed charitable contributions actually served a charitable purpose, it is inconsistent with §170.

Petitioners cite judicial decisions that allowed taxpayers to claim deductions for the expenses of third parties who assisted the taxpayers in rendering services to qualified organizations. See, e.g., Rockefeller v. Commissioner, 676 F. 2d 35 (CA2 1982); McCollum v. Commissioner, 37 TCM 1817 (1978); Smith v. Commissioner, 60 T.C. 988 (1973). These cases are inapposite, as petitioners do not claim that they were independently rendering services to the Church, assisted by their sons.

We conclude that §1.170A-1(g) does not allow taxpayers to claim a deduction for expenses not incurred in connection with the taxpayers' own rendition of services to a qualified organization. Therefore, petitioners are not entitled to a deduction under §1.170A-1(g).

Petitioners also assert that because their sons are agents of the Church authorized to receive payments to support their own missionary efforts, payments made to their sons are payments to the Church. Because this argument was neither raised before nor decided by the Court of Appeals, we decline to address it here. See, e.g., Delta Air Lines, Inc. v. August, 450 U.S. 346, 362 (1981); United States v. Mendenhall, 446 U.S. 544, 551-552, n. 5 (1980).

Accordingly, we hold that petitioners' transfer of funds into their sons' accounts was not a contribution "to or for the use of" the Church for purposes of §170. The judgment of the Court of Appeals is

Affirmed.

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

If, in a taxable year beginning in 1991, a taxpayer makes a charitable contribution of tangible personal property that constitutes capital gain property within the meaning of section 57(a)(6) of the Code and the charitable deduction for that property is limited by the percentage rules of section 170(b), a carryover of the excess charitable contribution that is deducted under the rules of section 170 in a succeeding taxable year will not generate an item of tax preference under section 57(a)(6) in that succeeding taxable year. See Rev. Rul. 90-111, page 30.

Section 194.—Amortization of Reforestation Expenditures

26 CFR 1.194-1: Amortization of reforestation expenditures.

Costs of replanting tree seedlings that die because of an abnormal drought may be amortizable. See Rev. Rul. 90-61, page 39.

Section 216.—Deduction of Taxes, Interest, and Business Depreciation by Cooperative Housing Corporation Tenant-Stockholder

26 CFR 1.216-1: Amounts representing taxes and interest paid to cooperative housing corporations.

T.D. 8316

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

Cooperative Housing Corporations

AGENCY: Internal Revenue Service, Treasury

ACTION: Final regulations.

SUMMARY: This document contains amendments to the Income Tax Regulations under section 216 of the Internal Revenue Code of 1986, relating to cooperative housing corporations. Section 216 of the Code was amended by the Tax Reform Act of 1986. The regulations provide cooperative housing corporations and tenant-stockholders with guidance needed to comply with the law.

EFFECTIVE DATE: The regulations are effective for taxable year beginning after December 31, 1986.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this final regulation has been reviewed and approved by the Office of Management and Budget in accordance with the requirements of the Paperwork Reduction Act (44 U.S.C. 3504(h)) under control number 1545-1041. The estimated annual burden per respondent or recordkeeper varies from 15 minutes to 1 hour, depending on individual circumstances.

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

Comments regarding the accuracy of this burden estimate and sugges-

tions for reducing this burden should be directed to the above named contact person at the Internal Revenue Service, 1111 Constitution Ave., N.W., Washington, D.C. 20224, and to the Office of Information and Regulatory Affairs, Attention: Desk Officer for the Internal Revenue Service, Office of Management and Budget, Paperwork Reduction Project, Washington, D.C. 20503.

Background

On Friday, May 27, 1988, the Federal Register published (53 Fed. Reg. 19,312) [LR-102-86, 1988-2 C.B. 831] proposed amendments to the Income Tax Regulations (26 CFR Part 1) under section 216 of the Internal Revenue Code. These amendments were proposed to conform the regulations to section 644 of the Tax Reform Act of 1986 (100 Stat. 2285) [Pub. L. 99-514, 1986-3 C.B. (Vol. 1) 1, 202]. A public hearing was not requested and none was held. Several comments were received. After consideration of all comments regarding the proposed amendments, those amendments are adopted as revised by this Treasury decision.

Explanation of Provisions

The Act expanded the definition of a tenant-stockholder under section 216(b)(2) to include persons other than individuals. Prior to its amendment by the Act, section 216(b)(2) restricted the definition of tenant-stockholders generally to individuals.

Section 216(b)(3)(B) provides an elective alternative to the proportionate share rule contained in section 216(b)(3)(A) for determining the amount a tenant-stockholder may deduct on account of real estate taxes and interest. Previously, the proportionate share rule required that a tenant-stockholder's share of the cooperative housing corporation's interest and real estate taxes bear the same ratio to the total amount of the corporation's interest and real estate taxes that the amount of stock held by the tenant-stockholder bore to the total outstanding amount of stock of the corporation.

Under the elective alternative, for taxable years beginning after 1986, if the corporation allocates to each tenant-stockholder a portion of the interest or real estate taxes or both that reasonably reflects the cost of these items to the corporation attributable to each tenant-stockholder's dwelling unit (and each unit's share of the common areas), the corporation may make an election under which the tenant-stockholder's proportionate share of the corporation's interest or real estate taxes will equal the amount or amounts separately allocated. The regulations incorporate the procedure for making this election that was prescribed in the temporary regulations under §5h.5 (relating to elections under the Tax Reform Act of 1986). Those temporary regulations relating to this election will be superseded by these regulations.

In order to make the election under section 216(b)(3)(B), the regulations provide that the cooperative housing corporation must furnish to each tenant-stockholder a written statement showing the amount of real estate taxes or interest (or both) allocated to the tenant-stockholder by January 31 of the year following the first calendar year that includes any period to which the election applies. The January 31 deadline for making the election coincides with the deadline under section 6050H(d) and (g) imposed upon the cooperative for furnishing a statement to each tenant-stockholder of the total mortgage interest received from each tenant-stockholder. One comment suggested deletion of the January 31 deadline in the proposed regulation and stated that the cooperative's failure to distribute a statement of the reasonable allocation to one shareholder by January 31 should not preclude the corporation from making the election. This suggestion was not adopted. The January 31 deadline provides a reasonable time period for the corporation to furnish the requisite information on the allocation to its tenant-shareholders and is consistent with the policy underlying section 6050H(d) of furnishing information to the tenant-stockholders on a timely basis.

The proposed regulations provided several examples of circumstances whereby an allocation of the cooperative housing corporation's interest and taxes would meet the requirement that the allocation reasonably reflect the cost to the corporation of the interest and taxes attributable to the tenant-stockholder's unit. One of the comments received suggested that an additional example be provided to illustrate that an allocation of taxes to the tenant-stockholders may take into account the reduction of real estate taxes under local law for senior citizen tenant-stockholders. An additional example has been provided to accommodate this suggestion.

Section 216(b)(5) as amended provides that in certain circumstances a person may be eligible for tenant-stockholder status despite an agreement with the cooperative housing corporation that the person or the person's nominee may not occupy the house or apartment without the prior approval of the cooperative housing corporation. The regulations reflect this change for taxable years beginning after 1986, but no inference is to be drawn as to the effect of such agreements in prior years on the eligibility of a person as a tenant-stockholder.

For taxable years beginning after 1986, section 216(c) was amended by the Act to provide for a carry forward to the succeeding taxable year of any amount disallowed as a deduction for depreciation because it exceeded the tenant-stockholders's adjusted basis in his or her stock in the cooperative housing corporation at the end of the taxable year.

Section 216(d) was added by the Act to clarify that amounts paid or incurred by a cooperative housing corporation which are chargeable to the corporation's capital account may not be deducted by a stockholder. Such amounts, however, are to be added to the adjusted basis of the stockholder's stock in the cooperative housing corporation. The regulations reflect this clarification. No inference is to be drawn, however, as to the treatment of such amounts in taxable years beginning prior to 1987. In response to a comment, the regulations have been revised to include additional examples of expenditures that are chargeable to a corporation's capital account.

Special Analyses

It has been determined that these rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. It has also been determined that section 553(b) of the Administra-

tive 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 final Regulatory Flexibility Analysis is not required.

* * * * *

Adoption of Amendments to the Regulations

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

PART 1—[AMENDED]

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

Authority: 26 U.S.C. 7805 *** Section 1.216–2 also issued under 26 U.S.C. 216(d).

Par. 2. Section 1.216–1 is amended as follows:

1. In paragraph (a) introductory text, the first sentence is amended by removing the words "An individual who qualifies as a" and by adding in their place the word "A".

2. In paragraph (c)(1), the second sentence is amended by removing the language "paragraph (f)" and adding in its place the language "paragraph (g)". Paragraph (c)(2) is redesignated as paragraph (c)(3) and is amended by adding at the end thereof three new examples to read as set forth below.

3. New paragraph (c)(2) is added immediately preceding newly redesignated paragraph (c)(3) to read as set forth below.

4. In paragraph (d)(1), the last sentence is amended by removing the language "paragraph (f)" and by adding in its place the language "paragraph (g)". Paragraph (d)(2) is revised to read as set forth below.

5. Paragraph (e) is revised to read as set forth below.

6. Paragraphs (c), (d), (e), (f), and (g) are redesignated as paragraphs (d), (e), (f), (g) and (h) respectively.

7. New paragraph (c) is added immediately preceding newly redesignated paragraph (d) to read as set forth below.

1.216–1 Amounts representing taxes and interest paid to cooperative housing corporations.

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(c) *Disallowance of deduction for certain payments to the corporation.* For taxable years beginning after December 31, 1986, no deduction shall be allowed to a stockholder during any taxable year for any amount paid or accrued to a cooperative housing corporation (in excess of the stockholder's proportionate share of the items described in paragraph (a)(1) and (2) of this section) which is allocable to amounts that are paid or incurred at any time by the cooperative housing corporation and which is chargeable to the corporation's capital account. Examples of expenditures chargeable to the corporation's capital account include the cost of paving a community parking lot, the purchase of a new boiler or roof, and the payment of the principal of the corporation's building mortgage. The adjusted basis of the stockholder's stock in such corporation shall be increased by the amount of such disallowance. This paragraph may be illustrated by the following example:

Example. The X corporation is a cooperative housing corporation within the meaning of section 216. In 1988 X uses $275,000 that it received from its shareholders in such year to purchase and place in service a new boiler. The $275,000 will be chargeable to the corporation's capital account. A owns 10% of the shares of X and uses in a trade or business the dwelling unit appurtenant to A's shares and was responsible for paying 10% of the cost of the boiler. A is thus responsible for $27,500 of the cost of the boiler, which amount A will not be able to deduct currently. A will, however, add the $27,500 to A's basis for A's shares in X.

(d) *Tenant-stockholder's proportionate share.* ***

(2) *Special rule*—(i) *In general.* For taxable years beginning after December 31, 1986, if a cooperative housing corporation allocates to each tenant-stockholder a portion of the real estate taxes or interest (or both) that reasonably reflects the cost to the corporation of the taxes or interest attributable to each tenant-stockholder's dwelling unit (and the unit's share of the common areas), the cooperative housing corporation may elect to treat the amounts so allocated as the tenant-stockholder's proportionate shares.

(ii) *Time and manner of making election.* The election referred to in paragraph (d)(2)(i) of this section is effective only if, by January 31 of the year following the first calendar year that includes any period to which the election applies, the cooperative housing corporation furnishes to each person that is a tenant-stockholder during that period a written statement showing the amount of real estate taxes or interest (or both) allocated to the tenant-stockholder with respect to the tenant-stockholder's dwelling unit or units and share of common areas for that period. The election must be made by attaching a statement to the corporation's timely filed tax return (taking extensions into account) for the first taxable year for which the election is to be effective. The statement must contain the name, address, and taxpayer identification number of the cooperative housing corporation, identify the election as an election under section 216(b)(3)(B)(ii) of the Code, indicate whether the election is being made with respect to the allocation of real estate taxes or interest (or both), and include a description of the method of allocation being elected. The election applies for the taxable year and succeeding taxable years. It is revocable only with the consent of the Commissioner and will be binding on all tenant-stockholders.

(iii) *Reasonable allocation.* It is reasonable to allocate to each tenant-stockholder a portion of the real estate taxes or interest (or both) that bears the same ratio to the cooperative housing corporation's total interest or real estate taxes as the fair market value of each dwelling unit (including the unit's share of the common areas) bears to the fair market value of all the dwelling units with respect to which stock is outstanding (including stock held by the corporation) at the time of allocation. If real estate taxes are separately assessed on each dwelling unit by the relevant taxing authority, an allocation of real estate taxes to tenant-stockholders based on separate assessments is a reasonable allocation. If one or more of the tenant-stockholders prepays any portion of the principal of the indebtedness that gives rise to interest, an allocation of interest to those tenant-stockholders will be a reasonable allocation of interest if the allocation is reduced to reflect the reduction in the debt service attributable to the prepayment. In addition, similar kinds of allocations may also be reasonable, depending on the facts and circumstances.

(3) *Examples.* ***

Example (3). The X Corporation is a cooperative housing corporation within the meaning of section 216. In 1987, it acquires for

$1,000,000 a building containing 10 category A apartments, 10 category B apartments, and 10 category C apartments. The value of each category A apartment is $20,000, of each category B apartment is $30,000 and of each category C apartment is $50,000. X issues 1 share of stock to each of the 30 tenant-stockholders, each share carrying the right to occupy one of the apartments. X allocates the real estate taxes and interest to the tenant-stockholders on the basis of the fair market value of their respective apartments. Since the total fair market value of all of the apartments is $1,000,000, the allocation of taxes and interest to each tenant-stockholder that has the right to occupy a category A apartment is 2/100 ($20,000/$1,000,000). Similarly, the allocation of taxes and interest to each tenant-stockholder who has a right to occupy a category B apartment is 3/100 ($30,000/$1,000,000) and of a category C apartment is 5/100 ($50,000/$1,000,000). X may elect in accordance with the rules described in paragraph (d)(2) of this section to treat the amounts so allocated as each tenant-stockholder's proportionate share of real estate taxes and interest.

Example (4). The Y Corporation is a cooperative housing corporation within the meaning of section 216. In 1987, it acquires a housing development containing 5 detached houses for $1,500,000, incurring an indebtedness of $1,000,000 for the purchase of the property. Each house is valued at $300,000, although the shares appurtenant to those houses have been sold to tenant-stockholders for $100,000. Y issues one share of stock to each of the five tenant-stockholders, each share carrying the right to occupy one of the houses. A, a tenant-stockholder, prepays all of the corporation's indebtedness allocable to A's house. The periodic charges payable to Y by A are reduced commensurately with the reduction in Y's debt service. Because no part of the indebtedness remains outstanding with respect to A's house, A's share of the interest expense is $0. The other four tenant-stockholders do not prepay their share of the indebtedness. Accordingly, 1/4 of the interest is allocated to each of the tenant-stockholders other than A. Y may elect in accordance with the rules described in paragraph (d)(2) of this section to treat the amounts so allocated as each tenant-stockholder's proportionate share of interest.

Example (5). The Z Corporation is a cooperative housing corporation within the meaning of section 216. In 1987, it acquires a building containing 10 apartments. One of the apartments is occupied by a senior citizen. Under local law, a senior citizen who owns and occupies a residential apartment is entitled to a $500 reduction in local property taxes assessed upon the apartment. As a result, Z corporation is eligible under local law for a reduction in local property taxes assessed upon the building. Z's real estate tax assessment for the year would have been $10,000, however, with the senior citizen reduction, the assessment is $9,500. The proprietary lease provides for a reduced maintenance fee to the senior citizen tenant-stockholder in accordance with the real estate tax reduction. Accordingly, each apartment owner is assessed $1,000 for local real estate taxes, except the senior citizen tenant-stockholder, who is assessed $500. Z may elect in accordance with the rules described in paragraph (d)(2) of this section to treat the amounts so allocated as each tenant-stockholder's proportionate share of taxes.

(e) *Cooperative housing corporation.* ***

(2) *Right of occupancy.* Each stockholder of the corporation, whether or not the stockholder qualifies as a tenant-stockholder under section 216(b)(2) and paragraph (f) of this section, must be entitled to occupy for dwelling purposes an apartment in a building or a unit in a housing development owned or leased by such corporation. The stockholder is not required to occupy the premises. The right as against the corporation to occupy the premises is sufficient. Such right must be conferred on each stockholder solely by reason of his or her ownership of stock in the corporation. That is, the stock must entitle the owner thereof either to occupy the premises or to a lease of the premises. The fact that the right to continue to occupy the premises is dependent upon the payment of charges to the corporation in the nature of rentals or assessments is immaterial. For taxable years beginning after December 31, 1986, the fact that, by agreement with the cooperative housing corporation, a person or his nominee may not occupy the house or apartment without the prior approval of such corporation will not be taken into account for purposes of this paragraph in the following cases:

(i) In any case where a person acquires stock of the cooperative housing corporation by operation of law, by inheritance, or by foreclosure (or by instrument in lieu of foreclosure),

(ii) In any case where a person other than an individual acquires stock in the cooperative housing corporation, and

(iii) In any case where the person from whom the corporation has acquired the apartments or houses (or leaseholds therein) acquires any stock of the cooperative housing corporation from the corporation not later than one year after the date on which the apartments or houses (or leaseholds therein) are transferred to the corporation by such person. For purposes of the preceding sentence, paragraph (e)(2)(i) and (ii) of this section will not apply to acquisitions of stock by foreclosure by the person from whom the corporation has acquired the apartments or houses (or leaseholds therein).

*****

(f) *Tenant-stockholder.* The term "tenant-stockholder" means a person that is a stockholder in a cooperative housing corporation, as defined in section 216(b)(1) and paragraph (e) of this section, and whose stock is fully paid up in an amount at least equal to an amount shown to the satisfaction of the district director as bearing a reasonable relationship to the portion of the fair market value, as of the date of the original issuance of the stock, of the corporation's equity in the building and the land on which it is situated that is attributable to the apartment or housing unit which such person is entitled to occupy (within the meaning of paragraph (e)(2) of this section). Notwithstanding the preceding sentence, for taxable years beginning before January 1, 1987, tenant-stockholders include only individuals, certain lending institutions, and certain persons from whom the cooperative housing corporation has acquired the apartments or houses (or leaseholds thereon).

*****

Par. 3. Section 1.216–2 is amended by revising paragraph (c) to read as follows:

1.216–2 Treatment as property subject to depreciation.

*****

(c) *Limitation.* If the allowance for depreciation for the taxable year determined in accordance with the provisions of paragraph (b) of this section exceeds the adjusted basis (provided in section 1011) of the stock described in paragraph (a) of this section allocable to the tenant-stockholder's proprietary lease or right of tenancy used in a trade or business or for the production of income, such excess is not allowable as a deduction. For taxable years beginning after December 31, 1986, such excess, subject to the provisions of this paragraph (c), is allowable as a deduction for depreciation in the succeeding taxable year. To determine the portion of the adjusted basis of such stock which is allocable to such proprietary lease or right of tenancy, the adjusted basis is reduced by taking into account the same factors as are taken into account under para-

graph (b)(1) of this section in determining the allowance for depreciation.

*****

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 4. The authority for Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 5. Section 602.101(c) is amended by inserting in the appropriate phrase in the table "1.216-1-(d)(2). . .1545-1041".

Fred T. Goldberg, Jr.,
Commissioner of Internal Revenue.

Approved September 24, 1990.

Kenneth W. Gideon,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on October 16, 1990, 8:45 a.m., and published in the issue of the Federal Register for October 17, 1990, 55 F.R. 42003)

Part IX.—Items Not Deductible

Section 262.—Personal, Living, and Family Expenses

Whether the value of lodging furnished to a "principal representative" of the U.S. is excludable from the gross income of the principal representative under section 119(a)(2) of the Code. Also, whether amounts deducted from the salary of the principal representative to pay for usual household expenses that must be borne personally by the representative are excludable from the gross income of the principal representative or allowable as a deduction. See Rev. Rul. 90-64, page 35.

Section 263.—Capital Expenditures

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

An administrative procedure is provided whereby certain life insurance companies may expeditiously obtain the consent of the Commissioner to change their method of accounting for ceding commissions to comply with the principles of Rev. Rul. 82-69 and the Supreme Court decision in *Colonial American Life Insurance Co.* See Rev. Proc. 90-36, page 357.

Section 263.—Capital Expenditures

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

For a revenue procedure that describes three alternative methods of accounting for package design costs and provides the exclusive procedure for taxpayers to obtain consent from the Commissioner to change to each of the alternative methods. See Rev. Proc. 90-63, page 664.

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

26 CFR 1.263A-1T: Capitalization and inclusion in inventory costs of certain expenses.

For a revenue procedure that describes three alternative methods of accounting for package design costs and provides the exclusive procedure for taxpayers to obtain consent from the Commissioner to change to each of the alternative methods. See Rev. Proc. 90-63, page 664.

26 CFR 1.263A-1T: Capitalization and inclusion in inventory costs of certain expenses (temporary).

Economically recoverable precious metal fabricated into items used in a taxpayer's trade or business are not depreciable if their cost is more than half the total cost of the item into which they are fabricated. See Rev. Rul. 90-65, page 41.

Section 265.—Expenses and Interest Relating to Tax-Exempt Income

26 CFR 1.265-2: Interest relating to tax-exempt income.

The Service will not issue advance rulings or determination letters on whether indebtedness is incurred or continued to purchase or carry obligations the interest on which is wholly exempt from the taxes imposed by subtitle A of the Code. See Rev. Proc. 90-40, page 367.

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

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

Rules set forth for the deemed substantiation of the amount of ordinary and necessary business expenses of an employee for lodging, meal, and/or incidental expenses incurred while traveling away from home when a payor provides per diem allowance to the employee do not apply when the employee and payor are related parties. See Rev. Proc. 90-60, page 651.

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

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

The revenue procedure provides a special method for determining the amount of ordinary and necessary expenses of an employee or self-employed individual in the transportation industry for meal and incidental expenses incurred while traveling away from home that will be deemed substantiated for purposes of section 1.274-5T of the temporary regulations. See Rev. Proc. 90-38, page 363.

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

Simplified optional method for computing allowable deductions for the cost of operating an automobile for business purposes. See Rev Proc. 90-59, page 644.

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

Rules are set forth for the deemed substantiation of the amount of ordinary and necessary business expenses of an employee for lodging, meal, and/or 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. 90-60, page 651.

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of July 1990. See Rev. Rul. 90-52, page 192.

Federal short-term, mid-term, and long-term rates are set forth for the month of August 1990. See Rev. Rul. 90-66, page 194.

Federal short-term, mid-term, and long-term rates are set forth for the month of September 1990. See Rev. Rul. 90-75, page 195.

Federal short-term, mid-term, and long-term rates are set forth for the month of October 1990. See Rev. Rul. 90-81, page 196.

Federal short-term, mid-term, and long-term rates are set forth for the month of November 1990. See Rev. Rul. 90-92, page 198.

Federal short-term, mid-term, and long-term rates are set forth for the month of December 1990. See Rev. Rul. 90-99, page 199.

Subchapter C.—Corporation Distributions and Adjustments
Part I.—Distributions By Corporations
Subpart A.—Effects on Recipients

Section 305.—Distribution of Stock and Stock Rights

26 CFR 1.305-2: Distributions in lieu of money.

Stock dividend; election to receive stock or other property. Federal Home Loan Bank members receiving stock distributions do not have an election to receive stock or other property for purposes of section 305(b)(1) of the Code. However, the principles of Rev. Rul. 83-68, 1983-1 C.B. 75, will continue to apply to distributions by corporations that are not Federal Home Loan Banks and that regularly grant redemption requests. Rev. Rul. 83-68 modified.

Rev. Rul. 90-98

ISSUE

Whether any member bank receiving a stock dividend from a Federal Home Loan Bank has an election to receive stock or property within the meaning of section 305(b)(1) of the Internal Revenue Code?

FACTS

Rev. Rul. 83-68, 1983-1 C.B. 75, deals with stock dividends distributed by a Federal Home Loan Bank (FHLB). Pursuant to federal statute, an FHLB has the discretion to grant a member bank's request to retire any shares of stock held by the member bank in excess of the amount it is statutorily required to hold. Shares of its stock distributed as a stock dividend by an FHLB may be retired by an FHLB in the same manner and under the same regulations and policies that apply to all other shares.

The facts of Rev. Rul. 83-68 are that, in accordance with an established policy of the FHLB, all requests to redeem the distributed stock were honored. Furthermore, the FHLB had not refused to grant a request in the previous ten years, and it apparently would not refuse such a request, although the option to refuse redemption requests remained available.

Rev. Rul. 83-68 reasons that, although the FHLB retained discretion to redeem stock held by member banks, the established policy of the FHLB to honor all redemption requests in substance conferred on the distributee banks an option to retire any shares distributed in excess of their required stock holdings. Because all of the shares distributed to at least one member bank were in excess of its required stock holdings, the entire distribution received by each member was treated as one to which section 301 of the Code applied by reason of the application of section 305(b)(1).

LAW AND ANALYSIS

Section 305(a) of the Code provides the general rule that gross income does not include the amount of any distribution of stock by a corporation to its shareholders with respect to its stock.

Section 305(b)(1) of the Code provides that section 305(a) does not apply to a distribution by a corporation of its stock, and the distribution is treated as a distribution of property to which section 301 applies, if the distribution is, at the election of any of the shareholders (whether exercised before or after the declaration thereof), payable either in the corporation's stock or in property.

If any shareholder has the right to an election or option with respect to whether a distribution shall be made either in money or any other property, or in stock of the distributing corporation, then, with respect to all shareholders, the distribution of stock is treated as a distribution of property to which section 301 applies. This is so regardless of whether the election governing the nature of the distribution is provided in the declaration of the distribution or in the corporate charter or arises from the circumstances of the distribution and regardless of whether all or part of the shareholders have the election. Section 1.305-2(a)(4) and (5) of the Income Tax Regulations.

Thus, if a shareholder in substance has the ability to determine whether a distribution will be received in either the distributing corporation's stock or some other property, the shareholder has an election within the meaning of section 305(b)(1) of the Code. It is immaterial whether that ability is explicitly or implicitly granted by the distributing corporation, or whether that ability results directly from the terms of the distribution or indirectly from the facts surrounding the distribution.

In *Frontier Savings Association v. Commissioner*, 87 T.C. 665 (1986), *aff'd sub nom. Colonial Savings Association v. Commissioner*, 854 F.2d 1001 (7th Cir. 1988), *cert. denied* 109 S. Ct. 1556 (1989), *acq.*, 1990-1 C.B. 1, the facts were essentially identical to those in Rev. Rul. 83-68. The court specifically rejected the conclusion of Rev. Rul. 83-68. Instead, the court held that discretion to approve redemption requests was not relinquished by the FHLB and that the member bank therefore did not have an election within the meaning of section 305(b)(1).

In reaching its conclusion, the court considered the purpose and structure of the FHLB system. The system was created by the Federal Home Loan Bank Act of 1932, 12 U.S.C. sections 1421-1449 (1988), with the explicit purpose of providing a means for creating meaningful and flexible liquidity in savings and loan associations and other members. 12 U.S.C. section 1425a(a) (1988) (prior to its repeal by section 720 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA"), Pub. L. No. 101-73, 103 Stat. 183, 423 (1989)). An FHLB is "a federal instrumentality organized to carry out public policy and its functions are wholly governmental . . ." *Fahey v. O'Melveny & Myers*, 200 F.2d 420, 446 (9th Cir. 1952), *cert. denied*, 345 U.S. 952 (1953), quoted in *Colonial Savings Ass'n*, 854 F.2d at 1013. An FHLB is exempt from federal, state, and local income tax. 12 U.S.C. section 1433 (1988).

A member of an FHLB must maintain a stock interest in the FHLB equal to a percentage of its net home mortgage loans outstanding and a fraction of its total borrowings from the FHLB. Prior to 1961, 12 U.S.C. section 1426(c) (redesignated 1426(b) by FIRREA section 706, at 416) permitted a member bank to have its excess shares redeemed on request. In 1961, then section 1426(c) was amended to provide that requests were to be granted in the discretion of the FHLB and subject to the approval of the Federal Home Loan Bank Board (FHLBB), the adminis-

trative agency in the Executive Branch of the federal government then responsible for the supervision of the FHLB. With that amendment, Congress made clear that the FHLB and the FHLBB, not the member banks, were to have the discretion to approve or deny redemption requests.

The structure of the system clearly evidences a Congressional intent to retain the broadest kind of federal control over the numbers, powers, capitalization, and existence of an FHLB. The substantial federal involvement in the FHLB system ensured that the discretion to deny redemption requests remained vested in the FHLB and the FHLBB and that each decision to grant a request was to be made by the FHLB and the FHLBB with due regard to the statutory objectives and the public interest the system was created to protect.

However, a pattern of approving redemption requests can in substance confer an election within the meaning of section 305(b)(1) of the Code since the stock distribution can be a "mere subterfuge for a cash distribution." *Computer Frontier*, 87 T.C. at 678. Thus, "[i]f a discretionary act of the board of directors of a shareholder corporation to redeem stock dividends becomes a routine matter, it might . . . develop into an 'option' that arises after the distribution or a distribution pursuant to a 'plan.' " *Frontier*, at 679 (Hamblen, J., concurring). *See also Western Federal Savings & Loan Association v. Commissioner*, T.C. Memo. 1988-107, *aff'd*, 880 F.2d 1005 (8th Cir. 1989).

Although, under the facts of Rev. Rul. 83-68, the FHLB never chose to exercise its discretion by denying a redemption request, Congress had specifically directed that discretion to redeem FHLB stock be vested in and exercisable by the FHLB, a tax exempt instrumentality of the federal government, and subject to the concurrence of the FHLBB, an administrative agency of the federal government. Further, decisions to approve any such requests were to be made with full consideration of the public purposes for which the FHLB system was created. Thus, the discretion to approve or deny redemption requests remained vested in the FHLB and the FHLBB. Under these limited circumstances, where the FHLB and the FHLBB have a duty imposed by federal statute to protect the public interest, the Service will not infer from a pattern of granting redemption requests alone that a particular FHLB or the FHLBB (or its successor) has relinquished authority to deny such requests. Accordingly, no member bank will be considered to have an election within the meaning of section 305(b)(1) of the Code.

HOLDING

Rev. Rul. 83-68 no longer represents the Service's position regarding whether any member bank receiving a stock dividend from an FHLB has an election to receive stock or property within the meaning of section 305(b)(1) of the Code. However, except in the case of an FHLB acting pursuant to a federal statutory directive and in protection of the public interest, the Service will continue to apply the principles underlying Rev. Rul. 83-68 and section 305(b)(1) to a pattern of granting redemption requests in determining whether in substance the pattern confers an election to receive stock or property.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 83-68 is modified.

Subpart C.—Definitions; Constructive Ownership of Stock

Section 316.—Dividend Defined

26 CFR 1.316-1: Dividends.

Do Alaska Permanent Fund Dividends constitute dividends as defined in section 316(a) of the Code? See Rev. Rul. 90-56, page 102.

Part II.—Corporate Liquidations

Subpart A.—Effects on Recipients

Section 332.—Complete Liquidations of Subsidiaries

26 CFR 1.332-1: Distributions in liquidation of subsidiary corporations; general.

A checklist questionnaire is provided with regard to standard representations and other information to be included in a request for a letter ruling under section 332 of the Code. See Rev. Proc. 90-52, page 626.

Subpart B.—Effects on Corporations

Section 337.—Nonrecognition for Property Distributed to Parent in Complete Liquidation of Subsidiary

26 CFR 1.337(d)-1: Transitional loss limitation rule.

T.D. 8319

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Corporations; Consolidated Returns—Special Rules Relating to Dispositions and Deconsolidations of Subsidiary Stock

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations; temporary regulations; removal of temporary regulations.

SUMMARY: This document contains final §1.337(d)-1 and temporary §1.337(d)-2T. These regulations implement aspects of the repeal of the *General Utilities* doctrine by limiting losses of consolidated groups with respect to the stock of subsidiaries for certain transitional periods. This document also withdraws temporary §1.1502-20T. New proposed §1.1502-20 appears in *** [CO-93-90, page 696, this Bulletin].

DATES: These regulations are effective December 26, 1990, except §1.337(d)-1, which is effective November 19, 1990. Section 1.337(d)-1 generally applies to dispositions after January 6, 1987, and before the effective date of §1.337(d)-2T, of stock of a subsidiary that became a member of an affiliated group after January 6, 1987. Section 1.337(d)-2T generally applies to dispositions and deconsolidations of stock of a subsidiary occurring after November 18, 1990, and before the effective date of §1.1502-20.

SUPPLEMENTARY INFORMATION:

A. Paperwork Reduction Act

The collection of information contained in final §1.337(d)-1 has been

reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1980 (44 U.S.C. 3504(h)) under the previous control number 1545-1160. The estimated annual burden per respondent to comply with §1.337(d)-1 is 2 hours.

This estimate is an approximation of the average time expected to be necessary for a collection of information. It is based on such information as is available to the Internal Revenue Service. Individual respondents may require greater or less time, depending on their particular circumstances.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be directed to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, T:FP, Washington, D.C. 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, D.C. 20503.

Temporary §1.337(d)-2T is being issued without prior notice and public procedure pursuant to the Administrative Procedure Act (5 U.S.C. 553). For this reason, the collections of information contained in these regulations have been submitted to the Office of Management and Budget (OMB) pursuant to the Paperwork Reduction Act of 1980 (44 U.S.C. 3507). Notice of OMB action will be published in a subsequent issue of the Federal Register.

The estimated average annual burden per respondent is 2 hours. This estimate is an approximation of the average time expected to be necessary for a collection of information. It is based on such information as is available to the Internal Revenue Service. Individual respondents may require greater or less time, depending on their particular circumstances.

For further information concerning these collections of information, and where to submit comments on these collections of information and the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble to the cross-referenced notice of proposed rulemaking published in *** [CO-93-90, page 696, this Bulletin].

B. Introduction

T.D. 8294, [1990-1 C.B. 66] filed with the Federal Register on March 9, 1990, and published in the Federal Register on March 14, 1990, added temporary §§1.1502-20T and 1.337(d)-1T to Part 1 of Title 26 of the Code of Federal Regulations.

Section 1.1502-20T added to the consolidated return regulations a general rule that disallowed all consolidated group losses on the disposition of a subsidiary's stock (the "loss disallowance rule"). The regulations also provided a number of related rules, including a basis reduction rule applicable on deconsolidation of a subsidiary's stock and an anti-stuffing rule applicable to transfers of property between members in connection with the disposition or deconsolidation of a subsidiary's stock. Also provided was a rule that permitted reattribution of a subsidiary's losses to the common parent to the extent loss would otherwise be disallowed to the consolidated group on the disposition of a subsidiary's stock. The rules added by §1.1502-20T generally applied to any disposition or deconsolidation of a subsidiary's stock on or after March 9, 1990.

Section 1.337(d)-1T added a transitional rule that generally limited loss on the disposition of a subsidiary's stock after January 6, 1987, if the subsidiary became a member of the group after that date (a "transitional subsidiary") and the disposition was not subject to §1.1502-20T. Unlike §1.1502-20T, these regulations permitted the loss to the extent the group established that the loss was not attributable to the recognition of "built-in gain" on the disposition of assets owned by the subsidiary (or any lower tier subsidiary). Moreover, although §1.1502-20T reduced the basis of subsidiary stock on its deconsolidation, §1.337(d)-1T continued to treat the stock as subject to loss disallowance on later disposition.

Sections 1.1502-20T and 1.337(d)-1T implemented Notice 87-14, 1987-1 C.B. 445, in which the Internal Revenue Service announced its intention to publish regulations that would prevent utilization of §§1.1502-32 and 1.1502-33(c) (the "investment adjustment rules") to circumvent the repeal of the *General Utilities* doctrine by the Tax Reform Act of 1986 [Pub.L. 99-514, 1986-3 (Vol. 1) C.B. 1]. The loss disallowance rule of §1.1502-20T addressed another problem relating to the investment adjustment rules by preventing a subsidiary's losses from being duplicated as investment losses of the parent when the parent disposes of the subsidiary's stock.

Also filed with the Federal Register on March 9, 1990, and published on March 14, 1990, was a notice of proposed rulemaking (CO-78-87 [1990-1 C.B. 558]) that incorporated by cross reference the text of §§1.1502-20T and 1.337(d)-1T. Many written comments were received, and a public hearing was held on June 26, 1990.

After full consideration of the written comments and the testimony at the public hearing, the following actions are being taken:

1. Proposed §1.337(d)-1 is amended and promulgated as a final regulation by this document as §1.337(d)-1, replacing temporary §1.337(d)-1T.

2. New §1.337(d)-2T is promulgated by this document as a temporary regulation. Commentators characterized §1.1502-20T as far broader than required by Notice 87-14 and requested that taxpayers retain the ability to dispose of subsidiary stock under the more limited approach of §1.337(d)-1T until the rules of §1.1502-20T are revised. Section 1.337(d)-2T continues the principles of §1.337(d)-1 by adding another transitional rule applicable to all subsidiary stock (not just stock of transitional subsidiaries and transitional parents). The new rule allows groups to establish that loss is not attributable to the recognition of built-in gain, but only if the group's entire equity interest in the subsidiary is disposed of in one or more transactions to unrelated persons before the effective date of new §1.1502-20. Section 1.337(d)-2T also provides basis reduction rules for subsidiary stock that is deconsolidated and anti-stuffing rules. The text of §1.337(d)-2T set forth in this document also serves as the text of proposed §1.337(d)-2, cross-referenced in a notice of proposed rulemaking (CO-93-90), published in *** [page 696, this Bulletin].

3. Section 1.1502-20T is withdrawn by this document.

4. The notice of proposed rulemaking (CO-93-90) published in *** [page 696, this Bulletin] withdraws proposed §1.1502-20 as added by (CO-78-87) and adds new proposed §1.1502-20. For a discussion of new proposed §1.1502-20, see the preamble in the notice of proposed rulemaking.

5. A Revenue Procedure will be issued as a consequence of these rules setting forth procedures under which the Internal Revenue Service will grant permission for all of the members of the group to discontinue filing consolidated returns. Conditions will be included to restrict reconsolidation of any member (or successor) for at least 5 years.

C. Amendments to Proposed §1.337(d)-1

Proposed §1.337(d)-1 is amended and adopted as a final regulation. For a description of the original provisions of proposed §1.337(d)-1, see T.D. 8294, published on March 14, 1990. Following is a description of the principal amendments.

1. Coordination with loss deferral rules

Sections 1.337(d)-1(a)(3) and 1.337(d)-1(b)(3) provide that, if a loss is deferred, any disallowance of the loss is also deferred until the loss is taken into account under the consolidated return regulations. The loss disallowance rule takes precedence over other loss disallowance and deferral rules of the Code and regulations, however, and these other rules apply only to the extent that loss is not disallowed under §1.337(d)-1.

2. Stacking rules

Section 1.337(d)-1(a)(1) disallows loss recognized by a member of a consolidated group on the disposition of stock of a transitional subsidiary. However, §1.337(d)-1(a)(2) provides an exception under which loss is not disallowed to the extent the taxpayer establishes that the loss is not attributable to the recognition of built-in gain on the disposition of an asset after January 6, 1987. The burden is on taxpayers to establish that loss is not attributable to built-in gain.

Example (3) in proposed §1.337(d)-1(a)(5) treated any loss on the sale of stock as first attributable to recognized built-in gain. Example (3) is clarified and a new Example (4) is added to clarify that, for purposes of determining whether stock loss is attributable to built-in gain, recognized built-in gain may be offset by recognized built-in loss. If built-in gains and losses are both reflected in the basis of purchased subsidiary stock (or, in the case of subsidiary stock acquired in a carryover basis transaction, neither is reflected in the basis of subsidiary stock), the netting is appropriate. The built-in gain does not create or enhance stock loss when offset by built-in loss.

3. Statements

The requirement that a separate statement be filed with respect to deduction of loss on the disposition of stock of transitional subsidiaries is extended to the deduction of loss on the disposition of stock of transitional parents.

4. Other clarifying changes

Section 1.337(d)-1 is revised to clarify several provisions. The revisions include—(a) simplifying the definition of built-in gain, (b) correcting technical defects in the definition of transitional parent and in the successor rule, and (c) additional examples to illustrate such rules as the application of the section to subsidiary stock no longer held by a member and to post-acquisition appreciation. In addition, because §1.1502-20T has been replaced by a proposed regulation, several rules and examples previously incorporated by cross reference have been restated in full.

D. Transitional issues

Proposed §1.337(d)-1 applied to all the stock of a subsidiary that became a member of a group after January 6, 1987, regardless of whether the stock of the subsidiary was acquired by purchase. Commentators have argued that §1.337(d)-1 should apply only to subsidiary stock that was acquired by purchase after January 6, 1987. They contend that Notice 87-14 did not provide adequate notice that §1.337(d)-1 would reach all cases in which stock losses with respect to transitional subsidiaries are attributable to the recognition of built-in gain. Commentators also contend that, although a particular target within a group may be subject to §1.337(d)-1, no notice was given that §1.337(d)-1 would continue to apply if the target is transferred by merger or otherwise to other members who were members before January 7, 1987.

Notice 87-14 states that "in cases where a target's stock is sold, the regulations will prevent recognition of losses that are attributable to the subsidiary's recognition of built-in gains. The regulations will be effective with respect to stock in a target that was acquired after January 6, 1987." The notice did not define the terms "target" or "acquired," or make clear whether it was the stock or the target that had to be acquired after January 6, 1987.

Notice 87-14 provides a general statement of the policy concerns of the Service by stating simply that regulations would "affect the adjustment to stock basis in certain cases where one or more members have acquired stock of a target with a built-in gain asset. . . .In general, the adjustment to stock basis [would] not reflect built-in gains that are recognized by target on sales of, or by reason of distributions of, its assets." Because the notice stated simply that these concerns would be addressed with respect to acquisitions after January 6, 1987, taxpayers should reasonably have expected that the policies expressed in the Notice would be implemented so as to treat taxpayers presenting similar policy concerns similarly, despite different forms of acquisition or location within a group. Section 1.337(d)-1 prohibits the deduction of loss only in limited circumstances. A taxpayer must have acquired a subsidiary's stock after January 6, 1987, and thereafter disposed of a built-in gain asset. Applying this rule to a target acquired after January 6, 1987, regardless of whether its stock was acquired by purchase, is consistent with both the language and the policy of Notice 87-14.

E. Explanation of new temporary §1.337(d)-2T

In response to comments that a transitional period should have been provided before §1.1502-20T became effective, the effective date of new §1.1502-20 has been deferred. New §1.337(d)-2T provides a transitional rule, carrying forward the rules of §1.337(d)-1, that allows loss to the

extent the group establishes that the loss is not attributable to the recognition of built-in gain. For this purpose, gain recognized by a consolidated group (or a prior consolidated group) on the disposition of an asset is built-in gain to the extent the asset has an excess of value over basis attributable to a separate return year (as defined in §1.1502-1(e)) with respect to the consolidated group (or prior consolidated group).

Unlike §1.337(d)-1, §1.337(d)-2T is a prospective rule which taxpayers may take into account when planning transactions. Accordingly, §1.337(d)-2T contains a deconsolidation rule and an anti-stuffing rule similar to those contained in new §1.1502-20, in order to limit circumvention of the basic loss limitation rule. The deconsolidation and anti-stuffing rules are explained in the preamble to new §1.1502-20, published in *** [CO-93-90, page 696, this Bulletin].

Section 1.337(d)-2T generally applies with respect to dispositions and deconsolidations after November 18, 1990. The rule permitting a group to establish that loss is not attributable to recognition of built-in gain applies, however, only if the group's entire equity interest in a subsidiary is disposed of in one or more transactions to unrelated persons before the application of new §1.1502-20. Thus, it does not apply (and the loss disallowance rule of §1.337(d)-2T(a) does apply) if only a portion of the stock held by the group is disposed of, or if the stock is sold to a related party. (See new §1.1502-20(h), set forth in *** [CO-93-90, page 696, this Bulletin], which permits taxpayers to elect to apply the rules of new §1.1502-20 instead of §1.337(d)-2T.) The ability to establish that loss is not attributable to built-in gain is limited under §1.337(d)-2T in order to avoid the need for continued application of these rules to deconsolidated subsidiaries for a substantial period. Like new §1.1502-20, §1.337(d)-2T applies to all subsidiary stock, whether or not the subsidiary is a transitional subsidiary or transitional parent, and even if the disposition of the built-in gain asset occurred before January 7, 1987.

F. Section 1.1502-20T

Section 1.1502-20T is removed by this document and a new proposed §1.1502-20 appears in *** [CO-93-90, page 696, this Bulletin]. An explanation of a withdrawal of §1.1502-20T and of the new provisions is set forth in the preamble to new proposed §1.1502-20.

Special Analysis

It has been determined that these rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required.

It is hereby certified that these rules do not have a significant impact on a substantial number of small entities. The rules will primarily affect affiliated groups of corporations filing (or required to file) consolidated returns, which tend to be larger businesses. It will 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, the notice of proposed rulemaking for the regulations was submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR Chapter I is amended as follows:

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

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

Authority: 26 U.S.C. 7805; *** §1.337(d)-1 also issued under 26 U.S.C. 337(d); *** §1.337(d)-2T also issued under 26 U.S.C. 337(d); *** §1.1502-1 also issued under 26 U.S.C. 1502.

Par. 2. The authority citation for Part 1 continues to include the following citation:

Authority: 26 U.S.C. 7805; *** §1.469-1T also issued under 26 U.S.C. 469(1).

Par. 3. The authority citation for Part 1 is further amended by removing the citations for §§1.337(d)-1T, and 1.1502-20T.

Par. 3A. Section 1.337(d)-1T is removed.

Par. 4. New §1.337(d)-1 is added to read as follows:

§1.337(d)-1 Transitional loss limitation rule.

(a) *Loss limitation rule for transitional subsidiary—(1) General rule.* No deduction is allowed for any loss recognized by a member of a consolidated group with respect to the disposition of stock of a transitional subsidiary.

(2) *Allowable loss*—(i) *In general.* Paragraph (a)(1) of this section does not apply to the extent the taxpayer establishes that the loss is not attributable to the recognition of built-in gain by any transitional subsidiary on the disposition of an asset (including stock and securities) after January 6, 1987.

(ii) *Statement of allowable loss.* Paragraph (a)(2)(i) of this section applies only if a separate statement entitled "ALLOWABLE LOSS UNDER SECTION 1.337(d)-1(a)" is filed with the taxpayer's return for the year of the stock disposition. If the separate statement is required to be filed with a return the due date (including extensions) of which is before January 16, 1991, or with a return due (including extensions) after January 15, 1991, but filed before that date, the statement may be filed with an amended return for the year of the disposition or with the taxpayer's first subsequent return the due date (including extensions) of which is after January 15, 1991.

(iii) *Contents of statement.* The statement required under paragraph (a)(2)(ii) of this section must contain—

(A) The name and employer identification number (E.I.N.) of the transitional subsidiary.

(B) The basis of the stock of the transitional subsidiary immediately before the disposition.

(C) The amount realized on the disposition.

(D) The amount of the deduction not disallowed under paragraph (a)(1) of this section by reason of this paragraph (a)(2).

(E) The amount of loss disallowed under paragraph (a)(1) of this section.

(3) *Coordination with loss deferral rules*—(i) *Single entity treatment of deferred intercompany loss.* If loss with respect to the disposition of a transitional subsidiary's stock is deferred, paragraph (a)(1) of this section does not apply until the loss is taken into account. For this purpose, the amount of the loss deferred and when the loss is taken into account are determined under §§1.1502-13, 1.1502-13T, 1.1502-14, and 1.1502-14T, without the application of any other provision of the Code or regulations, such as section 267(f), that provides for disallowance or deferral of the loss.

(ii) *Other loss deferral rules.* If paragraph (a)(1) of this section applies to a loss subject to deferral or disallowance under any other provision of the Code or the regulations, the other provision applies to the loss only to the extent it is not disallowed under paragraph (a)(1).

(4) *Definitions.* For purposes of this section—

(i) The definitions in §1.1502-1 apply.

(ii) "Transitional subsidiary" means any corporation that becomes a subsidiary of the group (whether or not the group was a consolidated group) after January 6, 1987. Notwithstanding the preceding sentence, a subsidiary is not a transitional subsidiary if the subsidiary (and each predecessor) was a member of the group at all times after the subsidiary's (and each predecessor's) organization.

(iii) "Built-in gain" of a transitional subsidiary means gain attributable, directly or indirectly, in whole or in part, to any excess of value over basis, determined immediately before the transitional subsidiary became a subsidiary, with respect to any asset owned directly or indirectly by the transitional subsidiary at that time.

(iv) "Disposition" means any event in which gain or loss is recognized, in whole or in part.

(v) "Value" means fair market value.

(5) *Examples.* For purposes of the examples in this section, unless otherwise stated, the group files consolidated returns on a calendar year basis, the facts set forth the only corporate activity, and all sales and purchases are with unrelated buyers or sellers. The basis of each asset is the same for determining earnings and profits adjustments and taxable income. Tax liability and its effect on basis, value, and earnings and profits are disregarded. "Investment adjustment system" means the rules of §§1.1502-32 and 1.1502-33(c). The principles of this paragraph (a) are illustrated by the following examples:

Example (1). Loss attributable to recognized built-in gain. (i) P buys all the stock of T for $100 on February 1, 1987, and T becomes a member of the P group. T has an asset with a value of $100 and basis of $0. T sells the asset in 1989 and recognizes $100 of built-in gain on the sale (*i.e.*, the asset's value exceeded its basis by $100 at the time T became a member of the P group). Under the investment adjustment system, P's basis in the T stock increases to $200. P sells all the stock of T on December 31, 1989, and recognizes a loss of $100. Under paragraph (a)(1) of this section, no deduction is allowed to P for the $100 loss.

(ii) Assume that, after T sells its asset but before P sells the T stock, T issues additional stock to unrelated persons and ceases to be a member of the P group. P then sells all its stock of T in 1997. Although T ceases to be a subsidiary within the meaning of §1.1502-1, T continues to be a transitional subsidiary within the meaning of this section. Consequently, under paragraph (a)(1) of this section, no deduction is allowed to P for its $100 loss.

Example (2). Loss attributable to post-acquisition loss. P buys all the stock of T for $100 on February 1, 1987, and T becomes a member of the P group. T has $50 cash and an asset with $50 of built-in gain. During 1988, T retains the asset but loses $40 of the cash. The P group is unable to use the loss, and the loss becomes a net operating loss carryover attributable to T. Under the investment adjustment system, P's basis in the stock of T remains $100. P sells all the stock of T on December 31, 1988, for $60 and recognizes a $40 loss. Under paragraph (a)(2)(i) of this section, P establishes that it did not dispose of the built-in gain asset. None of P's loss is disallowed under paragraph (a)(1) if P satisfies the requirements of paragraph (a)(2)(ii) of this section.

Example (3). Stacking rules—postacquisition loss offsets postacquisition gain. (i) P buys all the stock of T for $100 on February 1, 1987, and T becomes a member of the P group. T has 2 assets. Asset 1 has a basis and value of $50, and asset 2 has a basis of $0 and a value of $50. During 1989, asset 1 declines in value to $0, and T sells asset 2 for $50, and reinvests the proceeds in asset 3. The value of asset 3 appreciates to $90. Under the investment adjustment system, P's basis in the stock of T increases from $100 to $150 as a result of the gain recognized on the sale of asset 2 but is unaffected by the unrealized post-acquisition decline in the value of asset 1. On December 31, 1989, P sells all the stock of T for $90 and recognizes a $60 loss.

(ii) Although T incurred a $50 post-acquisition loss of built-in gain because of the decline in the value of asset 1, T also recognized $50 of built-in gain. Under paragraph (a)(2) of this section, any loss on the sale of stock is treated first as attributable to recognized built-in gain. Thus, for purposes of determining under paragraph (a)(2) of this section whether P's $60 loss on the disposition of the T stock is attributable to the recognition of built-in gain on the disposition of an asset, T's unrealized post-acquisition gain of $40 offsets $40 of the $50 of unrealized post-acquisition loss. Therefore, $50 of the $60 loss is attributable to the recognition of built-in gain on the disposition of an asset and is disallowed under paragraph (a)(1) of this section.

Example (4). Stacking rules—built-in loss offsets built-in gain. (i) P buys all the stock of T for $50 on February 1, 1987, and T becomes a member of the P group. T has 2 assets. Asset 1 has a basis of $50 and a value of $0, and asset 2 has a basis of $0 and a value of $50. During 1989, T sells asset 1 for $0 and asset 2 for $50, and reinvests the $50 proceeds in asset 3. The value of asset 3 declines to $40. Under the investment adjustment system, P's basis in the stock of T remains $50 as a result of the offsetting gain and loss recognized on the sale of assets 1 and 2 and is unaffected by the unrealized post-acquisition decline in the value of asset 3. On December 31, 1989, P sells all the stock of T for $40 and recognizes a $10 loss.

(ii) Although T recognized a $50 built-in gain on the sale of asset 2, T also recognized a $50 built-in loss on the sale of asset 1. For purposes of determining under paragraph (a)(2) of this section whether P's $10 loss on the disposition of the T stock is attributable to the recognition of built-in gain on the disposition of an asset, T's recognized built-in gain is offset by its recognized built-in loss. Thus none of P's $10 loss is attributable to the recognition of built-in gain on the disposition of an asset.

(iii) The result would be the same if, instead of a $50 built-in loss in asset 2, T has a $50 net operating loss carryover when P buys the T stock, and the new operating loss carryover is used to offset the built-in gain.

Example (5). Outside basis partially corresponds to inside basis. (i) Individual A owns all the stock of T, for which A has a basis of $60. On February 1, 1987, T owns 1 asset with a basis of $0 and a value of $100, P acquires all the stock of T from A in an exchange to which section 351(a) applies, and T becomes a member of the P group. P has a carryover basis of $60 in the T stock. During 1988, T sells the asset and recognizes $100 of gain. Under the investment adjustment system, P's basis in the T stock increases from $60 to $160. T reinvests the $100 proceeds in another asset, which declines in value to $90. On January 1, 1989, P sells all the stock of T for $90 and recognizes a loss of $70.

(ii) Although P's basis in the T stock was increased by $100 as a result of the recognition of built-in gain on the disposition of T's asset, only $60 of the $70 loss on the sale of the stock is attributable under paragraph (a)(2) of this section to the recognition of built-in gain from the disposition of the asset. (Had T's asset not declined in value to $90, the T stock would have been sold for $100, and a $60 loss would have been attributable to the recognition of the built-in gain.) Therefore, $60 of the $70 loss is disallowed under paragraph (a)(2), and $10 is not disallowed if P satisfies the requirements of paragraph (a)(2). If P had sold the stock of T for $95 because T's other assets had

unrealized appreciation of $5, $60 of the $65 loss would still be attributable to T's recognition of built-in gain on the disposition of assets.

Example (6). Creeping acquisition. P owns 60 percent of the stock of S on January 6, 1987. On February 1, 1987, P buys an additional 20 percent of the stock of S, and S becomes a member of the P group. P sells all the S stock on March 1, 1989, and recognizes loss of $100. All 80 percent of the stock of S owned by P is subject to the rules of this section and, under paragraph (a)(1) and (2) of this section, P is not allowed to deduct the $100 loss, except to the extent P establishes the loss is not attributable to the recognition by S of built-in gain on the disposition of assets.

Example (7). Effect of post-acquisition appreciation. P buys all the stock of T for $100, and T becomes a member of the P group. T has an asset with a basis of $0 and a value of $100. T sells the asset for $100. Under the investment adjustment system, P's basis in the T stock increases to $200. T reinvests the proceeds of the sale in an asset that appreciates in value to $180. Five years after the sale, P sells all the stock of T for $180 and recognizes a $20 loss. Under paragraph (a)(1) of this section, no deduction is allowed to P for the $20 loss.

Example (8). Deferred loss and recognized gain. (i) P, the common parent of a group, owns 50 shares of the stock of T with an aggregate basis of $10, and S, a wholly owned subsidiary of P, recently purchased the remaining 50 shares of T stock in which it has an aggregate basis of $50. T has an asset with a basis of $40 and a value of $100. T sells the assets for $100. Under the investment adjustment system, P's basis in the T stock increases from $10 to $40, and S's basis in the T stock increases from $50 to $80. S sells its block of T stock to P for $50 in a deferred intercompany transaction, and S liquidates 2 years later. P subsequently sells all the stock of T for $100 to X, a member of the same controlled group (as defined in section 267(f)) as P but not a member of the P consolidated group.

(ii) Under paragraph (a)(3)(i) of this section, the application of paragraph (a)(1) of this section to S's $30 loss is deferred, because S's loss is deferred under §1.1502-13(c) (determined without the application of any other provision of the Code or regulations that provides for disallowance or deferral of the loss).

(iii) S's deferred $30 loss is inherited by P under §1.1502-13(c)(6) following the liquidation of S. When the T stock is sold to X (a member of the same controlled group but not a member of the P consolidated group), the inherited deferred $30 loss is taken into account under §1.1502-13(f) and paragraph (a)(3) of this section. Under paragraph (a)(1) of this section, no deduction is allowed to P for the $30 loss.

(b) *Indirect disposition of transitional subsidiary*—(1) *Loss limitation rule for transitional parent.* No deduction is allowed for any loss recognized by a member of a consolidated group with respect to the disposition of stock of a transitional parent.

(2) *Allowable loss*—(i) *In general.* Paragraph (b)(1) of this section does not apply to the extent the taxpayer establishes that the loss exceeds the amount that would be disallowed under paragraph (a) of this section if each highest tier transitional subsidiary's stock in which the transitional parent has a direct or indirect interest had been sold immediately before the disposition of the transitional parent's stock. In applying the preceding sentence, appropriate adjustments shall be made to take into account circumstances where less than all the stock of a transitional parent owned by members of a consolidated group is disposed of in the same transaction, or the stock of a transitional subsidiary or a transitional parent is directly owned by more than 1 member.

(ii) *Statement of allowable loss.* Paragraph (b)(2)(i) of this section applies only if a separate statement entitled "ALLOWABLE LOSS UNDER SECTION 1.337(d)-1(b)" is filed with the taxpayer's return for the year of the stock disposition. If the separate statement is required to be filed with a return the due date (including extensions) of which is before January 16, 1991, or with a return due (including extensions) after January 15, 1991, but filed before that date, the statement may be filed with an amended return for the year of the disposition or with the taxpayer's first subsequent return the due date (including extensions) of which is after January 15, 1991.

(iii) *Contents of statement.* The statement required under paragraph (b)(2)(ii) of this section must contain—

(A) The name and employer identification number (E.I.N.) of the transitional parent.

(B) The basis of the stock of the transitional parent immediately before the disposition.

(C) The amount realized on the disposition.

(D) The amount of the deduction not disallowed under paragraph (b)(1) of this section by reason of this paragraph (b)(2).

(E) The amount of loss disallowed under paragraph (b)(1) of this section.

(3) *Coordination with loss deferra rules*—(i) *Single entity treatment o deferred intercompany loss.* If los with respect to the disposition of transitional parent's stock is deferred paragraph (b)(1) of this section doe not apply until the loss is taken int account. For this purpose, th amount of the loss deferred and whe the loss is taken into account ar determined under §§1.1502-13 1.1502-13T, 1.1502-14, and 1.1502-14T, without the applicatio of any other provision of the Code o regulations, such as section 267(f), that provides for disallowance or deferral of the loss.

(ii) *Other loss deferral rules.* I paragraph (b)(1) of this section applies to a loss subject to deferral o disallowance under any other provision of the Code or the regulations, the other provision applies to the loss only to the extent it is not disallowed under paragraph (b)(1).

(4) *Definitions.* For purposes of this section—

(i) "Transitional parent" means any subsidiary, other than a transitional subsidiary, that owned at any time after January 6, 1987, a direct or indirect interest in the stock of a corporation that is a transitional subsidiary.

(ii) "Highest tier transitional subsidiary" means the transitional subsidiary (or subsidiaries) in which the transitional parent has a direct or indirect interest and that is the highest transitional subsidiary (or subsidiaries) in a chain of members.

(5) *Examples.* The principles of this paragraph (b) are illustrated by the following examples:

Example (1). Ownership of chain of transitional subsidiaries. (i) P forms S with $200 o January 1, 1985, and S becomes a member o the P group. On February 1, 1987, S buys a the stock of T, and T buys all the stock of T1 and both T and T1 become members of the P group. On January 1, 1988, P sells all the stock of S and recognizes a $90 loss on the sale.

(ii) Under paragraph (a)(4)(ii) of this section both T and T1 are transitional subsidiaries because they became members of the P grou after January 6, 1987. Under paragrap (b)(4)(i) of this section, S is a transitiona parent, because it owns a direct interest i stock of transitional subsidiaries and is no itself a transitional subsidiary.

(iii) Under paragraph (b)(1) and (2) of thi section, because S is a transitional parent, n deduction is allowed to P for its $90 loss excep to the extent the loss exceeds the amount of S' loss that would have been disallowed if S ha sold all the stock of T, S's highest tier trans

tional subsidiary, immediately before P's sale of all the S stock. Assume all the T stock would have been sold for a $90 loss and that all the loss would be attributable to the recognition of built-in gain from the disposition of assets. Because in that case $90 of loss would be disallowed, all of P's loss on the sale of the S stock is disallowed under paragraph (b).

Example (2). Ownership of brother-sister transitional subsidiaries. (i) P forms S with $200 on January 1, 1985, and S becomes a member of the P group. On February 1, 1987, S buys all the stock of both T and T1, and T and T1 become members of the P group. On January 1, 1988, P sells all the stock of S and recognizes a $90 loss on the sale.

(ii) Under paragraph (b)(1) and (2) of this section, no deduction is allowed to P for its $90 loss except to the extent P establishes that the loss exceeds the amount of S's stock losses that would be disallowed if S sold all the stock of T and T1, S's highest tier transitional subsidiaries, immediately before P's sale of all the S stock. Assume that all the T stock would have been sold for a $50 loss, all the T1 stock for a $40 loss, and that the entire amount of each loss would be attributable to the recognition of built-in gain on the disposition of assets. Because $90 of loss would be disallowed with respect to the sale of S's T and T1 stock, P's $90 loss on the sale of all the S stock is disallowed under paragraph (b).

(c) *Successors*—(1) *General rule.* This section applies, to the extent necessary to effectuate the purposes of this section, to—

(i) Any property owned by a member or former member, the basis of which is determined, directly or indirectly, in whole or in part, by reference to the basis in a subsidiary's stock, and

(ii) Any property owned by any other person whose basis in the property is determined, directly or indirectly, in whole or in part, by reference to a member's (or former member's) basis in a subsidiary's stock.

(2) *Examples.* The principles of this paragraph (c) are illustrated by the following examples:

Example (1). Merger into grandfathered subsidiary. P, the common parent of a group, owns all the stock of T, a transitional subsidiary. On January 1, 1989, T merges into S, a wholly owned subsidiary of P that is not a transitional subsidiary. Under paragraph (c)(1) of this section, all the stock of S is treated as stock of a transitional subsidiary. As a result, no deduction is allowed for any loss recognized by P on the disposition of any S stock, except to the extent the P group establishes under paragraph (a)(2) that the loss is not attributable to the recognition of built-in gain on the disposition of assets of T.

Example (2). Nonrecognition exchange of transitional stock. (i) P, the common parent of a group, owns all the stock of T, a transitional subsidiary. On January 1, 1989, P transfers the stock of T to X, a corporation that is not a member of the P group, in exchange for 20 percent of its stock in a transaction to which section 351(a) applies. T and X file separate returns.

(ii) Under paragraph (c)(1) of this section, all the stock of X owned by P is treated as stock of a transitional subsidiary because P's basis for the X stock is determined by reference to its basis for the T stock. As a result, no deduction is allowed to P for any loss recognized on the disposition of the X stock, except to the extent permitted under paragraph (a) of this section.

(iii) Under paragraph (c)(1), X is treated as a member subject to paragraph (a) of this section with respect to the T stock because X's basis for the stock is determined by reference to P's basis for the stock. Moreover, all of the T stock owned by X continues to be stock of a transitional subsidiary. As a result, no deduction is allowed to X for any loss recognized on the disposition of any T stock, except to the extent permitted under paragraph (a) of this section.

(d) *Investment adjustments and earnings and profits*—(1) *In general.* For purposes of determining investment adjustments under §1.1502-32 and earnings and profits under §1.1502-33(c) with respect to a member of a consolidated group that owns stock in a subsidiary, any deduction that is disallowed under this section is treated as a loss absorbed by the member in the tax year in which the disallowance occurs.

(2) *Example.* (i) In 1986, P forms S with a contribution of $100, and S becomes a member of the P group. On February 1, 1987, S buys all the stock of T for $100. T has an asset with a basis of $0 and a value of $100. In 1988, T sells the asset for $100. Under the investment adjustment system, S's basis in the T stock increases to $200, P's basis in the S stock increases to $200, and P's earnings and profits and S's earnings and profits increase by $100. In 1989, S sells all of the T stock for $100, and S's recognized loss of $100 is disallowed under paragraph (a)(1) of this section.

(ii) Under paragraph (d)(1) of this section, S's earnings and profits for 1989 are reduced by $100, the amount of the loss disallowed under paragraph (a)(1). As a result, P's basis in the S stock is reduced from $200 to $100 under the investment adjustment system. P's earnings and profits for 1989 are correspondingly reduced by $100.

(e) *Effective dates*—(1) *General rule.* This section is effective November 19, 1990, and applies with respect to dispositions after January 6, 1987. After November 18, 1990, however, this section applies only if the stock was deconsolidated (as that term is defined in §1.337(d)-2T(b)(2)) before November 19, 1990, and only to the extent the disposition is not subject to §1.337(d)-2T.

(2) *Binding contract rule.* For purposes of this paragraph (e), if a corporation became a subsidiary pursuant to a binding written contract entered into before January 6, 1987, and in continuous effect until the corporation became a subsidiary, or a disposition was pursuant to a binding written contract entered into before March 9, 1990, and in continuous effect until the disposition, the date the contract became binding shall be treated as the date the corporation became a subsidiary or as the date of disposition.

Par. 5. New §1.337(d)-2T is added to read as follows:

§1.337(d)-2T Loss limitation window period (temporary).

(a) *Loss disallowance*—(1) *General rule.* No deduction is allowed for any loss recognized by a member of a consolidated group with respect to the disposition of stock of a subsidiary.

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

(i) The definitions in §1.1502-1 apply.

(ii) "Disposition" means any event in which gain or loss is recognized, in whole or in part.

(3) *Coordination with loss deferral rules*—(i) *Single entity treatment of deferred intercompany loss.* If loss with respect to the disposition of a subsidiary's stock is deferred, paragraph (a)(1) of this section does not apply until the loss is taken into account. For this purpose, the amount of the loss deferred and when the loss is taken into account are determined under §§1.1502-13, 1.1502-13T, 1.1502-14, and 1.1502-14T, without the application of any other provision of the Code or regulations, such as section 267(f), that provides for disallowance or deferral of the loss.

(ii) *Other loss deferral rules.* If paragraph (a)(1) of this section applies to a loss subject to deferral or disallowance under any other provision of the Code or the regulations, the other provision applies to the loss only to the extent it is not disallowed under paragraph (a)(1).

(b) *Basis reduction on deconsolidation*—(1) *General rule.* If the basis of a member of a consolidated group in a share of stock of a subsidiary exceeds its value immediately before a deconsolidation of the share, the basis of the share is reduced at that time to an amount equal to its value. If

both a disposition and a deconsolidation occur with respect to a share in the same transaction, paragraph (a) of this section applies and, to the extent necessary to effectuate the purposes of this section, this paragraph (b) applies following the application of paragraph (a).

(2) *Deconsolidation.* "Deconsolidation" means any event that causes a share of stock of a subsidiary that remains outstanding to be no longer owned by a member of any consolidated group of which the subsidiary is also a member.

(3) *Value.* "Value" means fair market value.

(4) *Loss within 2 years after basis reduction*—(i) *In general.* If the basis of a share of stock is reduced under this paragraph (b) and a direct or indirect disposition of the stock occurs within 2 years after the date of the basis reduction, a separate statement entitled "STATEMENT PURSUANT TO SECTION 1.337(d)-2T(b)(4)" must be filed with the taxpayer's return for the year of disposition. If the taxpayer fails to file the statement as required, no deduction is allowed for any loss recognized on the disposition. If the separate statement is required to be filed with a return the due date (including extensions) of which is before January 16, 1991, or with a return due (including extensions) after January 15, 1991, but filed before that date, the statement may be filed with an amended return for the year of the disposition or with the taxpayer's first subsequent return the due date (including extensions) of which is after January 15, 1991. A disposition after the 2-year period described in this paragraph (b)(4) that is pursuant to an agreement, option, or other arrangement entered into within the 2-year period is treated as a disposition within the 2-year period for purposes of this section.

(ii) *Contents of statement.* The statement required under paragraph (b)(4)(i) of this section must contain—

(A) The name and employer identification number (E.I.N.) of the subsidiary.

(B) The amount of prior basis reduction with respect to the stock of the subsidiary under paragraph (b)(1) of this section.

(C) The basis of the stock of the subsidiary immediately before the disposition.

(D) The amount realized on the disposition.

(E) The amount of the deduction not disallowed under paragraph (b)(4)(i) of this section.

(F) The amount of loss disallowed under paragraph (b)(4)(i) of this section.

(c) *Allowable loss*—(1) *Application.* This paragraph (c) applies with respect to stock of a subsidiary only if—

(i) The consolidated group disposes (in one or more transactions), before the effective date of §1.1502-20, of its entire equity interest in the subsidiary to persons not related to any member of the consolidated group within the meaning of sections 267(b) and 707(b)(1) (substituting "10 percent" for "50 percent" each place that it appears), and

(ii) A separate statement entitled "ALLOWED LOSS UNDER SECTION 1.337(d)-2T(c)" is filed in accordance with paragraph (c)(3) of this section.

(2) *General rule.* Loss is not disallowed under paragraph (a)(1) of this section and basis is not reduced under paragraph (b)(1) of this section to the extent the taxpayer establishes that the loss or basis is not attributable to the recognition of built-in gain on the disposition of an asset (including stock and securities). Loss or basis may be attributable to the recognition of built-in gain on the disposition of an asset by a prior consolidated group. For purposes of this section, gain recognized by the consolidated group (or prior consolidated group) on the disposition of an asset is built-in gain to the extent attributable, directly or indirectly, in whole or in part, to any excess of value over basis attributable to a separate return year (as defined in §1.1502-1(e)) with respect to the consolidated group (or prior consolidated group).

(3) *Contents of statement and time of filing.* The statement required under paragraph (c)(1)(ii) of this section must be filed with the taxpayer's return for the year of the disposition or deconsolidation, and must contain—

(i) The name and employer identification number (E.I.N.) of the subsidiary.

(ii) The basis of the stock of the subsidiary immediately before the disposition or deconsolidation.

(iii) The amount realized on the disposition and the amount of fair market value on the deconsolidation.

(iv) The amount of the deduction not disallowed under paragraph (a)(1) of this section by reason of this paragraph (c) and the amount of basis not reduced under paragraph (b)(1) of this section by reason of this paragraph (c).

(v) The amount of loss disallowed under paragraph (a)(1) of this section and the amount of basis reduced under paragraph (b)(1) of this section. If the separate statement is required to be filed with a return the due date (including extensions) of which is before January 16, 1991, or with a return due (including extensions) after January 15, 1991, but filed before that date, the statement may be filed with an amended return for the year of the disposition or deconsolidation or with the taxpayer's first subsequent return the due date (including extensions) of which is after January 15, 1991.

(4) *Examples.* For purposes of the examples in this section, unless otherwise stated, the group files consolidated returns on a calendar year basis, the facts set forth the only corporate activity, and all sales and purchases are with unrelated buyers or sellers. The basis of each asset is the same for determining earnings and profits adjustments and taxable income. Tax liability and its effect on basis, value, and earnings and profits are disregarded. "Investment adjustment system" means the rules of §§1.1502-32 and 1.1502-33(c). The principles of paragraphs (a), (b), and (c) of this section, such as the attribution of recognized gain to built-in gain, are illustrated by the examples in §1.337(d)-1(a)(5) and by the examples in this paragraph (c)(4). For an example that treats a disposition after the 2-year period as being within the period, see paragraph (e)(3) of this section.

Example (1). Simultaneous application of loss disallowance rule and basis reduction rule to stock of the same subsidiary. (i) P buys all the stock of T for $100 in 1985, and T becomes a member of the P group. T has an asset with a basis of $0 and a value of $100. T sells the

asset for $100 and recognizes built-in gain (*i.e.*, gain that is attributable to a separate return year with respect to the group recognizing the gain). Under the investment adjustment system, P's basis in the T stock increases to $200. Five years later, P sells 60 shares of T stock for $60 and recognizes a $60 loss on the sale.

(ii) P's $60 loss on the sale of T stock is disallowed under paragraph (a)(1) of this section.

(iii) P's sale of 60 shares of T stock causes a deconsolidation of the remaining 40 shares held by P. Under paragraph (b)(1) of this section, P must reduce the basis of the 40 shares of T stock it continues to own from $80 to $40, the value of the shares immediately before the deconsolidation. Although P's disposition of the 60 shares also causes a deconsolidation of these shares, paragraph (b)(1) of this section provides that, if both paragraph (a) and paragraph (b) of this section apply to a share in the same transaction, paragraph (a) applies first and paragraph (b) applies only to the extent necessary to effectuate the purposes of this section. Under paragraph (a)(1), P's $60 loss on the sale of the 60 shares is disallowed. Under the facts of this example, it is not necessary to also apply paragraph (b) of this section to the 60 shares in order to effectuate the purposes of this section.

Example (2). Deconsolidation of subsidiary stock on contribution to a partnership. (i) P buys all the stock of T for $100, and T becomes a member of the P group. T has an asset with a basis of $0 and a value of $100. T sells the asset for $100. Under the investment adjustment system, P's basis in the T stock increases to $200. Five years later, P transfers all the stock of T to partnership M in exchange for a partnership interest in M, in a transaction to which section 721 applies.

(ii) At the time of the exchange, P's basis in the T stock is $200 and the T stock's value is $100. Under paragraph (b)(1) of this section, the transfer to M causes a deconsolidation of the T stock, and P must reduce its basis in the T stock, immediately before the transfer to M, from $200 to the stock's $100 value at that time. As a result, P has a basis of $100 in its interest in M, and M has a basis of $100 in the stock of T.

Example (3). Simultaneous application of loss disallowance rule and basis reduction rule to stock of different subsidiaries. (i) P owns all the stock of S, which in turn owns all the stock of S1, and S and S1 are members of the P group. P's basis in the S stock is $100 and S's basis in the S1 stock is $100. S1 buys all the stock of T for $100, and T becomes a member of the P group. T has an asset with a basis of $0 and a value of $100. T sells the asset for $100. Under the investment adjustment system, S1's basis in the T stock, S's basis in the S1 stock, and P's basis in the S stock each increase from $100 to $200. S then sells all the S1 stock for $100 and recognizes a loss of $100.

(ii) Under paragraph (a)(1) of this section, S's $100 loss on the sale of the S1 stock is disallowed.

(iii) If S1 and T are not members of a consolidated group immediately after the sale of the stock of S1, the T stock is deconsolidated, and under paragraph (b)(1) of this section, S1 must reduce the basis of the T stock to $100, its value immediately before the sale.

(iv) If S1 and T are members of a consolidated group immediately after the sale of the S1 stock, the T stock is not deconsolidated, and no reduction is required under paragraph (b)(1). However, if the new group sells the T stock and recognizes a $100 loss, the loss is disallowed, because under paragraph (c)(2) of this section the loss is attributable to T's recognition of built-in gain (*i.e.*, gain attributable to a separate return year with respect to the group recognizing the gain).

Example (4). Loss offsetting built-in gain in a prior group. (i) P buys all the stock of T for $50 in Year 1, and T becomes a member of the P group. T has 2 assets. Asset 1 has a basis of $50 and a value of $0, and asset 2 has a basis of $0 and a value of $50. T sells asset 2 during Year 3 for $50, and recognizes a $50 gain. Under the investment adjustment system, P's basis in the T stock increases to $100 as a result of the recognition of gain. In year 5, all of the stock of P is acquired by the P1 group, and the former members of the P group become members of the P1 group. T then sells asset 1 for $0, and recognizes a $50 loss. Under the investment adjustment system, P's basis in the T stock decreases to $50 as a result of the loss. T's assets decline in value from $50 to $40. P then sells all the stock of T for $40 and recognizes a $10 loss.

(ii) P's cost basis on acquisition of the T stock reflects both T's unrecognized gain and unrecognized loss. The gain T recognizes on the disposition of asset 2 is attributable to the recognition of built-in gain with respect to both the P and the P1 groups for purposes of paragraph (c)(2) of this section. As with the recognized built-in gain, the built-in loss that was recognized in the P1 group before P's disposition of the T stock was attributable to a separate return year with respect to the P and P1 groups. T's recognition of the built-in loss while a member of the P1 group offset the effect of the recognition of the built-in gain on T's stock basis, even though the gain was recognized in the P group. Thus, under paragraph (c)(2), P's $10 loss on the sale of the T stock is not attributable to the recognition of built-in gain, and the loss is therefore not disallowed under paragraph (c)(2).

(iii) The result would be the same if when P buys the T stock, T has a $50 net operating loss carryover instead of a $50 built-in loss in asset 2, and the net operating loss carryover is used to offset the built-in gain.

(d) *Successors*—(1) *General rule.* This section applies, to the extent necessary to effectuate the purposes of this section, to any property the basis of which is determined, directly or indirectly, in whole or in part, by reference to the basis of a subsidiary's stock.

(2) *Example.* The principles of this paragraph (d) are illustrated by Example 1 in §1.337(d)-1(c).

(e) *Anti-stuffing rule*—(1) *Application.* This paragraph (e) applies if—

(i) A transfer of any asset (including stock and securities) after March 8, 1990, is followed within 2 years by a direct or indirect disposition or a deconsolidation of stock, and

(ii) The transfer is with a view to avoiding, directly or indirectly, in whole or in part—

(A) The disallowance of loss on the disposition or the basis reduction on the deconsolidation of stock of a subsidiary, or

(B) The recognition of the unrealized gain on the transferred asset. A disposition after the 2-year period described in this paragraph (e)(1) that is pursuant to an agreement, option, or other arrangement entered into within the 2-year period is treated as a disposition within the 2-year period for purposes of this section.

(2) *Basis reduction.* If this paragraph (e) applies, the basis of the stock is reduced, immediately before the disposition or deconsolidation, to cause recognition of gain in an amount equal to the loss disallowance or basis reduction, or the gain recognition, otherwise avoided by reason of the transfer.

(3) *Examples.* The principles of this paragraph (e) are illustrated by the following examples:

Example (1). Basic stuffing case. (i) In Year 1, P buys all the stock of T for $100, and T becomes a member of the P group. T has an asset with a basis of $0 and a value of $100. T sells the asset for $100. Under the investment adjustment system, P's basis in the T stock increases from $100 to $200. In Year 5, P transfers to T an asset with a basis of $0 and a value of $100 in a transaction to which section 351 applies, with the view described in paragraph (e)(1) of this section. In Year 6, P sells all the stock of T for $200.

(ii) Under paragraph (e)(2) of this section, P must reduce the basis in its T stock by $100 immediately before the sale. This basis reduction causes a $100 gain to be recognized on the sale.

(iii) The $100 basis reduction also would be required if the T stock is deconsolidated in Year 6 instead of being sold. P must reduce the basis in its T stock by $100 immediately before the deconsolidation.

(iv) The $100 basis reduction also would be required if the P stock were acquired at the beginning of Year 6 by the M group, even though the asset transfer took place outside the M group. Paragraph (e)(1) requires only that the transferor have the view at the time of the transfer.

Example (2). Stacking rules. (i) In Year 1, P buys all the stock of T for $100, and T becomes a member of the P group. T has an asset with a basis of $0 and a value of $100. T sells the asset for $100. Under the investment adjustment system, P's basis in the T stock increases from $100 to $200. In Year 5, when the value of the T stock remains $100, P transfers to T an asset with a basis of $0 and a value of $100 in a transaction to which section 351 applies, with the view described in paragraph (e)(1) of this section. Thereafter, the value of the contributed asset declines to $10. In Year 6, P sells all the T stock for $110.

(ii) Because the transferred asset declined in value by $90, the transfer enabled P to avoid the disallowance of loss on the sale of T only to the extent of $10. Under paragraph (e)(2) of this section, P must reduce the basis in its T stock immediately before the sale to cause recognition of gain in an amount equal to the loss disallowance otherwise avoided by reason of the transfer. The amount of this basis reduction is $100, causing a $10 gain to be recognized on the sale.

(iii) Assume, instead, that the transferred asset does not decline in value and that T reinvests the $100 in proceeds from the asset sale in another asset that appreciates in value to $190. In Year 6, P sells T for $290. Because the new asset appreciated in value by $90, the transfer enabled P to avoid the disallowance of loss on the sale of T only to the extent of $10. Under paragraph (e)(2) of this section, P must reduce the basis in its T stock immediately before the sale to cause recognition of gain in an amount equal to the loss disallowance otherwise avoided by reason of the transfer. The amount of this basis reduction is $10, causing a $100 gain to be recognized on the sale.

Example (3). Contribution of built-in loss asset. (i) In Year 1, P forms S with a contribution of $100 in exchange for all of S's stock, and S becomes a member of the P group. S buys an asset for $100, and the asset appreciates in value to $200. P then buys all the stock of T for $100, and T becomes a member of the P group. T has an asset with a basis of $0 and a value of $100. T sells the asset for $100, and under the investment adjustment system P's basis in the T stock increases from $100 to $200. In Year 5, when the value of the T stock remains $100, P transfers the T stock to S in a transaction to which section 351 applies, with the view described in paragraph (e)(1) of this section. The transfer causes P's basis in the S stock to increase from $100 to $300 and the value of S to increase from $200 to $300. In Year 6, P sells the S stock for $300.

(ii) Under paragraph (e)(2) of this section, P must reduce the basis in its S stock immediately before the sale to cause recognition of gain in an amount equal to the gain recognition otherwise avoided by reason of the transfer. The amount of this basis reduction is $100, causing a $100 gain to be recognized on the sale.

Example (4). Absence of view. (i) In Year 1, P buys all the stock of T for $100, and T becomes a member of the P group. T has 2 assets, asset 1 with a basis of $50 and value of $100, and asset 2 with a basis of $50 and value of $0. T sells asset 1 for $100. Under the investment adjustment system, P's basis in the T stock increases from $100 to $150. In Year 5, T transfers asset 2 to P in a transaction to which §1.1502-14(a) applies, with a view to having the group retain the loss inherent in the asset. This transfer reduces P's basis in the T stock from $150 to $100. In Year 6, P sells all the stock of T for $100.

(ii) The transfer from T to P achieves a result that could have been obtained by other methods that would not have been prevented by this section. The transfer therefore is not with the view described in paragraph (e)(1) of this section, P is not required to reduce the basis of its T stock under paragraph (e)(2) of this section. P is in substantially the same position holding asset 2 as it would be if T sold the asset and the resulting loss was available to the P group through T.

Example (5). Extending the time period for dispositions. (i) In Year 1, P buys all the stock of T for $100, and T becomes a member of the P group. T has an asset with a basis of $0 and a value of $100. T sells the asset for $100. Under the investment adjustment system, P's basis in the T stock increases from $100 to $200. At the beginning of Year 5, P transfers to T an asset with a basis of $0 and a value of $100 in a transaction to which section 351 applies, with the view described in paragraph (e)(1) of this section. Within 2 years, P agrees to sell all the stock of T for $200 at the end of Year 7.

(ii) Under paragraph (e)(1) of this section, P's disposition of the T stock at the end of Year 7 is treated as occurring within the 2-year period following P's transfer of the asset to T, because the disposition is pursuant to an agreement reached within 2 years after the transfer. Accordingly, under paragraph (e)(2) of this section, P must reduce the basis in its T stock by $100 immediately before the sale. This result is reached whether or not the agreement is in writing. P's disposition would also have been treated as occurring within the 2-year period if the disposition were pursuant to an option issued within the period.

(f) *Investment adjustments and earnings and profits*—(1) *Effect on investment adjustments and earnings and profits*—(i) *General rule.* For purposes of determining investment adjustments under §1.1502-32 and earnings and profits under §1.1502-33(c) with respect to a member of a consolidated group that owns stock in a subsidiary, any deduction that is disallowed, or any amount by which basis is reduced, under this section is treated as a loss absorbed by a member in the tax year in which the disallowance or basis reduction occurs.

(ii) *Example.* (A) In year 1, P forms S with a contribution of $100, and S becomes a member of the P group. S buys all the stock of T for $100. T has an asset with a basis of $0 and a value of $100. In Year 2, T sells the asset for $100. Under the investment adjustment system, S's basis in the T stock increases to $200, and P's basis in the S stock increases to $200. In Year 6, S sells all the stock of T for $100, and S's recognized loss of $100 is disallowed under paragraph (a)(1) of this section.

(B) Under paragraph (f)(1) of this section, the earnings and profits of S for Year 6 are reduced by $100, the amount of the loss disallowed under paragraph (a)(1). P's basis in the S stock is reduced from $200 to $100 under the investment adjustment system. Correspondingly, P's earnings and profits for Year 6 are reduced by $100, the amount of the loss disallowed under paragraph (a)(1) of this section.

(2) *Coordination rules*—(i) *Order of adjustments.* Deconsolidation of a share is treated as a disposition of the share for purposes of determining when investment adjustments are made to the share.

(ii) *No tiering up of certain adjustments.* If the basis of stock of a subsidiary owned by a member (the "owning member") is reduced under this section on the deconsolidation of the stock, no corresponding adjustment is made under §1.1502-32 to the basis of the stock of the owning member (or any higher tier member) if a disposition or deconsolidation occurs in the same transaction with respect to all the stock of the owning member. In the case of a disposition or deconsolidation in the same transaction of less than all the stock of the owning member, appropriate adjustments shall be made under §1.1502-32 with respect to the stock of the owning member (or any higher tier member).

(iii) *Example.* (A) P, the common parent of a group, owns all the stock of S, S owns all the stock of S1, and S1 owns all the stock of S2. P's basis in the S stock is $100, S's basis in the S1 stock is $100, and S1's basis in the S2 stock is $100. In Year 1, S2 buys T for $100. T has an asset with a basis of $0 and a value of $100. In Year 2, T sells the asset for $100. Under the investment adjustment system, the basis of each subsidiary's stock increases from $100 to $200. In Year 6, S sells all the stock of S1 for $100 to A, an individual, and recognizes a loss of $100. S1, S2, and T are not members of a consolidated group immediately after the sale because the new S1 group does not file a consolidated return for its first taxable year.

(B) Under paragraph (a)(1) of this section, no deduction is allowed to S for its loss on the sale of the S1 stock. Under paragraph (f)(1) of this section, S's earnings and profits for Year 6 are reduced by the $100 loss that is disallowed. Correspondingly, under the investment adjustment system, S's reduction in earnings and profits causes a reduction in P's basis in the S stock, and a reduction in P's earnings and profits for Year 6.

(C) Under paragraph (b)(1) of this section, because the stock of T and S2 is deconsolidated, S2 must reduce the basis of the T stock from $200 to $100 (its value immediately before the deconsolidation), and S1 must reduce immediately before the deconsolidation). Under paragraph (f)(1), S2's earnings and profits for Year 6 are reduced by the $100 reduction to the basis of the T stock, and S1's earnings and profits are reduced by the $100 reduction to the basis of the S2 stock. Under paragraph (f)(2)(ii) of this section, because the stock of S2 is deconsolidated in the same transaction, the basis reduction to the T stock does not cause any corresponding investment adjustment to the stock of S2, or to the stock of any higher tier subsidiary. Similarly, because the stock of S1 is disposed of in the same transaction, the reduction to the basis of the S2 stock does not cause an investment adjustment to the stock of S1, or the stock of any higher tier subsidiary.

(iv) *Basis reduction treated as investment adjustment.* For purposes of

the consolidated return regulations, the amount of any basis reduction to stock under this section is generally treated as a net negative adjustment under §1.1502-32(e) (in addition to the adjustment otherwise required under §1.1502-32(e)) with respect to the stock. The amount of the basis reduction is not treated as a net negative adjustment for purposes of §1.1502-32T(a), however.

(g) *Effective dates*—(1) *General rule.* This section is effective December 26, 1990. Except as otherwise provided in this paragraph (g), this section applies with respect to dispositions and deconsolidations after November 18, 1990, but only to the extent the disposition or deconsolidation is not subject to §1.1502-20. For this purpose, dispositions deferred under §§1.1502-13, 1.1502-13T, 1.1502-14, and 1.1502-14T are deemed to occur at the time the deferred gain or loss is taken into account unless the stock was deconsolidated before November 19, 1990. If stock of a subsidiary became worthless during a taxable year including November 19, 1990, the disposition with respect to the stock is treated as occurring on the date the stock became worthless.

(2) *Binding contract rule.* For purposes of this paragraph (g), if a disposition or deconsolidation is pursuant to a binding written contract entered into before March 9, 1990, and in continuous effect until the disposition or deconsolidation, the date the contract became binding is treated as the date of the disposition or deconsolidation.

Par. 6. New temporary §1.267(f)-3T is added to read as follows:

§1.267(f)-3T Disposition or deconsolidation of subsidiary stock (temporary).

For purposes of applying section 267(f)(2) to the sale or exchange of the stock of one member of a consolidated group by another member, see §§1.337(d)-1(a) and 1.337(d)-2T(a). For purposes of this section, the definitions in §1.1502-1 apply.

Par. 7. Paragraph (h)(2) of §1.469-1T is revised to read as follows:

§1.469-1T General rules (temporary).
*****

(h) ***

(2) *Definitions.* For purposes of this paragraph (h)—

(i) The terms "group," "consolidated group," "member," "subsidiary," and "consolidated return year" have the meanings set forth in §1.1502-1; and

(ii) The term "consolidated taxable income" has the meaning set forth in §1.1502-11.
*****

Par. 8. The text of §1.1502-1T is redesignated as §1.1502-1(h) and the section heading is removed.

Par. 9. Paragraph (r) of §1.1502-12 is revised to read as follows:

§1.1502-12 Separate taxable income.
*****

(r) For rules relating to loss disallowance or basis reduction on the disposition or deconsolidation of stock of a subsidiary, see §§1.337(d)-1 and 1.337(d)-2T.
*****

Par. 9A. Section 1.1502-20T is removed.

Par. 10. The last sentence of §1.1502-32(a) is revised to read as follows:

§1.1502-32 Investment adjustment.
*****

(a) *** For rules relating to loss disallowance or basis reduction on the disposition or deconsolidation of stock of a subsidiary, see §§1.337(d)-1 and 1.337(d)-2T.
*****

Par. 11. The last sentence of §1.1502-33(c)(6) is revised to read as follows:

§1.1502-33 Earnings and profits.
*****

(c) ***

(6) *** For rules relating to the effect on earnings and profits of loss disallowance or basis reduction on the disposition or deconsolidation of stock of a subsidiary, see §§1.337(d)-1 and 1.337(d)-2T.
*****

Par. 12. Section 1.1502-79 is amended by removing paragraph (a)(1)(iii).

PART 602—[AMENDED]

Par. 13. The authority for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

§602.101 [Amended]

Par. 14. Section 602.101(c) is amended by inserting in the appropriate place in the table "Section 1.337(d)-1 *** 1545-1160".

Need for temporary regulations

Because of the need to prevent circumvention of the repeal of the *General Utilities* doctrine, it is impracticable and contrary to the public interest to issue temporary regulation §1.337(d)-2T with notice and public procedure under section 553(b) of title 5 of the United States Code, or subject to the effective date limitation of section 553(d) of title 5.

Fred T. Goldberg, Jr.,
Commissioner of Internal Revenue.

Approved November 8, 1990.

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Assistant Secretary of the Treasury.

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Section 338.—Certain Stock Purchases Treated as Asset Acquisitions

26 CFR 1.338-4T: Questions and answers relating to miscellaneous issues under section 338.

QSP: reverse subsidiary cash merger. Circumstances are set forth under which a reverse subsidiary cash merger will be treated as a section 338 qualified stock purchase of a target. In situation 1, the target remains a subsidiary after the purchase. In situation 2, the target is immediately liquidated after the purchase.

Rev. Rul. 90-95

ISSUES

(1) If a corporation organizes a subsidiary solely for the purpose of acquiring the stock of a target corporation in a reverse subsidiary cash merger, is the corporation treated on the occurrence of a merger as having acquired the stock of the target in a qualified stock purchase under section 338 of the Internal Revenue Code?

(2) If the corporation makes a qualified stock purchase of the target

stock and immediately liquidates the target as part of a plan to acquire the assets of the target, is the corporation treated as having made an asset acquisition pursuant to the *Kimbell-Diamond* doctrine or a section 338 qualified stock purchase followed by a liquidation of the target?

FACTS

Situation 1. *P*, a domestic corporation, formed a wholly owned domestic subsidiary corporation, *S*, for the sole purpose of acquiring all of the stock of an unrelated domestic target corporation, *T*, by means of a reverse subsidiary cash merger. Prior to the merger, *S* conducted no activities other than those required for the merger.

Pursuant to the plan of merger, *S* merged into *T* with *T* surviving. The shareholders of *T* exchanged all of their *T* stock for cash from *S*. Part of the cash used to carry out the acquisition was received by *S* from *P*; the remaining cash was borrowed by *S*. Following the merger, *P* owned all of the outstanding *T* stock.

Situation 2. The facts are the same as in *Situation 1*, except that *P* planned to acquire *T*'s assets through a prompt liquidation of *T*. State law prohibited *P* from owning the stock of *T*. Pursuant to the plan, *T* merged into *P* immediately following the merger of *S* into *T*. The merger of *T* into *P* satisfied the requirements for a tax-free liquidation under section 332 of the Code. The liquidation was not motivated by the evasion or avoidance of federal income tax.

LAW AND ANALYSIS

In *Kimbell-Diamond Milling Co. v. Commissioner*, 14 T.C. 74 (1950), *aff'd per curiam*, 187 F.2d 718 (5th Cir. 1951), *cert. denied*, 342 U.S. 827 (1951), the court held that the purchase of the stock of a target corporation for the purpose of obtaining its assets through a prompt liquidation should be treated by the purchaser as one transaction, namely, a purchase of the target's assets with the purchaser receiving a cost basis in the assets. Old section 334(b)(2) of the Code was added in 1954 to codify the principles of *Kimbell-Diamond*. *See* S. Rep. No. 1622, 83d Cong. 2d Sess. 257 (1954).

In 1982, Congress repealed old section 334(b)(2) of the Code and enacted section 338. Section 338 was "intended to replace any nonstatutory treatment of a stock purchase as an asset purchase under the *Kimbell-Diamond* doctrine." H.R. Conf. Rep. No. 760, 97th Cong., 2d Sess. 536 (1982), 1982-2 C.B. 600, 632. Under section 338, in the case of any qualified stock purchase, rules are provided governing whether the transaction gives rise to purchase of target stock treatment or purchase of target asset treatment. Under these rules, stock purchase or asset purchase treatment generally results whether or not the target is liquidated, merged into another corporation, or otherwise disposed of by the purchasing corporation. *See* section 1.338-4T(d) *Question and Answer 1*, temporary Income Tax Regulations.

A qualified stock purchase is generally the purchase by a corporation of at least 80 percent of a target's stock, by vote and value, within a 12-month period. Section 338(d)(3). The requirements for a qualified stock purchase may be satisfied through a combination of purchases of target stock by the purchasing corporation and redemptions by the target. Section 1.338-4T(c)(4) of the temporary regulations.

Stock purchase or asset purchase treatment generally turns on whether the purchasing corporation makes or is deemed to make a section 338 election. If the election is made or deemed made, asset purchase treatment results and section 338 of the Code generally treats all of the assets of the target as having been sold by the target at fair market value on the date of the qualified stock purchase and then repurchased by the target on the following day. The basis of the target's assets is adjusted to reflect the stock purchase price and other relevant items. If an election is not made or deemed made, stock purchase treatment generally results. In such a case, the basis of the target's assets is not adjusted to reflect the stock purchase price and other relevant items.

Question and Answer 3 of section 1.338-4T(d) of the temporary regulations provides that the parent of the subsidiary corporation in a reverse subsidiary cash merger is considered to have made a qualified stock purchase of the target if the subsidiary's existence is properly disregarded under the step-transaction doctrine and the requirements of a qualified stock purchase are satisfied. A subsidiary used to acquire target stock in a reverse subsidiary cash merger is ordinarily disregarded for federal income tax purposes if it was formed solely for the purpose of acquiring the stock and did not conduct any activities other than those required for the merger. *See* Rev. Rul. 79-273, 1979-2 C.B. 125; Rev. Rul. 73-427, 1973-2 C.B. 301.

Section 269 of the Code generally provides that the Secretary may disallow certain tax benefits when evasion or avoidance of federal income tax is the principal purpose for the acquisition of a corporation or its assets. The section 269 disallowance may apply to a qualified stock purchase followed by a liquidation of the target pursuant to a plan of liquidation adopted not more than two years after the purchase if the principal purpose of the liquidation was the evasion or avoidance of federal income tax by securing tax benefits that the purchasing corporation would not otherwise enjoy. Section 269(b).

In *Situations 1 and 2*, the step-transaction doctrine is properly applied to disregard the existence of *S* for federal income tax purposes. *S* had no significance apart from *P*'s acquisition of the *T* stock. *S* was formed for the sole purpose of enabling *P* to acquire the *T* stock, and *S* did not conduct any activities that were not related to that acquisition. Accordingly, the transaction is treated as a qualified stock purchase of *T* stock by *P*.

In *Situation 2*, the step-transaction doctrine does not apply to treat the stock acquisition and liquidation as an asset purchase. Section 338 of the Code replaced the *Kimbell-Diamond* doctrine and governs whether a corporation's acquisition of stock is treated as an asset purchase. Under section 338, asset purchase treatment turns on whether a section 338 election is made (or is deemed made) following a qualified stock purchase of target stock and not on whether the target's stock is acquired to obtain the assets through a prompt liquidation of the target. The acquiring corporation may receive stock purchase treatment or asset purchase treatment whether or not the target is subsequently liquidated. A qualified stock purchase of

target stock is accorded independent significance from a subsequent liquidation of the target regardless of whether a section 338 election is made or deemed made. This treatment results even if the liquidation occurs to comply with state law. Accordingly, in *Situation 2*, the acquisition is treated as a qualified stock purchase by *P* of *T* stock followed by a tax-free liquidation of *T* into *P*.

HOLDINGS

(1) In *Situations 1 and 2*, *P* is treated as having acquired stock of *T* in a qualified stock purchase under section 338 of the Code.

(2) In *Situation 2*, *P* is treated as having acquired stock of *T* in a qualified stock purchase under section 338 followed by a liquidation of *T* into *P*, rather than having made an acquisition of assets pursuant to the *Kimbell-Diamond* doctrine.

Part III. Corporate Organizations and Reorganizations
Subpart A.—Corporate Organizations

Section 351.—Transfer to Corporation Controlled by Transferor

26 CFR 1.351-1: Transfer to corporation controlled by transferor.

The Service will no longer issue advance rulings or determination letters regarding most holding company formations, mergers, and changes in identity, form or place of organization of a corporation. See Rev. Proc. 90-56, page 639.

Subpart D.—Special Rule; Definitions

Section 368.—Definitions Relating to Corporate Reorganizations

26 CFR 1.368-2: Definition of terms.

The Service will no longer issue advance rulings or determination letters regarding most holding company formations, mergers, and changes in identity, form or place of organization of a corporation. See Rev. Proc. 90-56, page 639.

Part V.—Carryovers

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

The adjusted federal long-term rate is set forth for the month of July 1990. See Rev. Rul. 90-52, page 192.

The adjusted federal long-term rate is set forth for the month of August 1990. See Rev. Rul. 90-66, page 194.

The adjusted federal long-term rate is set forth for the month of September 1990. See Rev. Rul. 90-75, page 195.

The adjusted federal long-term rate is set forth for the month of October 1990. See Rev. Rul. 90-81, page 196.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1990. See Rev. Rul. 90-92, page 198.

The adjusted applicable federal long-term rate is set forth for the month of December 1990. See Rev. Rul. 90-99, page 199.

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

Section 404.—Deduction for Contributions of an Employer to an Employees' Trust or Annuity Plan and Compensation Under a Deferred-Payment Plan

Deduction for contributions of an employer. Guidance is issued concerning the application of section 404(a)(6) of the Code to contributions to a cash or deferred arrangement under section 401(k) or to a defined contribution plan as matching contributions, where such contributions are attributable to compensation earned by plan participants after the end of the taxable year.

Rev. Rul. 90-105

ISSUE

Whether contributions to a qualified cash or deferred arrangement within the meaning of section 401(k) or to a defined contribution plan as matching contributions within the meaning of section 401(m) are deductible by an employer for a taxable year, if the contributions are attributable to compensation earned by plan participants after the end of that taxable year.

FACTS

Corporation M maintains Plan X, which consists of a qualified cash or deferred arrangement within the meaning of section 401(k), and which also provides for matching contributions within the meaning of section 401(m). M's taxable year is the fiscal year ending June 30. Plan X has a calendar plan year. By the last day of Plan X's 1989 calendar plan year, M had contributed amounts to Plan X in accordance with the terms of the plan. These amounts consisted of (a) the elective deferral and matching contributions attributable to compensation earned by plan participants before the end of M's taxable year ending June 30, 1989 (Pre-Year End Contributions), and (b) the elective deferral and matching contributions attributable to compensation earned by plan participants after the end of M's taxable year ending June 30, 1989 (Post-Year End Contributions).

M received an extension of time to March 15, 1990, to file the income tax return for its taxable year ending June 30, 1989 (1989 Taxable Year). On the income tax return for its 1989 Taxable Year, which was timely filed on March 1, 1990, M claimed a deduction for the entire amount of the elective deferral and matching contributions made to Plan X during Plan X's 1989 calendar plan year. Approximately one-half of the claimed deduction related to the Pre-Year End Contributions, while the remaining portion of the claimed deduction related to the Post-Year End Contributions. The total amount contributed and claimed by M as a deduction did not exceed 15 percent of the total compensation otherwise paid or accrued during M's 1989 Taxable Year to participants under Plan X, in accordance with the percentage limitation under section 404(a)(3)(A)(i).

LAW

Section 404(a) provides in relevant part that if contributions are paid to a profit-sharing or stock bonus plan and are otherwise deductible under chapter 1 of the Code, those contributions are deductible under section 404 (subject to certain limitations) in the taxable year of the employer when paid, and are not deductible under any other section of chapter 1 of the Code. In the case of a contribution that is otherwise deductible under section 162 or 212, section 1.404(a)-1(b) of the Income Tax Reg-

ulations provides that in order to be deductible under section 404(a), the contribution must be an ordinary and necessary expense during the taxable year in carrying on a trade or business or for the production of income and must be compensation for services actually rendered.

Section 1.404(a)-1T, Q&A-1, of the Regulations provides that in order to be deductible under section 404(a), a contribution otherwise deductible under section 162 or 212 must be paid or incurred for purposes of those sections, in addition to satisfying the other requirements for deductibility under those sections. Section 7701(a)(25) states that the term "paid or incurred" shall be construed according to the method of accounting used by the taxpayer to compute its taxable income. Section 301.7701-16 of the Regulations adopts the same definition for purposes of the Regulations.

Section 461(a), in conjunction with section 1.461-1(a)(2) of the Regulations, provides that, for a taxpayer using an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of liability and the amount thereof can be determined with reasonable accuracy. Section 1.461-1(a)(2) specifically states that "no accrual shall be made in any case in which all of the events have not occurred which fix the liability. . ."

Section 404(a)(6) provides in relevant part that, for purposes of section 404(a)(3), "a taxpayer shall be deemed to have made a payment on the last day of the preceding taxable year if the payment is on account of such taxable year and is made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof)." The sole effect of section 404(a)(6) is to deem a payment to have been made on the last day of the preceding taxable year. Section 404(a)(6) does not make a contribution deductible in a taxable year where the contribution could not otherwise have been deducted in that taxable year if it had actually been paid on the last day of the taxable year. See S. Rep. No. 1622, 83d Cong., 2d Sess. 55 (1954) (section 404(a)(6) merely provides to accrual basis taxpayers a grace period to compute the amount of the contribution due to the difficulty of gathering information about the taxable year by the close of the taxable year); H.R. Rep. No. 1280, 93d Cong., 2d. Sess. 347 (1974) (extending the same grace period to cash basis taxpayers); *Don E. Williams Co. v. Commissioner*, 429 U.S. 569, 575 n.6 (1977).

Rev. Rul. 76-28, 1976-1 C.B. 106, provides that a contribution made after the close of an employer's taxable year will be deemed to have been made on account of the preceding taxable year under section 404(a)(6) if, among other conditions, the payment is treated by the plan in the same manner as the plan would treat a payment actually received on the last day of such preceding taxable year of the employer.

ANALYSIS

Under section 404(a)(6), as interpreted by Rev. Rul. 76-28, the payment of M's Post-Year End Contributions to Plan X could be deemed to have been made on the last day of M's 1989 Taxable Year, if Plan X treated the payment of those contributions at the time they were actually received in the same manner that the plan would have treated a payment of those same contributions had they instead been received on the last day of M's 1989 Taxable Year. However, Plan X could not have done so. Compensation cannot be deferred and contributed to a plan as elective deferrals, and matching contributions cannot be made to a plan with respect to such elective deferrals, until the underlying compensation has actually been earned. At the time Plan X actually received the payment of M's Post-Year End Contributions, Plan X could properly treat the payment as consisting of elective deferral and matching contributions, because the underlying compensation had already been earned. If Plan X had instead received a payment of the Post-Year End Contributions on the last day of M's 1989 Taxable Year, Plan X could not at that time have properly treated the payment as consisting of elective deferral and matching contributions, because the underlying compensation had not been earned. It would have been necessary to wait for six months to determine the amount of compensation actually earned by plan participants after the end of M's 1989 Taxable Year and therefore what portion of the payment could properly be treated as consisting of elective deferral and matching contributions. Accordingly, M did not satisfy section 404(a)(6) with respect to the Post-Year End Contributions. This is true regardless of whether M uses the cash or an accrual method of accounting.

Even if M could have satisfied section 404(a)(6) with respect to the Post-Year End Contributions, section 404(a)(6) does not provide that the Post-Year End Contributions would therefore be deductible for M's 1989 Taxable Year. Section 404(a)(6) merely would have deemed the contributions to have been paid on the last day of that year.

In order for the Post-Year End Contributions to be deductible for M's 1989 Taxable Year, M would have been required to show that the contributions would have been deductible under section 404(a), and in turn would have been otherwise deductible under chapter 1 of the Code, for M's 1989 Taxable Year, if the contributions had actually been paid on the last day of that taxable year. However, the contributions are attributable to compensation earned by plan participants after the end of M's 1989 Taxable Year, so that as of the last day of that taxable year the payment of the contributions could not have been compensation for services actually rendered. Under section 1.404(a)-1(b) of the Regulations, the Post-Year End Contributions therefore could not have been deducted for M's 1989 Taxable Year. This conclusion applies regardless of whether M uses the cash or an accrual method of accounting.

In addition, if M uses an accrual method of accounting, the application of section 461(a) also would have precluded the Post-Year End Contributions from being deductible for M's 1989 Taxable Year, because all events fixing the fact of M's liability to make the contributions had not occurred as of the end of M's 1989 Taxable Year. Because the Post-Year End Contributions are attributable to compensation earned by plan participants after the end of that taxable year, the compensation could not have been actually deferred as of that date, so that M's liability to make elective deferral and matching contri-

butions with respect to that compensation would not have been fixed.

HOLDING

Contributions to a qualified cash or deferred arrangement within the meaning of section 401(k) or to a defined contribution plan as matching contributions within the meaning of section 401(m) are not deductible by the employer for a taxable year, if the contributions are attributable to compensation earned by plan participants after the end of that taxable year. This holding applies regardless of whether section 404(a)(6) deems the contributions to have been paid on the last day of that taxable year, and regardless of whether the employer uses the cash or an accrual method of accounting.

APPLICATION

Taxpayers using a method of accounting inconsistent with this revenue ruling are required to change their method of accounting. If a taxpayer makes the change in accordance with this revenue ruling, the change is to be effective for purposes of claiming deductions under section 404(a) for all elective deferral and matching contributions actually paid after December 31, 1989, except to the extent such contributions were deducted on a return filed before December 7, 1989 (the Release Date). Because this change is to be implemented on a "cut-off" basis, it is made without a section 481(a) adjustment.

In order to make the change in accordance with this revenue ruling, the taxpayer must account for all contributions actually paid after December 31, 1989, consistently with the holding of this revenue ruling, except to the extent these contributions were deducted on a return filed before the Release Date. Any contribution for which a deduction was claimed on a return filed before the Release Date may not again be deducted on a return filed on or after the Release Date, even though that contribution would, under the holding of this revenue ruling, otherwise be deductible on a return filed after the Release Date. In addition, the taxpayer must type or legibly print on the first return filed after the Release Date the following notation: "Change in Method of Accounting under Rev. Rul. 90-105." If a taxpayer changes its method in accordance with this revenue ruling, the Service will not apply the holding in this revenue ruling to contributions actually paid before January 1, 1990, or to contributions actually paid on or after that date for which a deduction was claimed on a return filed before the Release Date (even if the Service has raised the issue of the deductibility of such a contribution upon examination). A taxpayer who amends a return filed before the Release Date is not required to make the change on that amended return. No taxpayer is permitted to file an amended return on or after the Release Date in order to claim a deduction that is inconsistent with the holding in this revenue ruling, even though such deduction relates to contributions actually paid before January 1, 1990.

Thus, assuming that M has not filed before the Release Date the return for its taxable year ending June 30, 1990 (1990 Return), M is permitted on its 1990 Return to deduct elective deferral and matching contributions actually paid after December 31, 1989, only to the extent those contributions are attributable to compensation earned by plan participants between January 1, 1990, and June 30, 1990. M is not permitted to deduct on its 1990 Return elective deferral and matching contributions attributable to compensation earned by plan participants between July 1, 1989, and December 31, 1989, because those amounts previously were deducted on a return filed before the Release Date (i.e., M's return for its 1989 Taxable Year). In addition, M is not permitted on its 1990 Return to deduct elective deferral and matching contributions attributable to compensation earned by plan participants on or after July 1, 1990, because deducting those contributions on that return would be inconsistent with the holding in this revenue ruling. If M complies with the requirements set forth in the preceding paragraph, M is not required to amend the return for its 1989 Taxable Year, nor will the Service apply the holding in this revenue ruling to that return (or to a return for any previous year), even though the return may claim a deduction for contributions attributable to compensation earned by plan participants after the last day of the taxable year for which the return was filed.

If a taxpayer, however, fails to change its method of accounting in accordance with this revenue ruling, the Service may require the taxpayer to change its method of accounting in the earliest open taxable year on a cut-off basis, notwithstanding the provisions of Rev. Proc. 84-74, 1984-2 C.B. 736.

ADDITIONAL INFORMATION

This revenue ruling does not address similar issues that may arise under section 404 with respect to plans that are not subject to section 401(k) or (m). The Service anticipates issuing further guidance on these issues.

Section 408.—Individual Retirement Accounts

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

Specification for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 90-44, page 498.

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

Specification for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 90-44, page 498.

Subpart B.—Special Rules

Section 412.—Minimum Funding Standards

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1990. See Rev. Rul. 90-52, page 192.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1990. See Rev. Rul. 90-66, page 194.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1990. See Rev. Rul. 90-75, page 195.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1990. See Rev. Rul. 90-81, page 196.

The adjusted federal long-term rate is set forth for the month of November 1990. See Rev. Rul. 90-92, page 198.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1990. See Rev. Rul. 90-99, page 199.

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26 CFR 1.412(c)(1)-3T: Applying the minimum funding requirements to restored plans (temporary).

T.D. 8317

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Minimum Funding Requirements—Plan Restoration

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations that add a new §1.412(c)(1)-3T to the regulations governing the minimum funding requirements for qualified plans under section 412 of the Internal Revenue Code. The temporary regulation supplements the existing regulations by providing rules for the treatment of plans that are being or have been terminated pursuant to section 4041(c) or 4042 of ERISA and are restored to their sponsoring employers by order of the Pension Benefit Guaranty Corporation ("PBGC") pursuant to section 4047 of the Employee Retirement Income Security Act of 1974 ("ERISA"). The temporary regulation was developed simultaneously with a new regulation issued by the Pension Benefit Guaranty Corporation under section 4047 of ERISA.

These rules are needed because plan restoration raises unique issues under section 412 but the existing regulations do not provide guidance for the treatment of the funding standard account of a restored plan. The funding standard account of a plan that has been restored must be reestablished because the funding standard account of the plan will have been closed out at the time of termination and there will generally be a hiatus during which no contributions will have been made to the plan.

The text of the temporary regulations set forth in this document also serves as the text of the proposed regulations cross-referenced in *** [EE-86-90, page 729, this Bulletin]. These regulations will provide the public with guidance necessary to comply with the law. They will affect sponsors of and participants in tax-qualified retirement plans.

EFFECTIVE DATE: The regulations are effective October 23, 1990, and thus apply for the plan valuation for the first plan year beginning on or after the later of October 23, 1990, or the date of a PBGC restoration order applicable to the plan.

SUPPLEMENTARY INFORMATION:

Background

This document adds new §1.412(c)(1)-3T to Part 1 of Title 26 of the Code of Federal Regulations. The document addresses the relationship between the funding requirements of section 412 of the Internal Revenue Code and the restoration provisions of section 4047 of the Employee Retirement Income Security Act of 1974 ("ERISA"). The relationship between the minimum funding requirements of section 412 and the restoration provisions of section 4047 of the Employee Retirement Income Security Act of 1974 ("ERISA") is one aspect of a long history of statutory interrelationship and coordination that has characterized the development of pension law in this area since the enactment of ERISA. The plan termination insurance program administered by the Pension Benefit Guaranty Corporation ("PBGC") for the protection of participants in defined benefit plans is one of the cornerstones of the congressional policy underlying ERISA. See H.R. Rep. No. 93-807, 93d Cong., 2d Sess., 13. The establishment of a program of plan termination insurance is predicated on the existence of adequate minimum funding requirements to assure that employers will, in general, fund their pension obligations in a timely manner. During the legislative development of ERISA, Congress reviewed the minimum funding requirements of pre-ERISA law and found them inadequate because, *inter alia*, they did not require the sponsor of a qualified defined benefit plan to contribute sufficient amounts to amortize the principal amount of the unfunded past service liabilities of the plan. H.R. Rep. No. 93-807, 93d Cong., 2d Sess., 73-74.

Accordingly, as part of the overall reform of the pension laws in ERISA, Congress raised the minimum funding standards applicable to qualified plans and required plans to establish and maintain a funding standard account to protect plan participants and the plan termination insurance program. The charges and credits to the funding standard account are prescribed in section 412(b) of the Internal Revenue Code. Additional minimum funding provisions requiring employers to make deficit reduction contributions were added with the enactment of section 412(l) of the Internal Revenue Code as part of the Omnibus Budget Reconciliation Act of 1987 ("OBRA 1987"), Pub. L. No. 100-203 [1987-3 C.B. 1]. This additional funding requirement was adopted in substantial part to protect the plan termination insurance system administered by the PBGC from large claims resulting from the termination of underfunded plans. H.R. Rep. No. 100-391 (Vol. II), 100th Cong., 1st Sess., 984.

Section 4047 of ERISA authorizes the PBGC to restore a terminated pension plan to its sponsoring employer whenever the PBGC determines that this action is appropriate and consistent with its duties under Title IV of ERISA. In any case in which the PBGC determines that a plan that is being terminated should be restored, it is authorized under section 4047 "to cease any activities undertaken to terminate the plan, and to take whatever action is necessary and within its power to restore the plan to its status prior to the determination that the plan was to be terminated." Similarly, in the case of a plan that has been terminated, the PBGC is authorized in any case in which it determines this action to be appropriate and consistent with its duties under Title IV, "to take such action as may be necessary to restore the plan to its pretermination status, including, but not limited to, the transfer to the employer or a plan

administrator of control of part or all of the remaining assets and liabilities of the plan."

The legislative history of section 4047 of ERISA demonstrates that Congress intended to confer broad authority on the PBGC to control the details of plan restorations. The purpose of section 4047 is explained as follows in the conference report to ERISA (H.R. Conf. Rep. No. 93-1280, 93d Cong., 2d Sess. 378-379:

Restoration of plans

Neither the House bill nor the Senate amendment had any specific provision that procedures against a plan in the termination phase might be abandoned by the corporation if the employer and plan enjoyed a favorable reversal of business trends, or if some other factor made termination no longer advisable.

Under the conference substitute, the corporation may cease any termination activities and do what it can to restore the plan to its former status. As a result, a terminated plan being operated by a trustee as a wasting trust may be restored if, during the period of its operation by the trustee, experience gains or increased funding make it sufficiently solvent. The corporation may, when appropriate, transfer to the employer or plan administrator part or all of the remaining assets and liabilities.

The United States Supreme Court recently upheld the broad authority of the PBGC to restore a pension plan in *PBGC* v. *LTV Corp.*, 110 S.Ct. 2668 (1990).

The restoration of a pension plan presents unique problems with respect to the application of the minimum funding standards of section 412 of the Internal Revenue Code because a restored plan is being or has been terminated and administered as a terminated plan during the time from the date of termination of the plan to the date of the restoration (or its implementation). During this interval, the funding standard account will have ceased to apply to the plan beginning with the plan year subsequent to the year in which the termination occurred. See Rev. Rul. 79-237, 1979-2 C.B. 190. In addition, during the period between the dates of termination and restoration (or its implementation), Schedules B of Form 5500 will not have been completed by the plan actuary, nor will contributions have been made to the plan. When the PBGC acts to restore the plan, the funding standard account must be reestablished and thereafter the funding standard account must be maintained.

The restoration of the plan under section 4047 of ERISA has the effect of retroactively reinstating benefit accruals under the plan because the statute provides for restoration of the plan to its pre-termination status. Because the plan will have been underfunded upon plan termination and because the plan sponsor will ordinarily not have made any contributions to the plan while it was being administered as a terminated plan, the plan is likely to be even more underfunded on restoration. This underfunding will be significantly increased if the plan has been administered as a terminated plan for an extended period of time.

Congress has recognized that, in certain limited cases, the Secretary may by regulation adapt the standards of section 412 to the extent necessary to provide rules for a special group of plans. Thus, for example, Congress expressed its intent to provide flexibility in computing funding requirements for a collectively bargained plan if the collective bargaining agreement under which the plan was funded required the employers contributing to the plan to pay a fixed amount per unit of service or production and if the employers complied with their obligations under the agreement. H.R. Rep. No. 93-1280, 93d Cong., 2d Sess., 285. In order to provide a mechanism for computing the minimum funding requirements based on estimated units of service or production in the case of collectively bargained plans, the Secretary promulgated the shortfall method in §1.412(c)(1)-2 of the Treasury Regulations. T.D. 7733, 1981-1 C.B. 234.

The rules in these temporary regulations apply to a plan that is being or has been terminated and restored by the PBGC and they provide a restoration method for funding the unfunded liability of the plan that is attributable to plan years prior to the later of the restoration or its implementation. Under this method, the required funding level for these liabilities is established by the PBGC in a restoration payment schedule order for a period that may be as long as 30 years after the beginning of the plan year in which the initial post-restoration valuation date falls.

Establishment of the restoration payment schedule by the PBGC is appropriate because the PBGC will normally have detailed knowledge of the financial condition of the plan sponsor (and its controlled group) of a restored plan, because the PBGC is directly at risk if restoration is ultimately unsuccessful and a restored plan must be re-terminated. It is also appropriate and essential to the effective administration of section 412 that the Secretary prescribe certain limits with respect to the restoration funding schedule in order to ensure that the schedule is consistent with and in furtherance of the congressional purposes underlying section 412.

Explanation of provisions

Appropriate provisions for the amortization of the large unfunded liability arising, in part, as a result of the lapse of time between the termination of a plan and the resumption of contributions to it are necessary to implement the PBGC's restoration authority. These regulations provide parameters within which the PBGC shall establish a restoration payment schedule consistent with the orderly restoration of the plan.

The regulations create a special funding method, known as the restoration method, which method adapts the underlying funding method used by the plan to the special circumstances that exist when a plan is restored. The restoration method is applicable only to plans that are being or have been terminated and are then restored by the PBGC. When the PBGC establishes a restoration payment schedule, the Executive Director of the PBGC must certify to the Corporation's Board of Directors, and to the Internal Revenue Service, that the Corporation has reviewed the funding of the plan, the financial condition of the plan sponsor and its controlled group members, the payments required under the restoration payment schedule (taking into account the availability of the deferrals permitted under the temporary regulations), and any other factor that the

Corporation deems relevant, and, based on that review, determines that it is in the best interests of participants and beneficiaries of the plan and the pension insurance program that the restored plan not be reterminated.

A plan that is being or has been terminated and restored, must use the restoration method until the initial restoration amortization base has been fully amortized. Use of the restoration method is permitted without securing prior approval from the Commissioner.

For purposes of applying the restoration method, §1.412(c)(1)-3T(b) of the regulations creates a special amortization base, known as the initial restoration amortization base, consisting of the unfunded liability of the plan as of the valuation for the plan year in which the initial post restoration valuation date falls, based upon the assets and liabilities restored by the PBGC. This initial restoration amortization base must be amortized over not more than 30 years. During this period, the plan sponsor and any controlled group members must contribute an amount sufficient to satisfy the requirements of section 412 taking into account the plan restoration provisions of this regulation §1.412(c)(1)-3T. At the end of the period established by the restoration payment schedule, the plan is required to comply with the minimum funding requirements of section 412 of the Internal Revenue Code in the same manner as a plan that had never been terminated and restored.

The PBGC must issue a restoration payment schedule order using the initial restoration amortization base. The factors that the PBGC may consider in prescribing a restoration payment schedule to amortize the initial restoration amortization base include but are not limited to the following: (1) the need for the plan to make an orderly transition from terminated status to ongoing status as a restored plan, (2) the need for the plan sponsor and its controlled group members to have sufficient time to fund the accrued liabilities of the plan arising from pre-restoration service, (3) the interests of plan participants and beneficiaries, (4) the financial condition of the plan, (5) the financial condition of the plan sponsor and its controlled group members, (6) changes in the law affecting the funding requirements applicable to the restored plan, (7) the length of time between the date the plan was terminated and the date of a PBGC restoration order, its implementation, or the restoration payment schedule order, (8) the grounds for the restoration, (9) the risk to the PBGC's plan termination insurance program, and (10) the pre-termination funding history of the plan.

The restoration payment schedule must provide that at the end of no more than 30 years, the entire amount of the initial restoration amortization base will have been amortized. Unlike the amortization bases described in section 412(b) of the Internal Revenue Code, however, the amortization charges need not be in level annual amounts. Nevertheless, at all times the present value of the future amortization charges under the restoration payment schedule must equal the outstanding balance of the initial restoration amortization base and the schedule must provide that at the end of no more than 30 years the entire amount of the initial restoration amortization base will have been fully amortized.

In addition, any restoration payment schedule established pursuant to these regulations must meet certain minimum annual payments and must satisfy certain interim amortization requirements. Under these regulations, the restoration payment schedule must provide for sufficient periodic charges so that the outstanding balance of the initial restoration amortization base at the end of the tenth plan year and at the end of the twentieth plan year of the restoration payment period will not be larger than the outstanding balances that would have remained at the end of the tenth plan year and at the end of the twentieth plan year, respectively, if the initial restoration amortization base had been amortized in level amounts over the restoration payment period. In addition, during each 10-year interval, the restoration payment schedule must require payments that are sufficient to prevent the outstanding balance of the initial restoration amortization base from exceeding the balance at the beginning of the interval.

As is the case with other bases used to amortize unfunded costs of a plan, the charges required under the restoration payment schedule prescribed by the PBGC are charged to the funding standard account of the plan in the year each payment is due. In the event that the plan sponsor or its controlled group members makes contributions in excess of those required, the resulting credit balances will be available to satisfy the charges in subsequent plan years.

The outstanding balance of the initial restoration amortization base must be calculated each year in conformity with the usual actuarial practice applicable to other amortization bases established under section 412(b) of the Internal Revenue Code. In determining the outstanding balance of this base, however, the calculation must be based upon the charges under the restoration payment schedule. Under the regulations, the Pension Benefit Guaranty Corporation may grant a deferral of the payment required under the restoration payment schedule for a particular year, under the conditions and in the manner provided in the regulations.

The normal operation of the funding standard account, and the other provisions of section 412 and the regulations thereunder, are unchanged except as provided in this plan restoration regulation §1.412(c)(1)-3T. If the actuarial assumptions and methods used in calculating the assets and liabilities of the plan are changed consistent with requirements of section 412(c)(3), and if the change results in a net change to the scheduled payments required to amortize the outstanding balance of the initial restoration amortization base over the remaining years of the restoration payment schedule, the plan must notify the PBGC of the changes so that the PBGC can make any necessary changes to the restoration payment schedule.

When a plan is under the restoration method, the deficit reduction contribution under section 412(l)(2) of the Internal Revenue Code is composed of the unfunded section 412(l) restoration liability amount plus the unfunded new liability amount. The unfunded section 412(l) restoration liability amount is the amount necessary to amortize the section 412(l) restoration liability in annual installments, not necessarily level, as prescribed by the PBGC over a period of

not more than 30 years. During the first 10 years after the initial post-restoration valuation date, the computation of the unfunded section 412(l) restoration liability amount must be made at the valuation interest rate, if that rate is lower than the current liability interest rate determined under section 412(b)(5)(B).

The difference between the unfunded section 412(l) restoration liability amount computed at the current liability rate and the unfunded section 412(l) restoration liability amount computed at the valuation rate must be accumulated during the first 10 years with interest at the current liability rate. This accumulated balance must be charged to the funding standard account of the plan at the end of the tenth plan year, but the PBGC may spread the charging of this amount over the eleventh through the fifteenth plan years, by an appropriate order. This rule is designed to give the PBGC a sufficient amount of flexibility in developing an amortization payment schedule under section 412(l) to enable the employer to meet its funding obligations to the restored plan during the years immediately after the restoration. The unfunded new liability amount is the applicable percentage, as determined under section 412(l)(4)(C), of the difference between the unfunded current liability of the plan and the outstanding balance of the section 412(l) restoration liability of the plan. The section 412(b) restoration payment for each year shall be offset against the deficit reduction contribution for that year, along with any other applicable offset amounts, as provided in section 412(l)(1)(A)(ii).

When the plan uses a funding method that does not maintain an unfunded liability, *e.g.* the aggregate method, the plan must change to a method that does maintain an unfunded liability. A plan may adopt any acceptable method, *i.e.* any method that maintains an unfunded liability, subject to the procedures established in Rev. Proc. 85-29, 1985-1 C.B. 581, as extended by Notice 90-63 (October 22, 1990), page 664, this Bulletin.

The PBGC retains the authority to modify the restoration payment schedule at any time during the period of up to 30 years that the schedule is effective. Any modification must, however, comply with the requirements of the regulation, including the minimum payment requirements and the requirement that the 30-year period not be extended. In addition, the PBGC may conduct a funding review of the plan at any time it deems appropriate. The purpose of a funding review is to determine the progress that the plan is making toward the establishment of an adequate level of funding, to make appropriate adjustments in the restoration payment schedule, and to assure an orderly transition when the restoration method ceases to apply. As part of the annual funding review, the Executive Director of the PBGC must certify to the Corporation's Board of Directors, and to the Internal Revenue Service, that the Corporation has reviewed the funding of the plan, the financial condition of the plan sponsor and its controlled group members, the payments required under the restoration payment schedule (taking into account the availability of the deferrals allowed under the temporary regulations), and any other factor that the Corporation deems relevant, and, based on that review, determines that it is in the best interests of participants and beneficiaries of the plan and the pension insurance program that the restored plan not be reterminated.

Effect on other laws

Pursuant to the Reorganization Plan No. 4 of 1978, satisfaction of the restoration method requirements set forth in these regulations will be treated as satisfaction of the minimum funding requirements under section 302 of Subtitle B of Title I of the Employee Retirement Income Security Act of 1974 (ERISA). Failure to make a required payment under the restoration method may be treated by the Secretary of Labor as a failure to meet the minimum funding standard under ERISA section 302 for purposes of the notice required under ERISA section 101(d).

Special Analyses

It has been determined that these rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. 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.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR Part 1 is amended as follows:

PART 1—[AMENDED]

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

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

Par. 2. The following new section is added to Part 1 in the appropriate place to read as follows:

§1.412(c)(1)-3T. Applying the minimum funding requirements to restored plans (Temporary).

(a) *In general*—(1) *Restoration method.* The restoration method is a funding method that adapts the underlying funding method of section 412 in the case of certain plans that are or have been terminated and are later restored by the Pension Benefit Guaranty Corporation. The normal operation of the funding standard account, and all other provisions of section 412 and the regulations thereunder, are unchanged except as provided in this §1.412(c)(1)-3T. Under the restoration method, the Pension Benefit Guaranty Corporation shall determine a restoration payment schedule, extending over no more than 30 years, that replaces all charges and credits to the funding standard account attributable to pre-restoration amortization bases. The restoration payment schedule is determined on the basis of an actuarial valuation of the accrued liability of the plan on the initial post-restoration valuation date less the actuarial value of the plan assets on that date. The initial post-restoration valuation date is the date of the first valuation that falls in the first plan year beginning on or after the later of October 23, 1990, or the date of the restoration order.

(2) *Applicability of restoration method.* A plan must use the restoration method if, and only if:

(i) The plan is being or has been terminated pursuant to section 4041(c) or section 4042 of the Employee Retirement Income Security Act of 1974 (ERISA), and

(ii) The plan has been restored by the Pension Benefit Guaranty Corporation pursuant to its authority under section 4047 of ERISA.

(b) *Computation and effect of the initial restoration amortization base*—(1) *In general.* The initial restoration amortization base is determined under the underlying funding method used by the plan. When the plan uses a spread gain funding method that does not maintain an unfunded liability, the plan must change either to an immediate gain method that directly calculates an accrued liability or to a spread gain method that maintains an unfunded liability. A plan may adopt any cost method that satisfies this requirement and that is acceptable under section 412 and the regulations thereunder, provided that the plan follows the procedures established by the Commissioner for changes in funding methods. The initial restoration amortization base is determined using the valuation for the plan year in which the initial post-restoration valuation date falls. The initial restoration amortization base equals the accrued liability with respect to plan benefit liabilities returned by the Pension Benefit Guaranty Corporation less the value of the plan assets returned by the Pension Benefit Guaranty Corporation. The initial restoration amortization base replaces all prior amortization bases including those under subparagraphs (B), (C), and (D) of section 412(b)(2) and under subparagraph (B) of section 412(b)(3). Any base resulting from a change in funding method is treated as a prior amortization base within the meaning of this paragraph (b). Any accumulated funding deficiency or credit balance in the funding standard account is set equal to zero when the initial restoration amortization base is established.

(2) *Example.* A pension plan uses the calendar year as its plan year, makes its annual periodic valuation as of January 1, and uses the unit credit actuarial cost method for funding purposes. The plan is in the process of being terminated. By order of the Pension Benefit Guaranty Corporation the plan is restored as of July 1, 1991, and a restoration payment schedule order issued on October 31, 1992. The initial post-restoration valuation date is January 1, 1993. If, as of that date, the accrued liability of the plan is $1,000,000 and the value of the plan assets is $200,000, the initial restoration amortization base is $800,000.

(c) *Establishment of a restoration payment schedule*—(1) *Certification requirement.* When the PBGC establishes a restoration payment schedule, the Executive Director of the PBGC must certify to the Corporation's Board of Directors, and to the Internal Revenue Service, that the Corporation has reviewed the funding of the plan, the financial condition of the plan sponsor and its controlled group members, the payments required under the restoration payment schedule (taking into account the availability of deferrals authorized under paragraph (c)(4) of this section), and any other factor that the Corporation deems relevant, and, based on that review, determines that it is in the best interests of participants and beneficiaries of the plan and the pension insurance program that the restored plan not be reterminated.

(2) *Requirements for restoration payment schedule*—(i) *Amortization of base over period of no more than 30 years.* The restoration payment schedule must be prescribed in an order requiring the employer to make stated contributions to the plan sufficient to amortize the initial restoration amortization base over a period extending not more than 30 years after the initial post-restoration valuation date (the restoration payment period). The restoration payment schedule must be sufficient to amortize the entire amount of the initial restoration amortization base by the end of the restoration payment period. The scheduled charges need not be in level amounts, but the present value of the prescribed charges on the initial post-restoration valuation date, computed with interest at the valuation rate, must equal the initial restoration amortization base.

(ii) *Minimum annual charge.* The restoration payment schedule must require annual charges that are sufficient to prevent the outstanding balance of the initial restoration amortization base from exceeding whichever of the following amounts is applicable:

(A) during the first 10 plan years on the restoration payment schedule, the amount of the initial restoration amortization base on the date the base was established, or

(B) during plan years 11 through 20 on the restoration payment schedule, the maximum permitted outstanding balance of the initial restoration amortization base at the end of the tenth plan year, as calculated under paragraph (c)(2)(iii) below, or

(C) during plan years 21 through the end of the restoration payment schedule, the maximum permitted outstanding balance of the initial restoration amortization base at the end of the twentieth plan year, as calculated under paragraph (c)(2)(iii) below.

(iii) *Interim amortization requirements.* The restoration payment schedule must provide for sufficient periodic charges so that the outstanding balance of the initial restoration amortization base at the end of the tenth plan year and at the end of the twentieth plan year of the restoration payment period will not be larger than the outstanding balance that would have remained at the end of the tenth plan year and at the end of the twentieth plan year, respectively, if the initial restoration amortization base had been amortized in level amounts over the restoration payment period at the valuation rate.

(3) *Amendments to the restoration payment schedule.* The order establishing the restoration payment schedule may be amended by the Pension Benefit Guaranty Corporation from time to time with respect to any remaining payments, provided that no amendment may extend the restoration payment period beyond 30 years from the initial post-restoration valuation date, and provided further that the restoration payment schedule, as amended, satisfies the requirements of paragraph (c)(2) of this section.

(4) *Deferral of minimum scheduled annual payment amounts.*

(i) *Authority to grant deferral.* Not later than 2½ months following the end of the plan year, the Pension Benefit Guaranty Corporation may grant a deferral of the charges required in the restoration payment schedule for that plan year if the requirements in paragraph (c)(4)(ii) of this section are satisfied. The Pension Benefit Guaranty Corporation may require the plan sponsor and its controlled group members to provide se-

curity to the plan as a condition to granting a deferral.

(ii) *Determination of business hardship.* Before granting a deferral under this paragraph (c)(4), the Pension Benefit Guaranty Corporation must make a determination that the granting of the deferral is in the best interests of plan participants and the plan termination insurance system, and that the plan sponsor and its controlled group members are unable to make the scheduled restoration payments without experiencing temporary substantial business hardship. In making these determinations, the factors the Pension Benefit Guaranty Corporation shall consider, include, but are not limited to, the following:

(A) Whether the plan sponsor and its controlled group members are operating at an economic loss,

(B) Whether there is substantial unemployment or underemployment in the trades or businesses of the plan sponsor and its controlled group members,

(C) Whether the sales and profits of the industry or industries are depressed or declining, and

(D) Whether it is reasonable to expect that the plan termination insurance system will suffer a greater loss if the plan is terminated than if it is continued as a restored plan.

(iii) *Amount of deferral.* The amount of the deferral for any particular plan year may not exceed the lesser of the amount that would have been required to be contributed under the restoration payment schedule for that year or interest on the outstanding balance of the initial restoration amortization base for that year. An amortization payment for a deferral granted for a prior plan year may not be deferred. No deferral may extend the overall restoration payment period beyond 30 years.

(iv) *Modification of payment schedule.* The restoration payment schedule must be adjusted to reflect any deferral granted for a plan year in the manner prescribed in this paragraph (c). The charge otherwise specified in the schedule is reduced by the amount of any deferral. The charges under the restoration payment schedule for the subsequent plan years are increased by the amounts in paragraph (c)(4)(v) of this section.

(v) *Amortization of deferred amount.* The amount of any deferral granted by the Pension Benefit Guaranty Corporation for any plan year must be amortized in level amounts over five years or such shorter period as may be prescribed by the Pension Benefit Guaranty Corporation, at the valuation rate, beginning with the plan year following the year of the deferral.

(vi) *Number of deferrals permitted.* The Pension Benefit Guaranty Corporation may not grant more than five deferrals of the minimum scheduled payments as required by this section during the restoration payment period and no more than three of these deferrals may be granted during the first ten years of that period.

(d) *Charging the scheduled restoration charges to the funding standard account.* In addition to any other charges and credits prescribed in the normal operation of the funding standard account under section 412, the amount of each charge specified in the restoration payment schedule shall be charged against the funding standard account of the plan for the plan year to which that payment is attributed in the restoration payment schedule.

(e) *Changes in actuarial assumptions.* If changes in actuarial assumptions increase or decrease the charges that would be required to amortize the outstanding balance of the initial restoration amortization base over the remaining years of the restoration payment schedule, the plan must notify the Pension Benefit Guaranty Corporation of the changes so that it may make appropriate changes to the restoration payment schedule.

(f) *Change to restoration method.* A plan that has been restored must use the restoration method until the initial restoration amortization base has been fully amortized. The use of this method does not require prior approval from the Commissioner. A plan using the restoration method must compute the charges and credits to the initial restoration amortization base in accordance with the order of the Pension Benefit Guaranty Corporation and in accordance with this section.

(g) *Deficit reduction contribution.*—(1) *Calculation of deficit reduction contribution.* For any plan using the restoration method, the deficit reduction contribution under section 412(l)(2) is equal to the sum of

(i) the unfunded section 412(l) restoration liability amount, plus

(ii) the unfunded new liability amount.

(2) *Unfunded section 412(l) restoration liability amount.* The unfunded section 412(l) restoration liability amount is the amount necessary to amortize fully the unfunded section 412(l) restoration liability in installments, as prescribed by the Pension Benefit Guaranty Corporation, over not more than 30 years. The annual amount need not be level, but at all times the present value of the future amortization charges under the restoration payment schedule, at the current liability interest rate, must equal the outstanding balance of the unfunded section 412(l) restoration liability and the schedule must provide that at the end of no more than 30 years the entire amount of the unfunded section 412(l) restoration liability base will have been fully amortized. The schedule prescribed for amortization of the unfunded section 412(l) restoration liability must comply with the requirements imposed in paragraph (c) of this section on the restoration payment schedule, except as provided in paragraph (g)(7) of this section and except that the maximum permitted outstanding balance of the unfunded section 412(l) restoration liability at the end of the tenth plan year must not be greater than the outstanding balance of the section 412(l) restoration liability that would have remained at the end of the tenth plan year if the unfunded section 412(l) restoration liability had been amortized in level amounts over the restoration payment period at the current liability interest rate, increased by the current liability interest rate differential as defined under paragraph (g)(7) of this section. The Pension Benefit Guaranty Corporation may amend the amortization schedule for the unfunded section 412(l) restoration liability subject to the limits on amendments to the amortization schedule prescribed for the initial restoration amortization base.

(3) *Establishment of unfunded section 412(l) restoration liability.* In the plan year in which the initial post-restoration valuation date falls, the unfunded section 412(l) restoration liability is equal to the unfunded current liability of the plan.

(4) *Unfunded new liability amount.* In the case of a plan using the restoration method, the unfunded new liability amount is the applicable percentage, as defined in section 412(l)(4)(C), of the unfunded new liability determined under paragraph (g)(5) of this section.

(5) *Unfunded new liability.* The unfunded new liability of a plan using the restoration method is the unfunded current liability of the plan for the plan year less the outstanding balance of the unfunded section 412(l) restoration liability determined under paragraph (g)(3) of this section and less any unpredictable contingent event benefit liabilities (without regard to whether or not the event has occurred).

(6) *Offset of amortization charges.* The charges specified in the restoration payment schedule to amortize the initial restoration amortization base, must be offset against the deficit reduction contribution in paragraph (g)(1) of this section along with any other applicable amounts provided in section 412(l)(1)(A)(ii).

(7) *Interest rate differential.* During the first 10 plan years after the initial post-restoration valuation date, the unfunded section 412(l) restoration liability amount for the plan as determined for purposes of this section must be sufficient to prevent the outstanding balance of the unfunded section 412(l) restoration liability from exceeding the initial amount of the unfunded section 412(l) restoration liability increased by the current liability interest rate differential. The current liability interest rate differential at any point during the first ten years of the restoration payment period is the excess if any of the accumulated interest on the unfunded section 412(l) restoration liability amount computed at the current liability interest rate over the accumulated interest on the unfunded section 412(l) restoration liability amount computed at the the current liability interest rate for the plan year in which the initial post restoration valuation date falls. The current liability interest rate differential is charged to the funding standard account at the end of the tenth plan year, but the Pension Benefit Guaranty Corporation may, as part of the restoration payment schedule order, or a modification to that order, direct that the charging of this amount must be spread over not more than 5 years, beginning with the eleventh plan year.

(h) *Election of the alternative minimum funding standard.* A plan using the restoration method may not elect the alternative minimum funding standard under section 412(g).

(i) *Funding review by the Pension Benefit Guaranty Corporation.* The Pension Benefit Guaranty Corporation must review the funding of any plan using the restoration method at least once in each plan year. As a result of a funding review, the Pension Benefit Guaranty Corporation may amend the restoration payment schedule as provided in paragraph (c)(3) of this section. As part of the funding review, the Executive Director of the PBGC must certify to the Corporation's Board of Directors, and to the Internal Revenue Service, that the Corporation has reviewed the funding of the plan, the financial condition of the plan sponsor and its controlled group members, the payments required under the restoration payment schedule (taking into account the availability of deferrals authorized under paragraph (c)(4) of this section), and any other factor that the Corporation deems relevant, and, based on that review, determines that it is in the best interests of participants and beneficiaries of the plan and the pension insurance program that the restored plan not be reterminated.

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

Fred T. Goldberg, Jr.,
Commissioner of Internal Revenue.

Approved October 15, 1990.

Kenneth W. Gideon,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on October 22, 1990, 8:45 a.m., and published in the issue of the Federal Register for October 23, 1990, 55 F.R. 42704)

Subchapter E.—Accounting Periods and Methods of Accounting

Part I.—Accounting Periods

Section 441.—Period for Computation of Taxable Income

26 CFR 1.441-4T: Taxable year of a personal service corporation (temporary).

The Service will not issue advance rulings or determination letters on whether the principal activity of the taxpayer during the testing period for the taxable year is the performance of personal services within the meaning of section 1.441-4T(d)(1)(iii) of the temporary regulations. See Rev. Proc. 90-40, page 367.

Part II. Methods of Accounting

Subpart A.—Methods of Accounting in General

Section 446.—General Rule For Methods Of Accounting

26 CFR 1.446-1: General rule for methods of accounting.

An administrative procedure is provided whereby certain life insurance companies may expeditiously obtain the consent of the Commissioner to change their method of accounting for ceding commissions to comply with the principles of Rev. Rul. 82-69 and the Supreme Court decision in *Colonial American Life Insurance Co.* See Rev. Proc. 90-36, page 357.

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26 CFR 1.446-1: General rule for methods of accounting.

Procedures are provided under which certain taxpayers are deemed to have obtained the approval of the Commissioner to a change in method of accounting for reporting interest income on short-term loans to customers to the method required by section 1281 of the Code. See Rev. Proc. 90-37, page 361.

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26 CFR 1.446-1: General rule for method of accounting.

For a revenue procedure that describes three alternative methods of accounting for package design costs and provides the exclusive procedure for taxpayers to obtain consent from the Commissioner to change to each of the alternative methods. See Rev. Proc. 90-63, page 664.

Section 448.—Limitation on Use of Cash Method of Accounting

26 CFR 1.448-1T: Limitation on the use of cash receipts and disbursements method of accounting (temporary).

The Service will not issue advance rulings or determination letters on whether 95 percent or more of the time spent by employees of the corporation, serving in their capacity as such,

is devoted to the performance of services within the meaning of section 1.448-1T(e)(4)(i) of the temporary regulations. See Rev. Proc. 90-40, page 367.

Subpart B.—Taxable Year for Which Items of Gross Income Included

Section 460.—Special Rules for Long-term Contracts

26 CFR 1.460-0: Outline of regulations under section 460.

T.D. 8315

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

Look-back Method for Long-term Contracts

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final Income Tax Regulations relating to the look-back method of section 460(b) of the Internal Revenue Code for long-term contract income reported under the percentage of completion method of accounting. The look-back method was enacted by the Tax Reform Act of 1986 (the "1986 Act"), Pub L. No. 99-514 [1986-3 C.B. (Vol. 1) 1], and amended by the Technical and Miscellaneous Revenue Act of 1988 (the "1988 Act"), Pub. L. No. 100-647 [1988-3 C.B. 1], and the Revenue Reconciliation Act of 1989 (the "1989 Act"), Pub. L. No. 101-239 [1990-1 C.B. 210]. The purpose of the look-back method is to compensate for deferral or acceleration of contract income that results from the use of estimated, rather than actual, total contract price and contract costs in applying the percentage of completion method. Taxpayers are required to pay interest if long-term contract income is deferred, and are entitled to receive interest if long-term contract income is accelerated, under the percentage of completion method. These regulations provide the public with guidance as to how interest is computed under the look-back method, and also include simplified methods to reduce the complexity of computing interest under the look-back method.

EFFECTIVE DATE: These regulations are effective with respect to contracts entered into after February 28, 1986; however, §1.460-6(d) (regarding the application of the simplified marginal impact method to domestic contracts of widely held pass-through entities) does not apply to any contract completed in a tax year for which the due date (determined with regard to extensions) of the return is before November 10, 1988.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1980 (44 U.S.C. 3504(h)) under control number 1545-1031. The estimated average annual burden per respondent is 13 hours and 55 minutes. This time estimate is included in the burden of Form 8697.

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

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be directed to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, T:FP, Washington, D.C. 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, D.C. 20503.

Background

On June 12, 1990, the FEDERAL REGISTER published proposed amendments to the Income Tax Regulations (26 CFR 1) relating to the look-back method for long-term contracts under section 460(b) of the Internal Revenue Code. *See* 55 Fed. Reg. 23755 [IA-130-86, page 819, this Bulletin]. Written comments were submitted by seven organizations or individuals and a public hearing was held on August 24, 1990. The preamble to the proposed regulations stated that a Treasury Decision adopting the proposed regulations with respect to the simplified marginal impact method in §1.460-6(d), and the delayed reapplication method in §1.460-6(e), was expected to be issued no later than September 17, 1990.

This document adds new §1.460-6 to Part 1 of Title 26 of the Code of Federal Regulations. These regulations conform the Income Tax Regulations to the requirements of section 460(b) of the Code, as enacted by section 804(a) of the 1986 Act and as amended by sections 1008(c)(2) and 5041(d) of the 1988 Act, and sections 7621(b) and 7811(e) of the 1989 Act.

Explanation of Provisions

IN GENERAL

Section 460(b) of the Code provides that, upon the completion of any long-term contract, the look-back method is applied to amounts reported under the contract using the percentage of completion method. The percentage of completion method requires the use of estimates of total contract price and total contract costs for reporting income in years prior to the year of contract completion. The look-back method is intended to offset the time-value effects of using estimates during the life of a contract that differ from the actual amounts determined upon the completion of the contract.

Under the look-back method, taxpayers are required to pay interest if tax liability is deferred as a result of underestimating the total contract price or overestimating total contract costs. Conversely, taxpayers are entitled to receive interest if tax liability is accelerated as a result of overestimating the total contract price or underestimating total contract costs. The amount of interest a taxpayer is required to pay or is entitled to receive under the look-back method is computed by applying the overpayment rate established by section 6621(a)(1), compounded daily, to the difference between the tax liability reported and the tax liability that would have been reported if the taxpayer had reported income on the basis of the actual contract price and the actual contract costs instead of the estimated contract price and costs (the "hypothetical underpayment" or

"hypothetical overpayment"). Congress provided the look-back method to prevent harsh results that would otherwise be produced by the percentage of completion method if, for example, an overall loss is experienced on a contract. H.R. Rep. No. 426, 99th Cong., 1st Sess. 626 (1985), 1986-3 (Vol. 2) C.B. 626.

The look-back method involves only the computation of interest with respect to hypothetical underpayments or overpayments of tax liability attributable to the use of estimated, rather than actual, contract price and contract costs and, accordingly, has no effect on the amount of tax liability reported for a previous tax year. For example, if the tax rates in effect during the second year of a 2-year contract are lower than tax rates in effect during the first year, and if contract income was accelerated to the first year of the contract because estimated contract costs were lower than actual contract costs, interest is credited to the taxpayer on the hypothetical overpayment of tax for the first year based on the tax rate actually in effect for that year. The taxpayer would not be entitled, however, to a refund representing the amount of tax that would have been saved by applying the lower tax rate in effect for the second tax year to the amount of income accelerated to the first year of the contract. The look-back method, therefore, by design only corrects for timing differences, not permanent differences in tax liability that result from over-or underestimation of contract price and costs. Accordingly, the look-back method does not replace the requirement to properly estimate total contract price and contract costs in reporting income under the percentage of completion method for each year of a contract. For this reason, taxpayers' estimates remain subject to verification upon audit. *See* Notice 89-15, 1989-1 C.B. 634, Q & A 24 through Q & A 27, for rules for estimating the total contract price and total contract costs.

OPERATION OF THE LOOK-BACK METHOD

The amount of interest charged or credited to a taxpayer under the look-back method is generally computed in three steps. The first step is to reapply the percentage of completion method to completed contracts using the actual, rather than estimated, contract price and contract costs. Income from the contract is thus reallocated among prior tax years. The second step is to compare what the tax liability for each affected year would have been if income had been reported as reallocated under the look-back method with the tax liability that was previously determined. If, for any year, there is a difference between these two amounts, the difference is treated as a hypothetical underpayment or overpayment of tax. The third step is to apply the rate of interest on overpayments established by section 6621 of the Code, compounded daily, to the hypothetical underpayment or overpayment of tax, from the year of the underpayment or overpayment until the year the contract was completed. The result is the amount of interest to be paid by or credited to the taxpayer. The regulations illustrate the three steps involved in applying the look-back method.

SIMPLIFIED METHOD

The regulations provide a "simplified marginal impact method," which generally simplifies the application of Step Two of the look-back method by eliminating the requirement to determine what a taxpayer's tax liability would have been if income were reported on the basis of actual contract price and actual contract costs. Under the simplified marginal impact method, a taxpayer reapplies the percentage of completion method, using the actual, rather than estimated, total contract price and total contract costs, to all contracts that are completed or adjusted in a particular year. The taxpayer then computes the aggregate marginal increase or decrease in income, from those contracts only, for each tax year affected by those contracts. This increase or decrease in income for each affected tax year is generally deemed to give rise to a hypothetical overpayment or underpayment of tax determined at the highest statutory tax rate in effect for that year under section 1, in the case of an individual, and section 11, in the case of a corporation (currently 28 percent and 34 percent, respectively).

In accordance with section 460(b)(4) of the Code, as added by section 5041(d) of the 1988 Act, the simplified marginal impact method must be used with respect to income from domestic long-term contracts of a widely held partnership, S corporation, or trust. With respect to this required application, the simplified marginal impact method is applied at the entity rather than at the owner level. In addition, hypothetical overpayments or underpayments of tax liability are deemed to arise at the highest statutory tax rate in effect for the majority of the entity's owners without regard to the actual tax rates or tax attributes of each of the owners.

The regulations also make the simplified marginal impact method available in the case of contracts that are not subject to the statutory simplified method. This extension results from a concern about the administrative burdens that would be imposed on taxpayers in the absence of this simplified method. Considerable complexity arises because a taxpayer otherwise must fully recompute tax liability for several years at a time and, in addition, recompute tax liability multiple times for the same year when the look-back method is applied to a year for which the tax liability has previously been recomputed under the look-back method. Additional complexity results because the time period for determining the amount of interest charged or credited to a taxpayer must be adjusted when the look-back method affects tax attributes such as net operating loss or credit carryovers and carrybacks that change the time period that a hypothetical underpayment or overpayment of tax was actually available to the taxpayer or the government.

The simplified marginal impact method simplifies the computation of hypothetical overpayments and underpayments and, in some cases, the time period for charging or crediting interest. Therefore, the regulations also permit C corporations, owners of widely held pass-through entities with respect to foreign contracts, owners of closely held pass-through entities, and sole proprietors to elect the simplified marginal impact method. The simplified marginal impact method is made available to these taxpayers under the authority of section 460(h), which provides that the Secretary shall prescribe such regulations as

may be necessary or appropriate to carry out the purposes of section 460.

A taxpayer that either is required to or elects to use the simplified marginal impact method must apply the method to all of the taxpayer's completed long-term contracts. If, however, the amount of income originally reported with respect to a long-term contract for any redetermination year exceeds the amount of income reallocated under the look-back method with respect to that contract for that year (*i.e.*, using actual contract price and contract costs) by the lesser of $1,000,000 or 20 percent of the amount of income reallocated under the look-back method with respect to that contract for that year, the regulations provide that the Commissioner may require a taxpayer that uses the simplified marginal impact method to apply the look-back method to that contract as if the simplified method did not apply. In determining whether to exercise this authority, the district director may take into account whether the taxpayer overreported income for a purpose of receiving interest on a hypothetical overpayment determined at the highest statutory tax rate. The district director also may take into account whether the taxpayer underreported income for the year in question with respect to other contracts. Moreover, if the Form 8697 is examined for any completion year and a year in which income was overreported is open under the statute of limitations, an adjustment to tax, rather than to look-back interest, will be made if the taxpayer did not properly estimate contract price and contract costs and the taxpayer would otherwise be permitted to obtain a permanent tax benefit.

To prevent the running of interest in a taxpayer's favor on amounts in excess of the taxpayer's actual tax liability for any year, a hypothetical overpayment in the case of a taxpayer electing the simplified marginal impact method is limited to the taxpayer's actual tax liability for the year, taking into account net operating losses carried to that year. Representatives of the construction industry commented that this tax liability ceiling could make the simplified marginal impact method impractical for contractors who experience wide fluctuations in their taxable income from year to year. The final regulations, however, retain the tax liability ceiling as a necessary limitation on hypothetical overpayments to prevent those taxpayers who were excluded from the statutory simplified method from receiving an unintended windfall by use of the method. Moreover, to the extent that the ceiling is based on a taxpayer's overall tax liability, the profitability of some activities will either partially or fully offset the negative impact on the ceiling from less profitable activities.

The tax liability ceiling does not apply in the case of the required use of the simplified marginal impact method. In this context, application of the ceiling would be impractical and would defeat the purpose of the simplified marginal impact method because hypothetical overpayments are determined solely at the pass-through entity level. Several commentators requested that closely held pass-through entities electing to use the simplified marginal impact method also be permitted to apply the method at the entity level to further reduce complexity arising from the owner level application. To the extent that a pass-through entity is closely held, each owner's share of income from a contract, and thus the potential for distortion from an entity-level application of the simplified marginal impact method, is likely to increase and yet could not be practicably made subject to the tax liability ceiling. Consequently, the regulations do not permit application of the elective use of the simplified marginal impact method at the entity level.

FORM 8697

The amount of interest due or to be refunded as a result of applying the look-back method is computed and reported on Form 8697 (Interest Computation Under the Look-back Method for Completed Long-term Contracts) for any tax year in which one or more long-term contracts are completed, or in which the contract price or contract costs are adjusted for one or more long-term contracts that were previously completed. Form 8697 is due no later than the due date (including extensions) of the tax return for the year of completion or adjustment. Form 8697 is filed with the same Internal Revenue Service Center with which a taxpayer's income tax return is filed.

In general each taxpayer that reports income from a long-term contract, or adjusts amounts attributable to a completed long-term contract, is required to file Form 8697 to apply the look-back method. In the case of a pass-through entity, such as a partnership or an S corporation, however, the regulations clarify that the owners or shareholders generally are required to file Form 8697 and are liable for, or entitled to receive, interest with respect to their distributive shares of income from a contract. However, widely held pass-through entities are required to apply the look-back method at the entity level with respect to income from domestic contracts.

MID-CONTRACT CHANGE IN TAXPAYER

The proposed regulations provided rules for applying the look-back method when there is a mid-contract change in the taxpayer reporting income from a contract. As proposed, these rules require the completing taxpayer to apply the look-back method with respect to all years of the contract, including tax years of a predecessor taxpayer. Several commentators have indicated that taxable sales should be excluded from this rule and treated as a constructive completion of the contract, consistent with the prior law treatment of taxable sales of a long-term contract. In part, the proposed regulations reflected the concern that a constructive completion would require the look-back method to be applied before actual completion of the contract and on the basis of estimates or, in the case of a sale of an entire business, on the basis of an allocation of the purchase price of the business, thereby producing results that may conflict with the purpose of the look-back method. In response, these commentators have stated that this concern is adequately alleviated by the tension in the taxable sale context between the seller's motivation to underallocate the purchase price to the contract (to minimize look-back interest) and the purchaser's motivation to overallocate the purchase price to the contract (to minimize the allocation to goodwill). In these final regulations, the treatment of mid-contract changes in the taxpayer is reserved for further consideration.

SCOPE OF LOOK-BACK METHOD

The regulations describe the scope of the look-back method, which generally includes all long-term contracts entered into after February 28, 1986, that are reported under the percentage of completion method or the percentage of completion-capitalized cost method. In the case of any long-term contract reported under the percentage of completion-capitalized cost method, interest is charged or credited to the taxpayer with respect to the percentage (40, 70, or 90, whichever applies) of the contract reported under the percentage of completion method.

Section 56(a)(3) provides that, in determining the amount of the alternative minimum taxable income for any tax year, the percentage of completion method of accounting (as modified by section 460(b)) is used in lieu of the method of accounting that is used for purposes of computing the regular tax. The regulations clarify that the look-back method accordingly applies to alternative minimum taxable income computed using the percentage of completion method as well as to regular taxable income.

DE MINIMIS EXCEPTION

The 1988 Act amended section 460(b) to exempt from the look-back method certain long-term contracts that are not otherwise exempt from the required use of the percentage of completion method (or the percentage of completion-capitalized cost method). Under section 460(b)(3)(B), the look-back method does not apply to any contract completed within 2 years if the gross contract price does not exceed the lesser of $1,000,000 or 1 percent of the taxpayer's average annual gross receipts. The regulations clarify that this de minimis exception is mandatory, even if income from the contract was accelerated as a result of the use of inaccurate estimates of contract price and contract costs, so that the taxpayer would otherwise be entitled to receive interest on the resulting hypothetical overpayment of tax.

If the de minimis exception applies to a contract for regular taxable income, then the exception also applies for alternative minimum taxable income. Because of the adjustments required for computing alternative minimum taxable income, a taxpayer's gross receipts for alternative minimum tax purposes may differ from gross receipts for regular income tax purposes. Thus, if the criteria for meeting the de minimis exception were applied separately for alternative minimum tax purposes using alternative minimum tax gross receipts, a difference between alternative minimum tax gross receipts and regular tax gross receipts could cause a contract to qualify for the de minimis exception for regular tax purposes, but not for alternative minimum tax purposes, or vice versa. To prevent this result, the regulations provide that gross receipts are determined for purposes of section 460(b)(3)(B) by reference only to regular taxable income.

The de minimis exception was enacted in 1988, effective for qualifying contracts entered into after February 28, 1986, and, therefore, may apply to contracts for which a taxpayer has already applied the look-back method. Since the de minimis exception was enacted retroactively, taxpayers are permitted to file an amended Form 8697 to reverse the application of the look-back method to qualifying contracts.

TREATMENT OF LOOK-BACK INTEREST

In accordance with section 460(b)(1), interest required to be paid by a taxpayer is treated as an increase in tax for purposes of subtitle F of the Code (other than the estimated tax penalty); however, interest received by a taxpayer is not treated as a reduction in tax liability. Under the regulations, the determination of whether interest computed under the look-back method is treated as tax for this purpose is determined on a "net" basis for each filing year. Thus, if a taxpayer computes for the current filing year both hypothetical overpayments and hypothetical underpayments for prior years, the taxpayer has an increase in tax only if the interest computed on the underpayments for all those prior years exceeds the interest computed on the overpayments for all those prior years.

For purposes of determining taxable income under subtitle A of the Code, however, any amount of interest required to be paid by the taxpayer under the look-back method is treated as interest expense. Consistent with the proposed regulations, the final regulations provide that this interest expense is treated as interest expense arising from an underpayment of income tax. Thus, any look-back interest required to be paid in the case of an individual (including an individual owner of any pass-through entity) is treated as personal interest in accordance with §1.163-9T(b)(2), even if that interest is attributable to long-term contract income of a trade or business.

Several commentators were of the view that the disallowance of a deduction for look-back interest is unfair to individual contractors that are not taxed as corporations. According to these commentators, look-back interest expense should not be subject to §1.163-9T(b)(2) because it results from hypothetical, not actual tax liabilities. However, by its terms, §1.163-9T(b)(2) generally applies to all interest relating to tax liabilities, including certain deferred tax liabilities that do not result from an error in the computation of tax. Further, in the legislative history underlying section 453A, which requires interest to be paid on deferred taxes arising from installment sales, Congress clarified that personal interest included interest relating to deferred taxes as well as actual tax deficiences. *See* H.R. Conf. Rep. No. 495, 100th Cong., 1st Sess. 930 (1987), 1987-3 C.B. 930. Interest expense required to be paid under the look-back method relates to the deferral of tax liability and, therefore, is within the scope of §1.163-9T(b)(2).

With respect to interest that is refunded under the look-back method, the regulations similarly provide that, for purposes of subtitle A, this amount is taxable interest income. The regulations also clarify that interest computed under the look-back method at the entity level under the simplified marginal impact method is allocated among the owners (or beneficiaries) in the same manner that interest income and interest expense are allocated to owners (or beneficiaries) and subject to the requirements of section 704 and any other applicable rules.

TREATMENT OF CHANGE ORDERS

The regulations clarify that the look-back method is applied to all amounts attributable to a single long-term contract. Section 460(f), which defines the term "long-term contract," authorizes the Secretary to prescribe regulations that require (1) two or more contracts that are interdependent (by reason of pricing or otherwise) to be treated as a single contract, and (2) a single contract that is properly severed to be treated as multiple contracts. Notice 89-15, Q & A 37 and 38, provides that the rules for severing and aggregating contracts in §1.451-3(e) determine what constitutes a single long-term contract for purposes of reporting income and allocating costs to long-term contracts under section 460. These rules apply for determining whether a change order or other similar agreement is treated as a separate contract or as part of the original contract. *Cf.* Notice 89-15, Q & A 11. Because the look-back method involves a hypothetical reapplication of the percentage of completion method (as modified by section 460), the same rules apply in determining what constitutes a single long-term contract for purposes of the look-back method. Accordingly, under the regulations, if a contract change order does not constitute a separate contract under the rules for severing and aggregating contracts, the revenue and expenses attributable to the change order are allocable under the look-back method to all tax years of the underlying contract.

TIME AT WHICH LOOK-BACK METHOD IS APPLIED

Section 460(b)(1)(B) of the Code requires the look-back method to be applied upon completion of a long-term contract, and then to be reapplied in any tax year in which there are post-completion adjustments to the contract price or contract costs.

COMPLETION

The regulations define the term "completion" for this purpose to mean final completion and acceptance within the meaning of §1.451-3(b)(2). With respect to any long-term contract, therefore, the look-back method generally is applied no later than the year in which the subject matter of the contract has been delivered and is available for use by the customer, even if the taxpayer expects to incur additional contract costs in a year subsequent to the completion year.

Although §1.451-3(b)(2) determines the "time" for completion, the provisions in §1.451-3(b)(2), and §1.451-3(d) (which separate contract revenues and contract costs from a long-term contract in certain circumstances, such as in the case of a dispute or contract term relating to contingent compensation) do not apply for purposes of the look-back method. These provisions, which are designed to prevent inappropriate deferral of income and expenses by taxpayers using the completed contract method, are not relevant under the percentage of completion method. Moreover, these provisions are inconsistent with the requirement of section 460(b)(1)(B) to reapply the look-back method to amounts taken into account after completion, since their application would otherwise permit income from a long-term contract to be accounted for under a method of accounting that is not subject to the look-back method.

In addition, section 460(b)(1) requires any portion of the contract price not previously included in income to be included in income for the year immediately following the completion year, even if the taxpayer expects to incur additional contract costs in a year subsequent to the year immediately following the completion year. This rule does not apply for purposes of the look-back method, however. Thus, to the extent that a taxpayer incurs additional costs after the year immediately following the year of completion, the taxpayer will be entitled to receive interest under the look-back method to compensate for any acceleration of income that resulted from this requirement.

POST-COMPLETION REAPPLICATIONS

The regulations clarify that, after completion of a contract, section 460(b) generally requires the look-back method to be reapplied in any subsequent tax year in which additional contract revenues or contract costs are taken into account, or in which amounts previously taken into account as income or deductions are adjusted for any reason. In reapplying the look-back method when any amount is taken into account after completion, including when any amount of revenue that is taken into account in the year immediately following the year of completion by reason of section 460(b)(1), the regulations provide that only costs actually incurred as of the reapplication year are included in the denominator of the percentage of completion ratio. Section 460(b)(2) provides that these amounts may be taken into account, for purposes of reapplying the look-back method, at a value that is discounted from the time the amount is taken into account to the time of completion. The regulations clarify that amounts of contract revenue that are properly taken into account under the percentage of completion method at the time of, or prior to, contract completion are not discounted under this rule, even if received after contract completion. Although section 460(b)(2) permits taxpayers to discount adjustments on a contract-by-contract basis, if a taxpayer discounts any adjustments relating to a particular contract, the taxpayer must discount all contract price or contract cost adjustments arising from the contract. *See* H.R. Rep. No. 247, 101st Cong., 1st Sess. 1411 (1989), which provides that adjustments to costs are to be treated in the same manner as adjustments to price.

The regulations provide a "delayed reapplication method" which, if elected, may reduce the number of times the look-back method is required to be reapplied for post-completion adjustments to a taxpayer's long-term contracts. Under the delayed reapplication method, taxpayers will be permitted to wait until the cumulative amount of adjustments to either the contract price or contract costs reaches a threshold of 10 percent of these amounts prior to adjustment or, if lesser, $1,000,000. To insure that all adjustments to the contract price are ultimately taken into account under the look-back method, a reapplication of the look-back method must be made (without regard to the thresholds) 5 years after the most recent application of the look-back method, or, if earlier, the year in which the taxpayer reasonably believes the contract is finally settled and closed.

Several commentators suggested that the look-back method should not have to be reapplied at any time after completion if the cumulative adjustments to net profit are de minimis. Because section 460(b) does not permit amounts attributable to a contract to be permanently forgiven from the application of the look-back method, the final regulations do not adopt this suggestion.

The regulations also do not reflect the comment that taxpayers be permitted to apply the look-back method prior to completion of a contract. Such a rule would unduly increase the complexity of the look-back method and, to the extent the regulations cannot require an early application, would be invoked selectively by taxpayers.

Special Analyses

It has been determined that these regulations are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis 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 final Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking for these regulations was submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

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Adoption of amendments to the regulations

The following amendments to 26 CFR Parts 1 and 602 are adopted:

PART 1—[AMENDED]

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

Authority: Sec. 7805, 68A Stat. 917; 26 U.S.C. 7805. ***Section 1.460-6 is also issued under 26 U.S.C. 460(h).

Par. 2. New §§1.460-0 and 1.460-6 are added under the heading "Taxable Year for Which Items of Gross Income Included" to read as follows:

§1.460-0. Outline of regulations under section 460.

This section lists the paragraphs contained in §1.460-1 through 1.460-8.

§1.460-1. Accounting for long-term contracts in general. [Reserved.]

§1.460-2. Definition of long-term contract. [Reserved.]

§1.460-3. Percentage of completion method. [Reserved.]

§1.460-4. Percentage of completion-capitalized cost method. [Reserved.]

§1.460-5. Cost allocation rules. [Reserved.]

§1.460-6. Look-back method.

(a) In general.

(1) Introduction.

(2) Overview.

(b) Scope of look-back method.

(1) In general.

(2) Exceptions from section 460.

(3) De minimis exception.

(4) Alternative minimum tax.

(5) Effective date.

(c) Operation of the look-back method.

(1) Overview.

(i) In general.

(ii) Post-completion revenue and expenses.

(A) In general.

(B) Completion.

(C) Discounting of contract price and contract cost adjustments subsequent to completion; election not to discount.

(*1*) General rule.

(*2*) Election not to discount.

(*3*) Year-end discounting convention.

(D) Revenue acceleration rule.

(2) Look-back Step One.

(i) Hypothetical reallocation of income among prior tax years.

(ii) Treatment of estimated future costs in year of completion.

(iii) Interim reestimates not considered.

(iv) Tax years in which income is affected.

(v) Costs incurred prior to contract execution; 10-percent method.

(A) General rule.

(B) Example.

(vi) Amount treated as contract price.

(A) General rule.

(B) Contingencies.

(C) Change orders.

(3) Look-back Step Two: Computation of hypothetical overpayment or underpayment of tax.

(i) In general.

(ii) Redetermination of tax liability.

(iii) Hypothetical underpayment or overpayment.

(iv) Cumulative determination of tax liability.

(v) Years affected by look-back only.

(vi) Definition of tax liability.

(4) Look-back Step Three: Calculation of interest on underpayment or overpayment.

(i) In general.

(ii) Changes in the amount of a loss or credit carryback or carryover.

(iii) Changes in the amount of tax liability that generated a subsequent refund.

(iv) Additional interest due on interest only after tax liability due.

(d) Simplified marginal impact method.

(1) Introduction.

(2) Operation.

(i) In general.

(ii) Applicable tax rate.

(iii) Overpayment ceiling.

(iv) Example.

(3) Anti-abuse rule.

(4) Application.

(i) Required use by certain pass-through entities.

(A) General rule.

(B) Closely held.

(C) Examples.

(D) Domestic contracts.

(1) General rule.

(2) Portion of contract income sourced.

(E) Application to foreign contracts.

(F) Effective date.

(ii) Elective use.

(A) General rule.

(B) Election requirements.

(C) Consolidated group consistency rule.

(e) Delayed reapplication method.

(1) In general.

(2) Time and manner of making election.

(3) Examples.

(f) Look-back reporting.
(1) Procedure.
(2) Treatment of interest on return.
(i) General rule.
(ii) Timing of look-back interest.
(g) Mid-contract change in taxpayer. [Reserved.]
(h) Examples.
(1) Overview.
(2) Step One.
(3) Step Two.
(4) Post-completion adjustments.
(5) Alternative minimum tax.
(6) Credit carryovers.
(7) Net operating losses.
(8) Alternative minimum tax credit.
(9) Period for interest.
§1.460-7. Exempt long-term contracts. [Reserved.]
§1.460-8. Changes in method of accounting. [Reserved.]

§1.460-1. *Accounting for long-term contracts in general. [Reserved.]*
§1.460-2. *Definition of long-term contract. [Reserved.]*
§1.460-3. *Percentage of completion method. [Reserved.]*
§1.460-4. *Percentage of completion-capitalized cost method. [Reserved.]*
§1.460-5. *Cost allocation rules. [Reserved.]*

§1.460-6. *Look-back method.*

(a) *In general*—(1) *Introduction.* With respect to income from any long-term contract reported under the percentage of completion method, a taxpayer is required to pay or is entitled to receive interest under section 460(b) on the amount of tax liability that is deferred or accelerated as a result of overestimating or underestimating total contract price or contract costs. Under this look-back method, taxpayers are required to pay interest for any deferral of tax liability resulting from the underestimation of the total contract price or the overestimation of total contract costs. Conversely, if the total contract price is overestimated or the total contract costs are underestimated, taxpayers are entitled to receive interest for any resulting acceleration of tax liability. The computation of the amount of deferred or accelerated tax liability under the look-back method is hypothetical; application of the look-back method does not result in an adjustment to the taxpayer's tax liability as originally reported, as reported on an amended return, or as adjusted on examination. Thus, the look-back method does not correct for differences in tax liability that result from over- or underestimation of contract price and costs and that are permanent because, for example, tax rates change during the term of the contract.

(2) *Overview.* Paragraph (b) explains which situations require application of the look-back method to income from a long-term contract. Paragraph (c) explains the operation of the three computational steps for applying the look-back method. Paragraph (d) provides guidance concerning the simplified marginal impact method. Paragraph (e) provides an elective method to minimize the number of times the look-back method must be reapplied to a single long-term contract. Paragraph (f) describes the reporting requirements for the look-back method and the tax treatment of look-back interest. Paragraph (g) provides rules for applying the look-back method when there is a transaction that changes the taxpayer that reports income from a long-term contract prior to the completion of a contract. Paragraph (h) provides examples illustrating the three computational steps for applying the look-back method.

(b) *Scope of look-back method*—(1) *In general.* The look-back method applies to any income from a long-term contract within the meaning of section 460(f) that is required to be reported under the percentage of completion method (as modified by section 460) for regular income tax purposes or for alternative minimum tax purposes. If a taxpayer uses the percentage of completion-capitalized cost method for long-term contracts, the look-back method applies for regular tax purposes only to the portion (40, 70, or 90 percent, whichever applies) of the income from the contract that is reported under the percentage of completion method. The requirements of section 460 also apply to income and expenses attributable to activities that benefit any long-term contract entered into by a party related to the taxpayer within the meaning of section 707(b) or 267(b), determined without regard to section 267(f)(1)(A) and by substituting "80 percent" for "50 percent" with regard to the ownership of the stock of a C corporation. Therefore, to the extent that the percentage of completion method is required to be used with respect to income and expenses that are attributable to activities that benefit a related party's long-term contract, the look-back method also applies to these amounts, even if those activities are not performed under a contract entered into directly by the taxpayer.

(2) *Exceptions from section 460.* The look-back method generally does not apply to the regular taxable income from any long-term construction contract within the meaning of section 460(e)(4) that

(i) is a home construction contract within the meaning of section 460(e)(1)(A), or

(ii) is not a home construction contract but is estimated to be completed within a 2-year period by a taxpayer whose average annual gross receipts for the 3 tax years preceding the tax year the contract is entered into do not exceed $10,000,000 (as provided in section 460(e)(1)(B)). These contracts are not subject to the look-back method for regular tax purposes, even if the taxpayer uses a version of the percentage of completion method permitted under §1.451-3, unless the taxpayer has properly changed its method of accounting for these contracts to the percentage of completion method as modified by section 460(b). The look-back method, however, applies to the alternative minimum taxable income from a contract of this type, unless it is exempt from the required use of the percentage of completion method under section 56(a)(3).

(3) *De minimis exception.* Notwithstanding that the percentage of completion method is otherwise required to be used, the look-back method does not apply to any long-term contract that (i) is completed within 2 years of the contract commencement date, and (ii) has a gross contract price (as of the completion of the contract) that does not exceed the lesser of $1,000,000 or 1 percent of the average annual gross receipts of the taxpayer for the 3 tax years preceding the tax year in which the contract is completed. This de minimis exception is mandatory and, therefore, precludes application of the look-back method to any contract that meets the requirements of the

exception. The de minimis exception applies for purposes of computing both regular taxable income and alternative minimum taxable income. Solely for this purpose, the determination of whether a long-term contract meets the gross receipts test for both alternative minimum tax and regular tax purposes is made based only on the taxpayer's regular taxable income.

(4) *Alternative minimum tax.* For purposes of computing alternative minimum taxable income, section 56(a)(3) generally requires long-term contracts within the meaning of section 460(f) (generally without regard to the exceptions in section 460(e)) to be accounted for using only the percentage of completion method as defined in section 460(b), including the look-back method of section 460(b), with respect to tax years beginning after December 31, 1986. However, section 56(a)(3) (and thus the look-back method) does not apply to any long-term contract entered into after June 20, 1988, and before the beginning of the first tax year that begins after September 30, 1990, that meets the conditions of both section 460(e)(1)(A) and clauses (i) and (ii) of section 460(e)(1)(B), and does not apply to any long-term contract entered into in a tax year that begins after September 30, 1990, that meets the conditions of section 460(e)(1)(A). A taxpayer that applies the percentage of completion method (and thus the look-back method) to income from a long-term contract only for purposes of determining alternative minimum taxable income, and not regular taxable income, must apply the look-back method to the alternative minimum taxable income in the year of contract completion and other filing years whether or not the taxpayer was liable for the alternative minimum tax for the filing year or for any prior year. Interest is computed under the look-back method to the extent that the taxpayer's total tax liability (including the alternative minimum tax liability) would have differed if the percentage of completion method had been applied using actual, rather than estimated, contract price and contract costs.

(5) *Effective date.* The look-back method, including the de minimis exception, applies to long-term contracts entered into after February 28, 1986. With respect to activities that are subject to section 460 solely because they benefit a long-term contract of a related party, the look-back method generally applies only if the related party's long-term contract was entered into after June 20, 1988, unless a principal purpose of the related-party arrangement is to avoid the requirements of section 460.

(c) *Operation of the look-back method*—(1) *Overview*—(i) *In general.* The amount of interest charged or credited to a taxpayer under the look-back method is computed in three steps. This paragraph (c) describes the three steps for applying the look-back method. These steps are illustrated by the examples in paragraph (h). The first step is to hypothetically reapply the percentage of completion method to all long-term contracts that are completed or adjusted in the current year (the "filing year"), using the actual, rather than estimated, total contract price and contract costs. Based on this reapplication, the taxpayer determines the amount of taxable income (and alternative minimum taxable income) that would have been reported for each year prior to the filing year that is affected by contracts completed or adjusted in the filing year if the actual, rather than estimated, total contract price and costs had been used in applying the percentage of completion method to these contracts, and to any other contracts completed or adjusted in a year preceding the filing year. If the percentage of completion method only applies to alternative minimum taxable income for contracts completed or adjusted in the filing year, only alternative minimum taxable income is recomputed in the first step. The second step is to compare what the tax liability would have been under the percentage of completion method (as reapplied in the first step) for each tax year for which the tax liability is affected by income from contracts completed or adjusted in the filing year (a "redetermination year") with the most recent determination of tax liability for that year to produce a hypothetical underpayment or overpayment of tax. The third step is to apply the rate of interest on overpayments designated under section 6621 of the Code, compounded daily, to the hypothetical underpayment or overpayment of tax for each redetermination year to compute interest that runs, generally, from the due date (determined without regard to extensions) of the return for the redetermination year to the due date (determined without regard to extensions) of the return for the filing year. The net amount of interest computed under the third step is paid by or credited to the taxpayer for the filing year. Paragraph (d) provides a simplified marginal impact method that simplifies the second step—the computation of hypothetical underpayments or overpayments of tax liability for redetermination years—and, in some cases, the third step—the determination of the time period for computing interest.

(ii) *Post-completion revenue and expenses*—(A) *In general.* The look-back method is applied upon the completion of any long-term contract and (unless the taxpayer elects the delayed reapplication method of this section) is applied in any subsequent tax year for which there are taken into account any increases or decreases in either total contract price or total contract costs allocable to the contract under section 460(c) ("allocable contract costs") to the extent those increases or decreases were not previously taken into account under the percentage of completion method. Any year in which the look-back method must be reapplied is treated as a filing year. See Example (3) of paragraph (h)(4) for an illustration of how the look-back method is applied to post-completion adjustments.

(B) *Completion.* A contract is considered to be completed for purposes of the look-back method no later than the year in which final completion and acceptance within the meaning of §1.451-3(b)(2) have occurred. Accordingly, determination of the completion year for any long-term contract is based on an analysis of all the relevant facts and circumstances, including the manner in which the parties to the contract deal with each other and with the subject matter of the contract and the nature of any work or costs remaining to be performed or incurred on the contract. Therefore, the first application of the look-back method must occur no later than the tax year in which the subject matter of the contract has been delivered and is available for use

by the customer, even if the taxpayer reasonably expects at that time to incur additional allocable contract costs.

(C) *Discounting of contract price and contract cost adjustments subsequent to completion; election not to discount—(1) General rule.* The amount of any post-completion adjustment to the total contract price or contract costs is discounted, solely for purposes of applying the look-back method, from its value at the time the amount is taken into account in computing taxable income to its value at the completion of the contract. The discount rate for this purpose is the Federal mid-term rate under section 1274(d) in effect at the time the amount is properly taken into account. For purposes of applying the look-back method for the completion year, no amounts are discounted, even if they are received after the completion year.

(2) *Election not to discount.* Notwithstanding the general requirement to discount post-completion adjustments, a taxpayer may elect not to discount contract price and contract cost adjustments with respect to any contract. The election not to discount is to be made on a contract-by-contract basis and is binding with respect to all post-completion adjustments that arise with respect to a contract for which an election has been made. An election not to discount with respect to any contract is made by stating that an election is being made on the taxpayer's timely filed federal income tax return (determined with regard to extensions) for the first tax year after completion in which the taxpayer takes into account (*i.e.*, includes in income or deducts) any adjustment to the contract price or contract costs. See §5h.6.

(3) *Year-end discounting convention.* In the absence of an election not to discount, any revisions to the contract price and contract costs must be discounted to their value as of the completion of the contract in reapplying the look-back method. For this purpose, the period of discounting is the period between the completion date of the contract and the date that any adjustment is taken into account in computing taxable income. Although taxpayers may use the period between the months in which these two events actually occur, in many cases, these dates may not be readily identifiable. Therefore, for administrative convenience, taxpayers are permitted to use the period between the end of the tax years in which these events occur as the period of discounting provided that the convention is used consistently with respect to all post-completion adjustments for all contracts of the taxpayer the adjustments to which are discounted. In that case, the taxpayer must use as the discount rate the Federal mid-term rate under section 1274(d) as of the end of the tax year in which any revision is taken into account in computing taxable income.

(D) *Revenue acceleration rule.* Section 460(b)(1) imposes a special rule that requires a taxpayer to include in gross income, for the tax year immediately following the year of completion, any previously unreported portion of the total contract price (including amounts that the taxpayer expects to receive in the future) determined as of that year, even if the percentage of completion ratio is less than 100 percent because the taxpayer expects to incur additional allocable contract costs in a later year. At the time any remaining portion of the contract price is includible in income under this rule, no offset against this income is permitted for estimated future contract costs. To achieve the requirement to report all remaining contract revenue without regard to additional estimated costs, a taxpayer must include only costs actually incurred through the end of the tax year in the denominator of the percentage of completion ratio in applying the percentage of completion method for any tax years after the year of completion. The look-back method also must be reapplied for the year immediately following the year of completion if any portion of the contract price is includible in income in that year by reason of section 460(b)(1). For purposes of reapplying the look-back method as a result of this inclusion in income, the taxpayer must only include in the denominator of the percentage of completion ratio the actual contract costs incurred as of the end of the year, even if the taxpayer reasonably expects to incur additional allocable contract costs. To the extent that costs are incurred in a subsequent tax year, the look-back method is reapplied in that year (or a later year if the delayed reapplication method is used), and the taxpayer is entitled to receive interest for the post-completion adjustment to contract costs. Because this reapplication occurs subsequent to the completion year, only the cumulative costs incurred as of the end of the reapplication year are includible in the denominator of the percentage of completion ratio.

(2) *Look-back Step One*—(i) *Hypothetical reallocation of income among prior tax years.* For each filing year, a taxpayer must allocate total contract income among prior tax years, by hypothetically applying the percentage of completion method to all contracts that are completed or adjusted in the filing year using the rules of this paragraph (c)(2). The taxpayer must reallocate income from those contracts among all years preceding the filing year that are affected by those contracts using the total contract price and contract costs, as determined as of the end of the filing year ("actual contract price and costs"), rather than the estimated contract price and contract costs. The taxpayer then must determine the amount of taxable income and the amount of alternative minimum taxable income that would have been reported for each affected tax year preceding the filing year if the percentage of completion method had been applied on the basis of actual contract price and contract costs in reporting income from all contracts completed or adjusted in the filing year and in any preceding year. If the percentage of completion method only applies to alternative minimum taxable income from the contract, only alternative minimum taxable income is recomputed in the first step. For purposes of reallocating income (and costs if the 10-percent year changes for a taxpayer using the 10-percent method of section 460(b)(5)) under the look-back method, the method of computing the percentage of completion ratio is the same method used to report income from the contract on the taxpayer's return. (Thus, an election to use the 10-percent method or the simplified cost-to-cost method is taken into account). See Example (1) of paragraph (h)(2) for an illustration of Step One.

(ii) *Treatment of estimated future costs in year of completion.* If a

taxpayer reasonably expects to incur additional allocable contract costs in a tax year subsequent to the year in which the contract is completed, the taxpayer includes the actual costs incurred as of the end of the completion year plus the additional allocable contract costs that are reasonably expected to be incurred (to the extent includible under the taxpayer's percentage of completion method) in the denominator of the percentage of completion ratio. The completion year is the only filing year for which the taxpayer may include additional estimated costs in the denominator of the percentage of completion ratio in applying the look-back method. If the look-back method is reapplied in any year after the completion year, only the cumulative costs incurred as of the end of the year of reapplication are includible in the denominator of the percentage of completion ratio in reapplying the look-back method.

(iii) *Interim reestimates not considered.* The look-back method cannot be applied to a contract before it is completed. Accordingly, for purposes of applying Step One, the actual total contract price and contract costs are substituted for the previous estimates of total contract price and contract costs only with respect to contracts that have been completed in the filing year and in a tax year preceding the filing year. No adjustments are made under Step One for contracts that have not been completed prior to the end of the current filing year, even if, as of the end of this year, the estimated total contract price or contract costs for these uncompleted contracts is different from the estimated amount that was used during any tax year for which taxable income is recomputed with respect to completed contracts under the look-back method for the current filing year.

(iv) *Tax years in which income is affected.* In general, because income under the percentage of completion method is generally reported as costs are incurred, the taxable income and alternative minimum taxable income are recomputed only for each year in which allocable contract costs were incurred. However, there will be exceptions to this general rule. For example, a taxpayer may be required to cumulatively adjust the income from a contract in a year in which no allocable contract costs are incurred if the estimated total contract price or contract costs was revised in that year. However, in applying the look-back method, no contract income is allocated to that year. Thus, there may be a difference between the amount of contract income originally reported for that year and the amount of contract income as reallocated. Similarly, because of the revenue acceleration rule of section 460(b)(1), income may be reported in the year immediately following the completion year even though no costs were incurred during that year and, in applying the look-back method in that year or another year, if additional costs are incurred or the contract price is adjusted in a later year, no income is allocated to the year immediately following the completion year.

(v) *Costs incurred prior to contract execution; 10-percent method*—(A) *General rule.* There are two situations in which allocable contract costs may be incurred without causing contract income to be reported under the percentage of completion method. First, allocable contract costs that are incurred in tax years prior to the tax year the contract is entered into are deductible in the tax year the contract is entered into, and no contract income is required to be reported in any of these prior tax years. The look-back method does not require allocation of contract income to tax years before the contract was entered into. Costs incurred prior to the year a contract is entered into are similarly first taken into account in the numerator of the percentage of completion ratio in the year the contract is entered into. Second, under the elective 10-percent method of section 460(b)(5), a taxpayer takes no contract revenues or contract costs into account until the tax year as of the close of which at least 10 percent of the total estimated contract costs are incurred (the 10-percent year). Instead, contract costs incurred in a tax year preceding the 10-percent year are deferred until the 10-percent year, at which time they are included in the numerator of the percentage of completion ratio and deducted from gross income. A taxpayer using the 10-percent method must also use the 10-percent method in applying the look-back method, using actual total contract costs to determine the 10-percent year. Thus, contract income is never reallocated to a year before the 10-percent year as determined on the basis of actual contract costs. If the 10-percent year is earlier as a result of applying Step One of the look-back method, contract costs incurred up to and including the new 10-percent year (as determined based on actual contract costs), are reallocated from the original 10-percent year to the new 10-percent, and costs incurred in later years but before the old 10-percent year are reallocated to those years. If the 10-percent year is later as a result of applying Step One of the look-back method, contract costs incurred up to and including the new 10-percent year are reallocated from all prior years to the new 10-percent year. This is the only case in which costs are reallocated under the look-back method.

(B) *Example.* The application of the look-back method by a taxpayer using the 10-percent method is illustrated by the following example:

Example. Z elected to use the 10-percent method of section 460(b)(5) for reporting income under the percentage of completion method. Z entered into a contract in 1990 for a fixed price of $1,000*x*. During 1990, Z incurred allocable contract costs of $80*x* and estimated that it would incur a total of $900*x* for the entire contract. Since $80*x* is less than 10 percent of total estimated contract costs, Z reported no revenue from the contract in 1990 and deferred the $80*x* of costs incurred. In 1991, Z incurred an additional $620*x* of contract costs, and completed the contract. Accordingly, in its 1991 return, Z reported the entire contract price of $1,000*x*, and deducted the $620*x* of costs incurred in 1991 and the $80*x* of costs incurred in 1990.

Under section 460(b)(5), the 10-percent method applies both for reporting contract income and the look-back method. Under the look-back method, since the costs incurred in 1990 ($80*x*) exceed 10 percent of the actual total contract costs ($700*x*), Z is required to allocate $114*x* of contract revenue ($80*x*/$700*x* x $1,000*x*) and the $80*x* of costs incurred to 1990. Thus, application of the look-back method results in a net increase in taxable income for 1990 of $34*x*, solely for purposes of the look-back method.

(vi) *Amount treated as contract price*—(A) *General rule.* The amount that is treated as total contract price for purposes of applying the percentage of completion method and reapplying the percentage of completion method under the look-back method under Step One includes all amounts that the taxpayer expects to receive from the customer. Thus, amounts are treated as part of the contract price as soon as it is reasonably estimated that they will be re-

ceived, even if the all-events test has not yet been met.

(B) *Contingencies.* Any amounts related to contingent rights or obligations, such as incentive fees or amounts in dispute, are not separated from the contract and accounted for under a non-long-term contract method of accounting, notwithstanding any provision in §1.451-3(b)(2)(ii), (iii), (iv), and §1.451-3(d)(2), (3), and (4), to the contrary. Instead, those amounts are treated as part of the total contract price in applying the percentage of completion method and the look-back method. For example, if an incentive fee under a contract to manufacture a satellite is payable to the taxpayer after a specified period of successful performance, the incentive fee is includible in the total contract price at the time and to the extent that it can reasonably be predicted that the performance objectives will be met, for purposes of both the percentage of completion method and the look-back method. Similarly, a portion of the contract price that is in dispute is included in the total contract price at the time and to the extent that the taxpayer can reasonably expect the dispute will be resolved in the taxpayer's favor (without regard to when the taxpayer receives payment for the amount in dispute or when the dispute is finally resolved).

(C) *Change orders.* In applying the look-back method, a change order with respect to a contract is not treated as a separate contract unless the change order would be treated as a separate contract under the rules for severing and aggregating contracts provided in §1.451-3(e). Thus, if a change order is not treated as a separate contract, the contract price and contract costs attributable to the change order must be taken into account in allocating contract income to all tax years affected by the underlying contract.

(3) *Look-back Step Two: Computation of hypothetical overpayment or underpayment of tax*—(i) *In general.* Step Two involves the computation of a hypothetical overpayment or underpayment of tax for each year in which the tax liability is affected by income from contracts that are completed or adjusted in the filing year (a "redetermination year"). The application of Step Two depends on whether the taxpayer uses the simplified marginal impact method contained in paragraph (d) or the actual method described in this paragraph (c)(3). The remainder of this paragraph (c)(3) does not apply if a taxpayer uses the simplified marginal impact method.

(ii) *Redetermination of tax liability.* Under the method described in this paragraph (c)(3) (the "actual method"), a taxpayer, first, must determine what its regular and alternative minimum tax liability would have been for each redetermination year if the amounts of contract income allocated in Step One for all contracts completed or adjusted in the filing year and in any prior year were substituted for the amounts of contract income reported under the percentage of completion method on the taxpayer's original return (or as subsequently adjusted on examination, or by amended return). See Example (2) of paragraph (h)(3) for an illustration of Step Two.

(iii) *Hypothetical underpayment or overpayment.* After redetermining the income tax liability for each tax year affected by the reallocation of contract income, the taxpayer then determines the amount, if any, of the hypothetical underpayment or overpayment of tax for each of these redetermination years. The hypothetical underpayment or overpayment for each affected year is the difference between the tax liability as redetermined under the look-back method for that year and the amount of tax liability determined as of the latest of the following:

(A) the original return date;

(B) the date of a subsequently amended or adjusted return (if, however, the amended return is due to a carryback described in section 6611(f), see paragraph (c)(4)(iii); or,

(C) the last previous application of the look-back method (in which case, the previous hypothetical tax liability is used).

(iv) *Cumulative determination of tax liability.* The redetermination of tax liability resulting from previous applications of the look-back method is cumulative. Thus, for example, in computing the amount of a hypothetical overpayment or underpayment of tax for a redetermination year, the current hypothetical tax liability is compared to the hypothetical tax liability for that year determined as of the last previous application of the look-back method.

(v) *Years affected by look-back only.* A redetermination of income tax liability under Step Two is required for every tax year for which the tax liability would have been affected by a change in the amount of income or loss for any other year for which a redetermination is required. For example, if the allocation of contract income under Step One changed the amount of a net operating loss that was carried back to a year preceding the year the taxpayer entered into the contract, the tax liability for the earlier year must be redetermined.

(vi) *Definition of tax liability.* For purposes of Step Two, the income tax liability must be redetermined by taking into account all applicable additions to tax, credits, and net operating loss carrybacks and carryovers. Thus, the tax, if any, imposed under section 55 (relating to alternative minimum tax) must be taken into account. For example, if the taxpayer did not pay alternative minimum tax, but would have paid alternative minimum tax for that year if actual rather than estimated contract price and costs had been used in determining contract income for the year, the amount of any hypothetical overpayment or underpayment of tax must be determined by comparing the hypothetical total tax liability (including hypothetical alternative minimum tax liability) with the actual tax liability for that year. The effect of taking these items into account in applying the look-back method is illustrated in Examples (4) through (7) of paragraphs (h)(5) through (h)(8) below.

(4) *Look-back Step Three: Calculation of interest on underpayment or overpayment*—(i) *In general.* After determining a hypothetical underpayment or overpayment of tax for each redetermination year, the taxpayer must determine the interest charged or credited on each of these amounts. Interest on the amount determined under Step Two is determined by applying the overpayment rate designated under section 6621, compounded daily. In general, the time period over which interest is charged on hypothetical underpayments or credited on hypothetical overpayments begins at the due date (not including

extensions) of the return for the redetermination year for which the hypothetical underpayment or overpayment determined in Step Two is computed. This time period generally ends on the earlier of

(A) the due date (not including extensions) of the return for the filing year, and

(B) the date both

(*1*) the income tax return for the filing year is filed, and

(*2*) the tax for that year has been paid in full. If a taxpayer uses the simplified marginal impact method contained in paragraph (d), the remainder of this paragraph (c)(4) does not apply.

(ii) *Changes in the amount of a loss or credit carryback or carryover.* The time period for determining interest may be different in cases involving loss or credit carrybacks or carryovers in order to properly reflect the time period during which the taxpayer (in the case of an underpayment) or the Government (in the case of an overpayment) had the use of the amount determined to be a hypothetical underpayment or overpayment. Thus, if a reallocation of contract income under Step One results in an increase or decrease to a net operating loss carryback (but not a carryforward), the interest due or to be refunded must be computed on the increase or decrease in tax attributable to the change to the carryback only from the due date (not including extensions) of the return for the redetermination year that generated the carryback and not from the due date of the return for the redetermination year in which the carryback was absorbed. In the case of a change in the amount of a carryover as a result of applying the look-back method, interest is computed from the due date of the return for the year in which the carryover was absorbed. See Examples (8) and (9) of paragraph (h)(9) for an illustration of these rules.

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

Example. Upon the completion of a long-term contract in 1990, the taxpayer redetermines its tax liability for 1988 under the look-back method. This redetermination results in a hypothetical reduction of tax liability from $1,500*x* (actual liability originally reported) to $1,200*x* (hypothetical liability). In addition, the taxpayer had already received a refund of some or all of the actual 1988 tax by carrying back a net operating loss (NOL) that arose in 1989. The time period over which interest would be computed on the hypothetical overpayment of $300*x* for 1988 would depend on the amount of the refund generated by the carryback, as illustrated by the following three alternative situations:

(A) If the amount refunded because of the NOL is $1,500*x*: interest is credited to the taxpayer on the entire hypothetical overpayment of $300*x* from the due date of the 1988 return, when the hypothetical overpayment occurred, until the due date of the 1989 return, when the taxpayer received a refund for the entire amount of the 1988 tax, including the hypothetical overpayment.

(B) If the amount refunded because of the NOL is $1,000*x*: interest is credited to the taxpayer on the entire amount of the hypothetical overpayment of $300*x* from the due date of the 1988 return, when the hypothetical overpayment occurred, until the due date of the 1990 return. In this situation interest is credited until the due date of the return for the completion year of the contract, rather than the due date of the return for the year in which the carryback arose, because the amount refunded was less than the redetermined tax liability. Therefore, no portion of the hypothetical overpayment is treated as having been refunded to the taxpayer before the filing year.

(C) If the amount refunded because of the NOL is $1,300*x*: interest is credited to the taxpayer on $100*x* ($1,300*x* - $1,200*x*) from the due date of the 1988 return until the due date of the 1989 return because only this portion of the total hypothetical overpayment is treated as having been refunded to the taxpayer before the filing year. However, the taxpayer did not receive a refund for the remaining $200*x* of the overpayment at that time and, therefore, is credited with interest on $200*x* through the due date of the tax return for 1990, the filing year. See Examples (10) and (11) of paragraph (h)(9) for a further illustration of this rule.

(iv) *Additional interest due on interest only after tax liability due.* For each filing year, taxpayers are required to file a Form 8697 (Interest Computation Under the Look-back Method for Completed Long-term Contracts) at the time the return for that filing year is filed to report the interest due or to be refunded under the look-back method. Even if the taxpayer has received an extension to file its income tax return for the filing year, look-back interest is computed with respect to the hypothetical increase (or decrease) in the tax liability determined under the look-back method only until the initial due date of that return (without regard to the extension). Interest is charged, unless the taxpayer otherwise has a refund that fully offsets the amount of interest due, (or credited) with respect to the amount of look-back interest due (or to be refunded) under the look-back method from the initial due date of the return through the date the return is filed. No interest is charged (or credited) after the due date of the return with respect to the amount of the hypothetical increases (or decreases) in tax liability determined under the look-back method.

(d) *Simplified marginal impact method*—(1) *Introduction.* This paragraph (d) provides a simplified method for calculating look-back interest. Any taxpayer may elect this simplified marginal impact method, except that pass-through entities described in paragraph (d)(4) of this section are required to apply the simplified marginal impact method at the entity level with respect to domestic contracts and the owners of those entities do not apply the look-back method to those contracts. Under the simplified marginal impact method, a taxpayer calculates the hypothetical underpayments or overpayments of tax for a prior year based on an assumed marginal tax rate. A taxpayer electing to use the simplified marginal impact method must use the method for each long-term contract for which it reports income (except with respect to domestic contracts if the taxpayer is an owner in a widely held pass-through entity that is required to use the simplified marginal impact method at the entity level for those contracts).

(2) *Operation*—(i) *In general.* Under the simplified marginal impact

method, income from those contracts that are completed or adjusted in the filing year is first reallocated in accordance with the procedures of Step One contained in paragraph (c)(2) of this section. Step Two is modified in the following manner. The hypothetical underpayment or overpayment of tax for each year of the contract (a "redetermination year") is determined by multiplying the applicable regular tax rate (as defined in paragraph (d)(2)(iii)) by the increase or decrease in regular taxable income (or, if it produces a greater amount, by multiplying the applicable alternative minimum tax rate by the increase or decrease in alternative minimum taxable income, whether or not the taxpayer would have been subject to the alternative minimum tax) that results from reallocating income to the tax year under Step One. Generally, the product of the alternative minimum tax rate and the increase or decrease in alternative minimum taxable income will be the greater of the two amounts described in the preceding sentence only with respect to contracts for which a taxpayer uses the full percentage of completion method only for alternative minimum tax purposes and uses the completed contract method, or the percentage of completion-capitalized cost method, for regular tax purposes. Step Three is then applied. Interest is credited to the taxpayer on the net overpayment and is charged to the taxpayer on the net underpayment for each redetermination year from the due date (determined without regard to extensions) of the return for the redetermination year until the earlier of

(A) the due date (determined without regard to extensions) of the return for the filing year, and

(B) the first date by which both the return is filed and the tax is fully paid.

(ii) *Applicable tax rate.* For purposes of determining hypothetical underpayments or overpayments of tax under the simplified marginal impact method, the applicable regular tax rate is the highest rate of tax in effect for the redetermination year under section 1 in the case of an individual and under section 11 in the case of a corporation. The applicable alternative minimum tax rate is the rate of tax in effect for the taxpayer under section 55(b)(1). The highest rate is determined without regard to the taxpayer's actual rate bracket and without regard to any additional surtax imposed for the purpose of phasing out multiple tax brackets or exemptions.

(iii) *Overpayment ceiling.* The net hypothetical overpayment of tax for any redetermination year is limited to the taxpayer's total federal income tax liability for the redetermination year reduced by the cumulative amount of net hypothetical overpayments of tax for that redetermination year resulting from earlier applications of the look-back method. If the reallocation of contract income results in a net overpayment of tax and this amount exceeds the actual tax liability (as of the filing year) for the redetermination year, as adjusted for past applications of the look-back method and taking into account net operating loss, capital loss, or credit carryovers and carrybacks to that year, the actual tax so adjusted is treated as the overpayment for the redetermination year. This overpayment ceiling does not apply when the simplified marginal impact method is applied at the entity level by a widely held pass-through entity in accordance with paragraph (d)(4) of this section.

(iv) *Example.* The application of the simplified marginal impact method is illustrated by the following example:

Example. Corporation X, a calendar-year taxpayer, reports income from long-term contracts and elected the simplified marginal impact method when it filed its income tax return for 1989. X uses only the percentage of completion method for both regular taxable income and alternative minimum taxable income. X completed contracts A, B, and C in 1989 and, therefore, was required to apply the look-back method in 1989. Income was actually reported for these contracts in 1987, 1988, and 1989. X's applicable tax rate, as determined under section 11, for the redetermination years 1987 and 1988 was 40 percent and 34 percent, respectively. The amount of contract income originally reported and reallocated for contracts A, B, and C, and the net overpayments and underpayments for the redetermination years are as follows:

	1987	*1988*
Contract A:		
Originally reported	$5,000*x*	$4,000*x*
Reallocated	3,000*x*	5,000*x*
Increase/(Decrease)	(2,000*x*)	1,000*x*
Contract B:		
Originally reported	6,000*x*	2,000*x*
Reallocated	7,000*x*	1,500*x*
Increase/(Decrease)	1,000*x*	(500*x*)
Contract C:		
Originally reported	8,000*x*	5,000*x*
Reallocated	4,000*x*	7,000*x*
Increase/(Decrease)	(4,000*x*)	2,000*x*
Net Increase/(Decrease)	(5,000*x*)	2,500*x*
Tentative (Underpayment)/Overpayment		
@ .40	2,000*x*	
@ .34		(850*x*)
Ceiling:		
Actual Tax Liability		
(After Carryovers and Carrybacks)	1,500*x*	500*x*
Final (Underpayment)/Overpayment	1,500*x*	(850*x*)

Under the simplified marginal impact method, X determined a tentative hypothetical net overpayment for 1987 and a net underpayment for 1988. X determined these amounts by first aggregating the difference for contracts A, B, and C between the amount of contract price originally reported and the amount of contract price as reallocated and, then, applying the highest regular tax rate to the aggregate decrease in income for 1987 and the aggregate increase in income for 1988.

However, X's overpayment for 1987 is subject to a ceiling based on X's total tax liability. Because the tentative net overpayment of tax for 1987 exceeds the actual tax liability for that year after taking into account carryovers and carrybacks to that year, the final overpayment under the simplified marginal impact method is the amount of tax liability paid instead of the tentative net overpayment. Since application of the look-back method for 1988 results in a tentative underpayment of tax, it is not subject to a ceiling. If the look-back method is applied in 1991, the ceiling amount for 1987 will be zero and the ceiling amount for 1988 will be $1,350.

X is entitled to receive interest on the hypothetical overpayment from March 15, 1988, to March 15, 1990. X is required to pay interest on the underpayment from March 15, 1989, to March 15, 1990.

(3) *Anti-abuse rule.* If the simplified marginal impact method is used

with respect to any long-term contract (including a contract of a widely held pass-through entity), the district director may recompute interest for the contract (including domestic contracts of widely held pass-through entities) under the look-back method using the actual method (and without regard to the simplified marginal impact method). The district director may make such a recomputation only if the amount of income originally reported with respect to the contract for any redetermination year exceeds the amount of income reallocated under the look-back method with respect to that contract for that year (using actual contract price and contract costs) by the lesser of $1,000,000 or 20 percent of the amount of income as reallocated (*i.e.*, based on actual contract price and contract costs) under the look-back method with respect to that contract for that year. In determining whether to exercise this authority upon examination of the Form 8697, the district director may take into account whether the taxpayer overreported income for a purpose of receiving interest under the look-back method on a hypothetical overpayment determined at the applicable tax rate. The district director also may take into account whether the taxpayer underreported income for the year in question with respect to other contracts. Notwithstanding the look-back method, the district director may require an adjustment to the tax liability for any open tax year if the taxpayer did not apply the percentage of completion method properly on its original return.

(4) *Application*—(i) *Required use by certain pass-through entities*—(A) *General rule.* The simplified marginal impact method is required to be used with respect to income reported from domestic contracts by a pass-through entity that is either a partnership, an S corporation, or a trust, and that is not closely held. With respect to contracts described in the preceding sentence, the simplified marginal impact method is applied by the pass-through entity at the entity level. For determining the amount of any hypothetical underpayment or overpayment, the applicable regular and alternative minimum tax rates, respectively, are generally the highest rates of tax in effect for corporations under section 11 and section 55(b)(1). However, the applicable regular and alternative minimum tax rates are the highest rates of tax imposed on individuals under section 1 and section 55(b)(1) if, at all times during the redetermination year involved (*i.e.*, the year in which the hypothetical increase or decrease in income arises), more than 50 percent of the interests in the entity were held by individuals directly or through 1 or more pass-through entities.

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

(C) *Examples.* The following examples illustrate the application of the rules of paragraph (d)(4)(i):

Example (1). P, a partnership, began a long-term contract on March 1, 1986, and completed this contract in its tax year ending December 31, 1989. P used the percentage of completion method for all contract income. Substantially all of the income from the contract arose from U.S. sources. At all times during all of the years for which income was required to be reported under the contract, exactly 25 percent of the value of P's interests was owned by Corporation M. The remaining 75 percent of the value of P's interests was owned in equal shares by 15 unrelated individuals, who are also unrelated to Corporation M. M's ownership of P represents less than 50 percent of the value of the beneficial interests in P, and, therefore, viewed alone, is insufficient to make P a closely held partnership. In addition, because no 4 of the individual owners together own 25 percent or more of the remaining value of P's beneficial interests, there is no group of 5 owners that together own, directly or indirectly, 50 percent or more by value of the beneficial interests in P. Therefore, P is not a closely held pass-through entity.

Because P is not a closely held pass-through entity, and because P completed the contract after the effective date of section 460(b)(4), P is required to use the simplified marginal impact method. Any interest computed under the look-back method will be paid to, or collected from, P, rather than its partners, and must be reported to each of the partners on Form 1065 as interest income or expense. Further, assume that, for the redetermination years, Corporation M is subject to alternative minimum tax at the rate of 20 percent and 3 of the individuals who own interests in P are subject to the highest marginal tax rate of 33 percent in 1988. Regardless of the actual marginal tax rates of its partners, P is required to determine the underpayment or overpayment of tax for each redetermination year at the entity level by applying a single rate to the increase or decrease in income resulting from the reallocation of contract income under the look-back method. Because more than 50 percent of the interests in P are held by individuals, P must use the highest rate specified in section 1 for each redetermination year. Thus, the rate applied by P is 50 percent for 1986, 38.5 percent for 1987, and 28 percent for 1988.

Example (2). Assume the same facts as in Example (1), except that one of the individuals, Individual I, who directly owns 5 percent of the value of the interests of P, also owns 100 percent of the stock of Corporation M. Section 1563(e)(4) of the Code provides that stock owned directly or indirectly by or for a corporation is considered to be owned by any person who owns 5 percent or more in value of its stock in that proportion which the value of the stock which that person so owns bears to the value of all the stock in that corporation. Because section 460(b)(4)(C)(iii) and this paragraph (d)(4) provide that rules similar to the constructive ownership rules of section 1563(e) apply in determining whether a pass-through entity is closely held, all of M's interest in P is attributed to I because I owns 100 percent of the value of the stock in M. Accordingly, because I's direct 5 percent and constructive 25 percent ownership of P, plus the interests owned by any 4 other individual partners, equals 50 percent or more of the value of the beneficial interests of P, P is a closely held pass-through entity within the meaning of section 460(b)(4)(C)(iii). Therefore, P cannot use the simplified marginal impact method at the entity level. Accordingly, each of the partners of P must separately apply the look-back method to their respective interests in the income and expenses attributable to the contract, but each partner may elect to use the simplified marginal impact method with respect to the partner's share of income from the contract.

(D) *Domestic contracts—(1) General rule.* A domestic contract is any contract substantially all of the income of which is from sources in the United States. For this purpose, "substantially all" of the income from a long-term contract is considered to be from United States sources if 95 percent or more of the gross income from the contract is from sources within the United States as determined under the rules in sections 861 through 865.

(2) Portion of contract income sourced. In determining whether sub-

stantially all of the gross income from a long-term contract is from United States sources, taxpayers must apply the allocation and apportionment principles of sections 861 through 865 only to the portion of the contract accounted for under the percentage of completion method. Under the percentage of completion method, gross income from a long-term contract includes all payments to be received under the contract (*i.e.*, any amounts treated as contract price). Similarly, all costs taken into account in the computation of taxable income under the percentage of completion method are deducted from gross income rather than added to a cost of goods sold account that reduces gross income. Therefore, allocable contract costs are not considered in determining whether a long-term contract is a domestic contract or a foreign contract, even if, under the taxpayer's facts, the allocation of contract costs to any portion of a contract not accounted for under the percentage of completion method would affect the relative percentages of United States and foreign source gross income from the entire contract if this portion of the contract were taken into account in applying the 95-percent test.

(E) *Application to foreign contracts.* If a widely held pass-through entity has some foreign contracts and some domestic contracts, the owners of the pass-through entity each apply the look-back method (using, if they elect, the simplified marginal impact method) to their respective share of the income and expense from foreign contracts. Moreover, in applying the look-back method to foreign contracts at the owner level, the owners do not take into account their share of increases or decreases in contract income resulting from the application of the simplified marginal impact method with respect to domestic contracts at the entity level.

(F) *Effective date.* The simplified marginal impact method must be applied to pass-through entities described in paragraph (d)(4)(i) of this section with respect to domestic contracts completed or adjusted in tax years for which the due date of the return (determined with regard to extensions) of the pass-through entity is after November 9, 1988.

(ii) *Elective use*—(A) *General rule.* As provided in paragraph (d)(4)(i) of this section, the simplified marginal impact method must be used by certain pass-through entities with respect to domestic contracts. C corporations, individuals, and owners of closely held pass-through entities may elect the simplified marginal impact method. Owners of other pass-through entities may also elect the simplified marginal impact method with respect to all contracts other than those for which the simplified marginal impact method is required to be applied at the entity level. This rule applies to foreign contracts of widely held pass-through entities. In the case of an electing owner in a pass-through entity, the simplified marginal impact method is applied at the owner level, instead of at the entity level, with respect to the owner's share of the long-term contract income and expense reported by the pass-through entity.

(B) *Election requirements.* A taxpayer elects the simplified marginal impact method by stating that the election is being made on a timely filed income tax return (determined with regard to extensions) for the first tax year the election is to apply. An election to use the simplified marginal impact method applies to all applications of the look-back method to all eligible long-term contracts for the tax year for which the election is made and for any subsequent tax year. The election may not be revoked without the consent of the Commissioner.

(C) *Consolidated group consistency rule.* In the case of a consolidated group of corporations within the meaning of section 1504(a), an election to use the simplified marginal impact method is made by the common parent of the group. The election is binding on all other affected members of the group (including members that join the group after the election is made with respect to all applications of the look-back method after joining). If a member subsequently leaves the group, the election remains binding as to that member unless the Commissioner consents to a revocation of the election. If a corporation using the simplified marginal impact method joins a group that does not use the method, the election is automatically revoked with respect to all applications of the look-back method after it joins the group.

(e) *Delayed reapplication method*—(1) *In general.* For purposes of reapplying the look-back method after the year of contract completion, a taxpayer may elect the delayed reapplication method to minimize the number of required reapplications of the look-back method. Under this method, the look-back method is reapplied after the year of completion of a contract (or after a subsequent application of the look-back method) only when the first one of the following conditions is met with respect to the contract:

(i) the net undiscounted value of increases or decreases in the contract price occurring since the time of the last application of the look-back method exceeds the lesser of $1,000,000 or 10 percent of the total contract price as of that time,

(ii) the net undiscounted value of increases or decreases in contract costs occurring since the time of the last application of the look-back method exceeds the lesser of $1,000,000 or 10 percent of the total actual contract costs as of that time,

(iii) the taxpayer goes out of existence,

(iv) the taxpayer reasonably believes the contract is finally settled and closed, or

(v) neither condition (i), (ii), (iii) nor (iv) above is met by the end of the fifth tax year that begins after the last previous application of the look-back method.

(2) *Time and manner of making election.* An election to use the delayed reapplication method may be made for any filing year for which the due date of the return (determined with regard to extensions) is after June 12, 1990. The election is made by a statement to that effect on the taxpayer's timely filed federal income tax return (determined with regard to extensions) for the first tax year the election is to be effective. An election to use the delayed reapplication method is binding with respect to all long-term contracts for which the look-back method would be reapplied without regard to the election in the year of election and any subsequent year unless the Commissioner consents to a revocation of the election. In the case of a consolidated group of corporations within the meaning of section 1504(a), an election to use the delayed reapplication method is made

by the common parent of the group. The election is binding on all other affected members of the group (including members that join the group after the election is made with respect to contracts adjusted after joining). If a member subsequently leaves the group, the election remains binding as to that member unless the Commissioner consents to a revocation of the election. If a corporation that has made the election joins a consolidated group that has not made the election, the election is treated as revoked with respect to contracts adjusted after joining.

(3) *Examples.* The operation of this delayed reapplication method is illustrated by the following examples:

Example (1). X completes a contract in 1987, and applies the look-back method when its return for 1987 is filed. X properly uses $600,000 as the actual contract price in applying the look-back method. In 1990, as a result of the settlement of a dispute with its customer, X redetermines total contract price to be $640,000, and includes $40,000 in gross income. On its return for 1990, X states that it is electing the delayed reapplication method. X is not required to reapply the look-back method at that time, because $40,000 does not exceed the lesser of $1,000,000 or 10 percent of the unadjusted contact price of $600,000, and 5 years have not passed since the last application of the look-back method.

Example (2). Assume the same facts as in Example (1), except that at the end of 1992, the fifth year after completion of the contract, no other adjustments to contract price or contract costs have occurred. X is required to reapply the look-back method in 1992 and, accordingly, redetermine its tax liability for each redetermination year. After redetermining the underpayment of tax for those years, X must compute the amount of interest charged on the underpayments. Although 1992 is the filing year, interest is due on the amount of each underpayment resulting from the adjustment only from the due date of the return for each redetermination year to the due date of the return for 1990 because the tax liability for the adjustment was fully paid in 1990. However, from the due date of the 1990 return until the due date of the 1992 return, when the look-back method is reapplied for the adjustment, interest is due on the amount of interest attributable to the underpayments.

(f) *Look-back reporting*—(1) *Procedure.* The amount of any interest due or to be refunded as a result of applying the look-back method is computed and reported on Form 8697 for any filing year. In general, the look-back method is applied by and Form 8697 is filed by the taxpayer that reports income from a long-term contract. See paragraph (g) of this section to determine who is responsible for applying the look-back method when, prior to the completion of a long-term contract, there is a transaction that changes the taxpayer that reports income from the contract.

(2) *Treatment of interest on return*—(i) *General rule.* The amount of interest required to be paid by a taxpayer is treated as an income tax under subtitle A, but only for purposes of subtitle F of the Code (other than sections 6654 and 6655), which addresses tax procedures and administration. Thus, a taxpayer that fails to file Form 8697 with respect to interest required to be paid or that fails to pay the amount of interest due is subject to any applicable penalties under subtitle F, including, for example, a penalty for failing to file Form 8697. However, interest required to be paid under the look-back method is treated as interest expense for purposes of computing taxable income under subtitle A, even though it is treated as income tax liability for penalty purposes. Interest received under the look-back method is treated as taxable interest income for all purposes, and is not treated as a reduction in tax liability. The determination of whether or not interest computed under the look-back method is treated as tax is determined on a "net" basis for each filing year. Thus, if a taxpayer computes for the current filing year both hypothetical overpayments and hypothetical underpayments for prior years, the taxpayer has an increase in tax only if the interest computed on the underpayments for all those prior years exceeds the interest computed on the overpayments for all those prior years, for all contracts completed or adjusted for the year.

(ii) *Timing of look-back interest.* For purposes of determining taxable income under subtitle A of the Code, any amount of interest refunded to the taxpayer under the lookback method is includible in gross income as interest income in the tax year it is properly taken into account under the taxpayer's method of accounting for interest income. Any amount of interest required to be paid is taken into account as interest expense arising from an underpayment of income tax in the tax year it is properly taken into account under the taxpayer's method of accounting for interest expense. Thus, look-back interest required to be paid by an individual, or by a pass-through entity on behalf of an individual owner (or beneficiary) under the simplified marginal impact method, is personal interest and, therefore, is disallowed in accordance with §1.163-9T(b)(2). Interest determined at the entity level under the simplified marginal impact method is allocated among the owners (or beneficiaries) for reporting purposes in the same manner that interest income and interest expense are allocated to owners (or beneficiaries) and subject to the requirements of section 704 and any other applicable rules.

(g) *Mid-contract change in taxpayer.* [Reserved.]

(h) *Examples*—(1) *Overview.* This paragraph provides computational examples of the rules of this section. Except as otherwise noted, the examples involve calendar-year taxpayers and involve long-term contracts subject to section 460 that are accounted for using the percentage of completion method, rather than the percentage of completion-capitalized cost method. If the percentage of completion-capitalized cost method were used by a taxpayer described in the examples, the amounts of contract income and expenses shown in the examples would be reduced, for purposes of determining regular taxable income, to the appropriate fraction (40, 70, or 90 percent) of contract items accounted for under the percentage of completion method. Tens of thousands of dollars ($ 00,000's) are omitted from the figures in the examples. The contracts described in the examples are assumed to be the taxpayers' only contracts that are subject to the look-back method of section 460. Except as otherwise stated, the examples assume that the taxpayer has no adjustments and preferences for purposes of section 55, so that alternative minimum taxable income is the same as taxable income, and no alternative minimum tax is imposed for the years involved. The examples assume that the taxpayer does not elect the 10-percent method, the simplified marginal impact method, or the delayed reapplication method.

(2) *Step One.* The following example illustrates the application of paragraph (c)(2):

Example (1). In 1989, W completes three long-term contracts, A, B, and C, entered into on January 1 of 1986, 1987, and 1988, respec-

tively. For Contract A, W used the completed contract method of accounting. For Contract B, W used the percentage of completion-capitalized cost method of accounting, taking into account 60 percent of contract income under W's normal method of accounting, which was the completed contract method. For Contract C, W used the percentage of completion method of accounting. The total price for each contract was $1,000. In computing alternative minimum taxable income, W is required to use the percentage of completion method for Contracts B and C. W used regular tax costs for purposes of determining the degree of contract completion under the alternative minimum tax.

Contract A is not taken into account for purposes of applying the look-back method, because it is subject to neither section 460 nor section 56(a)(3). Thus, even if W had used the percentage of completion method as permitted under §1.451-3, instead of the completed contract method, the look-back method would not be applicable because the Contract A was entered into before the effective date of section 460.

The actual costs allocated to Contracts B and C under section 460(c) and incurred in each year of the contract were as follows:

Contract	*1987*	*1988*	*1989*	*Total*
B	$200	$400	$200	$800
C	100	300	400	800

In applying the look-back method, the first step is to allocate the contract price among tax years preceding and including the completion year. That allocation would produce the following amounts of gross income for purposes of the regular tax. Note that no income from Contract C is allocated to 1987, the year before the contract was entered into, even though contract costs were incurred in 1987:

Contract	*1987*	*1988*	*1989*
B	$100 (40% x $200/$800 x $1000)	$200 ((40% x $600/$800 x $1000) - $100)	$700
C	0	500 ($400/$800 x $1000)	500

Because the percentage of completion-capitalized cost method may not be used for alternative minimum tax purposes, the allocation of contract income would produce the following amounts of gross income for purposes of computing alternative minimum taxable income:

Contract	*1987*	*1988*	*1989*
B	$250 ($200/$800 x $1000)	$500 (($600/$800 x $1000)-$250)	$250
C	0	500	500

(3) *Step Two.* The following example illustrates the application of paragraph (c)(3):

Example (2). (i) X enters into two long-term contracts (D and E) in 1988. X determines its tax liability for 1988 as follows:

e = estimate
a = amount originally reported (actual)
h = hypothetical

	1988 D	E	Total
1988 contract costs	$ 3,000a	$ 2,000a	
Total contract costs	8,000e	8,000e	
Total contract price	10,000e	10,000e	
1988 completion %	37.5%e	25%e	
1988 gross income	3,750a	2,500a	
less, 1988 costs	(3,000a)	(2,000a)	
1988 net contract income	750a	500a	$1,250a
Other 1988 net income (loss)			(2,000a)
Taxable income (NOL)			(750a)
Tax			-0-a
Refund from NOL carryback fully absorbed in 1985, at 46%			345a

(ii) X completes Contract D during 1989. X determines its taxable income for 1989 as follows:

	1989 D	E	Total
1989 contract costs	$ 3,000a	$ -0-a	
Total contract costs	6,000a	9,000e	
Total contract price	10,000a	10,000e	
1989 completion %	100%a	22.2%e	
1989 gross income/(loss)	6,250a	(278a)	
less, 1989 costs	(3,000a)	-0-a	
1989 net contract income	3,250a	(278a)	$2,972a
Other 1989 net income (loss)			-0-a
Taxable income (NOL)			2,972a
Tax at 34%			1,011a

(iii) For purposes of the look-back method, X must reallocate the actual total contract D price between 1988 and 1989 based on the actual total contract D costs. This results in the following hypothetical underpayment of tax for 1988 for purposes of the look-back method. Note that X does not reallocate the contract E price in applying the look-back method in 1989 because contract E has not been completed, even though X's estimate of contract E costs has changed. The following computation is only for purposes of applying the look-back method, and does not result in the assessment of a tax deficiency.

	1988 D	E	Total
1988 contract costs	$ 3,000a	$ 2,000a	
Total contract costs	6,000a	8,000e	
Total contract price	10,000a	10,000e	
1988 completion %	50%a	25%e 19	
88 gross income	5,000h	2,500a	
less, 1988 costs	(3,000a)	(2,000a)	
1988 net contract income	2,000h	500a	$ 2,500h
Other 1988 net income (loss)			(2,000a)
Taxable income (NOL)			500h
Tax at 34%			170h
less, previously computed tax			-0-a
Underpayment of 1988 tax			170h
Underpayment of 1985 tax from NOL carryback refund in 1988			345h
Total underpayment of tax			515h

For purposes of any subsequent application of the look-back method for which 1989 is a redetermination year, because the reallocation of contract income and redetermination of tax liability are cumulative, X will use for 1989 the amount of contract D income and the amount of tax liability that would have been reported in 1989 if X had used actual contract costs instead of the amounts that were originally reported using the estimate of $8,000. Assuming no subsequent revisions (due to, for example, adjustments to contract D price and costs determined after the end of 1989), this amount would be determined as follows:

	1989 D	E	Total
1989 contract costs	$ 3,000a	$ -0-a	
Total contract costs	6,000a	9,000e	
Total contract price	10,000a	10,000e	
1989 completion %	100%a	22.2%e	
1989 gross income	5,000h	(278a)	
less, 1989 costs	(3,000a)	-0-a	
1989 net contract income	2,000h	(278a)	$1,722h
Other 1989 net income (loss)			-0-a
Taxable income (NOL)			1,722h
Tax at 34%			585h

(iv) X completes contract E during 1990. X determines its taxable income for 1990 as follows:

	1990 D	E	Total
1990 contract costs		$ 7,000a	
Total contract costs		9,000a	
Total contract price		10,000a	
1990 completion %		100%a	
1990 gross income		7,778a	
less, 1990 costs		(7,000a)	
1990 net contract income		778a	$778a
Other 1990 net income (loss)			-0-a
Taxable income (NOL)			778a
Tax at 34%			265a

(v) For purposes of the look-back method, X must reallocate the actual total contract E price between 1988, 1989, and 1990, based on the actual total contract E costs. This results in the following hypothetical overpayment of tax for 1988. Note that X uses the amount of income for contract D determined in the last previous application of the look-back method, and not the amount of income actually reported:

	1988 D	E	Total
1988 contract costs	$ 3,000a	$ 2,000a	
Total contract costs	6,000a	9,000a	
Total contract price	10,000a	10,000a	
1988 completion %	50%a	22.2%a	
1988 gross income	5,000h	2,222h	
less, 1988 costs	(3,000a)	(2,000a)	
1988 net contract income	2,000h	222h	$ 2,222h
Other 1988 net income (loss)			(2,000a)
Taxable income (NOL)			222h
Tax at 34%			75h
less, previously computed tax (based on most recent application of the look-back method)			170h
Overpayment of 1988 tax			(95h)

In applying the look-back method to 1989, X again uses the amounts substituted as of the last previous application of the look-back method with respect to contract D. Thus, X computes its hypothetical underpayment for 1989 as follows:

	1989 D	E	Total
1989 contract costs	$ 3,000a	$ -0-a	
Total contract costs	6,000a	9,000a	
Total contract price	10,000a	10,000a	
1989 completion %	100%a	22.2%a	
1989 gross income	5,000h	-0-h	
less, 1989 costs	(3,000a)	(-0-a)	
1989 net contract income	2,000h	-0-a	$2,000h
Other 1989 net income (loss)			(-0-a)
Taxable income (NOL)			2,000h
Tax at 34%			680h
less, previously computed tax			585h
Underpayment of 1989 tax			95h

For purposes of any subsequent application of the look-back method for which 1990 is a redetermination year, X will use for 1990 the amount of Contract E income, and the amount of tax liability, that was originally reported in 1990 because X's estimate of the total contract costs from $8,000 to $9,000 did not change after 1989. Without regard to any subsequent revisions, these amounts are the same as in the table in paragraph (h)(3)(iv) above.

(4) *Post-completion adjustments.* The following example illustrates the application of paragraph (c)(1)(ii):

Example (3). The facts are the same as in Example (2). In 1991, X settles a lawsuit against its customer in Contract E. The customer pays X an additional $3,000, without interest, in 1991. Applying the Federal mid-term rate then in effect, this $3,000 has a discounted value at the time of contract completion in 1990 of $2,700. X is required to apply the look-back method for 1991 even though no contract was completed in 1991. X must include the full $3,000 adjustment (which was not previously includible in total contract price) in gross income for 1991. X does not elect not to discount adjustments to the contract price or costs. Thus, X adjusts the contract price by the discounted amount of the adjustment and, therefore, uses $12,700 (not $13,000) for total Contract E price, rather than $10,000, which was used when the look-back method was first applied with respect to Contract E.

For purposes of the look-back method, X must allocate the revised total Contract E price of $12,700 between 1988, 1989 and 1990 based on the actual total Contract E costs, and compare the resulting revised tax liability with the tax liability determined for the last previous application of the look-back method involving those years. This results in the following hypothetical underpayments of tax for purposes of the look-back method:

r = revised

	1988 D	E	Total
1988 contract costs	$ 3,000a	$ 2,000a	
Total contract costs	6,000a	9,000a	
Total contract price	10,000a	12,700r	
1988 completion %	50%a	22.2%a	
1988 gross income	5,000h	2,822rh	
less, 1988 costs	(3,000a)	(2,000a)	
1988 net contract income	2,000h	822rh	$ 2,822rh
Other 1988 net income/ (loss)			(2,000a)
Taxable income			822rh
Tax at 34%			279rh
less, previously computed tax			75h
Underpayment of 1988 tax			204rh

No Contract E costs were incurred in 1989, and there is no hypothetical underpayment for 1989.

	1990 D	E	Total
1990 contract costs		$ 7,000a	
Total contract costs		9,000a	
Total contract price		12,700r	
1990 completion %		100%a	
1990 gross income		9,878rh	
less, 1990 costs		(7,000a)	
1990 net contract income		2,878rh	$2,878rh
Other 1990 net income (loss)			-0-a
Taxable income (NOL)			2,878rh
Tax at 34%			978rh
less, previously computed tax			265h
Underpayment of 1990 tax			713rh

In 1992, X incurs an additional cost of $1,000 allocable to the contract, which was not previously includible in total contract costs. Applying the Federal mid-term rate then in effect, the $1,000 has a discounted value at the time of contract completion of $800. X deducts this additional $1,000 in expenses in 1992. Based on this increase to contract costs, X reapplies the look-back method, and determines the following hypothetical overpayments for 1988, 1989 and 1990 for purposes of the look-back method:

	1988 D	E	Total
1988 contract costs	$ 3,000a	$ 2,000a	
Total contract costs	6,000a	9,800r	
Total contract price	10,000a	12,700r	
1988 completion %	50%a	20.4%r	
1988 gross income	5,000h	2,592rh	
less, 1988 costs	(3,000a)	(2,000a)	
1988 net contract income	2,000h	592rh	$ 2,592rh
Other 1988 net income (loss)			(2,000a)
Taxable income (NOL)			592rh
Tax at 34%			201rh
less, previously computed tax			279rh
Overpayment of 1988 tax			(78rh)

No Contract E costs were incurred in 1989, and there is no hypothetical underpayment for 1989.

	1990 D	E	Total
1990 contract costs		$ 7,000a	
Total contract costs		9,800r	
Total contract price		12,700r	
1990 completion %		92%a	
1990 gross income		9,071rh	
less, 1990 costs		(7,000a)	
1990 net contract income		2,071rh	$2,071rh
Other 1990 net income (loss)			-0-a
Taxable income (NOL)			2,071rh
Tax at 34%			704rh
less, previously computed tax			978rh
Overpayment of 1990 tax			(274rh)

(5) *Alternative minimum tax.* The operation of the look-back method in the case of a taxpayer liable for the alternative minimum tax as provided in paragraph (c)(3)(vi) is illustrated by the following example:

Example (4). Y enters into a long-term contract in 1988 that is completed in 1989. Y used regular tax costs for purposes of determining the degree of contract completion under the alternative minimum tax.

(i) Y determines its tax liability for 1988 as follows:

1988 contract costs	$ 4,000a
Total contract costs	8,000e
Total contract price	20,000e
1988 completion %	50%e
1988 gross income	10,000a
less, 1988 contract costs	(4,000a)
1988 net contract income	6,000a
Other 1988 net income/(loss)	(3,400a)
Taxable income	2,600a
Regular tax at 34%	884a
Adjustments and preferences to produce alternative minimum taxable income	600a
Alternative minimum taxable income	3,200a
Tentative minimum tax at 20%	640a
Tax liability	884a

In 1989, Y determines the following amounts:

1989 contract costs	$ 6,000a
Total contract costs	10,000a
Total contract price	20,000a

(ii) For purposes of applying the look-back method, Y redetermines its tax liability for 1988, which results in a hypothetical overpayment of tax. This hypothetical overpayment is determined by comparing Y's original regular tax liability for 1988 with the hypothetical total tax liability (including alternative minimum tax liability) for that year because Y would have paid the alternative minimum tax if Y had used its actual contract costs to report income:

1988 contract costs	$ 4,000a
Total contract costs	10,000a
Total contract price	20,000a
1988 completion %	40%a
1988 gross income	8,000h
less, 1988 contract costs	(4,000a)
1988 net contract income	4,000h
Total contract costs	10,000a
Other 1988 net income/(loss)	(3,400a)
Taxable income	600h
Regular tax at 34%	204h
Adjustments and preferences to produce alternative minimum taxable income	600a

Alternative minimum taxable income	1,200h
Tentative minimum tax at 20%	240h
Alternative minimum tax	36h
Total tax liability	240h
ess, previously computed tax	884a
Underpayment/(overpayment)	(644h)

(6) *Credit carryovers.* The operation of the look-back method in the case of credit carryovers as provided in paragraph (c)(3)(v) is illustrated by the following example:

Example (5). Z enters into a contract in 1986 that is completed in 1987. Z determines its tax liability for 1986 as follows:

1986 contract costs	$ 400a
Total contract costs	1,000e
Total contract price	2,000e
1986 completion %	40%e
1986 gross income	800a
less, 1986 costs	(400a)
1986 net contract income	400a
Other 1986 net income	-0-a
Taxable income	400a
Tax at 46%	184a
Unused tax credits carried forward from 1985 allowable in 1986	350a
Net tax due	-0-a

Z determines the following amounts for 1987:

1987 contract costs	$ 400a
Total contract price	2,000a
Total contract costs	800a

If Z had used actual rather than estimated contract costs in determining gross income for 1986, Z would have reported tax liability of $276 (46% x $600) rather than $184. However, Z would have paid no additional tax for 1986 because its unused tax credits carried forward from 1985 would have been sufficient to offset this increased tax liability. Therefore, there is no hypothetical underpayment for 1986 for purposes of the look-back method. However, this hypothetical earlier use of the credit may increase the hypothetical tax liability for 1987 (or another subsequent year) for purposes of subsequent applications of the look-back method.

(7) *Net operating losses.* The operation of the look-back method in the case of net operating loss ("NOL") carryovers as provided in paragraph (c)(3)(v) is illustrated by the following example:

Example (6). A entered into a long-term contract in 1986, which was completed in 1987. A determined its tax liability for 1986 as follows:

1986 contract costs	$ 400a
Total contract costs	1,000e
Total contract price	2,000e
1986 completion %	40%e
1986 gross income	800a
less, 1986 costs	(400a)
1986 net contract income	400a
Other 1986 net income/(loss)	(1,000a)
Taxable income/(NOL)	(600a)
Tax	-0-a

An elected to carry this loss forward to 1987 pursuant to section 172(b)(3)(C).
For 1987, A determined the following amounts:

1987 contract costs	$ 400a
Total contract costs	800a
Total contract price	2,000a

If actual rather than estimated contract costs had been used in determining gross income for 1986, A would have reported $1,000 of gross income from the contract rather than $800, and thus would have reported a loss of $400 rather than $600. However, since A would have paid no tax for 1986 regardless of whether actual or estimated contract costs had been used, A does not have an underpayment for 1986 for purposes of the look-back method. If A had, instead, carried back the 1986 NOL, and this NOL had been absorbed in the tax years 1983 through 1985, it would have resulted in refunds of tax for those years in 1986. When A applies the look-back method, a hypothetical underpayment of tax would have resulted for those years due to a hypothetical reduction in the amount that would have been refunded if income had been reported on the basis of actual contract costs. See Example (2)(iii).

(8) *Alternative minimum tax credit.* The following example illustrates the application of the look-back method if affected by the alternative minimum tax credit as provided in paragraph (c)(3)(vi):

Example (4), above, illustrates that the reallocation of contract income under the look-back method can result in a hypothetical underpayment or overpayment determined using the alternative minimum tax rate, even though the taxpayer actually paid only the regular tax for that year. However, application of the look-back method had no effect on the difference between the amount of alternative minimum taxable income and the amount of regular taxable income taken into account in that year because the taxpayer was required to use the percentage of completion method for both regular and alternative minimum tax purposes and used the same version of the percentage of completion method for both regular and alternative minimum tax purposes (*i.e.*, the taxpayer had made an election to use regular tax costs in determining the percentage of completion for purposes of computing alternative minimum taxable income).

The following example illustrates the application of the look-back method in the case of a taxpayer that does not use the percentage of completion method of accounting for long-term contracts in computing taxable income for regular tax purposes and thus must make an adjustment to taxable income to determine alternative minimum taxable income. The example also shows how interest is computed under the look-back method when the taxpayer is entitled to a credit under section 53 for minimum tax paid because of this adjustment.

Example (7). X is a taxpayer engaged in the

construction of real property under contracts that are completed within a 24-month period and whose average annual gross receipts do not exceed $10,000,000. As permitted by section 460(e)(1)(B), X uses the completed contract method ("CCM") for regular tax purposes. However, X is engaged in the construction of commercial real property and, therefore, is required to use the percentage of completion method ("PCM") for alternative minimum tax ("AMT") purposes.

Assume that for 1988, 1989, and 1990, X has only one long-term contract, which is entered into in 1988 and completed in 1990. Assume further that X estimates gross income from the contract to be $2,000, total contract costs to be $1,000, and that the contract is 25 percent complete in 1988 and 75 percent complete in 1989. In 1990, the year of completion, the percentage of completion does not change but, upon completion, gross income from the contract is actually $3,000, instead of $2,000, and costs are actually $1,000.

For 1988, 1989, and 1990, X's income and tax liability using estimated contract price and costs are as follows:

Estimates	*1988*	*1989*	*1990*
Regular tax			
Long-term			
Contract-CCM	$ -0-	$ -0-	$2,000
Other Income	-0-	5,000	-0-
Total Income	-0-	5,000	2,000
Tax @ 34%	-0-	1,700	680
AMT			
Gross Income	500	1,000	1,500
Deductions	(250)	(500)	(250)
Total long-term			
Contract-PCM	250	500	1,250
Other Income	-0-	5,000	-0-
Total Income	250	5,500	1,250
Tax @ 20%	50	1,100	250
Tentative Minimum Tax	50	1,100	250
Regular Tax	-0-	1,700	680
Minimum Tax Credit	-0-	(50)	-0-
Net Tax Liability	50	1,650	680

When X files its tax return for 1990, X applies the look-back method to the contract. For 1988, 1989, and 1990, X's income and tax liability using actual contract price and costs are as follows:

Actual	*1988*	*1989*	*1990*
Regular tax			
Long-term			
Contract-CCM	$ -0-	$ -0-	$2,000
Other Income	-0-	5,000	-0-
Total Income	-0-	5,000	2,000
Tax @ 34%	-0-	1,700	680
AMT			
Gross Income	750	1,500	750
Deductions	(250)	(500)	(250)
Total long-term			
Contract-PCM	500	1,000	500
Other Income	-0-	5,000	-0-
Total Income	500	6,000	500
Tax @ 20%	100	1,200	100
Tentative Minimum Tax	100	1,200	100
Regular Tax	-0-	1,700	680
Minimum Tax Credit	-0-	(100)	-0-
Net Tax Liability	100	1,600	680
Underpayment	50		
Overpayment		50	

As shown above, application of the look-back method results in a hypothetical underpayment of $50 for 1988 because X was subject to the alternative minimum tax for that year. Interest is charged to X on this $50 underpayment from the due date of X's 1988 return until the due date of X's 1990 return.

In 1989, although X was required to compute alternative minimum taxable income using the percentage of completion method, X was not required to pay alternative minimum tax. Nevertheless, the look-back method must be applied to 1989 because use of actual rather than estimated contract price in computing alternative minimum taxable income for 1988 would have changed the amount of the alternative minimum tax credit carried to 1989. Interest is paid to X on the resulting $50 overpayment from the due date of X's 1989 return until the due date of X's 1990 return.

(9) *Period for interest.* The following Examples (8) through (11) illustrate how to determine the period for computing interest as provided in paragraph (c)(4):

Example (8). The facts are the same as in Example (6), except that the contract is completed in 1988, and A determined the following amounts for 1987 and 1988:

for 1987:	
1987 contract costs	$ -0-
Total contract costs	1,000e
Total contract price	2,000e
1987 completion %	40%e
1987 gross income	-0-a
less, 1987 costs	-0-a
Other 1987 net income	600a
Net operating loss carryforward from 1986	(600a)
taxable income	-0-a
tax	-0-a

for 1988:

1988 contract costs	400a
Total contract costs	800a
Total contract price	2,000a

If actual rather than estimated contract costs had been used in determining gross income for 1986, A would have reported $1,000 of gross income from the contract for 1986 rather than $800, and would have reported a net operating loss carryforward to 1987 of $400 rather than $600. Therefore, A would have reported taxable income of $200, and would have paid tax of $80 (*i.e.*, $200 x 40%) for 1987. The due date for filing A's Federal income tax return for its 1988 taxable year is March 15. A obtains an extension and files its 1988 return on September 15, 1989. Under the look-back method, A is required to pay interest on the amount of this hypothetical underpayment ($80) computed from the due date (determined without regard to extensions) for A's return for 1987 (not 1986, even though 1986 was the year in which the net operating loss arose) until March 15 (not September 15), the due date (without regard to extensions) of A's return for 1988. A is required to pay additional interest from March 15 until September 15 on the amount of interest outstanding as of March 15 with respect to the hypothetical underpayment of $80.

Example (9). The facts are the same as in Example (6), except that A carries the net operating loss of $600 back to 1983 rather than forward to 1987, and receives a refund of $276 ($600 reduction in 1983 taxable income x 46% rate in effect in 1983). As in Example (6), if actual contract costs had been used, A would have reported a loss for 1986 of $400 rather than $600. Thus, A would have received a refund of 1983 tax of $184 ($400 x 46%) rather than $276. Under the look-back method A is required to pay interest on the difference in these two amounts ($92) computed from the due date (determined without regard to extensions) of A's return for 1986 (the year in which the carryback arose rather than 1983, the year in which it was used) until the due date of A's return for 1988.

Example (10). B enters into a long-term contract in 1986 that is completed in 1988. B determines its 1986 tax liability as follows:

1986 contract costs	$ 400a
Total contract costs	1,000e
Total contract price	2,000e
1986 completion %	40%e
1986 gross income	800a
less, 1986 costs	(400a)
1986 net contract income	400a
Other 1986 net income	2,000a
Taxable income	2,400a
Tax at 46%	1,104a

B determines its tax liability for 1987 as follows:

1987 contract costs	$ 400a
Total contract costs	1,600e
Total contract price	2,000e
1987 completion %	50%e
1987 gross income (=(50% x $2,000) - $800 previously reported)	200a
less, 1987 costs	(400a)
1987 net contract income	(200a)
Other 1987 net income/(loss)	(2,200a)
Taxable income (NOL)	(2,400a)
Tax	-0-a

Assume that B had no taxable income in either 1984 or 1985, so that the entire amount of the $2,400 net operating loss is carried back to 1986, and B receives a refund, with interest from the due date of B's 1987 return, of the entire $1,104 in tax that it paid for 1986.

In 1988, B determines the following amounts:

1988 contract costs	$ 800a
Total contract costs	1,600a
Total contract price	2,000a

If B had used actual contract costs rather than estimated costs in determining its gross income for 1986, B would have had gross income from the contract of $500 rather than $800, and thus would have had taxable income of $2,100 rather than $2,400, and would have paid tax of $966 rather than $1,104. B is entitled to receive interest on the difference between these two amounts, the hypothetical overpayment of tax of $138. Interest is computed from the due date (without regard to extensions) of B's return for 1986 until the due date for B's return for 1987. Interest stops running at this date, because B's hypothetical overpayment of tax ended when B filed its original 1987 return and received a refund for the carryback to 1986, and interest on this refund began to run only from the due date of B's 1987 return. See section 6611 (f).

Example (11). C enters into a long-term contract in 1986, its first year in business, which is completed in 1988. C determines its tax liability for 1986 as follows:

1986 contract costs	$ 400a
Total contract costs	1,000e
Total contract price	2,000e
1986 completion %	40%e
1986 gross income	800a
less, 1986 costs	(400a)
1986 net contract income	400a
Other 1986 net income	2,000a
Taxable income (NOL)	2,400a
Tax at 46%	1,104a

C determines its tax liability for 1987 as follows:

1987 contract costs	$ 400a
Total contract costs	1,066e
Total contract price	2,000e

1987 completion %	75%e
1987 gross income	700a
less, 1987 costs	(400a)
1987 net contract income	300a
Other 1987 net income	(2,450a)
Taxable income (NOL)	(2,150a)
Tax	-0-a

C carries back the net operating loss to 1986, and files an amended return for 1986, showing taxable income of $250, and receives a refund of $989 (46% x $2,150). Interest on this refund begins to run only as of the due date of C's 1987 return. See section 6611(f).

In 1988, when the contract is completed, C determines the following amounts:

1988 contract costs	$ 800a
Total contract costs	1,600a
Total contract price	2,000a

If C had used actual contract price and contract costs in determining gross income for 1986, it would have reported gross income from the contract of $500 rather than $800, taxable income of $2,100 rather than $2,400, and tax liability of $966 rather than $1,104.

If C had used actual contract price and contract costs in determining gross income for 1987, it would have reported gross income from the contract of $500 rather than $700, and would have reported a net operating loss of $2,350, rather than $2,150, which would have been carried back to 1986.

Under the look-back method, C receives interest with respect to a total 1986 hypothetical overpayment of $138 ($1,104 minus $966). C is credited with interest on $23 of this amount only from the due date of C's 1986 return until the due date of C's 1987 tax return, because this portion of C's total hypothetical overpayment for 1986 was refunded to C with interest computed from the due date of C's 1987 return and, therefore, was no longer held by the government. However, because the remainder of the total hypothetical overpayment of $115 was not refunded to C, C is credited with interest on this amount from the due date of C's 1986 return until the due date of C's 1988 tax return.

Under the look-back method, C receives no interest with respect to 1987, because C had no tax liability for 1987 using either estimated or actual contract price and costs.

§1.460-7. *Exempt long-term contracts.* [*Reserved.*]

§1.460-8. *Changes in method of accounting.* [*Reserved.*]

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

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

Authority: 26 U.S.C. 7805

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

"§1.460-6 . . . 1545-1031."

Fred T. Goldberg, Jr.,
Commissioner of Internal Revenue.

Approved September 18, 1990.

Kenneth W. Gideon,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on October 12, 1990, 8:45 a.m., and published in the issue of the Federal Register for October 15, 1990, 55 F.R. 41665)

Subpart C.—Taxable Year for Which Deductions Taken

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 1990. See Rev. Rul. 90-52, page 192.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1990. See Rev. Rul. 90-66, page 194.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1990. See Rev. Rul. 90-75, page 195.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1990. See Rev. Rul. 90-81, page 196.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1990. See Rev. Rul. 90-92, page 198.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1990. See Rev. Rul. 90-99, page 199.

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

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1990. See Rev. Rul. 90-52, page 192.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1990. See Rev. Rul. 90-66, page 194.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1990. See Rev. Rul. 90-75, page 195.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1990. See Rev. Rul. 90-81, page 196.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1990. See Rev. Rul. 90-92, page 198.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1990. See Rev. Rul. 90-99, page 199.

Section 469.—Passive Activity Losses and Credits Limited

Deductions that may be (or are) disallowed under section 469 are treated as potentially allowable for purposes of section 6111 in computing an investor's tax shelter ratio. See Rev. Rul. 90-85, page 255.

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26 CFR 1.469-2T: Passive activity loss (temporary).
(Also Sections 163, 316; 1.316-1.)

Passive activity losses and credits; Alaska Permanent Fund Dividends. Alaska Permanent Fund Dividends do not constitute either investment income under section 163(d)(4)(B) of the Code or passive activity gross income under section 1.469-2T(c) of the temporary regulations. Rev. Rul. 85-39 amplified.

Rev. Rul. 90-56

ISSUE

Do Alaska Permanent Fund Dividends constitute either "investment income" as defined in section 163(d)(4)(B) of the Internal Revenue Code or "passive activity gross income" as defined in section 1.469-2T(c) of the temporary Income Tax Regulations?

FACTS

Under article IX, section 15, of its constitution, Alaska must deposit at least 25 percent of its annual mineral income into the Alaska Permanent Fund. That section also provides that all income from the Alaska Permanent Fund must be deposited in the State's general fund unless otherwise provided by law. The Fund's manager may purchase only certain income-producing assets for the Fund, including government and corporate obligations, preferred and common stock of U.S. corporations, and equity interests in partnerships and other entities that invest in real estate. Alaska Stat. §37.13.120(g) (Supp. 1989). Each year, the Alaska Commissioner of Revenue must transfer a portion of the Fund's income to a "dividend fund," from which the State of Alaska, through the Department of Revenue, pays a "dividend" to eligible Alaska residents. *See* Alaska Stat. §43.23.

LAW AND ANALYSIS

Article IX, Section 15, of the Alaska Constitution establishes that income of the Permanent Fund is income of the State of Alaska to be either deposited in the general fund or used in such other manner as may be provided by statute. Although the amount of the "dividend" residents receive from the State of Alaska is measured by the Permanent Fund's income, the payments are not a distribution of that income. Instead, the payments are a distribution of State funds pursuant to section 43.23 of the Alaska Statutes for the purpose of encouraging individuals to establish and maintain residence in the State.

In Rev. Rul. 85-39, 1985-1 C.B. 21, the Internal Revenue Service ruled that "dividends" paid by the State of Alaska pursuant to section 43.23 of the Alaska Statutes are includible in gross income under section 61 of the Code.

Section 163(d) of the Code generally prevents non-corporate taxpayers from deducting the amount of investment interest expense that exceeds net investment income. Section 163(d)(4)(B) defines "investment income" as the sum of gross income from property held for investment (other than gross income attributable to the disposition of that property) plus net gain attributable to the disposition of property held for investment.

Under section 163(d)(5)(A) of the Code, "property held for investment" includes any property that produces income of a type described in section 469(e)(1) (that is, gross income from interest, dividends, annuities, and royalties not derived in the ordinary course of a trade or business).

Alaska residents own no interest in the Fund's assets, because these assets belong to the State. *See* Alaska Const. art. IX, §15; Alaska Stat. §37.13.010. Therefore, payments the residents receive from the State of Alaska are not income from property they hold for investment and are not investment income. The residents may not include the payments in their net investment income to determine the investment interest deduction allowed under section 163(d)(1).

The fact that the distributions are labeled "dividends" is not determinative of their character for purposes of the Internal Revenue Code. Section 316(a) of the Code defines "dividend" as any distribution of property made by a corporation to its shareholders out of earnings and profits. Fund distributions the State of Alaska pays to its residents are not dividends as so defined. Thus, the State's payments are not "dividends" for purposes of section 163(d).

Section 469 of the Code generally prevents certain taxpayers from deducting expenses from passive activities that exceed gross income from passive activities. Under section 1.469-2T(c) of the temporary regulations, "passive activity gross income" includes an item of gross income only if that income is from a passive activity. Section 469(c) defines "passive activity" as a trade or business activity in which the taxpayer does not materially participate, or a rental activity.

Alaska residents do not own an interest in the Fund's assets, and carry on no trade or business activity or rental activity through the Fund. The right to payments from the Alaska Permanent Fund is established, and can only be established, by maintaining residence in the State. Maintaining such residence is neither a trade or business activity nor a rental activity. Therefore, payments the residents receive from the State of Alaska are not passive activity gross income. The residents may not take the payments into account in computing their income or loss from any passive activity or item of property used in a passive activity.

HOLDING

Alaska Permanent Fund Dividends constitute neither "investment income" as defined in section 163(d)(4)(B) of the Code nor "passive activity gross income" as defined in section 1.469-2T(c) of the temporary regulations.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 85-39 is amplified.

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26 CFR 1.469-2T: Passive activity loss (temporary).

T.D. 8318

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Limitations on Passive Activity Losses and Credits—Developer Rule Amendments

AGENCY: Internal Revenue Service, Treasury.

ACTION: Amendments of temporary regulations.

SUMMARY: This document amends the temporary regulations relating to the limitations on passive activity losses and passive activity credits. The amendments clarify the treatment of lease-up services under the net income recharacterization rule for certain property the rental of which is incidental to development activity. The

text of the temporary regulations also serves as the text of the proposed regulations for the notice of proposed rulemaking on this subject. The notice of proposed rulemaking appears in *** [PS-71-89, page 877, this Bulletin].

EFFECTIVE DATE: These amendments of the regulations are effective for taxable years beginning after December 31, 1987.

SUPPLEMENTARY INFORMATION:

Background

Section 1.469-2T(f)(5) reduces a taxpayer's passive activity gross income by the net income and gain from certain rental property. This rule applies to certain property that is not used in an activity involving the rental of the property for a period of at least 12 months between its development and its disposition. A taxpayer is subject to the rule if the taxpayer materially or significantly participated for any taxable year in an activity that involved for that year the performance of services for the purpose of enhancing the property's value.

Section 1.469-2T(f)(5)(ii) provides that the use of property in an activity involving its rental begins when the performance of value-enhancing services is complete and substantially all of the property is first held out for rent and is in a state of readiness for rental. Under §1.469-2T(f)(5)(iii)(C), services performed for the purpose of enhancing the value of property include "lease-up" (*e.g.*, the solicitation of tenants) if, as of the time the taxpayer acquires an interest in the property, a substantial portion of the property is not leased. Numerous commentators have asked when lease-up is complete for purposes of commencing the 12-month rental period preceding a disposition of a property. Commentators have also asked for guidance on when a substantial portion of property is not leased.

Treatment of Lease-up Clarified

These amendments of the regulations clarify that lease-up is treated as a value-enhancing service under §1.469-2T(f)(5) unless more than 50 percent of the property is leased when the taxpayer acquires an interest in the property. The Internal Revenue Service has determined that this objective test will help taxpayers determine whether lease-up is a value-enhancing service in any given case.

Although lease-up may be treated as a value-enhancing service under the net income recharacterization rule in §1.469-2T(f)(5), the Service believes that the commencement of the 12-month rental period should not be delayed until lease-up has been completed. Accordingly, these amendments of the regulations clarify that property is used in an activity involving its rental beginning on the first date on which (1) the taxpayer owns an interest in the item of property, (2) substantially all of the property is rented (or is held out for rent and is in a state of readiness for rental), and (3) no significant value-enhancing services (within the meaning of §1.469-2T(f)(5)(ii)(B)) remain to be performed. Under §1.469-2T(f)(5)-(ii)(B), significant value-enhancing services excludes lease-up.

These amendments of the regulations apply as if they had been included in §1.469-2T(f)(5) as promulgated in Treasury Decision 8175, 53 FR 5686, February 25, 1988 [1988-1 C.B. 191], and as amended by Treasury Decision 8253, 54 FR 20527, May 12, 1989 [1989-1 C.B. 121]. Under §1.469-11T(a)(2), §1.469-2T-(f)(5) applies for taxable years beginning after December 31, 1987.

Special Analyses

It has been determined that these rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. 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 final Regulatory Flexibility Analysis is not required.

* * * * *

Adoption of amendments to the regulations

Accordingly, Title 26, Chapter 1, Part 1 of the Code of Federal Regulations is amended as follows:

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

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

Authority: 26 U.S.C. 7805 *** Sections 1.469-1T, 1.469-2T, 1.469-3T, 1.469-5T, and 1.469-11T also issued under 26 U.S.C. 469(1).

Par. 2. Section 1.469-2T is amended as follows:

Paragraph (f)(5)(i)(B), (ii), (iii)(C), and (iv) is revised to read as set forth below.

§1.469-2T Passive activity loss (temporary).

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(f) *Recharacterization of passive income in certain situations.* ***

(5) *Net income from certain property rented incidental to development activity*—(i) ***

(B) The taxpayer's use of the item of property in an activity involving the rental of the property commenced less than 12 months before the date of the disposition (within the meaning of paragraph (c)(2)(iii)(B) of this section) of such property; and

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(ii) *Commencement of use*—(A) *In general.* For purposes of paragraph (f)(5)(i)(B) of this section, a taxpayer's use of an item of property in an activity involving the rental of the property commences on the first date on which—

(*1*) The taxpayer owns an interest in the item of property:

(*2*) Substantially all of the property is rented (or is held out for rent and is in a state of readiness for rental); and

(*3*) No significant value-enhancing services (within the meaning of paragraph (f)(5)(ii)(B) of this section) remain to be performed.

(B) *Value-enhancing services.* For purposes of this paragraph (f)(5)(ii), the term "value-enhancing services" means the services described in paragraphs (f)(5)(i)(C) and (iii) of this section, except that the term does not include lease-up. Thus, in cases in which this paragraph (f)(5) applies solely because substantial lease-up remains to be performed (*see* paragraph (f)(5)(iii)(C) of this section), the twelve month period described in paragraph (f)(5)(i)(B) of this section will begin when the taxpayer acquires an interest in the property if substantially all of the property is held out

for rent and is in a state of readiness for rental on that date.

(iii) ***

(C) Lease-up (unless more than 50 percent of the property is leased on the date that the taxpayer acquires an interest in the property).

(iv) *Examples.* The following examples illustrate the application of this paragraph (f)(5):

Example (1). (i) A, a calendar year individual, is a partner in calendar year partnership P, which develops real estate. In 1988, P acquires an interest in undeveloped land and arranges for the financing and construction of an office building on the land. Construction is completed in February 1990, and substantially all of the building is either rented or held out for rent and in a state of readiness for rental beginning on March 1, 1990. Twenty percent of the building is leased as of March 1, 1990.

(ii) P rents the building (or holds it out for rent) for the remainder of 1990 and all of 1991, and sells the building on February 1, 1992, pursuant to a contract entered into on January 15, 1991. P did not hold the building (or any other buildings) for sale to customers in the ordinary course of P's trade or business (*see* paragraph (c)(2)(v) of this section). A's distributive share of P's taxable losses from the rental of the building is $50,000 for 1990 and $30,000 for 1991. All of A's losses from the rental of the building are disallowed under §1.469-1T(a)(1)(i) (relating to the disallowance of the passive activity loss for the taxable year). A's distributive share of P's gain from the sale of the building is $150,000. A has no other gross income or deductions from the activity of renting the building.

(iii) The real estate development activity that A holds through P involves in 1988, 1989, and 1990 the performance of services (*e.g.*, construction) for the purpose of enhancing the value of the building. Accordingly, an amount equal to A's net rental activity income from the building may be treated as gross income that is not from a passive activity if A's use of the building in an activity involving the rental of the building commenced less than 12 months before the date of the disposition of the building. In this case, the date of the disposition of the building is January 15, 1991, the date of the binding contract for its sale.

(iv) A taxpayer's use of an item of property in an activity involving the rental of the property commences on the first date on which (A) the taxpayer owns an interest in the item of property, (B) substantially all of the property is rented (or is held out for rent and is in a state of readiness for rental), and (C) no significant value-enhancing services (within the meaning of paragraph (f)(5)(ii)(B) of this section) remain to be performed. In this case, A's use of the building in an activity involving the rental of the building commenced on March 1, 1990, less than 12 months before January 15, 1991, the date of disposition. Accordingly, if A materially (or significantly) participated in the real estate development activity in 1988, 1989, or 1990 (without regard to whether A materially participated in the activity in more than one of those years), an amount of A's gross rental activity income from the building for 1992 equal to A's net rental activity income from the building for 1992 is treated under this paragraph (f)(5) as gross income that is not from a passive activity. Under paragraph (f)(9)(iv) of this section, A's net rental activity income from the building for 1992 is $70,000 ($150,000 distributive share of gain from the disposition of the building minus $80,000 of reasonably allocable passive activity deductions).

Example 2. (i) X, a calendar-year taxpayer subject to section 469, acquires a building on February 1, 1992, when the building is 25 percent leased. During 1992, X rents the building (or holds it out for rent) and materially participates in an activity that involves the lease-up of the building. X's activities do not otherwise involve the performance of construction or other services for the purpose of enhancing the value of the building, and X does not hold the building (or any other building) for sale to customers in the ordinary course of X's trade or business. X sells the building on December 1, 1992.

(ii) Under paragraph (f)(5)(iii)(C) of this section, lease-up is considered a service performed for the purpose of enhancing the value of property unless more than 50 percent of the property is leased on the date the taxpayer acquires an interest in the property. Under paragraph (f)(5)(ii)(B) of this section, however, lease-up is not considered a value-enhancing service for purposes of determining when the taxpayer commences using an item of property in an activity involving the rental of the property. Accordingly, X's acquisition of the building constitutes a commencement of X's use of the building in a rental activity, because February 1, 1992, is the first date on which (A) the taxpayer owns an interest in the item of property, (B) substantially all of the property is held out for rent, and (C) no significant value-enhancing services (within the meaning of paragraph (f)(5)(ii)(B) of this section) remain to be performed. In this case, X disposes of the property within 12 months of the date X commenced using the building in a rental activity. Accordingly, an amount of X's gross rental activity income for 1992 equal to X's net rental activity income from the building for 1992 is treated under this paragraph (f)(5) as gain that is not from a passive activity.

Example 3. The facts are the same as in example (2) except that at the time X acquires the building it is 60 percent leased. Under paragraph (f)(5)(iii)(C) of this section, lease-up is not considered a service performed for the purpose of enhancing the value of property if more than 50 percent of the property is leased on the date the taxpayer acquires an interest in the property. Therefore, additional lease-up performed by X is not taken into account under this paragraph (f)(5). Since X's activities do not otherwise involve the performance of services for the purpose of enhancing the value of the building, none of X's gross rental activity income from the building will be treated as income that is not from a passive activity under this paragraph (f)(5).

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

Fred T. Goldberg, Jr.,
Commissioner of Internal Revenue.

Approved October 30, 1990.

Kenneth W. Gideon,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on November 16, 1990, 8:45 a.m., and published in the issue of the Federal Register for November 19, 1990, 55 F.R. 48107)

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 April 1990 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, April 30, 1990.

Rev. Rul. 90-58

The following price indexes for April 1990 were issued by the Bureau of Labor Statistics on May 18, 1990, for use by department stores, and are accepted by the Internal Revenue Service, under section 1.472-1(k) of the Income Tax Regulations and Rev. Proc. 86-46, 1986-2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, April 30, 1990.

Indexes are prepared on a national basis for the store total, for 23 major groups of departments, and for three special combinations—soft goods, durable goods and miscellaneous goods. The store total index covers all departments, including some not listed separately, with the following exceptions: candy, foods, liquor, tobacco, as well as contract departments.

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

Groups	April 1989	April 1990	Percent Change from April 1989 to April 1990[1]
1. Piece Goods	432.8	457.1	5.6
2. Domestics and Draperies	610.9	607.7	−0.5
3. Women's and Children's Shoes	593.6	604.8	1.9
4. Men's Shoes	823.7	860.8	4.5
5. Infants' Wear	582.1	608.2	4.5
6. Women's Underwear	474.3	482.6	1.7
7. Women's Hosiery	241.7	252.7	4.6
8. Women's and Girls' Accessories	526.5	532.2	1.1
9. Women's Outerwear and Girls' Wear	403.5	422.8	4.8
10. Men's Clothing	543.4	564.4	3.9
11. Men's Furnishings	531.4	549.4	3.4
12. Boys' Clothing and Furnishings	448.9	451.7	0.6
13. Jewelry	795.1	865.0	8.8
14. Notions	524.1	550.0	4.9
15. Toilet Articles and Drugs	732.8	764.2	4.3
16. Furniture and Bedding	577.4	595.7	3.2
17. Floor Coverings	486.2	513.1	5.5
18. Housewares	724.6	743.5	2.6
19. Major Appliances	244.0	244.8	0.3
20. Radio and Television	93.0	92.1	−1.0
21. Recreation and Education[2]	107.8	111.3	3.2
22. Home Improvements[2]	109.1	109.6	0.5
23. Auto Accessories[2]	103.7	105.4	1.6
Groups 1 - 15: Soft Goods	541.7	560.6	3.5
Groups 16 - 20: Durable Goods	446.0	453.7	1.7
Groups 21 - 23: Misc. Goods[2]	107.2	109.8	2.4
Store Total[3]	509.9	524.6	2.9

[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, with the following exceptions: Candy, foods, liquor, tobacco, as well as contract departments.

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

LIFO; price indexes; department stores. The May 1990 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, 1990.

Rev. Rul. 90-69

The following price indexes for May 1990 were issued by the Bureau of Labor Statistics on June 19, 1990, for use by department stores, and are accepted by the Internal Revenue Service, under section 1.472-1(k) of the Income Tax Regulations and Rev. Proc. 86-46, 1986-2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, May 31, 1990.

Indexes are prepared on a national basis for the store total, for 23 major groups of departments, and for three special combinations—soft goods, durable goods and miscellaneous goods. The store total index covers all departments, including some not listed separately, with the following exceptions: candy, foods, liquor, tobacco, as well as contract departments.

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

Groups	May 1989	May 1990	Percent Change from May 1989 to May 1990[1]
1. Piece Goods	433.4	440.3	1.6
2. Domestics and Draperies	599.1	610.7	1.9
3. Women's and Children's Shoes	590.1	607.2	2.9
4. Men's Shoes	828.6	860.1	3.8
5. Infants' Wear	589.3	599.3	1.7
6. Women's Underwear	471.3	480.9	2.0
7. Women's Hosiery	243.3	251.0	3.2
8. Women's and Girls' Accessories	526.3	535.3	1.7
9. Women's Outerwear and Girls' Wear	396.8	411.4	3.7
10. Men's Clothing	544.4	564.0	3.6
11. Men's Furnishings	535.8	554.2	3.4
12. Boys' Clothing and Furnishings	447.7	455.4	1.7
13. Jewelry	795.3	861.5	8.3
14. Notions	524.4	549.1	4.7
15. Toilet Articles and Drugs	735.8	765.3	4.0
16. Furniture and Bedding	579.2	592.9	2.4
17. Floor Coverings	498.9	521.8	4.6
18. Housewares	722.9	745.8	3.2
19. Major Appliances	245.9	244.6	-0.5
20. Radio and Television	92.4	92.0	-0.4
21. Recreation and Education[2]	108.0	111.8	3.5
22. Home Improvements[2]	108.9	110.5	1.5
23. Auto Accessories[2]	104.5	105.4	0.9
Groups 1 - 15: Soft Goods	539.2	557.7	3.4
Groups 16 - 20: Durable Goods	446.5	454.2	1.7
Groups 21 - 23: Misc. Goods[2]	107.4	110.3	2.7
Store Total[3]	508.9	523.6	2.9

[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, with the following exceptions: Candy, foods, liquor, tobacco, as well as contract departments.

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

LIFO; price indexes; department stores. The June 1990 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, 1990.

Rev. Rul. 90-78

The following price indexes for June 1990 were issued by the Bureau of Labor Statistics on July 20, 1990, for use by department stores, and are accepted by the Internal Revenue Service, under section 1.472-1(k) of the Income Tax Regulations and Rev. Proc. 86-46, 1986-2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, June 30, 1990.

Indexes are prepared on a national basis for the store total, for 23 major groups of departments, and for three special combinations—soft goods, durable goods and miscellaneous goods. The store total index covers all departments, including some not listed separately, with the following exceptions: candy, foods, liquor, tobacco, as well as contract departments.

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

Groups	June 1989	June 1990	Percent Change from June 1989 to June 1990[1]
1. Piece Goods	424.9	435.3	2.4
2. Domestics and Draperies	592.9	611.0	3.1
3. Women's and Children's Shoes	584.6	598.4	2.4
4. Men's Shoes	824.2	859.4	4.3
5. Infants' Wear	587.1	600.7	2.3
6. Women's Underwear	462.1	478.1	3.5
7. Women's Hosiery	246.1	253.5	3.0
8. Women's and Girls' Accessories	521.2	524.9	0.7
9. Women's Outerwear and Girls' Wear	378.8	398.8	5.3
10. Men's Clothing	536.9	556.4	3.6
11. Men's Furnishings	526.8	541.6	2.8
12. Boys' Clothing and Furnishings	439.5	456.2	3.8
13. Jewelry	803.4	857.4	6.7
14. Notions	523.0	555.3	6.2
15. Toilet Articles and Drugs	733.1	768.6	4.8
16. Furniture and Bedding	581.2	584.0	0.5
17. Floor Coverings	504.9	530.4	5.1
18. Housewares	724.3	744.6	2.8
19. Major Appliances	244.2	244.7	0.2
20. Radio and Television	93.6	91.4	-2.4
21. Recreation and Education[2]	108.2	112.2	3.7
22. Home Improvements[2]	109.0	112.0	2.8
23. Auto Accessories[2]	105.1	105.7	0.6
Groups 1-15: Soft Goods	529.9	550.8	3.9
Groups 16-20: Durable Goods	448.0	452.7	1.0
Groups 21-23: Misc. Good[2]	107.7	110.8	2.9
Store Total[3]	504.6	520.0	3.1

[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, with the following exceptions: Candy, foods, liquor, tobacco, as well as contract departments.

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

LIFO; price indexes; department stores. The July 1990 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, 1990.

Rev. Rul. 90-90

The following price indexes for July 1990 were issued by the Bureau of Labor Statistics on August 20, 1990, for use by department stores, and are accepted by the Internal Revenue Service, under section 1.472-1(k) of the Income Tax Regulations and Rev. Proc. 86-46, 1986-2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, July 31, 1990.

Indexes are prepared on a national basis for the store total, for 23 major groups of departments, and for three special combinations—soft goods, durable goods and miscellaneous goods. The store total index covers all departments, including some not listed separately, with the following exceptions: candy, foods, liquor, tobacco, as well as contract departments.

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

Groups	July 1989	July 1990	Percent Change from July 1989 to July 1990[1]
1. Piece Goods	418.5	445.3	6.4
2. Domestics and Draperies	595.5	607.0	1.9
3. Women's and Children's Shoes	580.5	591.0	1.8
4. Men's Shoes	822.1	858.7	4.5
5. Infants' Wear	565.8	601.8	6.4
6. Women's Underwear	462.4	481.8	4.2
7. Women's Hosiery	247.4	253.2	2.3
8. Women's and Girls' Accessories	520.2	523.6	0.7
9. Women's Outerwear and Girls' Wear	359.7	379.4	5.5
10. Men's Clothing	526.2	550.9	4.7
11. Men's Furnishings	522.3	532.2	1.9
12. Boys' Clothing and Furnishings	436.5	448.7	2.8
13. Jewelry	816.7	850.7	4.2
14. Notions	522.9	555.7	6.3
15. Toilet Articles and Drugs	733.6	766.7	4.5
16. Furniture and Bedding	583.4	593.0	1.6
17. Floor Coverings	504.5	531.1	5.3
18. Housewares	726.4	745.6	2.6
19. Major Appliances	244.8	247.5	1.1
20. Radio and Television	93.4	90.9	-2.7
21. Recreation and Education[2]	108.5	112.3	3.5
22. Home Improvements[2]	109.3	112.6	3.0
23. Auto Accessories[2]	104.7	105.8	1.1
Groups 1 - 15: Soft Goods	522.3	541.6	3.7
Groups 16 - 20: Durable Goods	448.8	454.5	1.3
Groups 21 - 23: Misc. Goods[2]	107.8	111.0	3.0
Store Total[3]	500.7	515.7	3.0

[1] Absence of a minus sign before percentage change in this column signifies price increase.

[2] Indexes on a January 1986 = 100 base.

[3] The store total index covers all departments, with the following exceptions: Candy, foods, liquor, tobacco, as well as contract departments.

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

LIFO; price indexes; department stores. The August 1990 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, 1990.

Rev. Rul. 90-97

The following price indexes for August 1990 were issued by the Bureau of Labor Statistics on September 20, 1990, for use by department stores, and are accepted by the Internal Revenue Service, under section 1.472-1(k) of the Income Tax Regulations and Rev. Proc. 86-46, 1986-2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, August 31, 1990.

Indexes are prepared on a national basis for the store total, for 23 major groups of departments, and for three special combinations—soft goods, durable goods and miscellaneous goods. The store total index covers all departments, including some not listed separately, with the following exceptions: candy, foods, liquor, tobacco, as well as contract departments.

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

Groups	August 1989	August 1990	Percent Change from August 1989 to August 1990[1]
1. Piece Goods	419.0	448.2	7.0
2. Domestics and Draperies	596.2	607.6	1.9
3. Women's and Children's Shoes	573.1	593.5	3.6
4. Men's Shoes	826.1	858.2	3.9
5. Infants' Wear	559.5	595.7	6.5
6. Women's Underwear	468.1	488.9	4.4
7. Women's Hosiery	247.1	251.8	1.9
8. Women's and Girls' Accessories	516.6	534.5	3.5
9. Women's Outerwear and Girls' Wear	357.0	387.6	8.6
10. Men's Clothing	527.5	562.7	6.7
11. Men's Furnishings	517.4	531.1	2.6
12. Boys' Clothing and Furnishings	442.3	444.3	0.5
13. Jewelry	817.8	853.4	4.4
14. Notions	530.1	549.3	3.6
15. Toilet Articles and Drugs	739.2	764.2	3.4
16. Furniture and Bedding	578.7	586.8	1.4
17. Floor Coverings	506.0	528.6	4.5
18. Housewares	733.4	744.5	1.5
19. Major Appliances	246.3	247.2	0.4
20. Radio and Television	92.2	90.3	−2.1
21. Recreation and Education[2]	108.3	112.5	3.9
22. Home Improvements[2]	109.5	114.1	4.2
23. Auto Accessories[2]	105.2	106.2	1.0
Groups 1 - 15: Soft Goods	521.2	545.1	4.6
Groups 16 - 20: Durable Goods	449.3	452.7	0.8
Groups 21 - 23: Misc. Goods[2]	107.9	111.5	3.3
Store Total[3]	500.3	517.5	3.4

[1] Absence of a minus sign before percentage change in this column signifies price increase.
[2] Indexes on a January 1986 = 100 base.
[3] The store total index covers all departments, with the following exceptions: Candy, foods, liquor, tobacco, as well as contract departments.

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

LIFO; price indexes; department stores. The September 1990 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, 1990.

Rev. Rul. 90-102

The following price indexes for September 1990 were issued by the Bureau of Labor Statistics on October 22, 1990, for use by department stores, and are accepted by the Internal Revenue Service, under section 1.472-1(k) of the Income Tax Regulations and Rev. Proc. 86-46, 1986-2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, September 30, 1990.

Indexes are prepared on a national basis for the store total, for 23 major groups of departments, and for three special combinations - soft goods, durable goods and miscellaneous goods. The store total index covers all departments, including some not listed separately, with the following exceptions: candy, foods, liquor, tobacco, as well as contract departments.

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

Groups	September 1989	September 1990	Percent Change from September 1989 to September 1990[1]
1. Piece Goods	424.0	452.3	6.7
2. Domestics and Draperies	606.3	614.6	1.4
3. Women's and Children's Shoes	582.2	611.4	5.0
4. Men's Shoes	830.4	853.6	2.8
5. Infants' Wear	565.2	600.0	6.2
6. Women's Underwear	474.9	493.5	3.9
7. Women's Hosiery	246.8	250.6	1.5
8. Women's and Girls' Accessories	529.0	538.1	1.7
9. Women's Outerwear and Girls' Wear	391.0	418.2	7.0
10. Men's Clothing	544.6	568.3	4.4
11. Men's Furnishings	527.8	542.5	2.8
12. Boys' Clothing and Furnishings	459.3	466.6	1.6
13. Jewelry	819.2	868.3	6.0
14. Notions	530.0	555.9	4.9
15. Toilet Articles and Drugs	737.5	770.0	4.4
16. Furniture and Bedding	580.8	586.6	1.0
17. Floor Coverings	499.9	543.2	8.7
18. Housewares	733.0	743.7	1.5
19. Major Appliances	246.1	246.7	0.2
20. Radio and Television	92.3	90.9	-1.5
21. Recreation and Education[2]	108.6	112.6	3.7
22. Home Improvements[2]	110.5	112.8	2.1
23. Auto Accessories[2]	105.2	106.3	1.0
Groups 1 - 15: Soft Goods	537.9	561.1	4.3
Groups 16 - 20: Durable Goods	449.2	453.5	1.0
Groups 21 - 23: Misc. Goods[2]	108.2	111.4	3.0
Store Total[3]	509.7	526.2	3.2

[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, with the following exceptions: Candy, foods, liquor, tobacco, as well as contract departments.

Part III. Adjustments

Section 481.—Adjustments Required By Changes In Method Of Accounting

26 CFR 1.481-1: Adjustments in general.

An administrative procedure is provided whereby certain life insurance companies may expeditiously obtain the consent of the Commissioner to change their method of accounting for ceding commissions to comply with the principles of Rev. Rul. 82-69 and the Supreme Court decision in *Colonial American Life Insurance Co.* See Rev. Proc. 90-36, page 357.

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26 CFR 1.481-5: Adjustments taken into account with consent.

Procedures are provided under which certain taxpayers are deemed to have obtained the approval of the Commissioner to a change in method of accounting for reporting interest income on short-term loans to customers to the method required by section 1281 of the Code. See Rev. Proc. 90-37, page 361.

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26 CFR 1.481-5: Adjustments taken into account with consent.

For a revenue procedure that describes three alternative methods of accounting for package design costs and provides the exclusive procedure for taxpayers to obtain consent from the Commissioner to change to each of the alternative methods. See Rev. Proc. 90-63, page 664.

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 1990. See Rev. Rul. 90-52, page 192.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1990. See Rev. Rul. 90-66, page 194.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1990. See Rev. Rul. 90-75, page 195.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1990. See Rev. Rul. 90-81, page 196.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1990. See Rev. Rul. 90-92, page 198.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1990. See Rev. Rul. 90-99, page 199.

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 1990 calendar year. See Rev. Rul. 90-68, page 200.

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

Section 501.—Exemption from Tax on Corporations, Certain Trusts, etc.

26 CFR 1.501(c)(3)-1: Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.

T.D. 8308

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1, 7, 20, 25, 53, 56 and 602

Lobbying by Public Charities; Lobbying by Private Foundations

AGENCY: Internal Revenue Service, Treasury

ACTION: Final regulations

SUMMARY: This document contains final regulations about lobbying expenditures by certain tax-exempt public charities and by private foundations. Changes to the tax laws governing lobbying by public charities were made by the Tax Reform Act of 1976 (the "Act") [Pub. L. 94-455, 1976-3 C.B. (Vol. 1) 1]. These regulations will provide organizations the guidance needed to comply with the Act, and will affect public charities electing the expenditure test under section 501(h) of the Internal Revenue Code of 1986 ("electing public charities"). These regulations will also provide organizations with clearer guidance needed to comply with the requirements of section 4945 (relating to lobbying expenditures by private foundations). Finally, in light of the unique charitable and educational purposes shared by all organizations described in section 501(c)(3), as well as the similarity of the statutory schemes governing lobbying by private foundations and by electing public charities, the regulations ensure that the rules regarding lobbying by private foundations are consistent with the rules regarding lobbying by electing public charities. However, these regulations do not apply to lobbying by ineligible or nonelecting public charities, which continue to be covered by the "substantial part" test regarding lobbying activities. Nor does any portion of these regulations apply to section 162(e), which allows a business expense deduction for certain lobbying expenses but disallows any deduction for certain others.

DATES: The regulations are effective for taxable years beginning after August 31, 1990.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in this final regulation have been reviewed and approved by the Office of Management and Budget in accordance with the requirements of the Paperwork Reduction Act (44 U.S.C. 3504(h)) under control number 1545-0052. The estimated annual burden per respondent varies from 1/4 hour to 10 3/4 hours, depending on individual circumstances, with an estimated average of 2 1/2 hours. The estimated average annual burden per recordkeeper is 4 hours.

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

Comments concerning the accuracy of these burden estimates and suggestions for reducing the burden should be directed to the Internal Revenue Service, Attn: IRS Reports Clearance Officer T:FP, Washington, D.C. 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, D.C. 20503.

OUTLINE OF IMPORTANT PORTIONS OF THIS TREASURY DECISION:

I. PREAMBLE

A. Prior Law
B. Summary of Expenditure Test
C. Background on Procedural History
D. Summary of Comments on the Three NPRMs and Explanation of Provisions in Final Regulations (including 20 separate items and a Question and Answer overview)

II. AMENDMENTS TO THE REGULATIONS

A. Deduction for charitable gifts to organizations that lobby (§§170, 2055, 2522)
B. Effect of lobbying on qualification as a tax-exempt organization (§§501(c) and 504)
C. Application of "expenditure test" limits to lobbying expenditures by electing public charities (§501(h))
D. Excise tax on private foundations' lobbying expenditures (§4945)
E. Excise tax on electing public charities' excess lobbying expenditures, including important definitions (§4911)

Prior Law

An organization will lose its tax exempt status under section 501(c)(3) if a substantial part of its activities is lobbying. This is known as the "substantial part test." Before the Tax Reform Act of 1976, there was uncertainty about what constituted a "substantial part" of an organization's activities. Congress was aware both of the severity of loss of tax exemption as a sanction and of the belief that the vague standards of the substantial part test tended to create uncertainty and allow subjective and selective enforcement. (Subsequent to the Tax Reform Act of 1976, in the Omnibus Budget Reconciliation Act of 1987, Congress enacted section 4912. That section imposes an excise tax on the lobbying expenditures of public charities, other than churches and certain church affiliated organizations, whose tax exempt status is revoked for violating the "substantial part test".)

Expenditure Test

Because of its concerns about the "substantial part test," Congress en-

acted, in 1976, an alternative to the substantial part test. Under sections 501(h) and 4911, which were added by section 1307 of the Tax Reform Act of 1976, certain publicly supported section 501(c)(3) organizations may elect to spend up to a certain (declining) percentage of their "exempt purpose expenditures" to influence legislation without incurring tax or losing qualification for tax-exempt status. Thus, if an eligible organization elects the "expenditure test" of sections 501(h) and 4911, specific statutory dollar limits on the organization's lobbying expenditures apply. Under the expenditure test, there are limits both upon the amount of the organization's grass roots lobbying expenditures and upon the total amount of the organization's direct and grass roots lobbying expenditures. In contrast to the substantial part test, the expenditure test imposes no limit on lobbying activities that do not require expenditures, such as certain unreimbursed lobbying activities conducted by bona fide volunteers. In general, if either or both of the expenditure test limits are exceeded, section 4911 imposes a 25 percent excise tax upon the greater of: (1) the amount by which the organization's grass roots lobbying expenditures exceed its grass roots lobbying limit, or (2) the amount by which an organization's total direct and grass roots lobbying expenditures exceed its total lobbying limit. Additionally, if an organization's grass roots expenditures or total lobbying expenditures normally exceed 150 percent of the applicable limitation on its lobbying expenditures, the organization will cease to be described in section 501(c)(3), and, therefore, will no longer be exempt from income tax or be eligible to receive tax deductible charitable contributions.

For more information about the expenditure test and related issues, see item 20, Simplified Summaries, near the end of this Preamble. That item provides an easy to understand overview, in Question and Answer format, of the laws governing certain taxexempt organizations' lobbying and political activities and expenditures.

Background

On November 25, 1980, the Federal Register published proposed amendments to the Income Tax Regulations (26 CFR Part 1) under sections 162, 6001, and 6033 of the Internal Revenue Code of 1954 (relating to grass roots lobbying expenditures by business corporations) and to the regulations on Foundation and Similar Excise Taxes (26 CFR Part 53) under section 4945 of the Internal Revenue Code of 1954 (relating to lobbying expenditures by private foundations) (45 FR 78167) ("the 1980 NPRM").

On November 5, 1986, the Federal Register published proposed amendments to the Income Tax Regulations (26 CFR Part 1), Temporary Income Tax Regulations under the Tax Reform Act of 1976 (26 CFR Part 7), Estate Tax Regulations (26 CFR Part 20), Gift Tax Regulations (26 CFR Part 25), and Foundation and Similar Excise Taxes (26 CFR Part 53), and also proposed regulations on Public Charity Excise Taxes (26 CFR Part 56), under sections 170, 501(c)(3), 501(c)(4), 501(h), 504, 2055, 2522, 4911, 4945, 6001, 6011, and 6033 of the Internal Revenue Code of 1954 (51 FR 40211) ("the 1986 NPRM") [EE-154-78, 1986-2 C.B. 750].

On December 23, 1988, the Federal Register published proposed amendments to the Income Tax Regulations (26 CFR Part 1), Foundation and Similar Excise Taxes (26 CFR Part 53), and also proposed regulations on Public Charity Excise Taxes (26 CFR Part 56) ("the 1988 NPRM") [EE-154-78, 1989-1 C.B. 925].

The 1988 NPRM superseded that portion of the 1980 NPRM that proposed amendments to the regulations under section 4945 of the Internal Revenue Code (relating to lobbying expenditures by private foundations). The 1988 NPRM also substantially revised certain parts of the 1986 NPRM relating to proposed regulations on Public Charity Excise Taxes (26 CFR Part 56) under section 4911 of the Internal Revenue Code. The 1988 NPRM also revised portions of the 1986 NPRM that proposed amendments to the regulations under sections 501(h) and 4945.

The 1988 NPRM contained major modifications of the 1986 NPRM definitions, including the definition of grass roots lobbying. Under the changes made in the 1988 NPRM, far fewer communications by public charities that elect the expenditure test will be considered lobbying than would have been the case under the 1986 NPRM. The 1988 NPRM also modified the definitions contained in the regulations under section 4945 (relating to lobbying by private foundations) to make them consistent with the definitions for public charities that elect the expenditure test.

Public Comments on the Three Notices of Proposed Rulemaking

More than 10,000 written comments were received concerning the 1986 NPRM. Numerous written comments were also received concerning the 1980 NPRM. In addition, on May 11 and 12, 1987, the Internal Revenue Service ("Service") held public hearings concerning the 1986 NPRM.

The numerous public comments and the two days of public hearings were helpful in formulating the 1988 NPRM. In addition, possible revisions to the controversial sections of the 1986 NPRM were discussed at length with the Commissioner's Exempt Organizations Advisory Group (comprised of legal and other representatives of exempt organizations as well as academics) at public meetings held on September 17, 1987, and February 26, 1988.

The 1988 NPRM resulted from a careful balancing of the statutory mandate limiting the amount of lobbying expenditures by section 501(c)(3) organizations with the expressed desire of the affected organizations and individuals to involve themselves in the public policymaking process to the greatest extent consistent with that statutory mandate. As a result, the 1988 NPRM made extensive changes to the 1980 NPRM and the 1986 NPRM in an effort to achieve this difficult balance. For example, the 1988 NPRM contains a definition of grass roots lobbying that is less inclusive than is permitted by the broad statutory language defining grass roots lobbying.

The 1988 NPRM resulted in fewer than 100 written comments from the public (as opposed to the more than 10,000 written public comments resulting from the 1986 NPRM). The 1988 NPRM was discussed with the Commissioner's Exempt Organizations Advisory Group at a public meeting held on January 10, 1989. A formal public hearing on the 1988 NPRM, with six speakers, was held on April 3, 1989.

Summary of Comments Received on the 1988 Notice of Proposed Rulemaking and Explanation of Provisions

1. *The General Definition of "Grass Roots Lobbying"*

The most significant revision of the 1986 NPRM in the 1988 NPRM was in the general definition of grass roots lobbying. The 1988 NPRM provides that, with limited exceptions, a communication is grass roots lobbying only if it:

1) refers to specific legislation;
2) reflects a view on such legislation; and
3) encourages the recipient of the communication to take action with respect to such legislation.

Most of the comments generally praised this revision, although, as described in more detail below, the comments also requested additional changes in and explanations of the terms "specific legislation," "refers to," "reflects a view" and "encourages ... action."

Even though this general definition is very lenient and will permit many clear advocacy communications to be treated as nonlobbying, the final regulations retain the general definition in substantially unchanged form. This is part of the Service's attempt to maintain a careful balance between the statutory limits on electing public charities' lobbying expenditures and the desire of those organizations to involve themselves in the public policymaking process to the greatest extent consistent with those statutory limits.

2. *Definition of "Specific Legislation"*

The 1988 NPRM provides that a communication is generally not considered lobbying unless it refers to specific legislation and reflects a view on that legislation. The term "specific legislation" is defined as including both legislation that has already been introduced and a specific legislative proposal that the organization either supports or opposes. Several examples in the 1988 NPRM further illustrate the meaning of the term "specific legislation" in particular fact situations.

A number of comments considered the term "specific legislation" to be vague. Also, several comments objected to the removal of certain language from the private foundation regulations. That language provided that lobbying includes attempts to influence legislation "to be submitted imminently to" a legislative body.

Deletion of the term "imminently" is justified because the term implies that a temporal standard determines whether or not an unintroduced legislative proposal is "specific legislation" that can be influenced. Given the nature of the legislative process, a temporal standard is inappropriate and underinclusive. For example, numerous specific legislative proposals are subject to extensive scrutiny, debate and controversy long before they are formally introduced as a bill. Moreover, effective lobbying could prevent a bill from ever being introduced. Therefore, the final regulations do not reintroduce the "to be submitted imminently" standard into the definition of "specific legislation".

In response to the comments regarding the vagueness of the definition of "specific legislation," the final regulations include additional examples. Like several examples already in the 1988 NPRM, these new examples further illustrate the scope of the term "specific legislation".

3. *Definition of "Legislation"*

One comment expressed concern about the scope of the statutory and regulatory definition of "legislation." Under both the statute and the proposed regulations, the term "legislation" includes "Acts, bills, resolutions, or similar items." The final regulations do not further expand on this language, except to include examples showing that the Senate's confirmation vote on Executive branch nominees is a vote on "legislation." This position is consistent with a published Service position, Notice 88-76, 1988-2 C.B. 392.

4. *Definition of "Refers To" and "Reflects a View"*

Under the 1988 NPRM, a communication is generally not a lobbying communication unless it refers to specific legislation and reflects a view on that specific legislation. A few comments requested more detail in defining the terms "refers to" and "reflects a view." The final regulations do not further define these terms. However, a number of the examples contained in the final regulations illustrate both terms.

5. *Definition of "Encourages Recipient to Take Action"*

Under the 1988 NPRM, a communication is generally not a grass roots lobbying communication unless (in addition to referring to specific legislation and reflecting a view on that legislation) it encourages recipients to take action with respect to the specific legislation. The 1988 NPRM states that a communication encourages a recipient to take action when it: 1) states that the recipient should contact legislators; 2) states a legislator's address, phone number, etc; 3) provides a petition, tear-off postcard or similar material for the recipient to send to a legislator; or 4) specifically identifies one or more legislators who will vote on legislation as: opposing the communication's view on the legislation, being undecided about the legislation, being the recipient's representative in the legislature, or being a member of the legislative committee that will consider the legislation. Further, a communication with the fourth type of encouragement to take action is grass roots lobbying only if, in addition to referring to and reflecting a view on specific legislation, it is a partisan communication that can not meet the "full and fair exposition" test as nonpartisan analysis, study or research.

Some comments argued that the fourth type of encouragement to a recipient to take action was too indirect and overinclusive. One comment contended that there should be a de minimis exception that would examine the communication as a whole.

The final regulations do not substantially modify the 1988 NPRM definition of "encouraging recipients to take action." Under the standard contained in the final regulations, clear advocacy of specific legislation is not grass roots lobbying at all unless it contains an encouragement to action. Further, if an advocacy communication contains only the fourth type of encouragement to action, the communication is not grass roots lobbying unless it is partisan. The Service believes this standard, holding that certain communications that clearly advocate or oppose specific legislation are not grass roots lobbying, is very lenient. Therefore, the Service believes that any further changes would only serve to deplete a standard that already allows numer-

ous clear advocacy communications to be treated as nonlobbying.

6. *Subsequent Use of Nonlobbying Material*

The 1988 NPRM provides that expenses incurred for nonlobbying materials or communications may, in certain circumstances, be characterized as lobbying expenditures where those materials or communications are subsequently used in a lobbying effort. Under the 1988 NPRM, this occurs only if the primary purpose of the organization in preparing the materials or communication was for use in lobbying. If the later lobbying use is by an organization that is not related to the organization that prepared the material, the organization preparing the materials will be charged with lobbying expenditures only if there is clear and convincing evidence of a lobbying purpose on the part of the preparing organization.

The 1988 NPRM provides a "safe harbor" for organizations concerned about the rule. The "safe harbor" provides that if the materials or communications are substantially distributed in a nonlobbying form prior to, or contemporaneously with, the lobbying use, the organization preparing the materials is not charged with a lobbying expenditure for the preparation of the materials or communications, regardless of later lobbying use of the materials by the preparing organization or any other organization.

Several comments stated that the clear and convincing standard for lobbying use by an unrelated organization should require conscious cooperation or collusion between the two organizations involved. Other comments objected that the subsequent use rule applies for an indefinite time period after materials are prepared. Some comments requested a safe harbor for raw, unpublished research data. Finally, several comments requested clarification of whether, for purposes of the safe harbor, the term "substantial distribution" is tested against the normal pattern of distribution of the preparing organization itself or of similar organizations.

In drafting the subsequent use rules in the 1988 NPRM, the Service attempted to meet two principal goals. The first goal was to limit potential abuses, such as where a charity creates a "nonlobbying" document advocating or opposing specific legislation, treats the preparation costs as nonlobbying, and then immediately adds an encouragement for the recipients to take action. The Service's second goal was to limit the anti-abuse rules in order to avoid treating as lobbying any research and preparation costs that were not intended to assist in lobbying efforts.

The final regulations restructure the subsequent use rule to make it easier to understand and apply. The final regulations clarify the scope of the clear and convincing evidence standard by specifying that for that standard to be met there must be evidence of cooperation or collusion between two unrelated organizations. The final regulations also clarify that the "safe harbor" distribution is tested against the normal pattern of distribution by that and similar organizations. Further, the final regulations set a time limit on the application of the subsequent use rule: if nonlobbying material is used in a lobbying campaign, the subsequent use rule applies only to expenditures paid less than six months before the first use of the nonlobbying material in the lobbying campaign.

7. *Nonpartisan Analysis, Study or Research*

Under the statute and the 1988 NPRM, nonpartisan analysis, study or research is not lobbying. The 1988 NPRM clarifies (both for private foundations and electing public charities) that a communication that reflects a view on specific legislation is not nonpartisan analysis, study or research if it directly encourages the recipients to take action with respect to legislation. The 1988 NPRM provides that the term "directly encourages" includes the first three of the four methods of encouraging recipients to take action. (Those four methods are set forth in the general grass roots lobbying definition and are also listed in item 5 of this Preamble.) Therefore, under the 1988 NPRM, a communication can be nonpartisan analysis, study or research even if it reflects a view on specific legislation and includes the fourth method of encouraging a recipient to action, so long as it does not include any of the first three methods of encouragement.

Several comments contended that even when a communication *directly* encourages recipients to take action, the communication may be nonpartisan analysis, study or research if the direct encouragement is incidental to the nonpartisan nature of the document.

The final regulations do not modify the 1988 NPRM on this point. The Service believes that any further loosening of the standard is not appropriate because this rule does not even come into consideration unless the communication refers to and reflects a view on specific legislation.

8. *Rebuttable Presumption for Mass Media Communications Two Weeks Before a Legislative Vote on Highly Publicized Legislation*

The 1988 NPRM provides a special rule for a limited number of communications in the mass media. The mass media rule in the 1988 NPRM is a rebuttable presumption that a mass media communication is grass roots lobbying if it: 1) is made within two weeks before a vote by a legislative body, or committee thereof, on highly publicized legislation; 2) reflects a view on the general subject of that legislation; and 3) either refers to the legislation or encourages the public to communicate with legislators on the general subject of the legislation. The presumption is rebutted either by showing that the charity regularly makes similar mass media communications without regard to the timing of legislation or that the communication's timing was unrelated to the upcoming vote.

The mass media rule in the 1988 NPRM was intended to deal with situations where a clear encouragement for the recipients to take action is not necessary in order for the communication to influence the public to contact legislators. The Service believes that such a situation exists where a communication contains the above-described elements and is made in the mass media within two weeks before a legislative vote on highly publicized legislation. In these situations, the Service believes recipients are sufficiently aware of the legislation to not require a specific encouragement to action.

Numerous comments were received about this rebuttable presumption for certain mass media communications. Many comments objected to the two week rule. They claimed that organi-

zations could never be sure when a communication would come under the rule since the timing of legislative votes is never certain.

The final regulations do not modify the two week rule. The Service notes that this rule can also favor charities. For example, if a vote is delayed or cancelled, the communication would not fall within the rule even if the organization fully expected that there would be a vote within two weeks of its mass media communication. This is clearly illustrated by new examples in the final regulations.

In considering charities' concerns about the two week rule, the Service considered whether the mass media presumption should apply whenever the legislation is highly publicized during the two weeks *before the advertisement is placed.* Under such a rule, a charity would know at the time it places an advertisement whether or not the mass media presumption applies.

The Service rejected this idea because such a rule would be even stricter than the 1988 NPRM. Because a given bill may be highly publicized for extended periods even in the absence of any legislative votes, such a rule could mean that all mass media communications on the general subject of that bill would be presumed grass roots lobbying (if the communication either mentions the bill or urges contact with legislators).

The Service believes that the two week rule as proposed in the 1988 NPRM strikes a reasonable balance. It focuses only on the time period when abuses are most likely to occur: when a legislative vote occurs shortly after the communication.

Several comments objected that the rule could include news reports in the mass media about an organization's lobbying. In response to these comments, the final regulations limit the rule to paid advertisements in the mass media as well as a very limited number of communications made by a charity in its own large scale mass media publication or broadcast.

A few comments noted critically that the 1988 NPRM does not apply the mass media presumption to large-scale direct mailings. Some comments said that this is unfair to charities that do not have large mailing lists. Other comments criticized this as a loophole for charities that do have large mailing lists. The final regulations do not apply the presumption to large-scale direct mailings. If significant abuses develop involving these direct mailings, the Service will consider proposing changes to the final regulations.

Several comments requested additional specificity on the meaning of the terms "highly publicized" and "general subject of the legislation." The scope of the former term is narrowed somewhat by the final regulations, and the 1988 NPRM's examples illustrating that term are retained. The final regulations do not significantly define the latter term beyond the 1988 NPRM's examples illustrating the term. The final regulations do not adopt a suggestion that the mass media presumption arises only where the mass media communication in question refers to specific legislation. Nor do the final regulations adopt a suggestion that the legislative vote, rather than the legislation, must be highly publicized in order for the mass media presumption to apply, but the final regulations do adopt a suggestion that subcommittee votes not be considered legislative votes for purposes of the mass media rule. Finally, in response to comments, changes were made in various examples illustrating the mass media rule.

The final regulations largely retain the 1988 NPRM's rebuttable presumption without substantial changes, although various technical revisions have been made. The Service believes that this rebuttable, and narrowly crafted, presumption provides an important bright line test for a very limited number of high profile communications for a very limited period of time. Any further narrowing of this rule could essentially eliminate the presumption.

9. *Referenda and Ballot Initiatives*

The 1988 NPRM includes several examples illustrating that an attempt to influence the outcome of a voter referendum or voter initiative is grass roots lobbying.

Many comments argued that expenditures to influence referenda and ballot initiatives should be considered direct lobbying expenditures rather than grass roots lobbying expenditures. Under the regulations, a communication is direct lobbying if and only if it is a communication with a legislator (or with certain other government officials) that both refers to and reflects a view on specific legislation. The comments contended that the voting public acts as the legislature with respect to a referendum or ballot initiative. Several comments also noted that, read literally, the 1988 NPRM's four categories of encouraging recipients to take action do not apply to attempts to influence referenda and ballot initiatives.

The final regulations provide that expenditures for attempts to influence referenda and ballot initiatives are considered direct lobbying expenditures. However, these final regulations do not modify the definition of direct lobbying (which requires that a communication with legislators refer to and reflect a view on specific legislation). Therefore, communications on referenda and ballot initiatives will be considered direct lobbying if they refer to and reflect a view on specific legislation, without the requirement (found in the definition of grass roots lobbying) for an encouragement to action.

There is no requirement for an encouragement to action in the definition of direct lobbying because direct lobbying communications are directed to legislators themselves, whereas grass roots lobbying communications are not directed at legislators and, to be most effective at influencing legislation, must generally encourage their recipients to contact legislators. Where the general public is the legislature, a communication directed to any member of the general public is directed to a legislator. Accordingly, in such a situation, a communication that refers to and reflects a view on specific legislation is designed to influence that recipient/legislator's vote, without regard to whether it encourages the recipient/legislator to contact others.

The final regulations also provide rules on when a referendum or ballot initiative is considered "specific legislation."

10. *Allocation Rules*

The 1988 NPRM has two different allocation rules for communications that have both a lobbying and a bona fide nonlobbying purpose. One allocation rule simply requires a "reasonable allocation." That rule applies to

an electing public charity's communications with its bona fide members.

The second allocation rule in the 1988 NPRM is for nonmembership communications. Where a nonmembership lobbying communication also has a bona fide nonlobbying purpose, the 1988 NPRM provides that an organization must include as lobbying expenditures all costs attributable to those parts of the communication that are on the same specific subject as the lobbying message. In general, the 1988 NPRM provides that part of the communication is on the "same specific subject" if it:

> ... discusses an activity or specific issue that would be directly affected by the proposed legislation that is the subject of the lobbying message. Moreover, discussion of the background or consequences of the proposed legislation, or discussion of the background or consequences of an activity or specific issue affected by the proposed legislation, is also considered to be on the same specific subject.

Many comments urged that the scope of the term "same specific subject" be narrowed and also be further defined. Some comments urged that the "same specific subject" rule be replaced with a "reasonable allocation" rule for all lobbying communications that also have a bona fide nonlobbying purpose.

The final regulations do not modify the "same specific subject" rule, but they do add an example further illustrating the scope of the rule. The Service believes this allocation rule is necessary in light of the lenient definition of grass roots lobbying. A weakening of the allocation rule, in combination with the final regulations' lenient definition of grass roots lobbying, could virtually eliminate the statutory limitation on an electing public charity's lobbying expenditures.

11. *Transfers to Noncharities That Lobby*

The 1988 NPRM provides that transfers by an electing public charity to a noncharity that lobbies will, in certain circumstances, be a grass roots or direct lobbying expenditure by the electing public charity even if the transfer is not earmarked for lobbying. However, a transfer to a noncharity is not treated as a lobbying expenditure if the transfer is a controlled grant (the charity limits the transfer to a nonlobbying specific project of the noncharity and maintains records on the grant's use).

Most comments expressed concern about the scope of the term "transfer." That term was not defined in the 1988 NPRM. The comments expressed particular concern about whether the rule included transfers for fair market value.

The final regulations clarify and limit the meaning of the term "transfer" to situations where the charity receives less than fair market value in return for the transfer. Also, the final regulations do not apply the transfer rule if the transfer is made for less than fair market value and a significant number of members of the general public receive goods or services from the charity at the same favorable (less than fair market value) price.

12. *The Production of Income as "Exempt Purpose Expenditures"*

The 1988 NPRM provides that costs for the production of income are not exempt purpose expenditures and, therefore, are not included in the base of expenditures on which the amount of permissible lobbying expenditures is calculated.

Several comments requested that the final regulations clarify that expenses for a substantially related trade or business are included as exempt purpose expenditures. Another comment requested that expenditures to manage an endowment be considered exempt purpose expenditures.

The final regulations clarify that expenditures are not exempt purpose expenditures if they are for a purpose or activity that is not substantially related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the organization's charitable, educational or other purpose that is the basis for the organization's exemption under section 501(c)(3). The final regulations also clarify that the costs of managing an endowment are not included as exempt purpose expenditures since they are incurred for the production of income.

13. *Fundraising Costs*

Under section 4911, amounts paid to or incurred for a separate fundraising unit are not exempt purpose expenditures. The 1988 NPRM defines the meaning of the term "separate fundraising unit."

Several comments requested guidance on whether postage and related costs paid directly by a charity for a fundraising communication prepared by a separate fundraising unit are costs that are incurred for a separate fundraising unit.

The final regulations clarify that amounts incurred for the creation, production, copying, and distribution of a separate fundraising unit's fundraising communication are amounts paid to or incurred for a separate fundraising unit, regardless of whether the charity pays some of the costs directly rather than through the separate fundraising unit.

14. *Affiliation Rules*

The 1988 NPRM did not change the extensive affiliation rules that were contained in the 1986 NPRM. These rules implement section 4911(f).

Several comments requested the deletion of the 1986 NPRM's provision that two organizations can be affiliated on the basis of an "implication" in one organization's governing instrument that that organization is bound by the other organization's legislative positions. Two comments requested that the regulations require affiliation only among section 501(c)(3) organizations and not include non-section 501(c)(3) organizations as members of an affiliated group.

The final regulations eliminate "implication" in a governing instrument as a test for whether two organizations are affiliated. The final regulations retain the position that, in determining whether two section 501(c)(3) organizations are affiliated, non-section 501(c)(3) affiliations will be considered. The Service believes that where two section 501(c)(3) organizations are not affiliated with each other, but are both affiliated with a section 501(c)(4) organization, the two section 501(c)(3) organizations are members of an affiliated group for purposes of section 4911. However, in the actual calculation of the expenditure test, only those members of the affiliated group that have elected are considered.

15. *Requests for Technical Advice*

The 1988 NPRM did not revise the 1986 NPRM provision that an organization is not lobbying if it testifies or presents written testimony to a legislative body or committee in response to a written request from that body or committee for technical advice.

One comment requested the elimination of the requirement that the request for technical advice be in writing. The comment also requested that the technical advice exception apply even if the request for technical advice is from an individual legislator or government official, as opposed to a legislative body or committee.

The final regulations do not substantially modify the technical advice exception. The Service believes that the requirements that the request be both in writing and from a legislative body or committee are clear statutory requirements. The Service is unable to discern any legislative intent for additional flexibility with respect to the technical advice exception.

16. *Self-Defense Exception*

The 1988 NPRM did not revise the 1986 NPRM provision that certain self-defense lobbying by an electing public charity is not treated as lobbying. One comment requested that this exception be revised to exclude from lobbying any lobbying by a section 501(c)(3) organization on issues affecting that organization's section 501(c)(3) members, even if not all members of the organization are section 501(c)(3) organizations. With certain restrictions, the final regulations do generally adopt this suggestion.

17. *Fairness Doctrine*

The 1986 and 1988 NPRMs included in the nonpartisan analysis, study or research exception a reference to the Fairness Doctrine. This reference first appeared in that exception as that exception was published in the regulations under section 4945.

Two comments requested that the reference to the Fairness Doctrine be deleted from the final regulations in light of uncertainty about the status of that doctrine. The comments stated that the application of the Fairness Doctrine is a matter best dealt with directly through Federal communications law and that it is inappropriate for the Fairness Doctrine to be applied indirectly through the tax law.

The final regulations delete references to the Fairness Doctrine from both the proposed regulations and the existing section 4945 regulations.

18. *Conforming Amendments*

The final regulations amend the regulations under §§1.170A-1(h)(5)(ii), 20.2055-1(a)(2) and 25.2522(a)-1(a)(2) by inserting the words "or in opposition to" after the words "any political campaign on behalf of". This change is a technical amendment so that each of these regulations conforms to its respective statute as well as to section 501(c)(3) as amended by the Omnibus Budget Reconciliation Act of 1987.

19. *Miscellaneous and Technical Comments*

The final regulations also contain a number of technical revisions. Most of these changes are being made in response to public comments.

20. *Simplified Summaries*

Each major section of the regulations is preceded by a brief and simple summary of the rules in that section. Also, the following 17 Questions and Answers should be of particular help to readers. These Q&As provide an easy to understand overview of the laws governing certain tax-exempt organizations' lobbying and political activities and expenditures. The Service hopes the Q&As and the final regulations' brief summaries will help readers more easily use the regulations.

The Q&As do not impose additional requirements or rules, nor do they amend or affect the text of the regulations. The Q&As are intended only to be a simple guide to understanding the regulations and should not be used as a substitute for reading the regulations. If there is any conflict between the Q&As and the text of the regulations, the text of the regulations controls. The chart that immediately precedes the questions and answers is designed to help illustrate the answers to some of the Q&As.

	CHARITIES (§501(c)(3) organizations)			CERTAIN NONCHARITIES (such as §501(c)(4) Social Welfare Organizations, §501(c)(5) Labor Unions and §501(c)(6) Professional Societies)
	PUBLIC CHARITIES		PRIVATE FOUNDATIONS	
	ELECTING	NONELECTING		
LOBBYING	*YES*, may lobby freely so long as lobbying expenses are within specified limits (the "expenditure test")—§§501(h) and 4911.[1]	*YES*, may lobby freely so long as lobbying is not a substantial part of the organization's activities ("substantial part test")—§501(c)(3).[2]	*NO*, lobbying expenditures are subject to a potentially severe two-tier excise tax—§4945.[3]	*YES*, may generally lobby in unlimited amounts so long as the lobbying is in furtherance of the noncharity's exempt purposes.[4]
INTERVENTION IN POLITICAL CAMPAIGN FOR ELECTIVE PUBLIC OFFICE	*NO*, intervening in a political campaign will cause loss of tax-exempt status and may also give rise to excise or other taxes—§501(c)(3), §527(f), §4945 (private foundations only), and §4955.[4]			*YES*, but:[4] 1) the noncharity's primary purpose and/or activities may not be political campaign intervention; and

	CHARITIES (§501(c)(3) organizations)			CERTAIN NONCHARITIES (such as §501(c)(4) Social Welfare Organizations, §501(c)(5) Labor Unions and §501(c)(6) Professional Societies)
	PUBLIC CHARITIES		PRIVATE FOUNDATIONS	
	ELECTING	NONELECTING		
				2) the noncharity may be subject to tax under §527(f) unless it maintains a separate segregated fund (essentially, a PAC).

[1] The §501(h) lobbying expenditure limit and the §4911 tax on excess lobbying expenditures apply.
[2]The §501(h) lobbying expenditure limit and the §4911 tax on excess lobbying expenditures do not apply. If, however, a substantial part of the public charity's activities is lobbying, the public charity will lose both its tax-exempt status under §501(c)(3) and its ability to receive tax-deductible charitable contributions. Also, public charities (other than churches) and their managers (in certain cases) are subject to an excise tax under §4912 on the lobbying expenditures.
[3]The §501(h) lobbying expenditure limit and the §4911 tax on excess lobbying expenditures do not apply. However, §4945 imposes a tax on any lobbying expenditure by a private foundation. Many definitions in the §4911 regulations apply.
[4]The §501(h) lobbying expenditure limit and the §4911 tax on excess lobbying expenditures do not apply.

Q-1: *Does the tax under section 4911 apply to all tax exempt organizations?*

A-1: No, the section 4911 tax does not apply to all tax exempt organizations: it applies only to certain organizations that are described in section 501(c)(3). Section 501(c)(3), generally speaking, describes charitable, educational and religious organizations. Therefore, for example, the tax does not apply to such tax exempt organizations as social welfare organizations (section 501(c)(4)), labor unions (section 501(c)(5)), or business leagues, chambers of commerce, or trade associations (section 501(c)(6)).

Q-2: *To which organizations described in section 501(c)(3) does the section 4911 tax apply?*

A-2: There are two kinds of section 501(c)(3) organizations: private foundations and public charities. (Private foundations generally are funded by a small number of individuals or corporations while public charities are generally funded by contributions from the general public and payments for services (see section 509(a)).) The section 4911 tax does not apply to all organizations described in section 501(c)(3): it applies only to "electing public charities." Electing public charities are those public charities that have made a valid election to be covered by the lobbying expenditure test under sections 501(h) and 4911. The rules about making and revoking the election, including the rules about which public charities are eligible to make the election, are in section 501(h) and in §1.501(h) of the regulations. The section 4911 tax does not apply to private foundations (but see Q&A-4), nor does the tax apply to nonelecting public charities (public charities that have not made a valid election to be covered by sections 501(h) and 4911) (but see Q&A-3).

Q-3: *What, in general terms, is the effect of sections 501(h) and 4911 on nonelecting public charities?*

A-3: If a public charity does not have a valid section 501(h) election in effect during a given year, that nonelecting public charity's lobbying activities and expenditures during that year are not covered by sections 501(h) and 4911, but are instead covered by what is known as the "substantial part test" under section 501(c)(3). In other words, sections 501(h) and 4911 do not apply to or affect nonelecting public charities. In fact, section 501(h)(7) says that nothing in sections 501(h) and 4911 (or the applicable Treasury Regulations) may be used to interpret the meaning of or the rules and definitions under the "substantial part test." (For a very brief summary of the "substantial part test," see Q&A-17).

Q-4: *What, in general terms, is the effect of sections 501(h) and 4911 on private foundations?*

A-4: Private foundations' lobbying expenditures are taxed under section 4945(d) rather than under section 4911. Unlike section 4911, which taxes only excessive lobbying expenditures, section 4945(d) taxes any lobbying expenditure by a private foundation. Even though the section 4911 tax does not apply to private foundations, portions of the regulations under section 4911 are nonetheless relevant to private foundations because the definition of what is and is not a lobbying expenditure is generally the same under section 4911 as under section 4945 (see §§56.4911-2 and -3, but disregard §56.4911-5).

Q-5: *To which expenditures by an electing public charity does the section 4911 tax apply?*

A-5: The section 4911 tax applies only to excess lobbying expenditures by an electing public charity. The tax does not apply to all lobbying expenditures by an electing public charity, but only to that portion of the organization's lobbying expenditures that exceed one of two permitted lobbying levels for that organization for that year. One of the permitted lobbying levels is based on total lobbying expenditures: total expenditures for both direct and grass roots lobbying. The other permitted lobbying level is a separate limit based on grass roots lobbying expenditures. See Q&A-12 for a general explanation of the difference between direct and grass roots lobbying.

Q-6: *Does the section 4911 tax apply to political expenditures as well as lobbying expenditures?*

A-6: No. It is important to note that the section 4911 tax applies only to *lobbying* expenditures, as opposed to *political* expenditures or activities. In contrast to lobbying, all charities are *absolutely prohibited* from intervening in a political campaign on behalf of or in opposition to any candidate for an elective public office. As stated above, public charities may engage in some lobbying but they must not intervene in a political campaign at all. If a charity does intervene in a political campaign, it would jeopardize both its tax-exempt status and its ability to receive tax-deductible charitable contributions (under section 170). It (and in certain cases its managers) may also be liable for tax under section 4955. Finally, under certain circumstances, the charity may also be subject to tax under section 527(f).

Q-7: *How much may an electing public charity spend on total lobbying without being taxed under section 4911?*

A-7: In any given year, an electing public charity may spend up to a specified percentage of its exempt purpose expenditures on total (both direct and grass roots) lobbying without being taxed under section 4911 (see §56.4911-1(c) for the specific declining percentages allowed for organizations of various sizes). In no case, however, may an electing public charity spend more than $1,000,000 in any given year on lobbying without being taxed under section 4911.

Q-8: *How much may an electing public charity spend on grass roots lobbying without being taxed under section 4911?*

A-8: In addition to the limit on an electing public charity's total lobbying expenditures, there is a separate limit for grass roots lobbying expenditures. In any given year, an electing public charity may spend up to that separate limit on grass roots lobbying without incurring any tax under section 4911. The amount of this separate limit for grass roots lobbying expenditures is 25 percent of the amount that the organization is permitted to spend during that year on total (both direct and grass roots) lobbying (see Q&A-7). In any event, $250,000 is the maximum amount an electing public charity may spend on grass roots lobbying without incurring tax under section 4911.

Q-9: *In addition to resulting in tax under section 4911, can excessive spending on lobbying have other adverse tax consequences for an electing public charity?*

A-9: Yes. If an electing public charity normally makes excessive lobbying expenditures, it may be in danger of losing its tax-exempt status. Generally speaking, an electing public charity will lose its tax-exempt status (and its ability to receive tax-deductible charitable contributions) if the organization's lobbying expenditures over a four-year period exceed one of the two lobbying limits by more than 150 percent. See section 501(h) and the applicable Treasury Regulations for further detail.

Q-10: *What is an exempt purpose expenditure?*

A-10: Because the amount an electing public charity may spend on lobbying (without incurring tax) is often a percentage of the organization's exempt purpose expenditures, it is important to understand which expenditures are and which are not exempt purpose expenditures. In general terms, an expenditure is an exempt purpose expenditure if it is paid or incurred by an electing public charity to accomplish the organization's exempt purposes. For further detail on the definition of "exempt purpose expenditure" see section 4911(e)(1) and §56.4911-4.

Q-11: *Which expenditures are lobbying expenditures and which are not?*

A-11: To know whether an organization has spent excessive amounts on lobbying, one needs to determine which expenditures are lobbying expenditures and which are not lobbying expenditures. In general, there are two types of lobbying expenditures: expenditures for direct lobbying communications and expenditures for grass roots lobbying communications.

Q-12: *How are the terms "direct lobbying communication" and "grass roots lobbying communication" defined?*

A-12: In very general terms (and subject to exceptions), a direct lobbying communication is an attempt to influence legislation by communicating directly with a government official, whereas a grass roots lobbying communication is an attempt to influence legislation by communicating with the general public or a segment thereof. (Note: some communications may be both direct and grass roots lobbying.) The terms "direct lobbying communication" and "grass roots lobbying communication" are defined at length in §56.4911-2. That section contains a general definition of each type of lobbying communication. It also has special definitions that apply only in limited circumstances (such as a special rebuttable presumption that certain paid mass media advertisements that run shortly before a legislative vote on highly publicized legislation are grass roots lobbying communications). Section 56.4911-2(c) contains several exceptions that sometimes apply to cause communications that would otherwise be lobbying to be nonlobbying. Throughout §56.4911-2, there are numerous examples designed to illustrate the various definitions and exceptions. (For more lenient definitions where an electing public charity makes a communication solely or primarily to its bona fide members, see section 4911(d)(3) and §56.4911-5.)

Q-13: *Is lobbying on referenda and ballot initiatives considered grass roots or direct lobbying?*

A-13: Lobbying on referenda, ballot initiatives and similar measures is, solely for purposes of section 4911, treated as direct rather than grass roots lobbying. See §56.4911-2(b)(1)(iii). However, charities are not permitted to intervene in a political campaign on behalf of or in opposition to a candidate for an elective public office (as described in Q&A-6).

Q-14: *Are there any special accounting and allocation rules for purposes of section 4911?*

A-14: An electing public charity that makes a direct and/or grass roots lobbying communication must treat the expenditures for that communication as lobbying expenditures in whole or in part. See §56.4911-3 for accounting rules regarding which expenditures are expenditures "for" the lobbying communication as well as rules regarding the allocation of expenditures that are for mixed purpose communications (for example, communications that are both direct and grass roots lobbying communica-

tions and communications that are lobbying communications but also have a bona fide nonlobbying purpose). Section 56.4911-3 also contains rules regarding whether certain of an electing public charity's payments (such as grants) to other organizations that lobby are treated as direct and/or grass roots lobbying expenditures by the electing public charity that makes the payments.

Q-15: *Can two or more organizations ever be considered one single organization for purposes of determining whether the organizations owe tax under section 4911 on excess lobbying expenditures?*

A-15: Yes. Under section 4911(f), certain closely affiliated organizations are sometimes treated as a single organization for purposes of determining whether the organizations owe tax under section 4911 on excess lobbying expenditures. See §§56.4911-7 through -10.

Q-16: *Must charities that lobby keep records and report on their lobbying expenditures and/or activities?*

A-16: Yes. For electing public charities, recordkeeping and return filing requirements are generally set forth in §§56.4911-6, 56.6001-1 and 56.6011-1. Nonelecting charities must also keep records and file returns as specified in various forms and their instructions.

Q-17: *If an organization is covered by the "substantial part test," what, in general, are the rules that govern the organization's lobbying activities and expenditures?*

A-17: The "substantial part test" applies to all section 501(c)(3) organizations other than electing public charities. Under the "substantial part test," no substantial part of the organization's activities may be carrying on propaganda, or otherwise attempting, to influence legislation (see §1.501(c)(3)-1). If an organization to which the substantial part test applies engages in substantial lobbying activities during a given year, the organization will lose both its tax exempt status and its ability to receive tax-deductible charitable contributions. The organization will also be subject to an excise tax under section 4912 on its lobbying expenditures during the year. In addition, the managers of such a nonelecting public charity may in certain cases be jointly and severally liable for a tax under section 4912(b). The tax under section 4912 does not apply to electing public charities. (This is the end of the Q&As.)

Rulings Regarding Application of the Regulations

Under its ruling program (see Rev. Proc. 83-36, 1983-1 C.B. 763 and Rev. Proc. 88-8, 1988-1 C.B. 628), the Service will consider requests for private letter rulings to clarify the application of the regulations to particular fact patterns.

Special Analyses

It has been determined that these rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. 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 final Regulatory Flexibility Analysis is not required.

Supersession

These regulations supersede §7.0(c)(4) of the Temporary Income Tax Regulations under the Tax Reform Act of 1976.

* * * * *

ADOPTION OF AMENDMENTS TO THE REGULATIONS

Accordingly, 26 CFR Chapter I is amended as follows:

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

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

Authority: 26 U.S.C. 7805. * * * §§1.504-1 and 1.504-2 also issued under 26 U.S.C. 504(b).

Par. 2. Section 1.170A-1 is amended by revising paragraph (h)(5), adding a new paragraph (h)(11), and revising paragraph (i). These revised and added provisions read as follows:

§1.170A-1 Charitable, etc., contributions and gifts; allowance of deduction.

* * * * *

(h) *Exceptions and other rules.* * * *

(5) No deduction shall be allowed under section 170 for amounts paid to an organization:

(i) Which is disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation, or

(ii) Which participates in, or intervenes in (including the publishing or distributing of statements), any political campaign on behalf of or in opposition to any candidate for public office.

For purposes of determining whether an organization is attempting to influence legislation or is engaging in political activities, see sections 501(c)(3), 501(h), 4911 and the regulations thereunder.

* * * * *

(11) No deduction shall be allowed under section 170 for out-of-pocket expenditures on behalf of an eligible organization (within the meaning of §1.501(h)-2(b)(1)) if the expenditure is made in connection with influencing legislation (within the meaning of section 501(c)(3) or §56.4911-2), or in connection with the payment of the organization's tax liability under section 4911. For the treatment of similar expenditures on behalf of other organizations see paragraph (h)(6) of this section.

(i) *Effective date.* In general this section applies to contributions paid in taxable years beginning after December 31, 1969. Paragraph (h)(11) of this section, however, applies only to out-of-pocket expenditures made in taxable years beginning after December 31, 1976.

Par. 3. In §1.501(c)(3)-1, paragraph (b)(3) is amended by adding a sentence at the end of the concluding text, and paragraph (c)(3)(ii) is amended by adding a sentence at the end of the concluding text, to read:

§.501(c)(3)-1 Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.

* * * * *

(b) *Organizational test.* * * *

(3) *Authorization of legislative or political activities.* * * *

* * * An organization's articles will not violate the provisions of paragraph (b)(3)(i) of this section even

though the organization's articles expressly empower it to make the election provided for in section 501(h) with respect to influencing legislation and, only if it so elects, to make lobbying or grass roots expenditures that do not normally exceed the ceiling amounts prescribed by section 501(h)(2)(B) and (D).

* * * * *

(c) *Operational test.* * * *

(3) *"Action" organizations.* * * *

(ii) * * *

* * * An organization for which the expenditure test election of section 501(h) is in effect for a taxable year will not be considered an "action" organization by reason of this paragraph (c)(3)(ii) for that year if it is not denied exemption from taxation under section 501(a) by reason of section 501(h).

* * * * *

Par. 4. In §1.501(c)(4)-1, paragraph (a)(2)(ii) is amended by revising the last sentence and adding a new sentence immediately thereafter. The revised and added sentences read as follows:

§1.501(c)(4)-1 Civic organizations and local associations of employees.

(a) *Civic organizations.* * * *

(2) *Promotion of social welfare.** * *

(ii) *Political or social activities.* * * * A social welfare organization that is not, at any time after October 4, 1976, exempt from taxation as an organization described in section 501(c)(3) may qualify under section 501(c)(4) even though it is an "action" organization described in §1.501(c)(3)-1(c)(3)(ii) or (iv), if it otherwise qualifies under this section. For rules relating to an organization that is, after October 4, 1976, exempt from taxation as an organization described in section 501(c)(3), see section 504 and § 1.504-1.

* * * * *

Par. 5. The following new §§1.501(h)-1 through 1.501(h)-3 are added in the appropriate place:

§1.501(h)-1 Application of the "expenditure test" to expenditures to influence legislation; introduction.

(a) *Scope*—(1) There are certain requirements an organization must meet in order to be a "charity" described in section 501(c)(3). Among other things, section 501(c)(3) states that "no substantial part of the activities of [a charity may consist of] carrying on propaganda, or otherwise attempting to influence legislation, (except as otherwise provided in subsection (h))." This requirement is called the "substantial part test."

(2) Under section 501(h), many public charities may elect the "expenditure test" as a substitute for the substantial part test. The expenditure test is described in section 501(h) and this §1.501(h). A public charity is any charity that is not a private foundation under section 509(a). (Unlike a public charity, a private foundation may not make any lobbying expenditures: if a private foundation does make a lobbying expenditure, it is subject to an excise tax under section 4945.) Section 1.501(h)-2 lists which public charities are eligible to make the expenditure test election. Section 1.501(h)-2 also provides information about how a public charity makes and revokes the election to be covered by the expenditure test.

(3) A public charity that makes the election may make lobbying expenditures within specified dollar limits. If an electing public charity's lobbying expenditures are within the dollar limits determined under section 4911(c), the electing public charity will not owe tax under section 4911 nor will it lose its tax exempt status as a charity by virtue of section 501(h). If, however, that electing public charity's lobbying expenditures exceed its section 4911 lobbying limit, the organization is subject to an excise tax on the excess lobbying expenditures. Further, under section 501(h), if an electing public charity's lobbying expenditures normally are more than 150 percent of its section 4911 lobbying limit, the organization will cease to be a charity described in section 501(c)(3).

(4) A public charity that elects the expenditure test may nevertheless lose its tax exempt status if it is an action organization under §1.501(c)(3)-1(c)(3)(iii) or (iv). A public charity that does not elect the expenditure test remains subject to the substantial part test. The substantial part test is applied without regard to the provisions of section 501(h) and 4911 and the related regulations.

(b) *Effective date.* The provisions of §1.501(h)-1 through §1.501(h)-3, are effective for taxable years beginning after August 31, 1990. An election made before August 31, 1990. An election made before August 31, 1990, under the provisions of §7.0(c)(4) or the instructions to Form 5768, will be effective under these regulations without again filing Form 5768.

§1.501(h)-2 Electing the expenditure test.

(a) *In general.* The election to be governed by section 501(h) may be made by an eligible organization (as described in paragraph (b) of this section) for any taxable year of the organization beginning after December 31, 1976, other than the first taxable year for which a voluntary revocation of the election is effective (see paragraph (d) of this section). The election is made by filing a completed Form 5768, Election/Revocation of Election by an Eligible Section 501(c)(3) Organization To Make Expenditures To Influence Legislation, with the appropriate Internal Revenue Service Center listed on that form. Under section 501(h)(6), the election is effective with the beginning of the taxable year in which the form is filed. For example, if an eligible organization whose taxable year is the calendar year files Form 5768 on December 31, 1979, the organization is governed by section 501(h) for its taxable year beginning January 1, 1979. Once made, the expenditure test election is effective (without again filing Form 5768) for each succeeding taxable year for which the organization is an eligible organization and which begins before a notice of revocation is filed under paragraph (d) of this section.

(b) *Organizations eligible to elect the expenditure test*—(1) *In general.* For purposes of section 501(h) and the regulations thereunder, an organization is an eligible organization for a taxable year if, for that taxable year, it is—

(i) Described in section 501(c)(3) (determined, in any year for which an election is in effect, without regard to the substantial part test of section 501(c)(3)),

(ii) Described in section 501(h)(4) and paragraph (b)(2) of this section, and

(iii) Not a disqualified organization described in section 501(h)(5) and paragraph (b)(3) of this section.

(2) *Certain organizations listed.* An organization is described in section 501(h)(4) and this paragraph (b)(2) if it is an organization described in —

(i) Section 170(b)(1)(A)(ii) (relating to educational institutions),

(ii) Section 170(b)(1)(A)(iii) (relating to hospitals and medical research organizations),

(iii) Section 170(b)(1)(A)(iv) (relating to organizations supporting government schools),

(iv) Section 170(b)(1)(A)(vi) (relating to organizations publicly supported by charitable contributions),

(v) Section 509(a)(2) (relating to organizations publicly supported by admissions, sales, etc.), or

(vi) Section 509(a)(3) (relating to organizations supporting public charities), except that for purposes of this paragraph (b)(2), section 509(a)(3) shall be applied without regard to the last sentence of section 509(a).

(3) *Disqualified organizations.* An organization is a disqualified organization described in section 501(h)(5) and this paragraph (b)(3) if the organization is —

(i) Described in section 170(b)(1)(A)(i) (relating to churches),

(ii) An integrated auxiliary of a church or of a convention or association of churches (see §1.6033-2(g)(5)), or

(iii) Described in section 501(c)(3) and affiliated (within the meaning of §56.4911-7) with one or more organizations described in pragraph (b)(3)(i) or (ii) of this section.

(4) *Other organizations ineligible to elect.* Under section 501(h)(4), certain organizations, although not disqualified organizations, are not eligible to elect the expenditure test. For example, organizations described in section 509(a)(4) are not listed in section 501(h)(4) and therefore are not eligible to elect. Similarly, private foundations (within the meaning of section 509(a)) are not eligible to elect. For the treatment of expenditures by a private foundation for the purpose of carrying on propaganda, or otherwise attempting, to influence legislation, see §53.4945-2.

(c) *New organizations.* A newly created organization may submit Form 5768 to elect the expenditure test under section 501(h) before it is determined to be an eligible organization and may submit Form 5768 at the time it submits its application for recognition of exemption (Form 1023). If the newly created organization is determined to be an eligible organization, the election will be effective under the provisions of paragraph (a) of this section, that is, with the beginning of the taxable year in which the Form 5768 is filed by the eligible organization. However, if a newly created organization is determined by the Service not to be an eligible organization, the organization's election will not be effective and the substantial part test will apply from the effective date of its section 501(c)(3) classification.

(d) *Voluntary revocation of expenditure test election—(1) Revocation effective.* An organization may voluntarily revoke an expenditure test election by filing a notice of voluntary revocation with the appropriate Internal Revenue Service Center listed on Form 5768. Under section 501(h)-(6)(B), a voluntary revocation is effective with the beginning of the first taxable year after the taxable year in which the notice is filed. If an organization voluntarily revokes its election, the substantial part test of section 501(c)(3) will apply with respect to the organization's activities in attempting to influence legislation beginning with the taxable year for which the voluntary revocation is effective.

(2) *Re-election of expenditure test.* If an organization's expenditure test election is voluntarily revoked, the organization may again make the expenditure test election, effective no earlier than for the taxable year following the first taxable year for which the revocation is effective.

(3) *Example.* X, an organization whose taxable year is the calendar year, plans to voluntarily revoke its expenditure test election effective beginning with its taxable year 1985. X must file its notice of voluntary revocation on Form 5768 after December 31, 1983, and before January 1, 1985. If X files a notice of voluntary revocation on December 31, 1984, the revocation is effective beginning with its taxable year 1985. The organization may again elect the expenditure test by filing Form 5768. Under paragraph (d)(2) of this section, the election may not be made for taxable year 1985. Under paragraph (a) of this section, a new expenditure test election will be effective for taxable years beginning with taxable year 1986, if the Form 5768 is filed after December 31, 1985, and before January 1, 1987.

(e) *Involuntary revocation of expenditure test election.* If, while an election by an eligible organization is in effect, the organization ceases to be an eligible organization, its election is automatically revoked. The revocation is effective with the beginning of the first full taxable year for which it is determined that the organization is not an eligible organization. If an organization's expenditure test election is involuntarily revoked under this paragraph (e) but the organization continues to be described in section 501(c)(3), the substantial part test of section 501(c)(3) will apply with respect to the organization's activities in attempting to influence legislation beginning with the first taxable year for which the involuntary revocation is effective.

(f) *Supersession.* This section supersedes §7.0(c)(4) of the Temporary Income Tax Regulations under the Tax Reform Act of 1976, effective August 31, 1990.

§1.501(h)-3 Lobbying or grass roots expenditures normally in excess of ceiling amount.

(a) *Scope.* This section provides rules under section 501(h) for determining whether an organization that has elected the expenditure test and that is not a member of an affiliated group of organizations (as defined in §56.4911-7(e)) either normally makes lobbying expenditures in excess of its lobbying ceiling amount or normally makes grass roots expenditures in excess of its grass roots ceiling amount. Under section 501(h) and this section, an organization that has elected the expenditure test and that normally makes expenditures in excess of the corresponding ceiling amount will cease to be exempt from tax under section 501(a) as an organization described in section 501(c)(3). For similar rules relating to members of an affiliated group of organizations, see §56.4911-9.

(b) *Loss of exemption*—(1) *In general.* Under section 501(h)(1), an organization that has elected the expenditure test shall be denied exemption from taxation under section 501(a) as an organization described in section 501(c)(3) for the taxable year following a determination year if —

(i) The sum of the organization's lobbying expenditures for the base years exceeds 150 percent of the sum of its lobbying nontaxable amounts for the base years, or

(ii) The sum of the organization's grass roots expenditures for its base years exceeds 150 percent of the sum of its grass roots nontaxable amounts for the base years.

The organization thereafter shall not be exempt from tax under section 501(a) as an organization described in section 501(c)(3) unless, pursuant to paragraph (d) of this section, the organization reapplies for recognition of exemption and is recognized as exempt.

(2) *Special exception for organization's first election.* For the first, second, or third consecutive determination year for which an organization's first expenditure test election is in effect, no determination is required under paragraph (b)(1) of this section, and the organization will not be denied exemption from tax by reason of section 501(h) and this section if, taking into account as base years only those years for which the expenditure test election is in effect —

(i) The sum of the organization's lobbying expenditures for such base years does not exceed 150 percent of the sum of its lobbying nontaxable amounts for the same base years, and

(ii) The sum of the organization's grass roots expenditure for those base years does not exceed 150 percent of the sum of its grass roots nontaxable amounts for such base years. If an organization does not satisfy the requirements of this paragraph (b)(2), paragraph (b)(1) of this section will apply.

(c) *Definitions.* For purposes of this section—

(1) The term "lobbying expenditures" means lobbying expenditures as defined in section 4911(c)(1) or section 4911(f)(4)(A) and §56.4911-2(a).

(2) The term "lobbying nontaxable amount" is defined in §56.4911-1(c)(1).

(3) An organization's "lobbying ceiling amount" is 150 percent of the organization's lobbying nontaxable amount for a taxable year.

(4) The term "grass roots expenditures" means expenditures for grass roots lobbying communications as defined in section 4911(c)(3) or section 4911(f)(4)(A) and §§56.4911-2 and 3.

(5) The term "grass roots nontaxable amount" is defined in §56.4911-1(c)(2).

(6) An organization's "grass roots ceiling amount" is 150 percent of the organization's grass roots nontaxable amount for a taxable year.

(7) In general, the term "base years" means the determination year and the three taxable years immediately preceding the determination year. The base years, however, do not include any taxable year preceding the taxable year for which the organization is first treated as described in section 501(c)(3).

(8) A taxable year is a "determination year" if it is a year for which the expenditure test election is in effect, other than the taxable year for which the organization is first treated as described in section 501(c)(3).

(d) *Reapplication for recognition of exemption*—(1) *Time of application.* An organization that is denied exemption from taxation under section 501(a) by reason of section 501(h) and this section may apply on Form 1023 for recognition of exemption as an organization described in section 501(c)(3) for any taxable year following the first taxable year for which exemption is so denied. See paragraphs (d)(2) and (d)(3) of this section for material to be included with an application described in the preceding sentence.

(2) *Section 501(h) calculation.* An application described in paragraph (d)(1) of this section must demonstrate that the organization would not be denied exemption from taxation under section 501(a) by reason of section 501(h) if the expenditure test election had been in effect for all of its last taxable year ending before the application is made by providing the calculations, described either in paragraph (b)(1)(i) and (ii) of this section or in §56.4911-9(b), that would have applied to the organization for that year.

(3) *Operations not disqualifying.* An application described in paragraph (d)(1) of this section must include information that demonstrates to the satisfaction of the Commissioner that the organization will not knowingly operate in a manner that would disqualify the organization for tax exemption under section 501(c)(3) by reason of attempting to influence legislation.

(4) *Reelection of expenditure test.* If an organization is denied exemption from tax for a taxable year by reason of section 501(h) and this section, and thereafter is again recognized as an organization described in section 501(c)(3) pursuant to this paragraph (d), it may again elect the expenditure test under section 501(h) in accordance with §1.501(h)-2(a).

(e) *Examples.* The provisions of this section are illustrated by the following examples, which also illustrate the operation of the tax imposed by section 4911.

Example (1). (1) The following table contains information used in this example concerning organization X.

Year	Exempt Purpose Expenditures (EPE)	Calculation	Lobbying Nontaxable Amount (LNTA)	Lobbying Expenditures (LE)
1979	$ 400,000	(20% of $400,000 =)	$ 80,000	$100,000
1980	300,000	(20% of $300,000 =)	60,000	100,000
1981	600,000	(20% of $500,000 + 15% of $100,000 =)	115,000	120,000
1982	500,000	(20% of $500,000 =)	100,000	100,000
Totals:	$1,800,000		$355,000	$420,000

(2) Organization X, whose taxable year is the calendar year, was organized in 1971. X first made the expenditure test election under section 501(h) effective for taxable years beginning with 1979 and has not revoked the election. None of X's lobbying expenditures for its taxable years 1979 through 1982 are grass roots expenditures. Under section 4911(a) and §56.4911-1(a), X must determine for each year for which the expenditure test election is effective whether it is liable for the 25 percent excise tax imposed by section 4911(a) on excess lobbying expenditures. X is liable for this tax for each of its taxable years 1979, 1980, and 1981, because in each year its lobbying expenditures exceeded its lobbying nontaxable amount for the year. For 1979, the tax imposed by section 4911(a) is $5,000 (25% x ($100,000 − $80,000) = $5,000). For 1980, the tax is $10,000. For 1981, the tax is $1,250.

(3) The taxable years 1979 through 1981 are all determination years under paragraph (c)(8) of this section. On its annual return for determination year 1979, the first year of its first election, X can demonstrate, under paragraph (b)(2) of this section, that its lobbying expenditures during 1979 ($100,000) do not exceed 150 percent of its lobbying nontaxable amount for 1979 ($120,000). For determination year 1980, under paragraph (b)(2), X can demonstrate that the sum of its lobbying expenditures for 1979 and 1980 ($200,000) does not exceed 150 percent of the sum of its lobbying nontaxable amounts for 1979 and 1980 ($210,000). For 1981, under paragraph (b)(2), X can demonstrate that the sum of its lobbying expenditures for 1979, 1980, and 1981 ($320,000) does not exceed 150 percent of the sum of its lobbying nontaxable amounts for 1979, 1980, and 1981 ($382,500). For each of the determination years 1979, 1980, and 1981, the first three years of its first election, X satisfies the requirements of paragraph (b)(2). Accordingly, no determination under paragraph (b)(1) of this section is required for those years, and X is not denied tax exemption by reason of section 501(h).

(4) Under paragraph (b)(1) of this section, X must determine for its determination year 1982 whether it has normally made lobbying expenditures in excess of the lobbying ceiling amount. This determination takes into account expenditures in base years 1979 through 1982. The sum of X's lobbying expenditures for the base years ($420,000) does not exceed 150% of the sum of the lobbying nontaxable amounts for the base years (150% x $355,000 = $532,500). Accordingly, X is not denied tax exemption by reason of section 501(h).

Example (2). (1) The following table contains information used in this example concerning W.

Year	Exempt Purpose Expenditures (EPE)	Calculation	Lobbying Nontaxable Amount (LNTA)	Lobbying Expenditures (LE)	Grass Roots Nontaxable Amount (25% of LNTA)	Grass Roots Expenditures
1979.....	$700,000	(20% of $500,000 + 15% of $200,000=)	$130,000	$120,000	$32,500	$30,000
1980.....	$800,000	(20% of $500,000 + 15% of $300,000+)	$145,000	$100,000	$36,250	$60,000
1981.....	$800,000	(20% of $500,000 + 15% of $300,000=)	$145,000	$100,000	$36,250	$65,000
1982.....	$900,000	(20% of $500,000 + 15% of $400,000=)	$160,000	$150,000	$40,000	$65,000
Totals:	$3,200,000		580,000	$470,000	$145,000	$220,000

(2) Organization W, whose taxable year is the calendar year, made the expenditure test election under section 501(h) effective for taxable years beginning with 1979 and has not revoked the election. W has been treated as an organization described in section 501(c)(3) for each of its taxable years beginning with its taxable year 1974.

(3) Under section 4911(a) and §56.4911-1(a), W must determine for each year for which the expenditure test election is effective whether it is liable for the 25 percent excise tax imposed by section 4911(a) on excess lobbying expenditures. In 1980, 1981, and 1982, W has excess lobbying expenditures because its grass roots expenditures in each of those years exceeded its grass roots nontaxable amount for the year. Therefore, W is liable for the excise tax under section 4911(a) for those years. The tax imposed by section 4911(a) for 1980 is $5,937.50 (25% × ($60,000 − $36,250) = $5,937.50).

For 1981, the tax is $7,187.50. For 1982, the tax is $6,250.

(4) On its annual return for its determination years 1979, 1980, and 1981, the first three years of its first election, W demonstrates that it satisfies the requirements of paragraph (b)(2) of this section. Accordingly, no determination under paragraph (b)(1) of this section is required for those years, and W is not denied tax exemption by reason of section 501(h).

(5) On its annual return for its determination year 1982, W must determine under paragraph (b)(1) whether it has normally made lobbying expenditures or grass roots expenditures in excess of the corresponding ceiling amount. This determination takes into account expenditures in base years 1979 through 1982. The sum of W's lobbying expenditures for the base years ($470,000) does not exceed 150% of the sum of W's lobbying nontaxable amounts for those years (150% x $580,000 = $870,000). However, the sum of W's grass roots expenditures for the base years ($220,000) does exceed 150% of the sum of W's grass roots nontaxable amounts for those years (150% x $145,000 = $217,500). Under section 501(h), W is denied tax exemption under section 501(a) as an organization described in section 501(c)(3) for its taxable year 1983. For its taxable year 1984 and any taxable year thereafter, W is exempt from tax as an organization described in section 501(c)(3) only if W applies for recognition of its exempt status under paragraph (d) of this section and is recognized as exempt from tax.

Example (3). (1) The following table contains information used in this example concerning organization Y.

Year	Exempt Purpose Expenditures (EPE)	Calculation	Lobbying Nontaxable Amount (LNTA)	Lobbying Expenditures (LE)	Grass Roots Nontaxable Amount (25% of LNTA)	Grass Roots Expenditures
1977	$700,000	(20% of $500,000 + 15% of $200,000=)	$130,000	$182,000	$32,500	$30,000
1978	$800,000	(20% of $500,000 + 15% of $300,000=)	$145,000	$224,750	$36,250	$35,000
Subtotal	$1,500,000		$275,000	$406,750	$68,750	$65,000
1979	$900,000	(20% of $500,000 15%of $400,000 =)	$160,000	$264,000	$40,000	$50,000
Totals:	$2,400,000		$435,000	$670,750	$108,750	$115,000

(2) Organization Y, whose taxable year is the calendar year, was first treated as an organization described in section 501(c)(3) on February 1, 1977. Y made the expenditure test election under section 501(h) effective for taxable years beginning with 1977 and has not revoked the election.

(3) For 1977, Y has excess lobbying expenditures of $52,000 because its lobbying expenditures ($182,000) exceed its lobbying nontaxable amount ($130,000) for the taxable year. Accordingly, Y is liable for the 25 percent excise tax imposed by section 4911(a). The amount of the tax is $13,000 (25% x ($182,000 - $130,000) = $13,000.

(4) For 1978, Y again has excess lobbying expenditures and is again liable for the 25 percent excise tax imposed by section 4911(a). The amount of the tax is $19,937.50 (25% x ($224,750 - $145,000) = $19,937.50).

(5) For 1979, Y's lobbying expenditures ($264,000) exceed its lobbying nontaxable amount ($160,000) by $104,000, and its grass roots expenditures ($50,000) exceed its grass roots nontaxable amount ($40,000) by $10,000. Under §56.4911-1(b), Y's excess lobbying expenditures are the greater of $104,000 or $10,000. The amount of the tax, therefore, is $26,000 (25% x $104,000 = $26,000).

(6) Under paragraph (c)(8) of this section, 1977 is not a determination year because it is the first year for which the organization is treated as described in section 501(c)(3). For 1977, Y need not determine whether it has normally made lobbying expenditures or grass roots expenditures in excess of the corresponding ceiling amount for purposes of determining whether it is denied exemption under section 501(h) for its taxable year 1978.

(7) For determination year 1978, Y must determine whether it has normally made lobbying or grass roots expenditures in excess of the corresponding ceiling amount, taking into account expenditures for the base years 1977 and 1978. For Y, the determination under paragraph (b)(2) of this section considers the same base years as the determination under paragraph (b)(1) of this section and is, therefore, redundant. Accordingly, Y proceeds to determine, under (b)(1), whether it is denied exemption. Y's grass roots expenditures for 1977 and 1978 ($65,000) did not exceed 150 percent of the sum of its grass roots nontaxable amounts for those years ($103,125). Y's lobbying expenditures for 1977 and 1978 ($406,750) did not exceed 150% of its lobbying nontaxable amount for those years (150% x $275,000 = $412,500). Therefore, Y is not denied tax exemption under section 501(h) for its taxable year 1979.

(8) For determination year 1979, the sum of Y's grass roots expenditures in base years 1977, 1978, and 1979 does not exceed 150 percent of its grass roots nontaxable amount (calculation omitted). However, the sum of Y's lobbying expenditures for the base years ($670,750) does exceed 150% of the sum of the lobbying nontaxable amounts for those years (150% x $435,000 = $652,500). Since Y was not described in section 501(c)(3) prior to 1977, only the years 1977, 1978, and 1979 may be considered in determining whether Y has normally made lobbying expenditures in excess of its lobbying ceiling. Therefore, Y determines that it has normally made lobbying expenditures in excess of its lobbying ceiling. Under section 501(h), Y is denied tax exemption under section 501(a) as an organization described in section 501(c)(3) for its taxable year 1980. For its taxable year 1981, and any taxable year thereafter, Y is exempt from tax as an organization described in section 501(c)(3) only if Y applies for recognition of its exempt status under paragraph (d) of this section and is recognized as exempt from tax.

Example (4). Organization M made the expenditure test election under section 501(h) effective for taxable years beginning with 1977 and has not revoked the election. M has $500,000 of exempt purpose expenditures during each of the years 1981 through 1984. In addition, during each of those years, M spends $75,000 for direct lobbying and $25,000 for grass roots lobbying. Since the amount expended for M's lobbying (both total lobbying and grass roots lobbying) is within the respective nontaxable expenditure limitations, M is not liable for the 25 percent excise tax imposed under section 4911(a) upon excess lobbying expenditures, nor is M denied tax-exempt status by reason of section 501(h).

Example (5). Assume the same facts as in Example (4), except that, on behalf of M, numerous unpaid volunteers conduct substantial lobbying activities with no reimbursement. Since the substantial lobbying activities of the unpaid volunteers are not counted towards the expenditure limitations and the amount expended for M's lobbying is within the respective nontaxable expenditure limitations, M is not liable for the 25 percent excise tax under section 4911, nor is M denied tax-exempt status by reason of section 501(h).

Par. 6. Section 1.504-1 is revised and new §1.504-2 is added, to read as follows:

§ 1.504-1 Attempts to influence legislation; certain organizations formerly described in section 501(c)(3) denied exemption.

Section 504(a) and this section apply to an organization that is exempt from taxation at any time after October 4, 1976, as an organization described in section 501(c)(3), and that ceases to be described in that section because it—

(a) Is an "action" organization within the meaning of §1.501(c)(3)-1(c)(3)(ii) or (iv), on account of activities occurring after October 4, 1976, or

(b) Is denied exemption under the provisions of section 501(h) (see §1.501(h)-3 or §56.4911-9).

This section does not apply, however, to an organization that was described in section 501(h)(5) and §1.501(h)-2(b)(3) (relating generally to churches) for its taxable year immediately preceding the first taxable year for which it is no longer an organization described in section 501(c)(3). An organization to which section 504(a) and this section apply shall not be treated as described in section 501(c)(4) at any time after the organization ceases to be described in section 501(c)(3). Further, an organization denied treatment as an organization described in section 501(c)(4) under this section may not be treated as an organization described in section 501(c) other than as an organization described in section 501(c)(3). For rules relating to recognition of exemption after exemption is denied under section 501(h), see §1.501(h)-3(d).

§1.504-2 Certain transfers made to avoid section 504(a).

(a) *Scope.* Under section 504(b), a transfer described in paragraph (b) or (c) of this section to an organization exempt from tax under section 501(a) may result in loss of exemption by the transferee unless the Commissioner determines, under paragraph (e) of this section, that the original transfer did not effect an avoidance of section 504(a). For purposes of this section, the term "transfer" includes any use by, or for the benefit of, the recipient of the transfer, but does not include any transfer made for adequate and full consideration.

(b) *Transferor and transferee commonly controlled*—(1) *Loss of exemption.* A transfer is described in this paragraph (b) if it is described in paragraphs (b)(2) through (b)(6). The transferee of a transfer described in this paragraph will cease to be exempt from tax under section 501(a), unless the provisions of paragraph (e) of this section apply.

(2) *Transferor organization.* A transfer is described in this paragraph (b)(2) only if it is from an organization that—

(i) Is or was described in section 501(c)(3), but not in section 501(h)(5), and

(ii) Is determined to be an "action" organization (as defined in §1.501(c)(3)-1(c)(3)(ii) or (iv)), or is denied exemption from tax by reason of section 501(h) and either §1.501(h)-3 or §56.4911-9.

(3) *Transferor and transferee commonly controlled.* A transfer is described in this paragraph (b)(3) only if, at the time of the transfer or at any time during the transferee's ten taxable years following the year in

which the transfer was made, the transferee is controlled (directly or indirectly), as defined in paragraph (f) of this section, by the same person or persons who control the transferor.

(4) *Time of transfer.* A transfer is described in this paragraph (b)(4) only if the transfer is made—

(i) After the date that is 24 months before the earliest of the effective date of the determination under section 501(h) that the transferor is not exempt, the effective date of the Commissioner's determination that the transferor is an "action" organization (as defined in §1.501(c)(3)(ii) or (iv)), or the date on which the Commissioner proposes to treat it as no longer described in section 501(c)(3), and

(ii) Before the transferor again is recognized as an organization described in section 501(c)(3).

(5) *Transferee.* A transfer is described in this paragraph (b)(5) only if the transferee is exempt from tax under section 501(a) but the transferee is neither —

(i) An organization described in section 501(c)(3), nor

(ii) An organization described in section 401(a) to which the transferor contributes as an employer.

(6) *Amount of transfer.* A transfer is described in this paragraph (b)(6) only if the amount of the transfer exceeds the lesser of 30 percent of the net fair market value of the transferor's assets or 50 percent of the net fair market value of the transferee's assets, computed immediately before the transfer. For purposes of this paragraph (b)(6) —

(i) The amount of a transfer by a transferor is the sum of the amounts transferred to any number of transferees in any number of transfers, all of which are described in paragraphs (b)(2) through (b)(5) of this section, and the time of the transfer is the time of the first transfer so taken into account; and

(ii) The amount of a transfer to a transferee is the sum of the amounts transferred by a transferor to the transferee in any number of transfers, all of which are described in paragraphs (b)(2) through (b)(5) of this section, and the time of the transfer is the time of the first transfer so taken into account.

(c) *Other transfers*—(1) *Transfers included.* A transfer is described in this paragraph (c) if it would be described in paragraph (b) of this section except that either —

(i) The amount of the transfer is less than the amount determined in paragraph (b)(6) of this section, or

(ii) The transferor and transferee are not commonly controlled as described in paragraph (b)(3) of this section, or

(iii) The transferee is an organization described in sections 501(c)(3) and 501(h)(4).

(2) *Loss of exemption.* The transferee of a transfer described in this paragraph (c) will cease to be exempt under section 501(a) if the Commissioner determines on all the facts and circumstances that the transfer effected an avoidance of section 504(a). In determining whether a transfer effected an avoidance of section 504(a), the Commissioner may consider whether the transferee engages, or has engaged, in attempts to influence legislation and may also consider any factors enumerated in paragraph (e) of this section.

(d) *Date of loss of exempt status.* A transferee of a transfer described in paragraph (b), (c)(1)(ii), or (c)(1)(iii) of this section will cease to be exempt from tax under section 501(a) on the date that all requirements of paragraph (b), (c)(1)(ii), or (c)(1)(iii) (other than the determination by the Commissioner) are satisfied. A transferee of a transfer described in paragraph (c)(1)(i) of this section will cease to be exempt from tax under section 501(a) on the date of the last transfer preceding notification of the transferee that the Commissioner proposes to treat the transferee as other than an exempt organization.

(e) *Transfers not in avoidance of section 504(a).* Notwithstanding paragraph (b) of this section, if, based on all the facts and circumstances, the Commissioner determines that a transfer described in paragraph (b) did not effect an avoidance of section 504(a), the transferee will not be denied exemption from tax by reason of section 504(b) and this section. In making the determination called for in the preceding sentence, the Commissioner may consider all relevant factors including:

(1) Whether enforceable and effective conditions on the transfer preclude use of any of the transferred assets for any purpose that, if it were a substantial part of an organization's activities, would be inconsistent with exemption as an organization described in section 501(c)(3);

(2) In the absence of conditions described in paragraph (e)(1) of this section, whether the transferred assets are used exclusively for purposes that are consistent with the transferor's exemption as an organization described in section 501(c)(3);

(3) Whether the assets transferred would be described in §53.4942(a)-2(c)(3) before, as well as after, the transfer if both the transferor and transferee were private foundations;

(4) Whether and to what extent the transfer would satisfy the provisions of §1.507-2(a)(7) and (8) if the transferor were a private foundation;

(5) Whether all of the transferred assets have been expended during a period when the transferee was not controlled (directly or indirectly) by the same person or persons who controlled the transferor; and

(6) Whether the entire amount of the transferred assets were in turn transferred, before the close of the transferee's taxable year following the taxable year in which the transferred assets were received, to one or more organizations described in section 507(b)(1)(A) none of which are controlled (directly or indirectly) by the same persons who control either the original transferor or transferee.

(f) *Control.* For purposes of section 504 and the regulations thereunder —

(1) The transferor will be presumed to control any organization with which it is affiliated within the meaning of §56.4911-7(a), or would be if both organizations were described in section 501(c)(3), and

(2) The transferee will be treated as controlled (directly of indirectly) by the same person or persons who control the transferor if the transferee would be treated as controlled under §53.4942(a)-3(a)(3), for which purpose the transferor shall be treated as a private foundation.

Par. 7. In section 1.6001-1(c), the last sentence is revised to read as follows:

§1.6001-1 Records.

* * * * *

(c) *Exempt Organizations.* * * * See section 6033 and §§1.6033-1 through -3.

Par. 8. Section 1.6033-2 is amended by adding paragraph (a)(2)(ii)(k). This added provision reads as follows:

§1.6033-2 Returns by exempt organizations (taxable years beginning after December 31, 1969) and returns by certain nonexempt organizations (taxable years beginning after December 31, 1980).

(a) *In general.* * * *

(2) * * *

(ii) * * *

(*k*) Its lobbying expenditures, grass roots expenditures, exempt purpose expenditures, lobbying nontaxable amount, and grass roots nontaxable amount for the taxable year and for prior taxable years that are base years (within the meaning of §1.501(h)-3(c)(7)), if the organization has an election under section 501(h) in effect for the taxable year. An organization that is a member of an affiliated group of organizations (as defined in §56.4911-7(e)) but that is not a member of a limited affiliated group (as defined in §56.4911-10(b)) shall report this information based on the expenditures of all members of the group during the taxable year of the group that ends with or within the member's taxable year and for prior taxable years of the group that are base years (within the meaning of §56.4911-9(b)). For additional information required to be furnished by members of an affiliated group of organizations, and by controlling members in a limited affiliated group, see §§56.4911-9(d) and 56.4911-10(f)(1), respectively.

* * * * *

PART 7—TEMPORARY INCOME TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1976

Par. 9. The authority citation for Part 7 continues to read in part:

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

Par. 10. In §7.0, paragraph (c)(4) is removed and paragraph (d) is amended by removing ", (c)(4)" from the first parenthetical phrase in the first sentence.

PART 20—ESTATE TAX REGULATIONS; ESTATES OF DECEDENTS DYING AFTER AUGUST 16, 1954

Par. 11. The authority citation for Part 20 continues to read in part:

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

Par. 12. Section 20.2055-1(a)(2) is revised to read as follows:

§20.2055-1 Deduction for transfers for public, charitable, and religious uses; In general.

(a) *General rule.* * * *

(2) To or for the use of any corporation or association organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes (including the encouragement of art and for the prevention of cruelty to children or animals), if no part of the net earnings of the corporation or association inures to the benefit of any private stockholder or individual (other than as a legitimate object of such purposes), if the organization is not disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation, and if, in the case of transfers made after December 31, 1969, it does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of or in opposition to any candidate for public office.

* * * * *

PART 25—GIFT TAX REGULATIONS; GIFTS MADE AFTER DECEMBER 31, 1954

Par. 13. The authority citation for Part 25 continues to read in part:

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

Par. 14. In §25.2522(a)-1, paragraphs (a)(2) and (b)(2) are revised to read as follows:

§25.2522(a)-1 Charitable and similar gifts; citizens or residents.

(a) * * *

(2) Any corporation, trust, community chest, fund, or foundation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, including the encouragement of art and the prevention of cruelty to children or animals, if no part of the net earnings of the organization inures to the benefit of any private shareholder or individual, if it is not disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation, and if, in the case of gifts made after December 31, 1969, it does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of or in opposition to any candidate for public office.

* * * * *

(b) * * *

(2) It must not be disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation.

* * * * *

PART 53—FOUNDATION AND SIMILAR EXCISE TAXES

Par. 15. The authority citation for Part 53 continues to read in part:

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

Par. 16. Section 53.4945-2 is amended as follows:

1. Paragraphs (a)(1), (a)(2) and (a)(5)(i) are revised to read as set forth below, and paragraph (a)(5)(iii) is removed;

2. Paragraphs (a)(6) and (a)(7) are added as set forth below;

3. Paragraphs (b) and (c) are removed and reserved.

4. Paragraph (d)(1)(i) is revised to read as set forth below.

5. Paragraph (d)(1)(ii) is revised to read as set forth below.

6. In paragraph (d)(1)(iv), the last sentence is revised to read as set forth below.

7. Paragraph (d)(1)(v), Examples, is redesignated as paragraph (d)(1)(vii), Examples (4) and (5) are revised, and new Examples (8) through (12) are added, to read as set forth below.

8. New paragraphs (d)(1)(v) and (d)(1)(vi) are added, to read as set forth below.

9. In paragraph (d)(2)(iii), new Examples (5) through (7) are added to read as set forth below.

10. Paragraph (d)(4) is revised to read as set forth below.

§53.4945-2 Propaganda influencing legislation.

(a) *Propaganda influencing legislation, etc.*—(1) *In general.* Under sec-

tion 4945(d)(1) the term "taxable expenditure" includes any amount paid or incurred by a private foundation to carry on propaganda, or otherwise to attempt, to influence legislation. An expenditure is an attempt to influence legislation if it is for a direct or grass roots lobbying communication, as defined in §56.4911-2 (without reference to §§56.4911-2(b)(3) and 56.4911-2(c)) and §56.4911-3. See, however, paragraph (d) of this section for exceptions to the general rule of this paragraph (a)(1).

(2) *Expenditures for membership communications.* Section 56.4911-5, which provides special rules for electing public charities' communications with their members, does not apply to private foundations. Thus, whether a private foundation's communications with its members (assuming it has any) are lobbying communications is determined solely under §56.4911-2 and without reference to §56.4911-5. However, where a private foundation makes a grant to an electing public charity, §56.4911-5 applies to the electing public charity's communications with its own members. Therefore, in the limited context of determining whether a private foundation's grant to an electing public charity is a taxable expenditure under section 4945, the §56.4911-5 membership rules apply. For example, if the grant is specifically earmarked for a communication from the electing public charity to its members and the communication is, because of §56.4911-5, a nonlobbying communication, the grant is not a taxable expenditure under section 4945.

* * * * *

(5) *Grants to public organizations*—(i) *In general.* A grant by a private foundation to an organization described in section 509(a)(1), (2), or (3) does not constitute a taxable expenditure by the foundation under section 4945(d), other than under section 4945(d)(1), if the grant by the private foundation is not earmarked to be used for any activity described in section 4945(d)(2) or (5), is not earmarked to be used in a manner which would violate section 4945(d)(3) or (4), and there does not exist an agreement, oral or written, whereby the grantor foundation may cause the grantee to engage in any such prohibited activity or to select the recipient to which the grant is to be devoted. For purposes of this paragraph (a)(5)(i), a grant by a private foundation is earmarked if the grant is given pursuant to an agreement, oral or written, that the grant will be used for specific purposes. For the expenditure responsibility requirements with respect to organizations other than those described in section 509(a)(1), (2), or (3), see §53.4945-5. For rules for determining whether grants to public charities are taxable expenditures under section 4945(d)(1), see paragraphs (a)(2), (a)(6) and (a)(7) of this section.

* * * * *

(6) *Grants to public organizations that attempt to influence legislation*—(i) *General support grant.* A general support grant by a private foundation to an organization described in section 509(a)(1), (2), or (3) (a "public charity" for purposes of paragraphs (a)(6) and (7) of this section) does not constitute a taxable expenditure under section 4945(d)(1) to the extent that the grant is not earmarked, within the meaning of §53.4945-2(a)(5)(i), to be used in an attempt to influence legislation. The preceding sentence applies without regard to whether the public charity has made the election under section 501(h).

(ii) *Specific project grant.* A grant by a private foundation to fund a specific project of a public charity is not a taxable expenditure by the foundation under section 4945(d)(1) to the extent that—

(A) The grant is not earmarked, within the meaning of §53.4945-2(a)(5)(i), to be used in an attempt to influence legislation, and

(B) The amount of the grant, together with other grants by the same private foundation for the same project for the same year, does not exceed the amount budgeted, for the year of the grant, by the grantee organization for activities of the project that are not attempts to influence legislation. If the grant is for more than one year, the preceding sentence applies to each year of the grant with the amount of the grant measured by the amount actually disbursed by the private foundation in each year or divided equally between years, at the option of the private foundation. The same method of measuring the annual amount must be used in all years of a grant. This paragraph (a)(6)(ii) applies without regard to whether the public charity has made the election under section 501(h).

(iii) *Reliance upon grantee's budget.* For purposes of determining the amount budgeted by a prospective grantee for specific project activities that are not attempts to influence legislation under paragraph (a)(6)(ii) of this section, a private foundation may rely on budget documents or other sufficient evidence supplied by the grantee organization (such as a signed statement by an authorized officer, director or trustee of such grantee organization) showing the proposed budget of the specific project, unless the private foundation doubts or, in light of all the facts and circumstances, reasonably should doubt the accuracy or reliability of the documents.

(7) *Grants to organizations that cease to be described in 501(c)(3)*—(i) *Not taxable expenditure; conditions.* A grant to a public charity (as defined in paragraph (a)(6)(i) of this section) that thereafter ceases to be an organization described in section 501(c)(3) by reason of its attempts to influence legislation is not a taxable expenditure if

(A) The grant meets the requirements of paragraph (a)(6) of this section,

(B) The recipient organization had received a ruling or determination letter, or an advance ruling or determination letter, that it is described in sections 501(c)(3) and 509(a),

(C) Notice of a change in the recipient organization's status has not been made to the public (such as by publication in the Internal Revenue Bulletin), and the private foundation has not acquired knowledge that the Internal Revenue Service has given notice to the recipient organization that it will be deleted from such status; and

(D) The recipient organization is not controlled directly or indirectly by the private foundation. A recipient organization is controlled by a private foundation for this purpose if the private foundation and disqualified persons (defined in section 4946(a)-(1)(A) through (H)) with reference to the private foundation, by aggregating their votes or positions of author-

ity, can cause or prevent action on legislative issues by the recipient.

(ii) *Examples.* The provisions of paragraphs (a)(6) and (a)(7) of this section are illustrated by the following examples:

Example (1). W, a private foundation, makes a general support grant to Z, a public charity described in section 509(a)(1). Z informs W that, as an insubstantial portion of its activities, Z attempts to influence the State legislature with regard to changes in the mental health laws. The use of the grant is not earmarked by W to be used in a manner that would violate section 4945(d)(1). Even if the grant is subsequently devoted by Z to its legislative activities, the grant by W is not a taxable expenditure under section 4945(d).

Example (2). X, a private foundation, makes a specific project grant to Y University for the purpose of conducting research on the potential environmental effects of certain pesticides. X does not earmark the grant for any purpose that would violate section 4945(d)(1) and there is no oral or written agreement or understanding whereby X may cause Y to engage in any activity described in section 4945(d)(1), (2), or (5), or to select any recipient to which the grant may be devoted. Further, X determines, based on budget information supplied by Y, that Y's budget for the project does not contain any amount for attempts to influence legislation. X has no reason to doubt the accuracy or reliability of the budget information. Y uses most of the funds for the research project; however, Y expends a portion of the grant funds to send a representative to testify at Congressional hearings on a specific bill proposing certain pesticide control measures. The portion of the grant funds expended with respect to the Congressional hearings is not treated as a taxable expenditure by X under section 4945(d)(1).

Example (3). M, a private foundation, makes a specific project grant of $150,000 to P, a public charity described in section 509(a)(1). In requesting the grant from M, P stated that the total budgeted cost of the project is $200,000, and that of this amount $20,000 is allocated to attempts to influence legislation related to the project. M relies on the budget figures provided by P in determining the amount P will spend on influencing legislation and M has no reason to doubt the accuracy or reliability of P's budget figures. In making the grant, M did not earmark any of the funds from the grant to be used for attempts to influence legislation. M's grant of $150,000 to P will not constitute a taxable expenditure under section 4945(d)(1) because M did not earmark any of the funds for attempts to influence legislation and because the amount of its grant ($150,000) does not exceed the amount allocated to specific project activities that are not attempts to influence legislation ($200,000 − $20,000 = $180,000).

Example (4). Assume the same facts as in example (3), except that M's grant letter to P provides that M has the right to renegotiate the terms of the grant if there is a substantial deviation from those terms. This additional fact does not make M's grant a taxable expenditure under section 4945(d)(1).

Example (5). Assume the same facts as in example (3), except that M made a specific project grant of $200,000 to P. Part of M's grant of $200,000 will constitute a taxable expenditure under section 4945(d)(1). The amount of the grant ($200,000) exceeds by $20,000 the amount P allocated to specific project activities that are not attempts to influence legislation ($180,000). M has made a taxable expenditure of $20,000.

Example (6). Assume the same facts as example (3), except that M made a specific project grant of $180,000, and received from P an enforceable commitment that grant funds would not be used in connection with attempts to influence legislation. M's grant is not a taxable expenditure under section 4945(d)(1).

Example (7). Assume the same facts as in example (3) except that M directed P to hire A, an individual, to expend $20,000 from the grant to engage in direct lobbying (within the meaning of §56.4911-2(b)) and grass roots lobbying (within the meaning of §56.4911-2(c)). P does not expend any other grant funds for lobbying activities. The $20,000 that is earmarked for direct lobbying and grass roots lobbying is a taxable expenditure under section 4945(d)(1).

Example (8). R, a public charity described in section 509(a)(1), requested N, a private foundation, to make a general purpose grant to it to aid R in carrying out its exempt purpose. In making this request, R notified N that it had elected the expenditure test under section 501(h) and that it expected to attempt to influence legislation in areas related to its exempt purpose. Since its formation, R generally has had exempt purpose expenditures (as defined in §56.4911-4) in excess of $7,000,000 in each of its taxable years, and has budgeted in excess of $7,000,000 of exempt purpose expenditures for the year of the grant. N made a grant of $200,000 to R. N did not earmark the funds for R's attempt to influence legislation. The general purpose grant by N does not constitute a taxable expenditure under section 4945(d)(1).

Example (9). Assume the same facts as in example (8), except that N learns that R has had excess lobbying expenditures (within the meaning of §56.4911-1(b)) in some prior years. N also learns that in no year has R's lobbying or grass roots expenditures (within the meaning of §56.4911-2(a) and (c)) exceeded the corresponding ceiling amount (within the meaning of §1.501(h)-3(c)(3) and (6)). N then makes the grant to R. After receiving the grant, R spends a large portion of its funds on influencing legislation and, as a consequence, is denied exemption from tax, as an organization described in section 501(c)(3), under section 501(h) and §1.501(h)-3. No disqualified person with respect to N controlled, in whole or in part, R's attempts to influence legislation. The general purpose grant will not constitute a taxable expenditure under section 4945(d)(1).

Example (10). X, a private foundation, makes a specific project grant to Y, a public charity described in section 509(a). In requesting the grant, Y stated that it planned to use the funds to purchase a computer for purposes of computerizing its research files and that the grant will not be used to influence legislation. Two years after X makes the grant, X discovers that Y has also used the computer for purposes of maintaining and updating the mailing list for Y's lobbying newsletter. Because X did not earmark any of the grant funds to be used for attempts to influence legislation and because X had no reason to doubt the accuracy or reliability of Y's documents representing that the grant would not be used to influence legislation, X's grant is not treated as a taxable expenditure.

Example (11). G, a private foundation, makes a specific project grant of $300,000 to L, a public charity described in section 509(a)(1) for a three-year specific project studying child care problems. L provides budget material indicating that the specific project will expend $200,000 in each of three years. L's budget materials indicate that attempts to influence legislation will amount to $10,000 in the first year, $20,000 in the second year and $100,000 in the third year. G intends to pay its $300,000 grant over three years as follows: $200,000 in the first year, $50,000 in the second year and $50,000 in the third year. The amount of the grant actually disbursed by G in the first year of the grant exceeds the nonlobbying expenditures of L in that year. However, because the amount of the grant in each of the three years, when divided equally among the three years ($100,000 for each year), is not more than the nonlobbying expenditures of L on the specific project for any of the three years, none of the grant is treated as a taxable expenditure under section 4945(d)(1).

Example (12). P, a private foundation, makes a $120,000 specific project grant to C, a public charity described in section 509(a) for a three-year project. P intends to pay its grant to C in three equal annual installments of $40,000. C provides budget material indicating that the specific project will expend $100,000 in each of three years. C's budget materials, which P reasonably does not doubt, indicate that the project's attempts to influence legislation will amount to $50,000 in each of the three years. After P pays the first annual installment to C, but before P pays the second installment to C, reliable information comes to P's attention that C has spent $90,000 of the project's $100,000 first-year budget on attempts to influence legislation. This information causes P to doubt the accuracy and reliability of C's budget materials. Because of the information, P does not pay the second-year installment to C. P's payment of the first installment of $40,000 is not a taxable expenditure under section 4945(d)(1) because the grant in the first year is not more than the nonlobbying expenditures C projected in its budget materials that P reasonably did not doubt.

Example (13). Assume the same facts as in Example (12), except that P pays the second-year installment of $40,000 to C. In the project's second year, C once again spends $90,000 of the project's $100,000 annual budget in attempts to influence legislation. Because P doubts or reasonably should doubt the accuracy or reliability of C's budget materials when P makes the second-year grant payment, P may not rely upon C's budget documents at that time. Accordingly, although none of the $40,000 paid in the first installment is a taxable expenditure, only $10,000 ($100,000 minus $90,000) of the second-year grant payment is not a taxable expenditure. The remaining $30,000 of the second installment is a taxable expenditure within the meaning of section 4945(d)(1).

Example (14). B, a private foundation, makes a specific project grant to C, a public charity described in section 509(a), of $40,000 for the purpose of conducting a study on the effectiveness of seat belts in preventing traffic deaths. B did not earmark any of the grant for attempts

to influence legislation. In requesting the grant from B, C submitted a budget of $100,000 for the project. The budget contained expenses for postage and mailing, computer time, advertising, consulting services, salaries, printing, advertising, and similar categories of expenses. C also submitted to B a statement, signed by an officer of C, that 30% of the budgeted funds would be devoted to attempts to influence legislation within the meaning of section 4945. B has no reason to doubt the accuracy of the budget figures or the statement. B may rely on the budget figures and signed statement provided by C in determining the amount C will spend on influencing legislation. B's grant to C will not constitute a taxable expenditure under section 4945(d)(1), because the amount of the grant does not exceed the amount allocated to specific project activities that are not attempts to influence legislation.

(b) [Reserved]

(c) [Reserved]

(d) *Exceptions*—(1) *Nonpartisan analysis, study, or research*—(i) *In general.* A communication is not a lobbying communication, for purposes of §53.4945-2(a)(1), if the communication constitutes engaging in nonpartisan analysis, study or research and making available to the general public or a segment or members thereof or to governmental bodies, officials, or employees the results of such work. Accordingly, an expenditure for such a communication does not constitute a taxable expenditure under section 4945(d)(1) and §53.4945- 2(a)(1).

(ii) *Nonpartisan analysis, study, or research.* For purposes of section 4945(e), "nonpartisan analysis, study, or research" means an independent and objective exposition of a particular subject matter, including any activity that is "educational" within the meaning of §1.501(c)(3)-1(d)(3). Thus, "nonpartisan analysis, study, or research" may advocate a particular position or viewpoint so long as there is a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent opinion or conclusion. On the other hand, the mere presentation of unsupported opinion does not qualify as "nonpartisan analysis, study, or research".

* * * * *

(iv) *Making available results of nonpartisan analysis, study, or research.* * * * For purposes of this paragraph (d)(1)(iv), such communications may not be limited to, or be directed toward, persons who are interested solely in one side of a particular issue.

(v) *Subsequent lobbying use of certain analysis, study or research*—(A) *In general.* Even though certain analysis, study or research is initially within the exception for nonpartisan analysis, study or research, subsequent use of that analysis, study or research for grass roots lobbying may cause that analysis, study or research to be treated as a grass roots lobbying communication that is not within the exception for nonpartisan analysis, study or research. This paragraph (d)(1)(v) of this section does not cause any analysis, study or research to be considered a direct lobbying communication. For rules regarding when analysis, study or research is treated as a grass roots lobbying communication that is not within the scope of the exception for nonpartisan analysis, study or research, see §56.4911-2(b)(2)(v).

(B) *Special rule for grants to public charities.* This paragraph (d)(1)(v)(B) of this section applies where a public charity uses a private foundation grant to finance, in whole or in part, a nonlobbying communication that is subsequently used in lobbying, causing the public charity's expenditures for the communication to be treated as lobbying expenditures under the subsequent use rule. In such a case, the private foundation's grant will ordinarily not be characterized as a lobbying expenditure by virtue of the subsequent use rule. The only situations where the private foundation's grant will be treated as a lobbying expenditure under the subsequent use rule are where the private foundation's primary purpose in making the grant to the public charity was for lobbying or where, at the time of making the grant, the private foundation knows (or in light of all the facts and circumstances reasonably should know) that the public charity's primary purpose in preparing the communication to be funded by the grant is for use in lobbying.

(vi) *Directly encouraging action by recipients of a communication.* A communication that reflects a view on specific legislation is not within the nonpartisan analysis, study or research exception of this §53.4945-2(d)(1) if the communication directly encourages the recipient to take action with respect to such legislation. For purposes of this section, a communication directly encourages the recipient to take action with respect to legislation if the communication is described in one or more of §56.4911-2(b)(2)(iii)(A) through (C). As described in §56.4911-2(b)(2)(iv), a communication would encourage the recipient to take action with respect to legislation, but not directly encourage such action, if the communication does no more than specifically identify one or more legislators who will vote on the legislation as: opposing the communication's view with respect to the legislation; being undecided with respect to the legislation; being the recipient's representative in the legislature; or being a member of the legislative committee or subcommittee that will consider the legislation.

(vii) *Examples.* * * *

Example (4). P publishes a bi-monthly newsletter to collect and report all published materials, ongoing research, and new developments with regard to the use of pesticides in raising crops. The newsletter also includes notices of proposed pesticide legislation with impartial summaries of the provisions and debates on such legislation. The newsletter does not encourage recipients to take action with respect to such legislation, but is designed to present information on both sides of the legislative controversy and does present such information fully and fairly. It is within the exception for nonpartisan analysis, study, or research.

Example (5). X is satisfied that A, a member of the faculty of Y University, is exceptionally well qualified to undertake a project involving a comprehensive study of the effects of pesticides on crop yields. Consequently, X makes a grant to A to underwrite the cost of the study and of the preparation of a book on the effect of pesticides on crop yields. X does not take any position on the issues or control the content of A's output. A produces a book which concludes that the use of pesticides often has a favorable effect on crop yields, and on that basis argues against pending bills which would ban the use of pesticides. A's book contains a sufficiently full and fair exposition of the pertinent facts, including known or potential disadvantages of the use of pesticides, to enable the public or an individual to form an independent opinion or conclusion as to whether pesticides should be banned as provided in the pending bills. The book does not directly encourage readers to take action with respect to the pending bills. Consequently, the book is within the exception for nonpartisan analysis, study, or research.

* * * * *

Example (8). Organization Z researches, writes, prints and distributes a study on the use and effects of pesticide X. A bill is pending in the U.S. Senate to ban the use of pesticide X. Z's study leads to the conclusion that pesticide X is extremely harmful and that the bill pending in the U.S. Senate is an appropriate and much needed remedy to solve the problems caused by pesticide X. The study contains a sufficiently full and fair exposition of the pertinent facts, including known or potential

advantages of the use of pesticide X, to enable the public or an individual to form an independent opinion or conclusion as to whether pesticides should be banned as provided in the pending bills. In its analysis of the pending bill, the study names certain undecided Senators on the Senate committee considering the bill. Although the study meets the three part test for determining whether a communication is a grass roots lobbying communication, the study is within the exception for nonpartisan analysis, study or research, because it does not directly encourage recipients of the communication to urge a legislator to oppose the bill.

Example (9). Assume the same facts as in Example (8), except that, after stating support for the pending bill, the study concludes: "You should write to the undecided committee members to support this crucial bill." The study is not within the exception for nonpartisan analysis, study or research because it directly encourages the recipients to urge a legislator to support a specific piece of legislation.

Example (10). Organization X plans to conduct a lobbying campaign with respect to illegal drug use in the United States. It incurs $5,000 in expenses to conduct research and prepare an extensive report primarily for use in the lobbying campaign. Although the detailed report discusses specific pending legislation and reaches the conclusion that the legislation would reduce illegal drug use, the report contains a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent conclusion regarding the effect of the legislation. The report does not encourage readers to contact legislators regarding the legislation. Accordingly, the report does not, in and of itself, constitute a lobbying communication.

Copies of the report are available to the public at X's office, but X does not actively distribute the report or otherwise seek to make the contents of the report available to the general public. Whether or not X's distribution is sufficient to meet the requirement in §53.4945-2(d)(1)(iv) that a nonpartisan communication be made available, X's distribution is not substantial (for purposes of §§53.4945-2(d)(1)(v) and 56.4911-2(b)(2)(v)) in light of all of the facts and circumstances, including the normal distribution pattern of similar nonpartisan reports. X then mails copies of the report, along with a letter, to 10,000 individuals on X's mailing list. In the letter, X requests that individuals contact legislators urging passage of the legislation discussed in the report. Because X's research and report were primarily undertaken by X for lobbying purposes and X did not make a substantial distribution of the report (without an accompanying lobbying message) prior to or contemporaneously with the use of the report in lobbying, the report is a grass roots lobbying communication that is not within the exception for nonpartisan analysis, study or research. Thus, the expenditures for preparing and mailing both the report and the letter are taxable expenditures under section 4945.

Example (11). Assume the same facts as in Example (10), except that before using the report in the lobbying campaign, X sends the research and report (without an accompanying lobbying message) to universities and newspapers. At the same time, X also advertises the availability of the report in its newsletter. This distribution is similar in scope to the normal distribution pattern of similar nonpartisan reports. In light of all of the facts and circumstances, X's distribution of the report is substantial. Because of X's substantial distribution of the report, X's primary purpose will be considered to be other than for use in lobbying and the report will not be considered a grass roots lobbying communication. Accordingly, only the expenditures for copying and mailing the report to the 10,000 individuals on X's mailing list, as well as for preparing and mailing the letter, are expenditures for grass roots lobbying communications, and are thus taxable expenditures under section 4945.

Example (12). Organization M pays for a bumper sticker that reads: "STOP ABORTION: Vote NO on Prop. X!" M also pays for a 30-second television advertisement and a billboard that similarly advocate opposition to Prop. X. In light of the limited scope of the communications, none of the communications is within the exception for nonpartisan analysis, study or research. First, none of the communications rises to the level of analysis, study or research. Second, none of the communications is nonpartisan because none contains a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent opinion or conclusion. Thus, each communication is a lobbying communication.

(2) *Technical advice or assistance—*

(i) * * *

* * * * *

(iii) *Examples.* * * *

Example (5). In response to a telephone inquiry from Senator X's staff, organization B sends Senator X a report concluding that the Senate should not advise and consent to the nomination of Z to serve as a Supreme Court Justice. Because the request was not in writing, and also because the request was not from the Senate itself or from a committee or subcommittee, B's report is not within the scope of the exception for responses to requests for technical advice. Accordingly, B's report is a lobbying communication unless the report is within the scope of the exception for nonpartisan analysis, study or research.

Example (6). Assume the same facts as in Example (5), except that B's report is sent in response to a written request that Senator X sends to B. The request from Senator X is a request from the Senator as an individual member of the Senate rather than from the Senate itself or from a committee or subcommittee. Accordingly, B's report is not within the scope of the exception for responses to requests for technical advice and is a lobbying communication unless the report is within the scope of the exception for nonpartisan analysis, study or research.

Example (7). Assume the same facts as in Example (6), except that B's report is sent in response to a written request from the Senate committee that is considering the nomination for an evaluation of the nominee's legal writings and a recommendation as to whether the candidate is or is not qualified to serve on the Supreme Court. The report is within the scope of the exception for responses to requests for technical advice and is not a lobbying communication.

* * * * *

(4) *Examinations and discussions of broad social, economic, and similar problems.* Examinations and discussions of broad social, economic, and similar problems are neither direct lobbying communications under §56.4911-2(b)(1) nor grass roots lobbying communications under §56.4911-2(b)(2) even if the problems are of the type with which government would be expected to deal ultimately. Thus, under §§56.4911-2(b)(1) and (2), lobbying communications do not include public discussion, or communications with members of legislative bodies or governmental employees, the general subject of which is also the subject of legislation before a legislative body, so long as such discussion does not address itself to the merits of a specific legislative proposal and so long as such discussion does not directly encourage recipients to take action with respect to legislation. For example, this paragraph (d)(4) excludes from grass roots lobbying under §56.4911-2(b)(2) an organization's discussions of problems such as environmental pollution or population growth that are being considered by Congress and various State legislatures, but only where the discussions are not directly addressed to specific legislation being considered, and only where the discussions do not directly encourage recipients of the communication to contact a legislator, an employee of a legislative body, or a government official or employee who may participate in the formulation of legislation.

Par. 17. Part 56 is added to read as follows:

PART 56—PUBLIC CHARITY EXCISE TAXES

Sec.

56.4911-0 Outline of regulations under section 4911.
56.4911-1 Tax on excess lobbying expenditures.
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56.6001-1 Notice or regulations requiring records, statements, and special returns.
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Authority: 26 U.S.C. 7805. Sec. 56.4911-7 also issued under 26 U.S.C. 4911(f)(3).

§56.4911-0 Outline of regulations under section 4911.

Immediately following is an outline of the regulations under section 4911 of the Internal Revenue Code relating to an excise tax on electing public charities' excess lobbying expenditures.

§56.4911-0 *Outline of regulations under section 4911.*

§56.4911-1 *Tax on excess lobbying expenditures.*

(a) In general.
(b) Excess lobbying expenditures.
(c) Nontaxable amounts.
(1) Lobbying nontaxable amount.
(2) Grass roots nontaxable amount.
(d) Examples.

§56.4911-2 *Lobbying expenditures, direct lobbying communications, and grass roots lobbying communications.*
(a) Lobbying expenditures.
(1) In general.
(2) Overview of §56.4911 and the definitions of "direct lobbying communication" and "grass roots lobbying communication".
(b) Influencing legislation: direct and grass roots lobbying communications defined.
(1) Direct lobbying communication.
(2) Grass roots lobbying communication.
(3) Exceptions to the definition of influencing legislation.
(4) Examples.
(5) Special rule for certain mass media advertisements.
(c) Exceptions to the definitions of direct lobbying communication and grass roots lobbying communication.
(1) Nonpartisan analysis, study, or research exception.
(2) Examinations and discussions of broad social, economic, and similar problems.
(3) Requests for technical advice.
(4) Communications pertaining to "self-defense" by the organization.
(d) Definitions.
(1) Legislation.
(2) Action.
(3) Legislative body.
(4) Administrative bodies.

§56.4911-3 *Expenditures for direct and/or grass roots lobbying communications.*

(a) Definition of term "expenditures for".
(1) In general.
(2) Allocation of mixed purpose expenditures.
(3) Allocation of mixed lobbying.
(b) Examples.
(c) Certain transfers treated as lobbying expenditures.
(1) Transfer earmarked for grass roots purposes.
(2) Transfer earmarked for direct and grass roots lobbying.
(3) Certain transfers to noncharities that lobby.

§56.4911-4 *Exempt purpose expenditures.*

(a) Application.
(b) Included expenditures.
(c) Excluded expenditures.
(d) Certain transfers treated as exempt purpose expenditures.
(e) Transfers not exempt purpose expenditures.
(f) Definitions.
(g) Example.

§56.4911-5 *Communications with members.*
(a) In general.
(b) Communications (directed only to members) that are not lobbying communications.
(c) Communications (directed only to members) that are direct lobbying communications.
(d) Communications (directed only to members) that are grass roots lobbying communications.
(e) Written communications directed to members and nonmembers.
(1) In general.
(2) Direct lobbying directly encouraged.
(3) Grass roots expenditure if grass roots lobbying directly encouraged.
(4) No direct encouragement of direct lobbying or of grass roots lobbying.
(f) Definitions and special rules.
(1) Member; general rule.
(2) Member; special rule.
(3) Member; affiliated group of organizations.
(4) Member; limited affiliated group of organizations.
(5) Subscriber.
(6) Directly encourages.
(7) Percentages of total distribution.
(8) Reasonable allocation rule.

§56.4911-6 *Records of lobbying and grass roots expenditures.*

(a) Records of lobbying expenditures.
(b) Records of grass roots expenditures.

§56.4911-7 *Affiliated group of organizations.*
(a) Affiliation between two organizations.
(1) In general.
(2) Organizations not described in section 501(c)(3).
(3) Action on legislative issues.
(b) Interlocking governing boards.
(1) In general.
(2) Majority or quorum.
(3) Votes required under governing instrument or local law.
(4) Representatives constituting less than 15% of governing board.
(5) Representatives.
(c) Governing instrument.
(d) Three or more organizations affiliated.
(1) Two controlled organizations affiliated.
(2) Chain rule.
(e) Affiliated group of organizations.
(1) Defined.
(2) Multiple membership.
(3) Taxable year of affiliated group.

(4) Electing member organization.
(5) Election of member's year as group's taxable year.
(f) Examples.

§56.4911-8 *Excess lobbying expenditures of affiliated group.*
(a) Application.
(b) Affiliated group treated as one organization.
(c) Tax imposed on excess lobbying expenditures of affiliated group.
(d) Liability for tax.
(1) Electing organizations.
(2) Tax based on excess lobbying expenditures.
(3) Tax based on excess grass roots expenditures.
(4) Tax based on exempt purpose expenditures.
(5) Taxable year for which liable.
(6) Organization a member of more than one affiliated group.
(e) Former member organization.

§56.4911-9 *Application of section 501(h) to affiliated groups of organizations.*
(a) Scope.
(b) Determination required.
(c) Member organizations that are not electing organizations.
(d) Filing of information relating to affiliated group of organizations.
(1) Scope.
(2) In general.
(3) Additional information required.
(4) Information required of electing member organization.
(e) Example.
(f) Cross reference.

§56.4911-10 *Members of a limited affiliated group of organizations.*
(a) Scope.
(b) Members of limited affiliated group.
(c) Controlling and controlled organizations.
(d) Expenditures of controlling organization.
(1) Scope.
(2) Expenditures for direct lobbying.
(3) Grass roots expenditures.
(4) Exempt purpose expenditures.
(e) Expenditures of controlled member.
(f) Reports of members of limited affiliated groups.
(1) Controlling member organization's additional information on annual return.
(2) Reports of controlling members to other members.
(3) Reports of controlled member organizations.
(g) National legislative issues.
(h) Examples.

§56.6001-1 *Notice or regulations requiring records, statements, and special returns.*
(a) In general.
(b) Cross references.

§56.6011-1 *General requirement of return, statement, or list.*

§56.4911-1 Tax on excess lobbying expenditures.

(a) *In general.* Section 4911(a) imposes an excise tax of 25 percent on the excess lobbying expenditures (as defined in paragraph (b) of this section) for a taxable year of an organization for which the expenditure test election under section 501(h) is in effect (an "electing public charity"). An electing public charity's annual limit on expenditures for influencing legislation (i.e., the amount of lobbying expenditures on which no tax is due) is the lobbying nontaxable amount or, on expenditures for influencing legislation through grass roots lobbying, the grass roots nontaxable amount (see paragraph (c) of this section). For rules concerning the application of the excise tax imposed by section 4911(a) to the members of an affiliated group of organizations (as defined in §56.4911-7(e)), see §56.4911-8.

(b) *Excess lobbying expenditures.* For any taxable year for which the expenditure test election under section 501(h) is in effect, the amount of an electing public charity's excess lobbying expenditures is the greater of—

(1) The amount by which the organization's lobbying expenditures (within the meaning of §56.4911-2(a)) exceed the organization's lobbying nontaxable amount, or

(2) The amount by which the organization's grass roots expenditures (within the meaning of §§56.4911-2(a)) exceed the organization's grass roots nontaxable amount.

(c) *Nontaxable amounts*—(1) *Lobbying nontaxable amount.* Under section 4911(c)(2), the lobbying nontaxable amount for any taxable year for which the expenditure test election is in effect is the lesser of—

(i) $1,000,000, or

(ii) To the extent of the electing public charity's exempt purpose expenditures (within the meaning of §56.4911-4) for that year, the sum of 20 percent of the first $500,000 of such expenditures, plus 15 percent of the second $500,000 of such expenditures, plus 10 percent of the third $500,000 of such expenditures, plus 5 percent of the remainder of such expenditures.

(2) *Grass roots nontaxable amount.* Under section 4911(c)(4), an electing public charity's grass roots nontaxable amount for any taxable year is 25 percent of its lobbying nontaxable amount for that year.

(d) *Examples.* The provisions of this section are illustrated by the examples in §1.501(h)-3.

§56.4911-2 Lobbying expenditures, direct lobbying communications, and grass roots lobbying communications.

(a) *Lobbying expenditures*—(1) *In general.* An electing public charity's lobbying expenditures for a year are the sum of its expenditures during that year for direct lobbying communications ("direct lobbying expenditures") plus its expenditures during that year for grass roots lobbying communications ("grass roots expenditures").

(2) *Overview of §56.4911-2 and the definitions of "direct lobbying communication" and "grass roots lobbying communication."* Paragraph (b)(1) of this section defines the term "direct lobbying communication." Paragraph (b)(2) of this section provides the general definition of the term "grass roots lobbying communication." (But also see paragraph (b)(5) of this section (special rebuttable presumption regarding certain paid mass media communications) and §56.4911-5 (special, more lenient, definitions for certain communications from an electing public charity to its bona fide members).) Paragraph (b)(3) of this section lists and cross-references various exceptions to the definitions set forth in paragraphs (b)(1) and (2) (the text of the exceptions, along with relevant definitions

and examples, is generally set forth in paragraph (c)). Paragraph (b)(4) of this section contains numerous examples illustrating the application of paragraphs (b)(1), (2) and (3). As mentioned above, paragraph (b)(5) of this section sets forth the special rebuttable presumption regarding a limited number of paid mass media communications about highly publicized legislation. Paragraph (d) of this section contains definitions of (and examples illustrating) various terms used in this section.

(b) *Influencing legislation: direct and grass roots lobbying communications defined*—(1) *Direct lobbying communication*—(i) *Definition.* A direct lobbying communication is any attempt to influence any legislation through communication with:

(A) Any member or employee of a legislative body; or

(B) Any government official or employee (other than a member or employee of a legislative body) who may participate in the formulation of the legislation, but only if the principal purpose of the communication is to influence legislation.

(ii) *Required elements.* A communication with a legislator or government official will be treated as a direct lobbying communication under this §56.4911-2(b)(1) if, but only if, the communication:

(A) Refers to specific legislation (see paragraph (d)(1) of this section for a definition of the term "specific legislation"); and

(B) Reflects a view on such legislation.

(iii) *Special rule for referenda, ballot initiatives or similar procedures.* Solely for purposes of this section 4911, where a communication refers to and reflects a view on a measure that is the subject of a referendum, ballot initiative or similar procedure, the general public in the state or locality where the vote will take place constitutes the legislative body, and individual members of the general public are, for purposes of this paragraph (b)(1), legislators. Accordingly, if such a communication is made to one or more members of the general public in that state or locality, the communication is a direct lobbying communication (unless it is nonpartisan analysis, study or research (see paragraph (c)(1) of this section).

(2) *Grass roots lobbying communication*—(i) *Definition.* A grass roots lobbying communication is any attempt to influence any legislation through an attempt to affect the opinions of the general public or any segment thereof.

(ii) *Required elements.* A communication will be treated as a grass roots lobbying communication under this §56.4911-2(b)(2)(ii) if, but only if, the communication:

(A) Refers to specific legislation (see paragraph (d)(1) of this section for a definition of the term "specific legislation");

(B) Reflects a view on such legislation; and

(C) Encourages the recipient of the communication to take action with respect to such legislation (see paragraph (b)(2)(iii) of this section for the definition of encouraging the recipient to take action).

For special, more lenient rules regarding an organization's communications directed only or primarily to bona fide members of the organization, see §56.4911-5. For special rules regarding certain paid mass media advertisements about highly publicized legislation, see paragraph (b)(5) of this section. For special rules regarding lobbying on referenda, ballot initiatives and similar procedures, see paragraph (b)(1)(iii) of this section.

(iii) *Definition of encouraging recipient to take action.* For purposes of this section, encouraging a recipient to take action with respect to legislation means that the communication:

(A) States that the recipient should contact a legislator or an employee of a legislative body, or should contact any other government official or employee who may participate in the formulation of legislation (but only if the principal purpose of urging contact with the government official or employee is to influence legislation);

(B) States the address, telephone number, or similar information of a legislator or an employee of a legislative body;

(C) Provides a petition, tear-off postcard or similar material for the recipient to communicate with a legislator or an employee of a legislative body, or with any other government official or employee who may participate in the formulation of legislation (but only if the principal purpose of so facilitating contact with the government official or employee is to influence legislation); or

(D) Specifically identifies one or more legislators who will vote on the legislation as: opposing the communication's view with respect to the legislation; being undecided with respect to the legislation; being the recipient's representative in the legislature; or being a member of the legislative committee or subcommittee that will consider the legislation. Encouraging the recipient to take action under this paragraph (b)(2)(iii)(D) does not include naming the main sponsor(s) of the legislation for purposes of identifying the legislation.

(iv) *Definition of directly encouraging recipient to take action.* Communications described in one or more of paragraphs (b)(2)(iii)(A) through (C) of this section not only "encourage," but also "directly encourage" the recipient to take action with respect to legislation. Communications described in paragraph (b)(2)(iii)(D) of this section, however, do not directly encourage the recipient to take action with respect to legislation. Thus, a communication would encourage the recipient to take action with respect to legislation, but not *directly* encourage such action, if the communication does no more than identify one or more legislators who will vote on the legislation as: opposing the communication's view with respect to the legislation; being undecided with respect to the legislation; being the recipient's representative in the legislature; or being a member of the legislative committee or subcommittee that will consider the legislation. Communications that encourage the recipient to take action with respect to legislation but that do not *directly* encourage the recipient to take action with respect to legislation may be within the exception for nonpartisan analysis, study or research (see paragraph (c)(1) of this section) and thus not be grass roots lobbying communications.

(v) *Subsequent lobbying use of nonlobbying communications or research materials*—(A) *Limited effect of application.* Even though certain communications or research materials

are initially not grass roots lobbying communications under the general definition set forth in paragraph (b)(2)(ii) of this section, subsequent use of the communications or research materials for grass roots lobbying may cause them to be treated as grass roots lobbying communications. This paragraph (b)(2)(v) does not cause any communications or research materials to be considered direct lobbying communications.

(B) *Limited scope of application.* Under this paragraph (b)(2)(v), only "advocacy communications or research materials" are potentially treated as grass roots lobbying communications. Communications or research materials that are not "advocacy communications or research materials" are not treated as grass roots lobbying communications under this paragraph (b)(2)(v). "Advocacy communications or research materials" are any communications or materials that both refer to and reflect a view on specific legislation but that do not, in their initial format, contain a direct encouragement for recipients to take action with respect to legislation.

(C) *Subsequent use in lobbying.* Where advocacy communications or research materials are subsequently accompanied by a direct encouragement for recipients to take action with respect to legislation, the advocacy communications or research materials themselves are treated as grass roots lobbying communications unless the organization's primary purpose in undertaking or preparing the advocacy communications or research materials was not for use in lobbying. In such a case, all expenses of preparing and distributing the advocacy communications or research materials will be treated as grass roots expenditures.

(D) *Time limit on application of subsequent use rule.* The characterization of expenditures as grass roots lobbying expenditures under paragraph (b)(2)(v)(C) shall apply only to expenditures paid less than six months before the first use of the advocacy communications or research materials with a direct encouragement to action.

(E) *Safe harbor in determining "primary purpose."* The primary purpose of the organization in undertaking or preparing advocacy communications or research materials will not be considered to be for use in lobbying if, prior to or contemporaneously with the use of the advocacy communications or research materials with the direct encouragement to action, the organization makes a substantial nonlobbying distribution of the advocacy communications or research materials (without the direct encouragement to action). Whether a distribution is substantial will be determined by reference to all of the facts and circumstances, including the normal distribution pattern of similar nonpartisan analyses, studies or research by that and similar organizations.

(F) *Special rule for partisan analysis, study or research.* In the case of advocacy communications or research materials that are not nonpartisan analysis, study or research, the nonlobbying distribution thereof will not be considered "substantial" unless that distribution is at least as extensive as the lobbying distribution thereof.

(G) *Factors considered in determining primary purpose.* Where the nonlobbying distribution of advocacy communications or research materials is not substantial, all of the facts and circumstances must be weighed to determine whether the organization's primary purpose in preparing the advocacy communications or research materials was for use in lobbying. While not the only factor, the extent of the organization's nonlobbying distribution of the advocacy communications or research materials is particularly relevant, especially when compared to the extent of their distribution with the direct encouragement to action. Another particularly relevant factor is whether the lobbying use of the advocacy communications or research materials is by the organization that prepared the document, a related organization, or an unrelated organization. Where the subsequent lobbying distribution is made by an unrelated organization, clear and convincing evidence (which must include evidence demonstrating cooperation or collusion between the two organizations) will be required to establish that the primary purpose for preparing the communication was for use in lobbying.

(H) *Examples.* The provisions of this paragraph (b)(2)(v) are illustrated by the following examples:

Example (1). Assume a nonlobbying "report" (that is not nonpartisan analysis, study or research) is prepared by an organization, but distributed to only 50 people. The report, in that format, refers to and reflects a view on specific legislation but does not contain a direct encouragement for the recipients to take action with respect to legislation. Two months later, the organization sends the report to 10,000 people along with a letter urging recipients to write their Senators about the legislation discussed in the report. Because the report's nonlobbying distribution is not as extensive as its lobbying distribution, the report's nonlobbying distribution is not substantial for purposes of this paragraph (b)(2)(v). Accordingly, the organization's primary purpose in preparing the report must be determined by weighing all of the facts and circumstances. In light of the relatively minimal nonlobbying distribution and the fact that the lobbying distribution is by the preparing organization rather than by an unrelated organization, and in the absence of evidence to the contrary, both the report and the letter are grass roots lobbying communications. Assume that all costs of preparing the report were paid within the six months preceding the mailing of the letter. Accordingly, all of the organization's expenditures for preparing and mailing the two documents are grass roots lobbying expenditures.

Example (2). Assume the same facts as in Example (1), except that the costs of the report are paid over the two month period of January and February. Between January 1 and 31, the organization pays $1,000 for the report. In February, the organization pays $500 for the report. Further assume that the report is first used with a direct encouragement to action on August 1. Six months prior to August 1 is February 1. Accordingly, no costs paid for the report before February 1 are treated as grass roots lobbying expenditures under the subsequent use rule. Under these facts, the subsequent use rule treats only the $500 paid for the report in February as grass roots lobbying expenditures.

(3) *Exceptions to the definition of influencing legislation.* In many cases, a communication is not a direct or grass roots lobbying communication under paragraph (b)(1) or (b)(2) of this section if it falls within one of the exceptions listed in paragraph (c) of this section. See paragraph (c)(1), *Nonpartisan analysis, study or research*; paragraph (c)(2), *Examinations and discussions of broad social, economic and similar problems*; paragraph (c)(3), *Requests for technical advice*; and paragraph (c)(4), *Communications pertaining to self-defense by the organization.* In addition, see §56.4911-5, which provides special rules regarding the treatment of certain lobbying communications direct-

ed in whole or in part to members of an electing public charity.

(4) *Examples.* This paragraph (b)(4) provides examples to illustrate the rules set forth in this section regarding direct and grass roots lobbying. The expenditure test election under section 501(h) is assumed to be in effect for all organizations discussed in the examples in this paragraph (b)(4). In addition, it is assumed that the special rules of §56.4911-5, regarding certain of a public charity's communications with its members, do not apply to any of the examples in this paragraph (b)(4).

(i) *Direct lobbying.* The provisions of this section regarding direct lobbying communications are illustrated by the following examples:

Example (1). Organization P's employee, X, is assigned to approach members of Congress to gain their support for a pending bill. X drafts and P prints a position letter on the bill. P distributes the letter to members of Congress. Additionally, X personally contacts several members of Congress or their staffs to seek support for P's position on the bill. The letter and the personal contacts are direct lobbying communications.

Example (2). Organization M's president writes a letter to the Congresswoman representing the district in which M is headquartered, requesting that the Congresswoman write an administrative agency regarding proposed regulations recently published by that agency. M's president also requests that the Congresswoman's letter to the agency state the Congresswoman's support of M's application for a particular type of permit granted by the agency. The letter written by M's president is not a direct lobbying communication.

Example (3). Organization Z prepares a paper on a particular state's environmental problems. The paper does not reflect a view on any specific pending legislation or on any specific legislative proposal that Z either supports or opposes. Z's representatives give the paper to a state legislator. Z's paper is not a direct lobbying communication.

Example (4). State X enacts a statute that requires the licensing of all day care providers. Agency B in State X is charged with preparing rules to implement the bill enacted by State X. One week after enactment of the bill, organization C sends a letter to Agency B providing detailed proposed rules that organization C suggests to Agency B as the appropriate standards to follow in implementing the statute on licensing of day care providers. Organization C's letter to Agency B is not a lobbying communication.

Example (5). Organization B researches, prepares and prints a code of standards of minimum safety requirements in an area of common electrical wiring. Organization B sells the code of standards booklet to the public and it is widely used by professionals in the installation of electrical wiring. A number of states have codified all, or part, of the code of standards as mandatory safety standards. On occasion, B lobbies state legislators for passage of the code of standards for safety reasons. Because the primary purpose of preparing the code of standards was the promotion of public safety and the standards were specifically used in a profession for that purpose, separate from any legislative requirement, the research, preparation, printing and public distribution of the code of standards is not an expenditure for a direct (or grass roots) lobbying communication. Costs, such as transportation, photocopying, and other similar expenses, incurred in lobbying state legislators for passage of the code of standards into law are expenditures for direct lobbying communications.

Example (6). On the organization's own initiative, representatives of Organization F present written testimony to a Congressional committee. The news media report on the testimony of Organization F, detailing F's opposition to a pending bill. The testimony is a direct lobbying communication but is not a grass roots lobbying communication.

Example (7). Organization R's monthly newsletter contains an editorial column that refers to and reflects a view on specific pending bills. R sends the newsletter to 10,000 nonmember subscribers. Senator Doe is among the subscribers. The editorial column in the newsletter copy sent to Senator Doe is not a direct lobbying communication because the newsletter is sent to Senator Doe in her capacity as a subscriber rather than her capacity as a legislator. (Note, though, that the editorial column may be a grass roots lobbying communication if it encourages recipients to take action with respect to the pending bills it refers to and on which it reflects a view.)

Example (8). Assume the same facts as in Example (7), except that one of Senator Doe's staff members sees Senator Doe's copy of the editorial and writes to R requesting additional information. R responds with a letter that refers to and reflects a view on specific legislation. R's letter is a direct lobbying communication unless it is within one of the exceptions set forth in paragraph (c) of this section (such as the exception for nonpartisan analysis, study or research). (R's letter is not within the scope of the exception for responses to written requests from a legislative body or committee for technical advice (see paragraph (c)(3) of this section) because the letter is not in response to a written request from a legislative body or committee.)

(ii) *Grass roots lobbying.* The provisions of this section regarding grass roots lobbying communications are illustrated in paragraph (b)(4)(ii)(A) of this section by examples of communications that are not grass roots lobbying communications and in paragraph (b)(4)(ii)(B) by examples of communications that are grass roots lobbying communications. The provisions of this section are further illustrated in paragraph (b)(4)(ii)(C), with particular regard to the exception for nonpartisan analysis, study, or research:

(A) *Communications that are not grass roots lobbying communications.*

Example (1). Organization L places in its newsletter an article that asserts that lack of new capital is hurting State W's economy. The article recommends that State W residents either invest more in local businesses or increase their savings so that funds will be available to others interested in making investments. The article is an attempt to influence opinions with respect to a general problem that might receive legislative attention and is distributed in a manner so as to reach and influence many individuals. However, the article does not refer to specific legislation that is pending in a legislative body, nor does the article refer to a specific legislative proposal the organization either supports or opposes. The article is not a grass roots lobbying communication.

Example (2). Assume the same facts as Example (1), except that the article refers to a bill pending in State W's legislature that is intended to provide tax incentives for private savings. The article praises the pending bill and recommends that it be enacted. However, the article does not encourage readers to take action with respect to the legislation. The article is not a grass roots lobbying communication.

Example (3). Organization B sends a letter to all persons on its mailing list. The letter includes an update on numerous environmental issues with a discussion of general concerns regarding pollution, proposed federal regulations affecting the area, and several pending legislative proposals. The letter endorses two pending bills and opposes another pending bill, but does not name any legislator involved (other than the sponsor of one bill, for purposes of identifying the bill), nor does it otherwise encourage the reader to take action with respect to the legislation. The letter is not a grass roots lobbying communication.

Example (4). A pamphlet distributed by organization Z discusses the dangers of drugs and encourages the public to send their legislators a coupon, printed with the statement "I support a drug-free America." The term "drug-free America" is not widely identified with any of the many specific pending legislative proposals regarding drug issues. The pamphlet does not refer to any of the numerous pending legislative proposals, nor does the organization support or oppose a specific legislative proposal. The pamphlet is not a grass roots lobbying communication.

Example (5). A pamphlet distributed by organization B encourages readers to join an organization and "get involved in the fight against drugs." The text states, in the course of a discussion of several current drug issues, that organization B supports a specific bill before Congress that would establish an expanded drug control program. The pamphlet does not encourage readers to communicate with legislators about the bill (such as by including the names of undecided or opposed legislators). The pamphlet is not a grass roots lobbying communication.

Example (6). Organization E, an environmental organization, routinely summarizes in each edition of its newsletter the new environment-related bills that have been introduced in Congress since the last edition of the newsletter. The newsletter identifies each bill by a bill number and the name of the legislation's sponsor. The newsletter also reports on the

status of previously introduced environment-related bills. The summaries and status reports do not encourage recipients of the newsletter to take action with respect to legislation, as described in paragraphs (b)(2)(iii)(A) through (D) of this section. Although the summaries and status reports refer to specific legislation and often reflect a view on such legislation, they do not encourage the newsletter recipients to take action with respect to such legislation. The summaries and status reports are not grass roots lobbying communications.

Example (7). Organization B prints in its newsletter a report on pending legislation that B supports, the Family Equity bill. The report refers to and reflects a view on the Family Equity bill, but does not directly encourage recipients to take action. Nor does the report specifically identify any legislator as opposing the communication's view on the legislation, as being undecided, or as being a member of the legislative committee or subcommittee that will consider the legislation. However, the report does state the following:

> Rep. Doe (D-Ky.) and Rep. Roe (R-Ma.), both ardent supporters of the Family Equity bill, spoke at B's annual convention last week. Both encouraged B's efforts to get the Family Equity bill enacted and stated that they thought the bill could be enacted even over a presidential veto. B's legislative affairs liaison questioned others, who seemed to agree with that assessment. For example, Sen. Roe (I-Ca.) said that he thinks the bill will pass with such a large majority, "the President won't even consider vetoing it."

Assume the newsletter, and thus the report, is sent to individuals throughout the U.S., including some recipients in Kentucky, Massachusetts and California. Because the report is distributed nationally, the mere fact that the report identifies several legislators by party and state as part of its discussion does not mean the report specifically identifies the named legislators as the Kentucky, Massachusetts and California recipients' representatives in the legislature for purposes of paragraph (b)(2)(iii) of this section. The report is not a grass roots lobbying communication.

(B) *Communications that are grass roots lobbying communications.*

Example (1). A pamphlet distributed by organization Y states that the "President's plan for a drug-free America," which will establish a drug control program, should be passed. The pamphlet encourages readers to "write or call your senators and representatives and tell them to vote for the President's plan." No legislative proposal formally bears the name "President's plan for a drug-free America," but that and similar terms have been widely used in connection with specific legislation pending in Congress that was initially proposed by the President. Thus, the pamphlet refers to specific legislation, reflects a view on the legislation, and encourages readers to take action with respect to the legislation. The pamphlet is a grass roots lobbying communication.

Example (2). Assume the same facts as in Example (1), except that the pamphlet does not encourage the public to write or call representatives, but does list the members of the committee that will consider the bill. The pamphlet is a grass roots lobbying communication.

Example (3). Assume the same facts as in Example (1), except that the pamphlet encourages readers to "write the President to urge him to make the bill a top legislative priority" rather than encouraging readers to communicate with members of Congress. The pamphlet is a grass roots lobbying communication.

Example (4). Organization B, a nonmembership organization, includes in one of three sections of its newsletter an endorsement of two pending bills and opposition to another pending bill and also identifies several legislators as undecided on the three bills. The section of the newsletter devoted to the three pending bills is a grass roots lobbying communication.

Example (5). Organization D, a nonmembership organization, sends a letter to all persons on its mailing list. The letter includes an extensive discussion concluding that a significant increase in spending for the Air Force is essential in order to provide an adequate defense of the nation. Prior to a concluding fundraising request, the letter encourages readers to write their Congressional representatives urging increased appropriations to build the B-1 bomber. The letter is a grass roots lobbying communication.

Example (6). The President nominates X for a position in the President's cabinet. Organization Y disagrees with the views of X and does not believe X has the necessary administrative capabilities to effectively run a cabinet-level department. Accordingly, Y sends a general mailing requesting recipients to write to four Senators on the Senate Committee that will consider the nomination. The mailing is a grass roots lobbying communication.

Example (7). Organization F mails letters requesting that each recipient contribute money to or join F. In addition, the letters express F's opposition to a pending bill that is to be voted upon by the U.S. House of Representatives. Although the letters are form letters sent as a mass mailing, each letter is individualized to report to the recipient the name of the recipient's congressional representative. The letters are grass roots lobbying communications.

Example (8). Organization C sends a mailing that opposes a specific legislative proposal and includes a postcard addressed to the President for the recipient to sign stating opposition to the proposal. The letter requests that the recipient send to C a contribution as well as the postcard opposing the proposal. C states in the letter that it will deliver all the postcards to the White House. The letter is a grass roots lobbying communication.

(C) *Additional examples.*

Example (1). The newsletter of an organization concerned with drug issues is circulated primarily to individuals who are not members of the organization. A story in the newsletter reports on the prospects for passage of a specifically identified bill, stating that the organization supports the bill. The newsletter story identifies certain legislators as undecided, but does not state that readers should contact the undecided legislators. The story does not provide a full and fair exposition sufficient to qualify as nonpartisan analysis, study or research. The newsletter story is a grass roots lobbying communication.

Example (2). Assume the same facts as in Example (1), except that the newsletter story provides a full and fair exposition sufficient to qualify as nonpartisan analysis, study or research. The newsletter story is not a grass roots lobbying communication because it is within the exception for nonpartisan analysis, study or research (since it does not directly encourage recipients to take action).

Example (3). Assume the same facts as in Example (2), except that the newsletter story explicitly asks readers to contact the undecided legislators. Because the newsletter story directly encourages readers to take action with respect to the legislation, the newsletter story is not within the exception for nonpartisan analysis, study or research. Accordingly, the newsletter story is a grass roots lobbying communication.

Example (4). Assume the same facts as in Example (1), except that the story does not identify any undecided legislators. The story is not a grass roots lobbying communication.

Example (5). X organization places an advertisement that specifically identifies and opposes a bill that X asserts would harm the farm economy. The advertisement is not a mass media communication described in paragraph (b)(5)(ii) of this section and does not directly encourage readers to take action with respect to the bill. However, the advertisement does state that Senator Y favors the legislation. Because the advertisement refers to and reflects a view on specific legislation, and also encourages the readers to take action with respect to the legislation by specifically identifying a legislator who opposes X's views on the legislation, the advertisement is a grass roots lobbying communication.

Example (6). Assume the same facts as in Example (5), except that instead of identifying Senator Y as favoring the legislation, the advertisement identifies the "junior Senator from State Z" as favoring the legislation. The advertisement is a grass roots lobbying communication.

Example (7). Assume the same facts as in Example (5), except that instead of identifying Senator Y as favoring the legislation, the advertisement states: "Even though this bill will have a devastating effect upon the farm economy, most of the Senators from the Farm Belt states are inexplicably in favor of the bill." The advertisement does not specifically identify one or more legislators as opposing the advertisement's view on the bill in question. Accordingly, the advertisement is not a grass roots lobbying communication because it does not encourage readers to take action with respect to the legislation.

Example (8). Organization V trains volunteers to go door-to-door to seek signatures for petitions to be sent to legislators in favor of a specific bill. The volunteers are wholly unreimbursed for their time and expenses. The volunteers' costs (to the extent any are incurred) are not lobbying or exempt purpose expenditures made by V (but the volunteers may not deduct their out-of-pocket expenditures (see section 170(f)(6))). When V asks the volunteers to contact others and urge them to sign the petitions, V encourages those volunteers to take action in favor of the specific bill. Accordingly, V's costs of soliciting the volunteers' help and its costs of training the volunteers are grass roots expenditures. In addition, the costs of preparing, copying, distributing, etc. the petitions (and any other materials on the same specific subject used in the door-to-door signature gathering effort), are grass roots expenditures.

(5) *Special rule for certain mass media advertisements*—(i) *In general.* A mass media advertisement that is not a grass roots lobbying communication under the three-part grass roots lobbying definition contained in paragraph (b)(2) of this section may be a grass roots lobbying communication by virtue of paragraph (b)(5)(ii) of this section. The special rule in paragraph (b)(5)(ii) generally applies only to a limited type of paid advertisements that appear in the mass media.

(ii) *Presumption regarding certain paid mass media advertisements about highly publicized legislation.* If within two weeks before a vote by a legislative body, or a committee (but not a subcommittee) thereof, on a highly publicized piece of legislation, an organization's paid advertisement appears in the mass media, the paid advertisement will be presumed to be a grass roots lobbying communication, but only if the paid advertisement both reflects a view on the general subject of such legislation and either: refers to the highly publicized legislation; or encourages the public to communicate with legislators on the general subject of such legislation. An organization can rebut this presumption by demonstrating that the paid advertisement is a type of communication regularly made by the organization in the mass media without regard to the timing of legislation (that is, a customary course of business exception) or that the timing of the paid advertisement was unrelated to the upcoming legislative action. Notwithstanding the fact that an organization successfully rebuts the presumption, a mass media communication described in this paragraph (b)(5)(ii) is a grass roots lobbying communication if the communication would be a grass roots lobbying communication under the rules contained in paragraph (b)(2) of this section.

(iii) *Definitions*—(A) *Mass media.* For purposes of this paragraph (b)(5), the term "mass media" means television, radio, billboards and general circulation newspapers and magazines. General circulation newspapers and magazines do not include newspapers or magazines published by an organization for which the expenditure test election under section 501(h) is in effect, except where both: the total circulation of the newspaper or magazine is greater than 100,000; and fewer than one-half of the recipients are members of the organization (as defined in §56.4911-5(f)).

(B) *Paid advertisement.* For purposes of this paragraph (b)(5), where an electing public charity is itself a mass media publisher or broadcaster, all portions of that organization's mass media publications or broadcasts are treated as paid advertisements in the mass media, except those specific portions that are advertisements paid for by another person. The term "mass media" is defined in paragraph (b)(5)(iii)(A).

(C) *Highly publicized.* For purposes of this paragraph (b)(5), "highly publicized" means frequent coverage on television and radio, and in general circulation newspapers, during the two weeks preceding the vote by the legislative body or committee. In the case of state or local legislation, "highly publicized" means frequent coverage in the mass media that serve the state or local jurisdiction in question. Even where legislation receives frequent coverage, it is "highly publicized" only if the pendency of the legislation or the legislation's general terms, purpose, or effect are known to a significant segment of the general public (as opposed to the particular interest groups directly affected) in the area in which the paid mass media advertisement appears.

(iv) *Examples.* The special rule of this paragraph (b)(5) is illustrated by the following examples. The expenditure test election under section 501(h) is assumed to be in effect for all organizations discussed in the examples in this paragraph (b)(5)(iv):

Example (1). Organization X places a television advertisement advocating one of the President's major foreign policy initiatives, as outlined by the President in a series of speeches and as drafted into proposed legislation. The initiative is popularly known as "the President's World Peace Plan," and is voted upon by the Senate four days after X's advertisement. The advertisement concludes: "SUPPORT THE PRESIDENT'S WORLD PEACE PLAN!" The President's plan and position are highly publicized during the two weeks before the Senate vote, as evidenced by: coverage of the plan on several nightly television network news program; more than one article about the plan on the front page of a majority of the country's ten largest daily general circulation newspapers; and an editorial about the plan in four of the country's ten largest daily general circulation newspapers. Although the advertisement does not encourage readers to contact legislators or other government officials, the advertisement does refer to specific legislation and reflect a view on the general subject of the legislation. The communication is presumed to be a grass roots lobbying communication.

Example (2). Assume the same facts as in Example (1), except that the advertisement appears three weeks before the Senate's vote on the plan. Because the advertisement appears more than two weeks before the legislative vote, the advertisement is not within the scope of the special rule for mass media communications on highly publicized legislation. Accordingly, the advertisement is a grass roots lobbying communication only if it is described in the general definition contained in paragraph (b)(2) of this section. Because the advertisement does not encourage recipients to take action with respect to the legislation in question, the advertisement is not a grass roots lobbying communication.

Example (3). Organization Y places a newspaper advertisement advocating increased government funding for certain public works projects the President has proposed and that are being considered by a legislative committee. The advertisement explains the President's proposals and concludes: "SUPPORT FUNDING FOR THESE VITAL PROJECTS!" The advertisement does not encourage readers to contact legislators or other government officials nor does it name any undecided legislators, but it does name the legislation being considered by the committee. The President's proposed funding of public works, however, is not highly publicized during the two weeks before the vote: there has been little coverage of the issue on nightly television network news programs, only one front-page article on the issue in the country's ten largest daily general circulation newspapers, and only one editorial about the issue in the country's ten largest daily general circulation newspapers. Two days after the advertisement appears, the committee votes to approve funding of the projects. Although the advertisement appears less than two weeks before the legislative vote, the advertisement is not within the scope of the special rule for mass media communications on highly publicized legislation because the issue of funding for public works projects is not highly publicized. Thus, the advertisement is a grass roots lobbying communication only if it is described in the general definition contained in paragraph (b)(2) of this section. Because the advertisement does not encourage recipients to take action with respect to the legislation in question, the advertisement is not a grass roots lobbying communication.

Example (4). Organization P places numerous advertisements in the mass media about a bill being considered by the State Assembly. The bill is highly publicized, as evidenced by numerous front-page articles, editorials and letters to the editor published in the state's general circulation daily newspapers, as well as frequent coverage of the bill by the television and radio stations serving the state. The advertisements run over a three week period and, in addition to showing pictures of a family being robbed at gunpoint, say: "The State Assembly is considering a bill to make gun ownership illegal. This outrageous legislation would violate your constitutional rights and the rights of other law-abiding citizens. If this legislation is passed, you and your family will be criminals if

you want to exercise your right to protect yourselves." The advertisements refer to and reflect a view on a specific bill but do not encourage recipients to take action. Sixteen days after the last advertisement runs, a State Assembly committee votes to defeat the legislation. None of the advertisements is a grass roots lobbying communication.

Example (5). Assume the same facts as in Example (4), except that it is publicly announced prior to the advertising campaign that the committee vote is scheduled for five days after the last advertisement runs. Because of public pressure resulting from the advertising campaign, the bill is withdrawn and no vote is ever taken. None of the advertisements is a grass roots lobbying communication.

(c) *Exceptions to the definitions of direct lobbying communication and grass roots lobbying communication*—(1) *Nonpartisan analysis, study, or research exception*—(i) *In general.* Engaging in nonpartisan analysis, study, or research and making available to the general public or a segment or members thereof or to governmental bodies, officials, or employees the results of such work constitute neither a direct lobbying communication under §56.4911-2(b)-(1) nor a grass roots lobbying communication under §56.4911-2(b)(2).

(ii) *Nonpartisan analysis, study, or research.* For purposes of this section, "nonpartisan analysis, study, or research" means an independent and objective exposition of a particular subject matter, including any activity that is "educational" within the meaning of §1.501(c)(3)-1(d)(3). Thus, "nonpartisan analysis, study, or research" may advocate a particular position or viewpoint so long as there is a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent opinion or conclusion. The mere presentation of unsupported opinion, however, does not qualify as "nonpartisan analysis, study, or research".

(iii) *Presentation as part of a series.* Normally, whether a publication or broadcast qualifies as "nonpartisan analysis, study, or research" will be determined on a presentation-by- presentation basis. However, if a publication or broadcast is one of a series prepared or supported by an electing organization and the series as a whole meets the standards of paragraph (c)(1)(ii) of this section, then any individual publication or broadcast within the series is not a direct or grass roots lobbying communication even though such individual broadcast or publication does not, by itself, meet the standards of paragraph (c)(1)(ii) of this section. Whether a broadcast or publication is considered part of a series will ordinarily depend upon all the facts and circumstances of each particular situation. However, with respect to broadcast activities, all broadcasts within any period of six consecutive months will ordinarily be eligible to be considered as part of a series. If an electing organization times or channels a part of a series which is described in this paragraph (c)(1)(iii) in a manner designed to influence the general public or the action of a legislative body with respect to a specific legislative proposal, the expenses of preparing and distributing such part of the analysis, study, or research will be expenditures for a direct or grass roots lobbying communication, as the case may be.

(iv) *Making available results of nonpartisan analysis, study, or research.* An organization may choose any suitable means, including oral or written presentations, to distribute the results of its nonpartisan analysis, study, or research, with or without charge. Such means include distribution of reprints of speeches, articles and reports; presentation of information through conferences, meetings and discussions; and dissemination to the news media, including radio, television and newspapers, and to other public forums. For purposes of this paragraph (c)(1)(iv), such communications may not be limited to, or be directed toward, persons who are interested solely in one side of a particular issue.

(v) *Subsequent lobbying use of certain analysis, study or research.* Even though certain analysis, study or research is initially within the exception for nonpartisan analysis, study or research, subsequent use of that analysis, study or research for grass roots lobbying may cause that analysis, study or research to be treated as a grass roots lobbying communication that is not within the exception for nonpartisan analysis, study or research. This paragraph (c)(1)(v) does not cause any analysis, study or research to be considered a direct lobbying communication. For rules regarding when analysis, study or research is treated as a grass roots lobbying communication that is not within the scope of the exception for nonpartisan analysis, study or research, see paragraph (b)(2)(v) of this section.

(vi) *Directly encouraging action by recipients of a communication.* A communication that reflects a view on specific legislation is not within the nonpartisan analysis, study, or research exception of this paragraph (c)(1) if the communication directly encourages the recipient to take action with respect to such legislation. For purposes of this section, a communication directly encourages the recipient to take action with respect to legislation if the communication is described in one or more of paragraphs (b)(2)(iii)(A) through (C) of this section. As described in paragraph (b)(2)(iv) of this section, a communication would encourage the recipient to take action with respect to legislation, but not directly encourage such action, if the communication does no more than specifically identify one or more legislators who will vote on the legislation as: opposing the communication's view with respect to the legislation; being undecided with respect to the legislation; being the recipient's representative in the legislature; or being a member of the legislative committee or subcommittee that will consider the legislation.

(vii) *Examples.* The provisions of this paragraph (c)(1) may be illustrated by the following examples:

Example (1). Organization M establishes a research project to collect information for the purpose of showing the dangers of the use of pesticides in raising crops. The information collected includes data with respect to proposed legislation, pending before several State legislatures, which would ban the use of pesticides. The project takes favorable positions on such legislation without producing a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent opinion or conclusion on the pros and cons of the use of pesticides. This project is not within the exception for nonpartisan analysis, study, or research because it is designed to present information merely on one side of the legislative controversy.

Example (2). Organization N establishes a research project to collect information concerning the dangers of the use of pesticides in raising crops for the ostensible purpose of examining and reporting information as to the pros and cons of the use of pesticides in raising crops. The information is collected and distributed in the form of a published report which analyzes the effects and costs of the use and nonuse of various pesticides under various conditions on humans, animals and crops. The

report also presents the advantages, disadvantages, and economic cost of allowing the continued use of pesticides unabated, of controlling the use of pesticides, and of developing alternatives to pesticides. Even if the report sets forth conclusions that the disadvantages as a result of using pesticides are greater than the advantages of using pesticides and that prompt legislative regulation of the use of pesticides is needed, the project is within the exception for nonpartisan analysis, study, or research since it is designed to present information on both sides of the legislative controversy and presents a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent opinion or conclusion.

Example (3). Organization O establishes a research project to collect information on the presence or absence of disease in humans from eating food grown with pesticides and the presence or absence of disease in humans from eating food not grown with pesticides. As part of the research project, O hires a consultant who prepares a "fact sheet" which calls for the curtailment of the use of pesticides and which addresses itself to the merits of several specific legislative proposals to curtail the use of pesticides in raising crops which are currently pending before State Legislatures. The "fact sheet" presents reports of experimental evidence tending to support its conclusions but omits any reference to reports of experimental evidence tending to dispute its conclusions. O distributes ten thousand copies to citizens' groups. Expenditures by O in connection with this work of the consultant are not within the exception for nonpartisan analysis, study, or research.

Example (4). P publishes a bi-monthly newsletter to collect and report all published materials, ongoing research, and new developments with regard to the use of pesticides in raising crops. The newsletter also includes notices of proposed pesticide legislation with impartial summaries of the provisions and debates on such legislation. The newsletter does not encourage recipients to take action with respect to such legislation, but is designed to present information on both sides of the legislative controversy and does present such information fully and fairly. It is within the exception for nonpartisan analysis, study, or research.

Example (5). X is satisfied that A, a member of the faculty of Y University, is exceptionally well qualified to undertake a project involving a comprehensive study of the effects of pesticides on crop yields. Consequently, X makes a grant to A to underwrite the cost of the study and of the preparation of a book on the effect of pesticides on crop yields. X does not take any position on the issues or control the content of A's output. A produces a book which concludes that the use of pesticides often has a favorable effect on crop yields, and on that basis argues against pending bills which would ban the use of pesticides. A's book contains a sufficiently full and fair exposition of the pertinent facts, including known or potential disadvantages of the use of pesticides, to enable the public or an individual to form an independent opinion or conclusion as to whether pesticides should be banned as provided in the pending bills. The book does not directly encourage readers to take action with respect to the pending bills. Consequently, the book is within the exception for nonpartisan analysis, study, or research.

Example (6). Assume the same facts as Example (2), except that, instead of issuing a report, X presents within a period of 6 consecutive months a two-program television series relating to the pesticide issue. The first program contains information, arguments, and conclusions favoring legislation to restrict the use of pesticides. The second program contains information, arguments, and conclusions opposing legislation to restrict the use of pesticides. The programs are broadcast within 6 months of each other during commensurate periods of prime time. X's programs are within the exception for nonpartisan analysis, study, or research. Although neither program individually could be regarded as nonpartisan, the series of two programs constitutes a balanced presentation.

Example (7). Assume the same facts as in Example (6), except that X arranged for televising the program favoring legislation to restrict the use of pesticides at 8:00 on a Thursday evening and for televising the program opposing such legislation at 7:00 on a Sunday morning. X's presentation is not within the exception for nonpartisan analysis, study, or research, since X disseminated its information in a manner prejudicial to one side of the legislative controversy.

Example (8). Organization Z researches, writes, prints and distributes a study on the use and effects of pesticide X. A bill is pending in the U.S. Senate to ban the use of pesticide X. Z's study leads to the conclusion that pesticide X is extremely harmful and that the bill pending in the U.S. Senate is an appropriate and much needed remedy to solve the problems caused by pesticide X. The study contains a sufficiently full and fair exposition of the pertinent facts, including known or potential advantages of the use of pesticide X, to enable the public or an individual to form an independent opinion or conclusion as to whether pesticides should be banned as provided in the pending bills. In its analysis of the pending bill, the study names certain undecided Senators on the Senate committee considering the bill. Although the study meets the three part test for determining whether a communication is a grass roots lobbying communication, the study is within the exception for nonpartisan analysis, study or research, because it does not directly encourage recipients of the communication to urge a legislator to oppose the bill.

Example (9). Assume the same facts as in Example (8), except that, after stating support for the pending bill, the study concludes: "You should write to the undecided committee members to support this crucial bill." The study is not within the exception for nonpartisan analysis, study or research because it directly encourages the recipients to urge a legislator to support a specific piece of legislation.

Example (10). Organization X plans to conduct a lobbying campaign with respect to illegal drug use in the United States. It incurs $5,000 in expenses to conduct research and prepare an extensive report primarily for use in the lobbying campaign. Although the detailed report discusses specific pending legislation and reaches the conclusion that the legislation would reduce illegal drug use, the report contains a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent conclusion regarding the effect of the legislation. The report does not encourage readers to contact legislators regarding the legislation. Accordingly, the report does not, in and of itself, constitute a lobbying communication.

Copies of the report are available to the public at X's office, but X does not actively distribute the report or otherwise seek to make the contents of the report available to the general public. Whether or not X's distribution is sufficient to meet the requirement in § 56.4911-2(c)(1)(iv) that a nonpartisan communication be made available, X's distribution is not substantial (for purposes of § 56.4911-2(b)(2)(v)(E)) in light of all of the facts and circumstances, including the normal distribution pattern of similar nonpartisan reports. X then mails copies of the report, along with a letter, to 10,000 individuals on X's mailing list. In the letter, X requests that individuals contact legislators urging passage of the legislation discussed in the report. Because X's research and report were primarily undertaken by X for lobbying purposes and X did not make a substantial distribution of the report (without an accompanying lobbying message) prior to or contemporaneously with the use of the report in lobbying, the report is a grass roots lobbying communication that is not within the exception for nonpartisan analysis, study or research.

Example (11). Assume the same facts as in Example (10), except that before using the report in the lobbying campaign, X sends the research and report (without an accompanying lobbying message) to universities and newspapers. At the same time, X also advertises the availability of the report in its newsletter. This distribution is similar in scope to the normal distribution pattern of similar nonpartisan reports. In light of all of the facts and circumstances, X's distribution of the report is substantial. Because of X's substantial distribution of the report, X's primary purpose will be considered to be other than for use in lobbying and the report will not be considered a grass roots lobbying communication. Accordingly, only the expenditures for copying and mailing the report to the 10,000 individuals on X's mailing list, as well as for preparing and mailing the letter, are expenditures for grass roots lobbying communications.

Example (12). Organization M pays for a bumper sticker that reads: "STOP ABORTION: Vote *NO* on Prop. X!" M also pays for a 30-second television advertisement and a billboard that similarly advocate opposition to Prop. X. In light of the limited scope of the communications, none of the communications is within the exception for nonpartisan analysis, study or research. First, none of the communications rises to the level of analysis, study or research. Second, none of the communications is nonpartisan because none contains a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent opinion or conclusion. Thus, each communication is a direct lobbying communication.

(2) *Examinations and discussions of broad social, economic, and similar problems.* Examinations and discussions of broad social, economic, and similar problems are neither direct lobbying communications under §56.4911-2(b)(1) nor grass roots lobbying communications under §56.4911-2(b)(2) even if the problems

are of the type with which government would be expected to deal ultimately. Thus, under §§56.4911-2(b)(1) and (2), lobbying communications do not include public discussion, or communications with members of legislative bodies or governmental employees, the general subject of which is also the subject of legislation before a legislative body, so long as such discussion does not address itself to the merits of a specific legislative proposal and so long as such discussion does not directly encourage recipients to take action with respect to legislation.

For example, this paragraph (c)(2) excludes from grass roots lobbying under §56.4911-2(b)(2) an organization's discussions of problems such as environmental pollution or population growth that are being considered by Congress and various State legislatures, but only where the discussions are not directly addressed to specific legislation being considered, and only where the discussions do not directly encourage recipients of the communication to contact a legislator, an employee of a legislative body, or a government official or employee who may participate in the formulation of legislation.

(3) *Requests for technical advice.* A communication is not a direct lobbying communication under §56.4911-2(b)(1) if the communication is the providing of technical advice or assistance to a governmental body, a governmental committee, or a subdivision of either in response to a written request by the body, committee, or subdivision, as set forth in §53.4945-2(d)(2).

(4) *Communications pertaining to "self-defense" by the organization.* A communication is not a direct lobbying communication under §56.4911-2(b)(1) if either:

(i) The communication is an appearance before, or communication with, any legislative body with respect to a possible action by the body that might affect the existence of the electing public charity, its powers and duties, its tax-exempt status, or the deductibility of contributions to the organization, as set forth in §53.4945-2(d)(3);

(ii) The communication is by a member of an affiliated group of organizations (within the meaning of §56.4911-7(e)), and is an appearance before, or communication with, a legislative body with respect to a possible action by the body that might affect the existence of any other member of the group, its powers and duties, its tax-exempt status, or the deductibility of contributions to it;

(iii) The communication is by an electing public charity more than 75 percent of the members of which are other organizations that are described in section 501(c)(3), and is an appearance before, or communication with, any legislative body with respect to a possible action by the body which might affect the existence of one or more of the section 501(c)(3) member organizations, their powers, duties, or tax-exempt status, or the deductibility (under section 170) of contributions to one or more of the section 501(c)(3) member organizations, but only if the principal purpose of the appearance or communication is to defend the section 501(c)(3) member organizations (rather than the non-section 501(c)(3) member organizations); or

(iv) The communication is by an electing public charity that is a member of a limited affiliated group of organizations under §56.4911-10, and is an appearance before, or communication with, the Congress of the United States with respect to a possible action by the Congress that might affect the existence of any member of the limited affiliated group, its powers and duties, tax-exempt status, or the deductibility of contributions to it.

(v) Under the self-defense exception of paragraphs (c)(4)(i) through (iv) of this section, a charity may communicate with an entire legislative body, with committees or subcommittees of a legislative body, with individual legislators, with legislative staff members, or with representatives of the executive branch who are involved with the legislative process, so long as such communication is limited to the prescribed subjects. Similarly, under the self-defense exception, a charity may make expenditures in order to initiate legislation if such legislation concerns only matters which might affect the existence of the charity, its powers and duties, its tax-exempt status, or the deductibility of contributions to such charity. For examples illustrating the application and scope of the self- defense exception of this paragraph (c)(4), see §53.4945-2(d)(3)(ii).

(d) *Definitions.* For purposes of section 4911 and the regulations thereunder—

(1) *Legislation*—(i) *In general.* "Legislation" includes action by the Congress, any state legislature, any local council, or similar legislative body, or by the public in a referendum, ballot initiative, constitutional amendment, or similar procedure. "Legislation" includes a proposed treaty required to be submitted by the President to the Senate for its advice and consent from the time the President's representative begins to negotiate its position with the prospective parties to the proposed treaty.

(ii) *Definition of specific legislation.* For purposes of paragraphs (b)(1) and (b)(2) of this section, "specific legislation" includes both legislation that has already been introduced in a legislative body and a specific legislative proposal that the organization either supports or opposes. In the case of a referendum, ballot initiative, constitutional amendment, or other measure that is placed on the ballot by petitions signed by a required number or percentage of voters, an item becomes "specific legislation" when the petition is first circulated among voters for signature.

(iii) *Examples.* The terms "legislation" and "specific legislation" are illustrated using the following examples:

Example (1). A nonmembership organization includes in its newsletter an article about problems with the use of pesticide X that states in part: "Legislation that is pending in Congress would prohibit the use of this very dangerous pesticide. Fortunately, the legislation will probably be passed. Write your congressional representatives about this important issue." This is a grass roots lobbying communication that refers to and reflects a view on specific legislation and that encourages recipients to take action with respect to that legislation.

Example (2). An organization based in State A notes in its newsletter that State Z has passed a bill to accomplish a stated purpose and then says that State A should pass such a bill. The organization urges readers to write their legislators in favor of such a bill. No such bill has been introduced into the State A legislature. The organization has referred to and reflected a view on a specific legislative proposal and has also encouraged readers to take action thereon.

(2) *Action.* The term "action" in paragraph (d)(1)(i) of this section is limited to the introduction, amend-

ment, enactment, defeat or repeal of Acts, bills, resolutions, or similar items.

(3) *Legislative body.* "Legislative body" does not include executive, judicial, or administrative bodies.

(4) *Administrative bodies.* "Administrative bodies" includes school boards, housing authorities, sewer and water districts, zoning boards, and other similar Federal, State, or local special purpose bodies, whether elective or appointive. Thus, for example, for purposes of section 4911, the term "any attempt to influence any legislation" does not include attempts to persuade an executive body or department to form, support the formation of, or to acquire property to be used for the formation or expansion of, a public park or equivalent preserves (such as public recreation areas, game, or forest preserves, and soil demonstration areas) established or to be established by act of Congress, by executive action in accordance with an act of Congress, or by a State, municipality or other governmental unit described in section 170(c)(1), as compared with attempts to persuade a legislative body, a member thereof, or other governmental official or employee, to promote the appropriation of funds for such an acquisition or other legislative authorization of such an acquisition. Therefore, for example, an organization would not be influencing legislation for purposes of section 4911, if it proposed to a Park Authority that it purchase a particular tract of land for a new park, even though such an attempt would necessarily require the Park Authority eventually to seek appropriations to support a new park. However, in such a case, the organization would be influencing legislation, for purposes of section 4911, if it provided the Park Authority with a proposed budget to be submitted to a legislative body, unless such submission is described by one of the exceptions set forth in paragraph (c) of this section.

§56.4911-3. Expenditures for direct and/or grass roots lobbying communications.

(a) *Definition of term "expenditures for"—(1) In general.* This §56.4911-3 contains allocation rules regarding what portion of a lobbying communication's costs is a direct lobbying expenditure, what portion is a grass roots expenditure and what portion is, in certain cases, a nonlobbying expenditure. Except as otherwise indicated in this paragraph (a), all costs of preparing a direct or grass roots lobbying communication are included as expenditures for direct or grass roots lobbying. Expenditures for a direct or grass roots lobbying communication ("lobbying expenditures") include amounts paid or incurred as current or deferred compensation for an employee's services attributable to the direct or grass roots lobbying communication, and the allocable portion of administrative, overhead, and other general expenditures attributable to the direct or grass roots lobbying communication. For example, except as otherwise provided in this paragraph (a), all expenditures for researching, drafting, reviewing, copying, publishing and mailing a direct or grass roots lobbying communication, as well as an allocable share of overhead expenses, are included as expenditures for direct or grass roots lobbying.

(2) *Allocation of mixed purpose expenditures—(i) Nonmembership communications.* Except as provided in paragraph (a)(2)(ii) of this section, lobbying expenditures for a communication that also has a bona fide nonlobbying purpose must include all costs attributable to those parts of the communication that are on the same specific subject as the lobbying message. All costs attributable to those parts of the communication that are not on the same specific subject as the lobbying message are not included as lobbying expenditures for allocation purposes. Whether or not a portion of a communication is on the same specific subject as the lobbying message will depend on the surrounding facts and circumstances. In general, a portion of a communication will be on the same specific subject as the lobbying message if that portion discusses an activity or specific issue that would be directly affected by the specific legislation that is the subject of the lobbying message. Moreover, discussion of the background or consequences of the specific legislation, or discussion of the background or consequences of an activity or specific issue affected by the specific legislation, is also considered to be on the same specific subject as the lobbying communication.

(ii) *Membership communications.* In the case of lobbying expenditures for a communication that also has a bona fide nonlobbying purpose and that is sent only or primarily to members, an electing public charity must make a reasonable allocation between the amount expended for the lobbying purpose and the amount expended for the nonlobbying purpose. An electing public charity that includes as a lobbying expenditure only the amount expended for the specific sentence or sentences that encourage the recipient to take action with respect to legislation has not made a reasonable allocation. For purposes of this paragraph, a communication is sent only or primarily to members if more than half of the recipients of the communication are members of the electing public charity making the communication within the meaning of §56.4911-5. See §56.4911-5 for separate rules on communications sent only or primarily to members. Nothing in this paragraph (a) shall change any allocation required by §56.4911-5.

(3) *Allocation of mixed lobbying.* If a communication (to which §56.4911-5 does not apply) is both a direct lobbying communication and a grass roots lobbying communication, the communication will be treated as a grass roots lobbying communication except to the extent that the electing public charity demonstrates that the communication was made primarily for direct lobbying purposes, in which case a reasonable allocation shall be made between the direct and the grass roots lobbying purposes served by the communication.

(b) *Examples.* The provisions of paragraph (a) of this section are illustrated by the following examples. Except where otherwise explicitly stated, the expenditure test election under section 501(h) is assumed to be in effect for all organizations discussed in the examples in this paragraph (b). See §56.4911-5 for special rules applying to the member communications described in some of the following examples.

Example (1). Organization R makes the services of E, one of its paid executives, available to S, an organization described in section 501(c)(4) of the Code. E works for several weeks to assist S in developing materials that

urge voters to contact their congressional representatives to indicate their support for specific legislation. In performing this work, E uses office space and clerical assistance provided by R. R pays full salary and benefits to E during this period and receives no reimbursement from S for these payments or for the other facilities and assistance provided. All expenditures of R, including allocable office and overhead expenses, that are attributable to this assignment are grass roots expenditures because E was engaged in an attempt to influence legislation.

Example (2). An organization distributes primarily to nonmembers a pamphlet with two articles on unrelated subjects. The total cost of preparing, printing and mailing the pamphlet is $11,000, $1,000 for preparation and $10,000 for printing and mailing. The cost of preparing one article, a nonlobbying communication, is $600. The article is printed on three of the four pages in the pamphlet. The cost of preparing the second article, a grassroots lobbying communication that addresses only one specific subject, is $400. This article is printed on one page of the four page pamphlet. In this situation, $400 of preparation costs and $2,500 (25% of $10,000) of printing and mailing costs are expenditures for a grass roots lobbying communication.

Example (3). Assume the same facts as in Example (2), except that the pamphlet is distributed only to members. In addition, assume the second article states that the recipient members should contact their congressional representatives. The organization allocates $400 of preparation costs and $2,500 of printing and mailing costs as expenditures for direct lobbying (see §56.4911-5(c)). The allocation is reasonable for purposes of §56.4911-3(a)(2)(ii).

Example (4). Organization J places a full-page advertisement in a newspaper. The advertisement urges passage of pending legislation to build three additional nuclear powered submarines, and states that readers should write their Congressional representatives in favor of the legislation. The advertisement also provides a general description of J's purposes and activities, invites readers to become members of J and asks readers to contribute money to J. Except for the cost of the portion of the advertisement describing J's purposes and activities and the portion specifically seeking members and contributions, the entire cost of the advertisement is an expenditure for a grass roots lobbying communication, because the entire advertisement, except for the lines specifically describing J and specifically seeking members and contributions, is on the same specific subject as the grass roots lobbying message.

Example (5). Assume the same facts as in Example (4), except that J places in the newspaper two separate half-page advertisements instead of one full-page advertisement. One of the two advertisements discusses the need for three additional nuclear powered submarines and urges readers to write their Congressional representatives in favor of the pending legislation to build the three submarines. The other advertisement contains only the membership and fundraising appeals, along with a general description of J's purposes and activities. The half-page advertisement urging readers to write to Congress is a grass roots lobbying communication and all of J's expenditures for producing and placing that advertisement are expenditures for a grass roots lobbying communication. J's expenditures for the other half-page advertisement are not expenditures for a grass roots or direct lobbying communication.

Example (6). Assume the same facts as in Example (4), except that the communication by J is in a letter mailed only to members of J, rather than in a newspaper advertisement, and the invitation to become a member of J is an invitation to join a new membership category. In addition, assume that the communication states that the member recipients should ask nonmembers to write their Congressional representatives. J allocates one-half of the cost of the mailing as an expenditure for a grass roots lobbying communication (see §56.4911-5(d)). Because the communication had both bona fide nonlobbying (e.g., membership solicitation and fundraising) purposes as well as lobbying purposes, J's allocation of one-half of the cost of the communication to grass roots lobbying and one-half to nonlobbying is reasonable for purposes of §56.4911-3(a)(2)(ii).

Example (7). A particular monthly issue of organization X's newsletter, which is distributed mainly to nonmembers of X, has three articles of equal length. The first article is a grass roots lobbying communication, the sole specific subject of which is pending legislation to help protect seals from being slaughtered in certain foreign countries. The second article discusses the rapid decline in the world's whale population, particularly because of the illegal hunting of whales by foreign countries. The third article deals with air pollution and the acid rain problem in North America. Because the first article is a grass roots lobbying communication, all of the costs allocable to that article (e.g., one-third of the newsletter's printing and mailing costs) are lobbying expenditures. The second article is not a lobbying communication and the pending legislation relating to seals addressed in the first article does not affect the illegal whale hunting activities. Because the second and third articles are not lobbying communications and are also not on the same specific subject as the first article, no portion of the costs attributable to those articles is a grass roots lobbying expenditure.

Example (8). Organization T, a nonmembership organization, prepares a three page document that is mailed to 3,000 persons on T's mailing list. The first two pages of the three page document, titled "The Need for Child Care," support the need for additional child care programs, and include statistics on the number of children living in homes where both parents work or in homes with a single parent. The two pages also make note of the inadequacy of the number of day care providers to meet the needs of these parents. The third page of the document, titled "H.R. 1," indicates T's support of H.R. 1, a bill pending in the U.S. House of Representatives. The document states that H.R. 1 will provide for $10,000,000 in additional subsidies to child care providers, primarily for those providers caring for lower income children. The third page of the document also notes that H.R. 1 includes new federal standards regulating the quality of child care providers. The document ends with T's request that recipients contact their congressional representative in support of H.R. 1. The entire three page document is on the same specific subject, and, therefore, all expenditures of preparing and distributing the three page document are grass roots lobbying expenditures.

Example (9). Assume the same facts as in Example (8), except that the document has a fourth page. The fourth page does not refer to the general need for child care or the specific need for additional child care providers. Instead, the fourth page advocates that a particular federal agency commence, under its existing statutory authority, licensing of day care providers in order to promote safe and effective child care. The cost of the fourth page is not a lobbying expenditure.

Example (10). Assume the same facts as in Example (8), except that T is a membership organization, 75 percent of the recipients of the three page document are members of T, and 25 percent of the recipients are nonmembers and are not subscribers within the meaning of §56.4911-5(f)(5). Assume also that the document states that readers should write to Congress, but does not state that the readers should urge nonmembers to write to Congress. T treats the document as having a bona fide nonlobbying purpose, the purpose of educating its members about the need for child care. Accordingly, T allocates one-half of the cost of preparing and distributing the document as a lobbying expenditure (see §56.4911-5(e)(2)(i)), of which 75 percent is a direct lobbying expenditure (see §56.4911-5(e)(2)(iii)) and 25 percent is a grass roots lobbying expenditure (see §56.4911- 5(e)(2)(ii)). The remaining one-half is allocated as a nonlobbying expenditure. T's allocation is reasonable for purposes of §56.4911-3(a)(2)(ii) and is correct for purposes of §56.4911-5(e).

Example (11). Assume the same facts as in Example (10), except that T allocates one percent of the cost of preparing and distributing the document as a lobbying expenditure (for purposes of §56.4911-5(e)(2)) and 99 percent as a nonlobbying expenditure. T's allocation is based upon the fact that out of 200 lines in the document, only two lines state that the recipient should contact legislators about the pending legislation. T's allocation is unreasonable for purposes of §56.4911-3(a)(2)(ii).

Example (12). Organization F, a nonmembership organization, sends a one page letter to all persons on its mailing list. The only subject of the letter is the organization's opposition to a pending bill allowing private uses of certain national parks. The letter requests recipients to send letters opposing the bill to their congressional representatives. A second one page letter is sent in the same envelope. The second letter discusses the broad educational activities and publications of the organization in all areas of environmental protection and ends by requesting the recipient to make a financial contribution to organization F. Since the separate second letter is on a different subject from the lobbying letter, and the letters are of equal length, 50 percent of the mailing costs must be allocated as an expenditure for a grass roots lobbying communication.

Example (13). Assume the same facts as in Example (12), except that F is a membership organization and the letters in question are sent primarily (90 percent) to members. The other 10 percent of the recipients are nonmembers and are not subscribers within the meaning of §56.4911-5(f)(5). Assume also that the first letter does not state that readers should urge nonmembers to write to legislators. F allocates one-half of the mailing costs as a lobbying expenditure, of which 90 percent is a direct lobbying expenditure and 10 percent is a grass

roots lobbying expenditure (see §56.4911-5(e)(2)). F's allocation is reasonable for purposes of §56.4911-3(a)(2)(ii) and is correct for purposes of §56.4911-5.

(c) *Certain transfers treated as lobbying expenditures*—(1) *Transfer earmarked for grass roots purposes.* A transfer is a grass roots expenditure to the extent that it is earmarked (as defined in §56.4911-4(f)(4)) for grass roots lobbying purposes and is not described in §56.4911-4(e).

(2) *Transfer earmarked for direct and grass roots lobbying.* A transfer that is earmarked for direct lobbying purposes or for direct lobbying and grass roots lobbying purposes is treated as a grass roots expenditure in full except to the extent the transferor demonstrates that all or part of the amounts transferred were expended for direct lobbying purposes, in which case that part of the amounts transferred is a direct lobbying expenditure by the transferor. This paragraph (c)(2) shall not apply to any expenditure described in §56.4911-4(e).

(3) *Certain transfers to noncharities that lobby*—(i) *Limited application of paragraph (c)(3)*—(A) *In general.* This paragraph (c)(3) applies only to transfers for less than fair market value from an electing public charity to any noncharity that makes lobbying expenditures. A noncharity is any entity that is not described in section 501(c)(3). In order for this paragraph to apply, the electing public charity must transfer to a noncharity more in value than it receives in return. For example, this paragraph does not apply to an electing public charity's fair market value payment of rent to a landlord. However, this paragraph does apply where an electing public charity and a noncharity share office space and the electing public charity pays more than fair market value rent to the noncharity. Similarly, this paragraph applies where an electing public charity sells goods or services to a noncharity for less than fair market value. See paragraphs (c)(3)(i)(B), (C) and (D) of this section for exceptions where non-fair market value transfers are not covered by this paragraph (c)(3). See paragraph (c)(3)(i)(E) of this section to determine the amount of any non-fair market value transfer covered by this paragraph (c)(3). See paragraph (c)(3)(ii) of this section for the rules that apply to transfers governed by this paragraph (c)(3).

(B) *Exception for controlled grants.* Notwithstanding paragraph (c)(3)(i)(A) of this section, this paragraph (c)(3) does not apply where an electing public charity makes a grant to a noncharity that is a controlled grant (as defined in §56.4911- 4(f)(3)).

(C) *Exception for transfers that artificially inflate exempt purpose expenditures.* Notwithstanding paragraph (c)(3)(i)(A) of this section, this paragraph (c)(3) does not apply where an electing public charity makes a grant to a noncharity that is an expenditure described in §56.4911-4(e) (relating to grants that artificially inflate exempt purpose expenditures).

(D) *Exception for substantially related activity.* Notwithstanding paragraph (c)(3)(i)(A) of this section, this paragraph (c)(3) does not apply where an electing public charity, in the course of an activity that is substantially related to the accomplishment of the electing public charity's exempt purposes, makes goods or services widely available for less than fair market value to individual members of the general public and those goods or services are actually purchased (or consumed for no charge) by a substantial number of wholly unrelated individual members of the general public for less than fair market value. For purposes of the preceding sentence, the term "individual member of the general public" does not include any person or entity directly or indirectly affiliated with the electing public charity in question. The following example illustrates this paragraph (c)(3)(i)(D):

Example. Organization P is an educational organization dedicated to preserving the environment. One of P's activities is educating the public about the benefits of installing cost-effective passive solar energy systems, thereby helping to preserve the environment. P charges for its extensive literature and advice, but the charges are less than the fair market value of the literature and advice. P makes its literature and advice widely available to individual members of the general public by advertising in various media and by pamphlets distributed in various areas. P annually provides its literature and advice for less than fair market value to 500 wholly unrelated families, businesses, and tax-exempt organizations. Several of the businesses and tax-exempt organizations make lobbying expenditures within the meaning of section 4911. P's provision of its goods and services to these entities is not covered by this paragraph (c)(3) (and thus does not give rise to a lobbying expenditure by P under paragraph (c)(3)(ii)).

(E) *Determination of amount of transfer governed by paragraph (c)(3).* Where an electing public charity receives nothing of value in return for its transfer, the amount of the transfer governed by this paragraph (c)(3) is the greater of the fair market value or the cost of the goods or services transferred to the noncharity. Where the noncharity transfers something of value to the electing public charity in return for the charity's transfer, but that payment is less than the fair market value of the charity's transfer to the noncharity, the amount of the transfer governed by this paragraph (c)(3) is the excess of: first, the greater of the fair market value or cost of the goods or services transferred to the noncharity over, second, the value of the amount transferred to the charity. For example, if an electing public charity transfers $10,000 of goods and services to a noncharity that makes lobbying expenditures in return for payment by the noncharity of $2,000, the amount of the transfer governed by this paragraph (c)(3) is $8,000.

(ii) *Rules governing transfers to which paragraph (c)(3) applies.* A transfer to which this paragraph (c)(3) applies is treated in whole or in part as a grass roots and/or direct lobbying expenditure by the transferor in accordance with paragraphs (c)(3)(ii)(A), (B) and (C) of this section. In applying those paragraphs, the expenditures of the transferee will be determined as if the regulations under section 4911 applied to the transferee. This paragraph (c)(3) discusses only when certain transfers are lobbying expenditures by the transferor. This paragraph does not address other issues that may arise when an electing public charity makes a noncontrolled grant to a noncharity. Nothing in this paragraph (c)(3) shall be used to interpret issues relating to noncontrolled grants by charities to noncharities, such as whether the noncontrolled grant is consistent with the continued tax-exempt status of the electing public charity.

(A) *Transfers treated as grass roots expenditures.* The transfer is treated as a grass roots expenditure to the extent of the lesser of two amounts: the amount of the transfer and the amount of the transferee's grass roots expenditures.

(B) *Transfers treated as direct lobbying expenditures.* If the transfer is greater than the transferee's grass roots expenditures, the excess is treated as a direct lobbying expenditure, but only to the extent of the transferee's direct lobbying expenditures. (If, however, the transfer is less than the transferee's grass roots expenditures, none of the transfer is a direct lobbying expenditure).

(C) *Transfers treated as nonlobbying.* If the transfer is greater than the sum of the transferee's grass roots and direct lobbying expenditures, the excess of the transfer over those lobbying expenses is not a lobbying expenditure.

(iii) *Example.* The following example illustrates the application of this paragraph (c)(3):

Example. Organization C, an electing public charity, shares employee E with N, a noncharity that makes lobbying expenditures. N's grass roots expenditures are $5,000 and its direct lobbying expenditures are $25,000. Each organization pays one-half of the $100,000 in direct and overhead costs associated with E. E devotes one-quarter of his time to C and three-quarters of his time to N. In substance, this arrangement is a transfer (for less than fair market value) from C to N in the amount of $25,000 (one-quarter of the $100,000 of direct and overhead costs associated with E's work). Accordingly, C is treated as having made a $5,000 grass roots expenditure (the lesser of N's grass roots expenditures ($5,000) or the amount of the transfer ($25,000)). C is also treated as having made a $20,000 direct lobbying expenditure (the lesser of N's direct lobbying expenditures ($25,000) or the remaining amount of the transfer ($20,000)).

§56.4911-4 Exempt purpose expenditures.

(a) *Application.* This section provides rules under section 4911(e) for determining an electing public charity's "exempt purpose expenditures" for a taxable year for purposes of section 4911(c)(2) and §56.4911-1(c)(2). Those two sections generally define an electing public charity's lobbying limit (lobbying nontaxable amount) as a sliding scale percentage of the organization's exempt purpose expenditures. In determining an electing public charity's exempt purpose expenditures, no expenditure shall be counted twice by an organization.

(b) *Included expenditures.* Amounts paid or incurred by an organization that are exempt purpose expenditures include —

(1) Amounts paid or incurred to accomplish a purpose enumerated in section 170(c)(2)(B), including (but not limited to) the amount of any transfer made by the organization (other than a transfer described in paragraph (e) of this section) to another organization to accomplish the transferor's exempt purposes, and including amounts expended by an organization out of transfers (other than a transfer described in paragraph (e) of this section) for which the organization is the transferee,

(2) Amounts paid or incurred as current or deferred compensation for an employee's services for a purpose enumerated in section 170(c)(2)(B),

(3) The allocable portion of administrative overhead, and other general expenditures attributable to the accomplishment of a purpose enumerated in section 170(c)(2)(B),

(4) Lobbying expenditures (as defined in §56.4911-2(a)) whether or not for a purpose enumerated in section 170(c)(2)(B),

(5) Amounts paid or incurred for activities described in §56.4911-2(c),

(6) Amounts paid or incurred for activities described in §56.4911-5 that are not lobbying expenditures,

(7) A reasonable allowance for exhaustion, wear and tear, obsolescence or amortization, of assets to the extent used for one or more of the purposes described in paragraphs (b)(1) through (6) of this section, computed on a straight-line basis (for this purpose, an allowance for depreciation will be treated as reasonable if based on a useful life that would satisfy section 312(k)(3)(A) as in effect on January 1, 1985), and

(8) fundraising expenditures (but see section 4911(e)(1)(C) and paragraphs (c)(3) and (4) of this section.)

(c) *Excluded expenditures.* Notwithstanding paragraph (b) of this section, exempt purpose expenditures do not include —

(1) Amounts paid or incurred that are neither expenditures to accomplish a purpose enumerated in section 170(c)(2)(B), lobbying expenditures (as defined in §56.4911-2(a)), nor expenditures described in paragraph (b)(5), (6) or (8) of this section,

(2) The amount of any transfer described in paragraph (e) of this section,

(3) Amounts paid to or incurred for a separate fundraising unit (as defined in paragraph (f)(2) of this section) of an organization or of an affiliated organization (see §56.4911-7(a)),

(4) Amounts paid to or incurred for any person not an employee, or any organization not an affiliated organization, if paid or incurred primarily for fundraising, but only if such person or organization engages in fundraising, fundraising counselling or the provision of similar advice or services,

(5) Amounts paid or incurred that are properly chargeable to a capital account, determined in accordance with the principles that apply under section 263 or, as applicable, section 263A, with respect to an unrelated trade or business,

(6) Amounts paid or incurred for a tax that is not imposed in connection with the organization's efforts to accomplish a purpose described in section 170(c)(2)(B), such as taxes imposed under sections 511(a)(1) and 4911(a), and

(7) Amounts paid or incurred for the production of income. For purposes of this section, amounts are paid or incurred for the production of income if they are paid or incurred for a purpose or activity that is not substantially related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exercise or performance by the organization of its charitable, educational or other purpose or function constituting the basis for its exemption under section 501. For example, the costs of managing an endowment are amounts that are paid or incurred for the production of income and are thus not exempt purpose expenditures. Fundraising expenditures are not, for purposes of this section, amounts that are paid or incurred for the production of income. Instead, the determination of whether fundraising costs are exempt purpose expenditures must be made with reference to section 4911(e)(1)(C) and paragraphs (b)(8), (c)(3) and (c)(4) of this section.

(d) *Certain transfers treated as exempt purpose expenditures*—(1) An organization's transfer will be treated as an exempt purpose expenditure under paragraph (b)(1) of this section if it is —

(i) Described in either paragraph (d)(2) or (d)(3) of this section, and

(ii) Not described in paragraph (e) of this section.

(2) A transfer is described in this paragraph (d)(2) if it is made to an organization described in section 501(c)(3) in furtherance of the transferor's exempt purposes and is not earmarked for any purpose other than a purpose described in section 170(c)(2)(B). Thus, a payment of dues by a local or state organization to, respectively, a state or national organization that is described in section 501(c)(3) is considered an exempt purpose expenditure of the transferor to the extent it is not otherwise earmarked.

(3) A transfer is described in this paragraph (d)(3) if it is a controlled grant (as defined in paragraph (f)(3) of this section), but only to the extent of the amounts that are paid or incurred by the transferee that would be exempt purpose expenditures if paid or incurred by the transferor.

(e) *Transfers not exempt purpose expenditures*—(1) An organization's transfer is described in this paragraph (e) if it is described in one of paragraphs (e)(2) through (e)(4).

(2) A transfer is described in this paragraph (e)(2) if it is made to a member of any affiliated group (as defined in §56.4911-7(e)) of which the transferor is a member.

(3) A transfer is described in this paragraph (e)(3) if the Commissioner determines that the transfer artificially inflates the amount of the transferor's or transferee's exempt purpose expenditures. In general, the Commissioner will make that determination if a substantial purpose of a transfer is to inflate those exempt purpose expenditures. A transfer described in this paragraph will not be considered an exempt purpose expenditure of the transferor, but will be an exempt purpose expenditure of the transferee to the extent that the transferee expends the transfer in the active conduct of its charitable activities or attempts to influence legislation. Standards similar to those found in §53.4942(b)-1(b) may be applied in determining whether the transferee has expended amounts in the "active conduct" of its charitable activities or attempts to influence legislation.

(4) A transfer is described in this paragraph (e)(4) if it is not a controlled grant and is made to an organization not described in section 501(c)(3) that does not attempt to influence legislation.

(f) *Definitions*—(1) For purposes of paragraph (c) of this section, "fundraising" includes —

(i) Soliciting dues or contributions from members of the organization, from persons whose dues are in arrears, or from the general public,

(ii) Soliciting grants from businesses or other organizations, including organizations described in section 501(c)(3), or

(iii) Soliciting grants from a governmental unit referred to in section 170(c)(1), or any agency or instrumentality thereof.

(2) For purposes of paragraph (c) of this section, a separate fundraising unit of any organization must consist of either two or more individuals a majority of whose time is spent on fundraising for the organization, or any separate accounting unit of the organization that is devoted to fundraising. For purposes of paragraph (c) of this section, amounts paid to or incurred for a separate fundraising unit include all amounts incurred for the creation, production, copying, and distribution of the fundraising portion of a separate fundraising unit's communication. (For example, an electing public charity that has a separate fundraising unit may not count the cost of postage for a separate fundraising communication as an exempt purpose expenditure even though, under the electing public charity's accounting system, that cost is attributable to the mailroom rather than to the separate fundraising unit).

(3) For purposes of this section, a "controlled grant" is a grant made by an eligible organization described in §1.501(h)-2(b) to an organization not described in section 501(c)(3) that meets the following requirements:

(i) The donor limits the grant to a specific project of the recipient that is in furtherance of the donor's (nonlobbying) exempt purposes; and

(ii) The donor maintains records to establish that the grant is used in furtherance of the donor's (nonlobbying) exempt purposes.

(4) A transfer, including a grant or payment of dues, is "earmarked" for a specific purpose —

(i) To the extent that the transferor directs the transferee to add the amount transferred to a fund established to accomplish the purpose, or

(ii) To the extent of the amount transferred or, if less, the amount agreed upon to be expended to accomplish the purpose, if there exists an agreement, oral or written, whereby the transferor may cause the transferee to expend amounts to accomplish the purpose or whereby the transferee agrees to expend an amount to accomplish the purpose.

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

Example. Organization X is an exempt organization described in section 501(c)(3) that is organized for the purpose of rehabilitating alcoholics. X elected to be subject to the provisions of section 501(h) in 1981. For 1981, X had the following expenditures that are included in its exempt purpose expenditures to the extent indicated.

Description	Total	Includible
Cost of real estate purchased for use as half-way house for alcoholics, attributable to the following:		
Land	$30,000	-0-
Building	200,000	-0-
Depreciation 40-year useful life	-0-	5,000
Expenses of operating its half-way house	170,000	170,000
Administrative expenses of the organization allocated to the operation of its half-way house	95,000	95,000
Depreciation and allowances for equipment	10,000	10,000
Expenses related to attempts to influence legislation (lobbying expenditures)	40,000	40,000

Description	Total	Includible
Amounts paid to Z by the Organization for fundraising	35,000	-0-
Total	580,000	320,000

Note.—For 1981, X's exempt purpose expenditures total $320,000. The $35,000 paid by X to Z for fundraising is not included in the exempt purpose expenditures total. All lobbying expenses are included in full. Only depreciation computed on a straight-line basis is included in exempt purpose expenditures.

§56.4911-5 Communications with members.

(a) *In general.* For purposes of section 4911, expenditures for certain communications between an organization and its members ("membership communications") are treated more leniently than are communications to nonmembers. This §56.4911-5 contains rules about the more lenient treatment. In certain cases, this section provides that expenditures for a membership communication are not lobbying expenditures even though those expenditures would be lobbying expenditures if the communication were to nonmembers. In other cases, this section provides that expenditures for a membership communication are direct lobbying expenditures even though those expenditures would be grass roots expenditures if the communication were to nonmembers. Paragraphs (b), (c) and (d) of this section set forth the more lenient rules that apply for communications that are directed only to members. Paragraph (e) of this section sets forth the more lenient rules that apply for communications that are directed primarily, but not solely, to members. Paragraph (f) of this section sets forth certain definitions and special rules.

(b) *Communications (directed only to members) that are not lobbying communications.* Expenditures for a communication that refers to, and reflects a view on, specific legislation communication satisfies the following requirements:

(1) The communication is directed only to members of the organization;

(2) The specific legislation the communication refers to, and reflects a view on, is of direct interest to the organization and its members;

(3) The communication does not directly encourage the member to engage in direct lobbying (whether individually or through the organization); and

(4) The communication does not directly encourage the member to engage in grass roots lobbying (whether individually or through the organization).

(c) *Communications (directed only to members) that are direct lobbying communications.* Expenditures for a communication that refers to, and reflects a view on, specific legislation and that satisfies the requirements of paragraphs (b)(1), (b)(2), and (b)(4) of this section, but does not satisfy the requirements of paragraph (b)(3) of this section, are treated as expenditures for direct lobbying.

(d) *Communications (directed only to members) that are grass roots lobbying communications.* Expenditures for a communication that refers to, and reflects a view on, specific legislation and that satisfies the requirements of paragraphs (b)(1) and (b)(2) of this section, but does not satisfy the requirements of paragraph (b)(4) of this section, are treated as grass roots expenditures (whether or not the communication satisfies the requirements of paragraph (b)(3) of this section).

(e) *Written communications directed to members and nonmembers*—(1) *In general.* Expenditures for any written communication that is designed primarily for members of an organization (but not directed only to members) and that refers to, and reflects a view on, specific legislation of direct interest to the organization and its members, are treated as expenditures for direct or grass roots lobbying in accordance with paragraph (e)(2), (e)(3) or (e)(4) of this section. For purposes of this section, a communication is designed primarily for members of an organization if more than half of the recipients of the communication are members of the organization.

(2) *Direct lobbying directly encouraged*—(i) *Lobbying expenditure amount.* If a written communication described in paragraph (e)(1) of this section directly encourages readers to engage individually or through the organization in direct lobbying but does not directly encourage them to engage in grass roots lobbying, the cost of the communication is allocated between expenditures for direct lobbying and grass roots expenditures in accordance with paragraphs (e)(2)(ii) and (iii) of this section. The portion of the cost to be allocated includes all costs of preparing all the material with respect to which readers are urged to engage in direct lobbying plus the mechanical and distribution costs attributable to the lineage devoted to this material (see §1.512(a)-1(f)(6)).

(ii) *Grass roots amount.* The amount allocable as a grass roots expenditure for a communication described in paragraph (e)(1) of this section is the amount calculated in paragraph (e)(2)(i) of this section multiplied by the sum of the nonmember subscribers percentage and the all other distribution percentage, both as defined in paragraph (f)(7) of this section. Solely for purposes of the allocation described in this paragraph (e)(2)(ii), the nonmember subscribers percentage is treated as zero unless it is greater than 15% of total distribution.

(iii) *Direct lobbying amount.* The amount allocable as an expenditure for direct lobbying for a communication described in paragraph (e)(1) of this section is the excess of the amount described in paragraph (e)(2)(i) of this section over the amount described in paragraph (e)(2)(ii) of this section.

(3) *Grass roots expenditure if grass roots lobbying directly encouraged.* If a written communication described in paragraph (e)(1) of this section directly encourages readers to engage individually or collectively (whether through the organization or otherwise) in grass roots lobbying (whether or not it also encourages readers to engage in direct lobbying), the grass roots expenditure includes all the

costs of preparing all the material with respect to which readers are urged to engage in grass roots lobbying plus the mechanical and distribution costs attributable to the lineage devoted to this material (see §1.512(a)-1(f)(6)).

(4) *No direct encouragement of direct lobbying or of grass roots lobbying.* If a written communication described in paragraph (e)(1) of this section does not directly encourage readers to engage in either direct lobbying or grass roots lobbying, expenditures for the communication are not lobbying expenditures.

(f) *Definitions and special rules.* For purposes of the regulations under section 4911 —

(1) *Member; general rule.* A person is a member of an electing public charity if the person —

(i) Pays dues or makes a contribution of more than a nominal amount,

(ii) Makes a contribution of more than a nominal amount of time, or

(iii) Is one of a limited number of "honorary" or "life" members who have more than a nominal connection with the electing public charity and who have been chosen for a valid reason (such as length of service to the organization or involvement in activities forming the basis of the electing public charity's exemption) unrelated to the electing public charity's dissemination of information to its members.

(2) *Member; special rule.* A person not a member of an electing public charity within the meaning of paragraph (f)(1) of this section may be treated as a member if the electing public charity demonstrates to the satisfaction of the Internal Revenue Service that there is a good reason for its membership requirements not meeting the requirements of such paragraph (f)(1), and that its membership requirements do not operate to permit an abuse of the rules described in this section.

(3) *Member; affiliated group of organizations.* For purposes of this section, a person who is a member of an organization that is a member of an affiliated group of organizations (within the meaning of §56.4911-7(e)) is treated as a member of each organization in the affiliated group.

(4) *Member; limited affiliated group of organizations.* For purposes of this section, a person who is a member of an organization that is a member of a limited affiliated group of organizations (within the meaning of §56.4911-10(b)) is treated as a member of each organization in the limited affiliated group, but only to the extent that the communication relates to a national legislative issue (within the meaning of §56.4911-10(g)).

(5) *Subscriber.* A person is a subscriber to a written communication if —

(i) The person is a member of the publishing organization and the membership dues expressly include the right to receive the written communication, or

(ii) The person has affirmatively expressed a desire to receive the written communication and has paid more than a nominal amount for the communication.

(6) *Directly encourages*—(i) *Direct lobbying*—(A) *In general.* For purposes of this section, a communication directly encourages a recipient to engage in direct lobbying, whether individually or through the organization, if the communication:

(*1*) States that the recipient should contact a legislator or an employee of a legislative body, or should contact any other government official or employee who may participate in the formulation of legislation (but only if the principal purpose of urging contact with the government official or employee is to influence legislation);

(*2*) States the address, telephone number, or similar information of a legislator or an employee of a legislative body; or

(*3*) Provides a petition, tear-off postcard or similar material for the recipient to communicate his or her views to a legislator or an employee of a legislative body, or to any other government official or employee who may participate in the formulation of legislation (but only if the principal purpose of so facilitating contact with the government official or employee is to influence legislation).

(B) *"Self-defense" exception for communications with members.* Notwithstanding the provisions of paragraph (f)(6)(i)(A) of this section, for purposes of paragraphs (b)(3), (e)(2)(i), (e)(3) and (e)(4) of this section, a communication that directly encourages a member to engage in direct lobbying activities that are described in section 4911(d)(2)(C) and that would not be attempts to influence legislation if engaged in directly by the organization is treated as a communication that does not directly encourage a member to engage in direct lobbying.

(ii) *Grass roots lobbying.* For purposes of paragraphs (b)(4), (e)(3) and (e)(4) of this section, a communication directly encourages recipients to engage individually or collectively (whether through the organization or otherwise) in grass roots lobbying if the communication:

(A) States that the recipient should encourage any nonmember to contact a legislator or an employee of a legislative body, or to contact any other government official or employee who may participate in the formulation of legislation (but only if the principal purpose of urging contact with the government official or employee is to influence legislation);

(B) States that the recipient should provide to any nonmember the address, telephone number, or similar information of a legislator or an employee of a legislative body; or

(C) Provides (or requests that the recipient provide to nonmembers) a petition, tear-off postcard or similar material for the recipient (or nonmember) to use to ask any nonmember to communicate views to a legislator or an employee of a legislative body, or to any other government official or employee who may participate in the formulation of legislation, but only if the principal purpose of so facilitating contact with the government official or employee is to influence legislation. For purposes of this paragraph (f)(6)(ii)(C), a petition is provided for the recipient to use to ask any nonmember to communicate views if, for example, the petition has an entire page of preprinted signature blocks. Similarly, for purposes of this paragraph (f)(6)(ii)(C), where a communication is distributed to a single member and provides several tear-off postcards addressed to a legislator, the postcards are presumed to be provided for the member to use to ask a nonmember to communicate with the legislator.

(7) *Percentages of total distribution.* With respect to a communication described in paragraph (e)(1) of this section —

(i) "Member percentage" means the percentage of total distribution that represents distribution of a single copy to any member;

(ii) "Nonmember subscribers percentage" means the percentage of total distribution that represents distribution to nonmember subscribers (including libraries); and

(iii) "All other distribution percentage" means 100% reduced by the sum of the member percentage and the nonmember subscribers percentage.

(8) *Reasonable allocation rule.* In the case of lobbying expenditures for a communication that also has a bona fide nonlobbying purpose and that is sent only or primarily to members, an electing public charity must make a reasonable allocation between the amount expended for the lobbying purpose and the amount expended for the nonlobbying purpose. See §56.4911-3(a)(2)(ii).

§56.4911-6 Records of lobbying and grass roots expenditures.

(a) *Records of lobbying expenditures.* An electing public charity must keep a record of its lobbying expenditures for the taxable year. Lobbying expenditures of which an organization must keep a record include the following:

(1) Expenditures for grass roots lobbying, as described in paragraph (b) of this section;

(2) Amounts directly paid or incurred for direct lobbying, including payments to another organization earmarked for direct lobbying, fees and expenses paid to individuals or organizations for direct lobbying, and printing, mailing, and other direct costs of reproducing and distributing materials used in direct lobbying;

(3) The portion of amounts paid or incurred as current or deferred compensation for an employee's services for direct lobbying;

(4) Amounts paid for out-of-pocket expenditures incurred on behalf of the organization and for direct lobbying, whether or not incurred by an employee;

(5) The allocable portion of administrative, overhead, and other general expenditures attributable to direct lobbying;

(6) Expenditures for publications or for communications with members to the extent the expenditures are treated as expenditures for direct lobbying under §56.4911-5; and

(7) Expenditures for direct lobbying of a controlled organization (within the meaning of §56.4911-10(c)) to the extent included by a controlling organization (within the meaning of §56.4911-10(c)) in its lobbying expenditures.

(b) *Records of grass roots expenditures.* An electing public charity must keep a record of its grass roots expenditures for the taxable year. Grass roots expenditures of which an organization must keep a record include the following:

(1) Amounts directly paid or incurred for grass roots lobbying, including payments to other organizations earmarked for grass roots lobbying, fees and expenses paid to individuals or organizations for grass roots lobbying, and the printing, mailing, and other direct costs of reproducing and distributing materials used in grass roots lobbying;

(2) The portion of amounts paid or incurred as current or deferred compensation for an employee's services for grass roots lobbying;

(3) Amounts paid for out-of-pocket expenditures incurred on behalf of the organization and for grass roots lobbying, whether or not incurred by an employee;

(4) The allocable portion of administrative, overhead and other general expenditures attributable to grass roots lobbying;

(5) Expenditures for publications or communications that are treated as expenditures for grass roots lobbying under §56.4911-5; and

(6) Expenditures for grass roots lobbying of a controlled organization (within the meaning of §56.4911-10(c)) to the extent included by a controlling organization (within the meaning of §56.4911-10(c)) in its grass roots expenditures.

§56.4911-7 Affiliated group of organizations.

(a) *Affiliation between two organizations.* Sections 4911(f)(1) through (3) contain a limited anti-abuse rule for groups of affiliated organizations. In general, the rule operates to prevent numerous organizations from being created for the purpose of avoiding the sliding-scale percentage limitation on an electing public charity's lobbying expenditures (as well as avoiding the $1,000,000 cap on a single electing public charity's lobbying expenditures). This is generally accomplished by treating the members of an affiliated group as a single organization for purposes of measuring both lobbying expenditures and permitted lobbying expenditures. The anti-abuse rule is implemented by this §56.4911-7 and §§56.4911-8 and -9. This §56.4911-7 defines the term "affiliated group of organizations" and defines the taxable year of an affiliated group of organizations. Section 56.4911-8 provides rules concerning the exempt purpose expenditures, lobbying expenditures and grass roots expenditures of an affiliated group of organizations, as well as rules concerning the application of the excise tax imposed by section 4911(a) on excess lobbying expenditures by the group. Section 56.4911-9 provides rules concerning the application of the section 501(h) lobbying expenditure limits to members of an affiliated group of organizations. (For additional rules for members of a limited affiliated group of organizations (generally, organizations that are affiliated solely by reason of governing instrument provisions that extend control solely with respect to national legislation), see section 4911(f)(4) and §56.4911-10.)

(1) *In general.* For purposes of the regulations under section 4911, two organizations are affiliated, subject to the limitation described in paragraph (a)(2) of this section, if one organization is able to control action on legislative issues by the other by reason of interlocking governing boards (see paragraph (b) of this section) or by reason of provisions of the governing instruments of the controlled organization (see paragraph (c) of this section). The ability of the controlling organization to control action on legislative issues by the controlled organization is sufficient to establish that the organizations are affiliated; it is not necessary that the control be exercised.

(2) *Organizations not described in section 501(c)(3).* Two organizations, neither of which is described in section 501(c)(3), are affiliated only if there exists at least one organization described in section 501(c)(3) that is affiliated with both organizations.

(3) *Action on legislative issues.* For purposes of this section, the term "action on legislative issues" includes taking a position in the organization's

name on legislation, authorizing any person to take a position in the organization's name on legislation, or authorizing any lobbying expenditures. The phrase does not include actions taken merely to correct unauthorized actions taken in the organization's name.

(b) *Interlocking governing boards*—(1) *In general.* Two organizations have interlocking governing boards if one organization (the controlling organization) has a sufficient number of representatives (within the meaning of paragraph (b)(5) of this section) on the governing board of the second organization (the controlled organization) so that by aggregating their votes, the representatives of the controlling organization can cause or prevent action on legislative issues by the controlled organization. If two organizations have interlocking governing boards, the organizations are affiliated without regard to how or whether the representatives of the controlling organization vote on any particular matter.

(2) *Majority or quorum.* Except as provided in paragraph (b)(3) or (4) of this section, the number of representatives of an organization (the controlling organization) who are members of the governing board of a second organization (the controlled organization) will be presumed sufficient to cause or prevent action on legislative issues by the controlled organization if that number either —

(i) Constitutes a majority of incumbents on the governing board, or

(ii) Constitutes a quorum, or is sufficient to prevent a quorum, for acting on legislative issues.

(3) *Votes required under governing instrument or local law.* Except as provided in paragraph (b)(4) of this section, if under the governing documents of an organization (the controlled organization), it can be determined that a lesser number of votes than the number described in paragraph (b)(2) of this section is necessary or sufficient to cause or to prevent action on legislative issues, the number of representatives of the controlling organization who are members of the governing board of the controlled organization will be considered sufficient to cause or prevent action on legislative issues if it equals or exceeds that number.

(4) *Representatives constituting less than 15% of governing board.* Notwithstanding paragraph (b)(2) or (3) of this section, if the number of representatives of one organization is less than 15 percent of the incumbents on the governing board of a second organization, the two organizations are not affiliated by reason of interlocking governing boards.

(5) *Representatives*—(i) This paragraph (b)(5) describes members of the governing board of one organization (the controlled organization) who are considered representatives of a second organization (the controlling organization). Under this paragraph (b)(5), a member of the governing board of a controlled organization may be a representative of more than one controlling organization. A person with no authority to vote on any issue being considered by the governing board is not a representative of any organization.

(ii) A board member of one organization (the controlled organization) is a representative of a second organization (the controlling organization) if the controlling organization has specifically designated that person to be a board member of the controlled organization. For purposes of this paragraph (b)(5)(ii) and paragraph (b)(5)(iii) of this section, a board member of the controlled organization is specifically designated by the controlling organization if the board member is selected by virtue of the right of the controlling organization, under the governing instruments of the controlled organization, either to designate a person to be a member of the controlled organization's governing board, or to select a person for a position that entitles the holder of that position to be a member of the controlled organization's governing board.

(iii) A board member of one organization who is specifically designated by a second organization, a majority of the governing board of which is made up of representatives of a third organization, is a representative of the third organization as well as being a representative of the second organization pursuant to paragraph (b)(5)(ii) of this section.

(iv) A board member of one organization who is also a member of the governing board of a second organization is a representative of the second organization.

(v) A board member of one organization who is an officer or paid executive staff member of a second organization is a representative of the second organization. Although titles are significant in determining whether a person is a member of the executive staff of an organization, any employee of an organization who possesses authority commonly exercised by an executive is considered an executive staff member for purposes of this paragraph (b)(5)(v).

(c) *Governing instrument.* One organization (the "controlling" organization) is affiliated with a second organization (the "controlled" organization) by reason of the governing instruments of the controlled organization if the governing instruments of the controlled organization limit the independent action of the controlled organization on legislative issues by requiring it to be bound by decisions of the other organization on legislative issues.

(d) *Three or more organizations affiliated*—(1) *Two controlled organizations affiliated.* If a controlling organization described in this section is affiliated with each of two or more controlled organizations described in this section, then the controlled organizations are affiliated with each other.

(2) *Chain rule.* If one organization is a controlling organization described in this section with respect to a second organization and that second organization is a controlling organization with respect to a third organization, then the first organization is affiliated with the third.

(e) *Affiliated group of organizations*—(1) *Defined.* For purposes of the regulations under section 4911, an affiliated group of organizations is a group of organizations —

(i) Each of which is affiliated with every other member for at least thirty days of the taxable year of the affiliated group (determined without regard to the election provided for in paragraph (e)(5) of this section),

(ii) Each of which is an eligible organization (within the meaning of §1.501(h)-2(b)(1)), and

(iii) At least one of which is an electing member organization (within the meaning of paragraph (e)(4) of this section). Each organization in a group of organizations that satisfies the requirements of the preceding sen-

tence is a member of the affiliated group of organizations for the taxable year of the affiliated group.

(2) *Multiple membership.* For any taxable year of an organization, it may be a member of two or more affiliated groups of organizations.

(3) *Taxable year of affiliated group.* If all members of an affiliated group have the same taxable year, that taxable year is the taxable year of the affiliated group. If the members of an affiliated group do not all have the same taxable year, the taxable year of the affiliated group is the calendar year, unless the election under paragraph (e)(5) of this section is made.

(4) *Electing member organization.* For purposes of the regulations under section 4911, an "electing member organization" is an organization to which the expenditure test election under section 501(h) applies on at least one day of the taxable year of the affiliated group of which it is a member. For purposes of the preceding sentence (and notwithstanding §1.501(h)-2(a)), the expenditure test is not considered to apply to the organization on any day before the date on which it files the Form 5768 making the expenditure test election.

(5) *Election of member's year as group's taxable year.* The taxable year of an affiliated group may be determined according to the provisions of this paragraph (e)(5) if all of the members of the affiliated group so elect. Under this paragraph (e)(5), each member organization shall apply the provisions of section 501(h) and 4911, and the regulations thereunder (unless the regulations provide otherwise), by treating its own taxable year as the taxable year of the affiliated group. The election may be made by an electing member organization by attaching to its annual return a statement from itself and every other member of the affiliated group that contains: the organization's name, address, and employer identification number; and its signed consent to the election provided for in this paragraph (e)(5). The election must be made no later than the due date of the first annual return of any electing member for its taxable year for which the member is liable for tax under section 4911(a), determined under §56.4911-8(d). The election may not be made or revoked after the due date of the return referred to in the preceding sentence except upon such terms and conditions as the Commissioner may prescribe.

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

Example (1). M, N, and O are eligible organizations within the meaning of §1.501(h)-2(b)(1). Each has a governing board made up of nine members. Five members on the board of N are also members of the board of M. N designates five individuals from among its board, officers, and executive staff members to serve on the board of O. M is affiliated with N, N is affiliated with O, and M is affiliated with O.

Example (2). X, an eligible organization, has a board consisting of 10 members. Five unaffiliated tax-exempt organizations each designate two individuals to serve on the governing board of X. A simple majority of the board of X is a quorum and may establish X's position on legislative issues. X is not affiliated with any of the five autonomous organizations by reason of interlocking governing boards.

Example (3). P and Q are eligible organizations. The governing instruments of Q state that it will not take a position on legislation if P disapproves of the position. In addition, there is regular correspondence between P and Q with regard to positions on legislation. P is affiliated with Q regardless of whether P has ever vetoed a position taken by Q.

Example (4). The governing board of organization R resolves to adopt the position taken on legislative issues by organization S. R and S are eligible organizations and do not have interlocking governing boards. The governing instruments of R do not mention organization S and do not indicate that R is to be bound by the decisions of legislation of any organization. R and S are not affiliated.

Example (5). Organization Z is bound, under the terms of its governing instruments, by the legislative positions of Organization Y. Organization Y, however, is bound, under the terms of its governing instruments, by the legislative positions of Organization X. Organization X is affiliated with Y and Z; Y is affiliated with X and Z; and Z is affiliated with X and Y.

Example (6). Organizations T and U have interlocking boards of directors. T is the controlling organization. Organization V is bound, under the terms of its governing instruments, by the legislative positions of U. T and V are affiliated because T may cause or prevent action on legislative issues by U, and V is bound by U's action. If U were the controlling organization, T and V would be affiliated as two organizations controlled by the same organization.

Example (7). Organization A is described in section 501(c)(4). It is affiliated, as the controlling organization, with organizations K and L, both of which are described in section 501(c)(3) and are eligible to elect under section 501(h). If K elects under section 501(h), K and L are an affiliated group of organizations. Even though A is affiliated with K and L, A is not a member of that affiliated group of organizations because A is not an eligible organization within the meaning of §1.501(h)-2(b)(1) (see §56.4911-7(e)(1) for the definition of which affiliated organizations may be members of an affiliated group of organizations).

Example (8). G, H, I, and J are eligible organizations. G, H, and I have elected the expenditure test under section 501(h). The governing board of J has nine members. Under the governing instruments of J, organizations G, H, and I each designate three members of the governing board of J. Also under the governing instruments of J, action on legislative issues requires the approval of any seven board members. Because the three representatives of G may prevent action on legislative issues, J is affiliated with G. Similarly, J is affiliated with each of H and I. However, under none of the rules of affiliation is G affiliated with H, or H with I, or I with G. Therefore J is a member of one affiliated group comprising G and J, of another group comprising H and J, and of a third group comprising I and J.

Example (9). Organizations C, D, and E have been affiliated for many years and have all elected the expenditure test. Each has a taxable year ending July 31. For every day of the year ending July 31, 1992, they were eligible organizations, electing member organizations, and affiliated with each other. On no day of that year were they affiliated with any other eligible organization having a different taxable year. Therefore, the year ending July 31, 1992, is the taxable year of the affiliated group comprising C, D, and E.

§56.4911-8 *Excess lobbying expenditures of affiliated group.*

(a) *Application.* This section provides rules concerning the exempt purpose expenditures, lobbying expenditures, and grass roots expenditures of an affiliated group of organizations, and the application of the excise tax imposed by section 4911(a) on the excess lobbying expenditures of the group.

(b) *Affiliated group treated as one organization.* Under section 4911(f), an affiliated group of organizations is treated as a single organization for purposes of the tax imposed by section 4911(a). For any taxable year of the affiliated group, the group's lobbying expenditures, grass roots expenditures, and exempt purpose expenditures are equal to the sum of the lobbying expenditures, grass roots expenditures, and exempt purpose expenditures, respectively, paid or incurred by each member during the taxable year of the affiliated group. The lobbying and grass roots nontaxable amounts for the affiliated group for a taxable year are determined under section 4911(c)(2) and (4) and §56.4911-1(c) and are based on the sum of the exempt purpose expenditures described in the preceding sentence. The lobbying and grass roots ceiling amounts for the affiliated group for a taxable year are calculated under §1.501(h)-3(c)(3) and (6)

based upon the nontaxable amounts determined pursuant to the preceding sentence.

(c) *Tax imposed on excess lobbying expenditures of affiliated group.* The excise tax under section 4911(a) is imposed for a taxable year of an affiliated group if the group has excess lobbying expenditures. For any taxable year of an affiliated group, the group's excess lobbying expenditures are the greater of —

(1) The amount by which the group's lobbying expenditures exceed the group's lobbying nontaxable amount, or

(2) The amount by which the group's grass roots expenditures exceed the group's grass roots nontaxable amount.

(d) *Liability for tax*—(1) *Electing organizations.* As provided in this paragraph (d), an electing member organization is liable for all or a portion of the excise tax imposed by section 4911(a) on the excess lobbying expenditures of an affiliated group of organizations. An organization that is liable under this paragraph (d) is not liable for any excise tax under section 4911 based on its own excess lobbying expenditures. A member of the affiliated group that is not an electing member organization is not liable for any portion of the excise tax that is imposed with respect to the affiliated group.

(2) *Tax based on excess lobbying expenditures.* If the excise tax imposed by section 4911(a) on the excess lobbying expenditures of an affiliated group of organizations is based upon the amount described in paragraph (c)(1) of this section, and at least one electing member has made lobbying expenditures, each electing member organization is liable for a portion of the tax equal to the amount of the tax multiplied by a fraction, the numerator of which is the electing member organization's lobbying expenditures paid or incurred during the taxable year of the affiliated group, and the denominator of which is the sum of the lobbying expenditures of all electing member organizations in the group paid or incurred during the taxable year of the affiliated group.

(3) *Tax based on excess grass roots expenditures.* If the excise tax imposed by section 4911(a) on the excess lobbying expenditures of an affiliated group of organizations is based upon the amount described in paragraph (c)(2) of this section, and at least one electing member has made grass roots expenditures, each electing member organization is liable for a portion of the tax equal to the amount of the tax multiplied by the fraction described in paragraph (d)(2) of this section, except that "grass roots expenditures" is substituted for "lobbying expenditures."

(4) *Tax based on exempt purpose expenditures.* If the excise tax imposed by section 4911(a) on the excess lobbying expenditures of an affiliated group of organizations is based upon the amount described in paragraph (c)(2) of this section, and if paragraphs (d)(2) and (d)(3) of this section do not apply because no electing organization has made lobbying or grass roots expenditures, respectively, each electing member organization is liable for a portion of the tax equal to the amount of tax multiplied by a fraction the numerator of which is the electing member organization's exempt purpose expenditures and the denominator of which is the exempt purpose expenditures of all the electing member organizations in the affiliated group.

(5) *Taxable year for which liable.* An electing member organization that is liable for all or a portion of the excise tax imposed by section 4911(a) on the excess lobbying expenditures of an affiliated group of organizations is liable for the tax as if the tax were imposed for its taxable year with which or within which ends the taxable year of the affiliated group.

(6) *Organization a member of more than one affiliated group.* If, under this paragraph (d), an organization is liable for its taxable year for two or more excise taxes imposed by section 4911(a) on the excess lobbying expenditures of two or more affiliated groups, then the organization is liable only for the greater of the two or more taxes.

(e) *Former member organization.* An electing member organization that ceases to be a member of an affiliated group of organizations, the taxable year of which is different from its own, must thereafter determine its liability under §56.4911-1 for the excise tax imposed by section 4911(a) as if its taxable year were the taxable year of the affiliated group of which it was formerly a member. An organization to which this paragraph (e) applies that is liable for the excise tax imposed by section 4911(a) is liable for the tax as if the tax were imposed for its taxable year within which ends the taxable year of the affiliated group of which it was formerly a member. The Commissioner may, at the Commissioner's discretion, permit an organization to disregard the rules of this paragraph (e) and to determine any liability under section 4911(a) based upon its own taxable year.

§56.4911-9 Application of section 501(h) to affiliated groups of organizations.

(a) *Scope.* This section provides rules concerning the application of the limitations of section 501(h) to members of an affiliated group of organizations (as defined in §56.4911-7(e)(1)).

(b) *Determination required.* For each taxable year of an affiliated group of organizations, the calculations described in §1.501(h)-3(b)(1)(i) and (ii) must be made, based on the expenditures of the group. If, for a taxable year of an affiliated group, it is determined that the sum of the affiliated group's lobbying or grass roots expenditures for the group's base years exceeds 150 percent of the sum of the group's corresponding nontaxable amounts for the base years, then under section 501(h), each member organization that is an electing member organization (as defined in §56.4911-7(e)(4)) at any time in the taxable year of the affiliated group shall be denied tax exemption beginning with its first taxable year beginning after the end of such taxable year of the affiliated group. Thereafter, exemption shall be denied unless (pursuant to §1.501(h)-3(d)) the organization reapplies and is recognized as exempt as an organization described in section 501(c)(3). For purposes of this section, the term "base years" generally means the taxable year of the affiliated group for which a determination is made and the group's three preceding taxable years. Base years, however, do not include any year preceding the first year in which at least one member of the group was treated as described in section 501(c)(3).

(c) *Member organizations that are not electing organizations.* An organi-

zation that is a member of an affiliated group of organizations but that is not an electing member organization remains subject to the "substantial part test" described in section 501(c)(3) with respect to its activities involving attempts to influence legislation.

(d) *Filing of information relating to affiliated group of organizations*—(1) *Scope.* The filing requirements described in this paragraph (d) apply to each member of an affiliated group of organizations for the taxable year of the member with which, or within which, ends the taxable year of the affiliated group.

(2) *In general.* Each member of an affiliated group of organizations shall provide to every other member of the group, before the first day of the second month following the close of the affiliated group's taxable year, its name, identification number, and the information required under §1.6033-2(a)(2)(ii)(k) for its expenditures during the group's taxable year and for prior taxable years of the group that are base years under paragraph (b). For groups electing under §56.4911-7(e)(5) to have each member file information with respect to the group based on its taxable year, each member shall provide the information required by the preceding sentence by treating each taxable year of any member of the group as a taxable year for the group.

(3) *Additional information required.* In addition to the information required by §1.6033-2(a)(2)(ii)(k), each member of an affiliated group of organizations must provide on its annual return the group's taxable year and, if the election under §56.4911-7(e)(5) is made, the name, identification number, and taxable year identifying the return with which its consent to the election was filed.

(4) *Information required of electing member organization.* In addition to the information required by §1.6033-2(a)(2)(ii)(k) and paragraph (d)(3) of this section, each electing member organization (as defined in §56.4911-7(e)(4)) must provide on its annual return —

(i) The name and identification number of each member of the group, and

(ii) The appropriate calculation described in §56.4911-8(d), if the organization is an electing member organization liable for all or any portion of the excise tax imposed by section 4911(a).

(e) *Example.* The provisions of this section may be illustrated by the following example:

Example. (1) M, N, and O are affiliated organizations under §56.4911-7(a). M's taxable year ends November 30, N's, January 31, and O's, June 30. On June 20, 1979, O files Form 5768 to elect to be governed by the expenditure test. M files Form 5768 in December of 1979. Neither M nor O revokes the election, and no organization makes the election provided for in §56.4911-7(e)(5). M, N, and O constitute an affiliated group of organizations, the first taxable year of which is the calendar year 1979.

(2) Because the organizations did not elect under §56.4911-7(e)(5) to use their own taxable years as the group's taxable years, the expenditures of the affiliated group for its first taxable year are the expenditures made by M, N, and O during calendar year 1979, and are reported by M, N, and O on their returns for their taxable years within which falls December 31, 1979. M reports the expenditures of the affiliated group for 1979 on its return for its taxable year ending November 30, 1980; and O, on its return for its taxable year ending June 30, 1980. N is not an electing member (as defined in §56.4911-7(e)(4)). Accordingly, under paragraph (d)(3)(i) of this section, it reports the name and identification number of each member of the group.

(3) The following tables summarize the expenditures by the affiliated group for the calendar years indicated. None of the group's lobbying expenditures for its taxable years 1979 through 1982 were grass roots expenditures.

Table I. Group's Expenditures

Year	Exempt Purpose Expenditures (EPE)	Calculation	Lobbying Nontaxable Amount (LNTA)	Lobbying Expenditures (LE)
1979	$ 400,000	(20% x $400,000 =)	$ 80,000	$100,000
1980	$ 300,000	(20% x $300,000 =)	$ 60,000	$100,000
1981	$ 600,000	(20% x $500,000 + 15% x $100,000 =)	$115,000	$120,000
1982	$ 500,000	(20% x $500,000 =)	$100,000	$220,000
Totals:	$1,800,000		$355,000	$540,000

Table II. Expenditures of M and O

	Exempt Purpose Expenditures		Lobbying Nontaxable Amount		Lobbying Expenditures		
	M	O	M	O	M	O	M plus O
1979	125,000	100,000	25,000	20,000	60,000	20,000	80,000
1980	100,000	50,000	20,000	10,000	40,000	40,000	80,000
1981	250,000	100,000	50,000	20,000	60,000	40,000	100,000
1982	200,000	100,000	40,000	20,000	160,000	40,000	200,000

(4) For the affiliated group's taxable years 1979, 1980, 1981, and 1982, the group has excess lobbying expenditures. Under section 4911(f)(1)(B) and §56.4911-8(d), M and O, as electing member organizations, are liable for a portion of the 25 percent excise tax imposed on the group's excess lobbying expenditures, based on their respective shares of the lobbying expenditures of all electing member organizations. For 1979, the excess lobbying expenditures are $20,000 ($100,000 − $80,000). The tax is 25% of $20,000 or $5,000; M must pay $3,750 $60,000/$80,000) x $5,000 = $3,750, and O must pay $1,250 ($20,000/$80,000) x $5,000 = $1,250. For 1980, the tax is $10,000 and each must pay $5,000. For 1981, the tax is $1,250, of which M must pay $750 and O must pay $500. For 1982, the tax is $30,000. M must pay $24,000 and O must pay $6,000. M and O are not liable for any separate 4911 excise tax that otherwise would have been imposed on their separate excess lobbying expenditures.

(5) Under §56.4911-9(b), the group must make the calculation described in §1.501(h)-3(b)(1) for each of the group's taxable years 1979 through 1982. The following illustrates only the required calculation for the group's taxable year 1982. For its taxable year 1982, the group must determine whether it normally has made lobbying expenditures in excess of its

lobbying ceiling amount. The determination takes into account the group's expenditures in base years 1979 through 1982. The sum of the group's lobbying expenditures for the base years ($540,000) exceeds 150% of the sum of the group's lobbying nontaxable amounts for the base years (150% x $355,000 = $532,500). Therefore, for its taxable year 1982, the group normally has made lobbying expenditures in excess of its lobbying ceiling amount. Under section 501(h) and § 56.4911-9(b), M is not exempt from tax under section 501(a) as an organization described in section 501(c)(3) for its taxable year beginning December 1, 1983, and O is not exempt for its year beginning July 1, 1983. Whether N's lobbying expenditures disqualify it for tax exemption at any time after January 1, 1979, is determined under the substantial part test of section 501(c)(3).

(f) *Cross reference.* For other provisions relating to members of an affiliated group of organizations, see §§56.4911-2(c)(4)(ii), 56.4911-4(c)(2), 56.4911-4(e), and 56.4911-5(f)(3).

§56.4911-10 Members of a limited affiliated group of organizations.

(a) *Scope.* This section provides additional rules for members of a limited affiliated group of organizations, as defined in paragraph (b) of this section (relating generally to organizations that are affiliated solely by reason of provisions of their governing instruments that extend control solely with respect to national legislation). Except as otherwise provided in this section, §§56.4911-8 and 56.4911-9 do not apply to members of a limited affiliated group. Thus, as modified by this section, the regulations under sections 501(h) and 4911 apply to electing members of a limited affiliated group individually. For example, §§56.4911-2 through -4, which, by their terms, include amounts described in paragraph (d) of this section, are used in applying sections 501(h) and 4911 to controlling member organizations (within the meaning of paragraph (c) of this section). Except as otherwise provided in this section, members of a limited affiliated group that are not electing organizations are subject to the substantial part test.

(b) *Members of limited affiliated group.* For purposes of section 4911, a limited affiliated group consists of two or more organizations that meet the following requirements:

(1) Each organization is a member of an affiliated group of organizations as defined in §56.4911-7(e);

(2) No two members of the affiliated group described in paragraph (b)(1) of this section are affiliated by reason of interlocking governing boards under §56.4911-7(b); and

(3) No member of the affiliated group described in paragraph (b)(1) of this section is, under its governing instrument, bound by decisions of one or more of the other such members on legislative issues other than national legislative issues.

Each organization in a group of organizations that satisfies the requirements of the preceding sentence is a member of the limited affiliated group.

(c) *Controlling and controlled organizations.* For purposes of this section, a member of a limited affiliated group is a controlling member organization if it controls one or more of the other members of the limited affiliated group, and a member of a limited affiliated group is a controlled member organization if it is controlled by one or more of the other members of the limited affiliated group. For purposes of the preceding sentence, whether an organization controls a second organization shall be determined by whether the second organization is bound, under its governing instruments, by actions taken by the first organization on national legislative issues.

(d) *Expenditures of controlling organization*—(1) *Scope.* This paragraph (d) applies to a controlling member organization that has the expenditure test election in effect for its taxable year. This paragraph (d) applies whether or not the organization is also a controlled member organization. In determining a controlling member organization's expenditures, no expenditure shall be counted twice.

(2) *Expenditures for direct lobbying.* A controlling member organization for which the expenditure test election is in effect shall include in its direct lobbying expenditures for its taxable year the direct lobbying expenditures (as defined in §§56.4911-2 and -3) paid or incurred with respect to national legislative issues during such year by each organization that is a member of the limited affiliated group and is controlled (within the meaning of paragraph (c) of this section) by such controlling member organization.

(3) *Grass roots expenditures.* A controlling member organization for which the expenditure test election is in effect shall include in its grass roots expenditures for its taxable year the grass roots expenditures (as defined in §§56.4911-2 and -3) paid or incurred with respect to national legislative issues during such year by each organization that is a member of the limited affiliated group and is controlled (within the meaning of paragraph (c) of this section) by such controlling member organization.

(4) *Exempt purpose expenditures.* The exempt purpose expenditures of a controlling member organization do not include the exempt purpose expenditures (other than lobbying expenditures described in paragraphs (d)(2) and (d)(3) of this section) of any organization that is a controlled member organization with respect to it.

(e) *Expenditures of controlled member.* A controlled member organization that is an electing organization but that does not control (within the meaning of paragraph (c) of this section) any organization in the limited affiliated group shall apply sections 501(h) and 4911 and the regulations thereunder without regard to the expenditures of any other member of the limited affiliated group.

(f) *Reports of members of limited affiliated groups*—(1) *Controlling member organization's additional information on annual return.* In addition to the information required by §1.6033-2(a)(2)(ii)(k), each controlling member organization for which the expenditure test election is in effect must provide on its annual return the name and identification number of each member of the limited affiliated group.

(2) *Reports of controlling members to other members.* Each controlling member organization for which an expenditure test election is in effect must notify each member that it controls of its taxable year in order for the controlled organization to prepare the report required by paragraph (f)(3) of this section. Such notification must be made before the beginning of the second month after the close of each taxable year of the controlling member for which the election is in effect.

(3) *Reports of controlled member organization.* Every controlled mem-

ber organization (whether or not the expenditure test election is in effect with respect to it) shall provide to each member of the limited affiliated group that controls it, before the first day of the second month following the close of the taxable year of each such controlling organization, its name, identification number, and the lobbying expenditures and grass roots expenditures on national legislative issues incurred by the controlled member organization.

(g) *National legislative issues.* The term "national legislative issue" means legislation, limited to action by the Congress of the United States or by the public in any national procedure. If an issue is both national and local, it is characterized as a national legislative issue if the contemplated legislation is Congressional legislation.

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

Example (1). State X has an income tax law that uses definitions contained in the Internal Revenue Code as it may be amended from time to time. Legislation to change a definition in the Internal Revenue Code is pending in Congress. This is a national legislative issue even though Congressional action may affect state law.

Example (2). Organization M takes a position favoring approval by Congress of a proposed amendment to the United States Constitution. This is a national legislative issue. After approval by Congress and submission to the states for ratification, the proposed amendment ceases to be a national legislative issue.

Example (3). N, O, and P are organizations described in section 501(c)(3) that do not have interlocking governing boards, within the meaning of §56.4911-7(b). N has elected the expenditure test under section 501(h). By virtue of the governing instruments of O and P, any decision made by N on national legislative issues (such as issues concerning action on acts, bills, resolutions, or similar items by Congress) binds both O and P. Under their governing instruments, O and P are not bound on any other issues. Therefore, N, O, and P constitute a limited affiliated group. If P sends a series of letters and pamphlets to members of Congress in support of bill V, their cost will be included in N's and P's expenditures for direct lobbying and in N's and P's exempt purposes expenditures, but will not be included in O's lobbying expenditures. If N hires a lobbyist to solicit support for bill V, the cost of hiring the lobbyist will be includable only in N's lobbying expenditures. Any lobbying expenditures incurred by either O or P on any issue that is not a national legislative issue will not be included in N's lobbying expenditures.

Example (4). Y is an electing organization and a member of a limited affiliated group of organizations. Y controls organizations A, B, and C with respect to national legislative issues but is not controlled by any other organization. Y's taxable year is the calendar year. During 1982, A dissolves on March 15th and D, also controlled by Y with respect to national legislative issues, is established on May 1st. For 1982 the limited affiliated group comprises Y, A, B, C, and D.

Example (5). P, Q, R, and S are electing organizations. The governing instruments of Q require it to adopt the positions on national legislative issues adopted by P. R is similarly bound by Q's positions. R and S have interlocking governing boards, within the meaning of §56.4911-7(b), but S's governing instruments do not require it to adopt the position of any other organization on any legislative issues. Under §56.4911-7(e)(1), P, Q, R, and S are members of an affiliated group. Applying paragraph (b) of this section, it is determined that (1) P, Q, R and S are members of an affiliated group; and (2) R and S are affiliated by reason of interlocking governing boards. Accordingly, P, Q, R and S are not a limited affiliated group. Similarly, P, Q, and R do not constitute a limited affiliated group because they are members of an affiliated group comprising P, Q, R, and S, two of whose members, R and S, are affiliated by reason of interlocking governing boards.

Example (6). T, U, V, and W are electing organizations. The governing instruments of U and V require them to adopt the positions on national legislative issues adopted by T, but do not require them to adopt the positions of any organization on any other legislative issues. The governing documents of W require it to adopt the positions of V on all legislative issues. Applying paragraph (b) of this section, it is determined that (1) T, U, V, and W are all members of an affiliated group; (2) no two of T, U, V, and W are affiliated by reason of interlocking governing boards; but (3) W is bound, under its governing instrument, by decisions of V on legislative issues that are not national legislative issues. Accordingly, T, U, V, and W do not constitute a limited affiliated group. Similarly, T, U, and V do not constitute a limited affiliated group. T, U, V, and W are an affiliated group under §56.4911-7.

§56.6001-1 Notice or regulations requiring records, statements, and special returns.

(a) *In general.* The provisions of §53.6001-1 shall apply to any person subject to tax under chapter 41, Subtitle D, of the Code, by treating each reference to chapter 42 in §53.6001-1 as a reference to chapter 41.

(b) *Cross references.* See §56.4911-6 for general information on records of lobbying expenditures. See §§56.4911-9(d) and 56.4911-10(f) for information that members of an affiliated group and a limited affiliated group, respectively, are to provide to other members of the group and to the Internal Revenue Service.

§56.6011-1 General requirement of return, statement, or list.

Every organization liable for the tax imposed by section 4911(a) shall file an annual return with respect to the tax on the form prescribed by the Internal Revenue Service for that purpose and shall include the information required by the form and its instructions.

OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

PART 602-[AMENDED]

Par. 18. The authority citation for Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 19. Section 602.101(c) is amended by inserting in the appropriate place in the table "§56.4911 . . . 1545-0052."

Fred T. Goldberg, Jr.,
Commissioner of Internal Revenue

Approved August 3, 1990.

Kenneth W. Gideon,
Assistant Secretary of the Treasury for Tax Policy.

(Filed by the Office of the Federal Register on August 30, 1990, 8:45 a.m., and published in the issue of the Federal Register for August 31, 1990, 55 F.R. 35579)

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26 CFR 1.501(c)(3)-1: Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.

Guidance is provided with respect to the notice required under section 508(a) of the Code for treatment as an organization described in section 501(c)(3) of the Code. See Rev. Rul. 90-100, below.

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26 CFR 1.501(c)(17)-1: Supplemental unemployment benefit trusts.

Do supplemental unemployment compensation benefits constitute wages for purposes of the Federal Insurance Contributions Act and the Federal Unemployment Tax Act, and compensation for purposes of the Railroad Retirement Tax Act? See Rev. Rul. 90-72, page 211.

Part II.—Private Foundations

Section 508.—Special Rules with respect to Section 501(c)(3) Organizations

26 CFR 1.508-1: Notices.
(Also Sections 501; 1.501(c)(3)-1, 1.9100-1.)

Special rules with respect to section 501(c)(3) organizations. Guidance is

provided in three factual situations as to whether the described organizations have given the notice required by section 508(a) of the Code within the 15-month period described in section 1.508-1(a)(2)(i) of the regulations.

Rev. Rul. 90-100

ISSUE

In the three situations described below, have the organizations given the notice required by section 508(a) of the Internal Revenue Code within the 15-month period described by section 1.508-1(a)(2)(i) of the Income Tax Regulations?

FACTS

Situation 1

X submitted a properly completed and executed Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code, within 15 months from the end of the month in which it was organized. While the application was still pending and prior to the issuance of any adverse ruling or adverse determination letter, *X* submitted a letter to the Service requesting that its application be treated as withdrawn. The Service thereupon closed the application file and notified *X* of such action in writing. Two years later, *X* submitted a new application on Form 1023. The new application established that *X* had been described in section 501(c)(3) continuously from the date it was organized.

Situation 2

Y submitted a properly completed and executed Form 1023 within 15 months from the end of the month in which it was organized. While the application was still pending and prior to the issuance of any adverse ruling or adverse determination letter, *Y* submitted an application for recognition of exemption as an organization described in section 501(c)(4) of the Code together with a letter requesting that its application as an organization described in section 501(c)(3) be treated as withdrawn. Thereupon, the Service closed the section 501(c)(3) application file and issued a letter to *Y* recognizing its exemption as an organization described in section 501(c)(4). Two years after withdrawal of the section 501(c)(3) application, *Y* submitted a new application on Form 1023 requesting recognition of exemption as an organization described in section 501(c)(3). The new application established that *Y* has been described in section 501(c)(3) continuously from the date it was organized.

Situation 3

The Service issued a group exemption letter to *C*, a central organization, recognizing its listed subordinate organizations as described in section 501(c)(3) of the Code. *Z* is a subordinate organization of *C* and is not a private foundation. One month after *Z* was organized, *C* listed it as a subordinate organization covered in the group exemption ruling. Five years after such listing, *Z* withdrew from the group exemption and applied separately on a Form 1023 for recognition as an organization described in section 501(c)(3). *Z* filed its application with the Service within 15 months from the date of its withdrawal from the group exemption. The application established that *Z* has been described in section 501(c)(3) continuously from the date it was organized.

LAW AND ANALYSIS

Section 508(a) of the Code provides, with certain mandatory exceptions not applicable here, that an organization organized after October 9, 1969, shall not be treated as an organization described in section 501(c)(3) for any period before it gives notice to the Secretary that it is applying for recognition of such status unless the notice is within the time prescribed by the regulations for giving such notice.

Section 1.508-1(a)(2)(i) of the regulations provides that an organization will be treated as described in section 501(c)(3) of the Code for the period prior to the giving of the notice referred to in section 508(a) if the notice is filed within 15 months from the end of the month in which an organization was organized. Such notice is filed by submitting a properly completed Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code.

Section 1.508-1(a)(3)(i)(c) of the regulations provides an exception to the notice requirements of section 1.508-1(a)(2)(i) for subordinate organizations (other than private foundations) covered by a group exemption letter.

The legislative history of section 508(a) of the Code evidences Congressional intent that the organization's notification include its claimed status in order to comply with the section. S. Rep. No. 91-552, 91st Cong., 1st Sess. 54 (1969), 1969-3 C.B. 423, 459; H.R. Rep. No. 91-413, (Part I), 91st Cong., 1st Sess. 38 (1969), 1969-3 C.B. 200, 225.

The act of withdrawing the application for recognition of exemption prior to the issuance of any adverse ruling or adverse determination letter cancels the organization's previous notification to the Service required under section 508 of the Code since it has withdrawn its claim to section 501(c)(3) status. Therefore, the organizations in *Situations 1 and 2* have not timely met the notification requirement of section 508(a)(2) and section 1.508-1(a)(2)(i) of the regulations and will be treated as organizations described in section 501(c)(3) of the Code only on a prospective basis from the date of the filing of the second Form 1023 requesting recognition of exemption as an organization described in section 501(c)(3).

Situation 3 presents a different set of circumstances. For five years the organization was covered under a section 501(c)(3) group exemption. The organization's exemption had been recognized under the group exemption letter from the date of its creation as allowed by section 1.508-1(a)(3)(i)(c) of the regulations. The regulation provides that subordinate organizations (other than private foundations) covered by a group exemption letter are excepted from the section 508 notice requirement.

Upon withdrawing from the group exemption, the organization in *Situation 3* was no longer covered by the exception to the notice requirement of the regulation. Accordingly, the date of withdrawal from the group exemption starts running the 15-month period described in section 1.508-1(a)(2)(i) of the regulations. Because the organization filed its Form 1023 within 15 months of its withdrawal from the group ruling, it continuously

maintained its section 501(c)(3) status from the date of its organization.

HOLDING

In *Situations 1 and 2* X and Y have not given the notice required by section 508(a) of the Code within the period prescribed by section 1.508-1-(a)(2)(i) of the regulations and will be treated as organizations described in section 501(c)(3) only on a prospective basis from the date of the filing of the second Form 1023 requesting recognition of exemption as an organization described in section 501(c)(3). In *Situation 3*, Z has given the notice required by section 508(a) within the period permitted by section 1.508-1-(a)(2)(i) and will be treated as an organization described in section 501(c)(3) from the date of its organization.

APPLICATION FOR EXTENSIONS OF THE TIME FOR FILING NOTICE UNDER SECTION 508(a)

The Service will give consideration to applying the Commissioner's discretionary authority under section 1.9100-1 of the regulations to extend the time for satisfying the notice requirement of section 508(a) of the Code. Rev. Proc. 79-63, 1979-2 C.B. 578, provides information and sets forth the representations that taxpayers must furnish to obtain such relief. It also discusses some factors that will be taken into consideration in determining whether such extensions will be granted.

Subchapter G.—Corporations Used to Avoid Income Tax on Shareholders

Part III.—Foreign Personal Holding Companies

Section 552.—Definition of Foreign Personal Holding Company

26 CFR 1.552-1: Definition of foreign personal holding company.

Whether a foreign corporation, all the stock of which is owned by a foreign trust and which is licensed to produce recordings of a resident alien entertainer, is a foreign personal holding company. See Rev. Rul. 90-106, page 162.

Subchapter H.—Banking Institutions

Part II.—Mutual Savings Banks, etc.

Section 593.—Reserves for Losses on Loans

An institution that is chartered as a bank cannot qualify as a domestic building and loan association under section 7701(a)(19) of the Code. See Rev. Rul. 90-54, page 270.

Subchapter I.—Natural Resources

Part I.—Deductions

Section 611.—Allowance of Deduction for Depletion

26 CFR 1.611-3: Rules applicable to timber.

Capitalized planting costs of tree seedlings that die in greater numbers than normally anticipated because of an abnormal drought may be deductible under section 165 of the Code. See Rev. Rul. 90-61, page 39.

Section 613.—Percentage Depletion

26 CFR 1.613-3: Gross income from the property.

If gas is sold after it is removed from the premises for a price that is lower than the representative market or field price (RMFP), is "gross income from the property" the RMFP for purposes of the allowance for percentage depletion under section 613A of the Code. See Rev. Rul. 90-62, below.

Section 613A.—Limitations on Percentage Depletion in Case of Oil and Gas Wells

(Also Section 613; 1.613-3.)

Natural gas sold after removal from the premises for less than the RMFP. If gas is sold after it is removed from the premises, for a price that is lower than the representative market or field price (RMFP), gross income from the property for purposes of the allowance for percentage depletion is determined without regard to the RMFP.

Rev. Rul. 90-62

ISSUE

If gas is sold after it is removed from the premises for a price that is lower than the representative market or field price (RMFP), is "gross income from the property" the RMFP for purposes of the allowance for percentage depletion under section 613A of the Internal Revenue Code?

FACTS

X owns an operating interest in a gas producing reservoir. In 1988, X sold its gas on a delivered basis under long-term fixed price contracts. Because the gas was transported from the well before it was sold, for purposes of calculating its depletion deduction, X determined its gross income from the property based on the RMFP. The RMFP exceeded the contract price; consequently, X claimed a greater depletion allowance than it could have claimed had it used the contract price in computing its gross income from the property.

LAW AND ANALYSIS

For years after 1974, section 613(d) of the Code provides that in the case of oil and gas wells the allowance for depletion shall be computed without reference to section 613, except as provided in section 613A.

Section 613(a) of the Code provides that, except as provided in section 613A, the allowance for depletion under section 611 of the Code with respect to any oil or gas wells shall be computed without regard to section 613. However, under section 613A(b), the allowance for depletion under section 611 shall be computed in accordance with section 613 when natural gas is sold pursuant to a fixed contract.

Section 613(a) of the Code provides generally for an allowance for percentage depletion in the case of mines, wells, and other natural deposits equal to a specified percentage of the gross income from the property, excluding an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property.

Section 1.613-3(a) of the Income Tax Regulations provides generally that in the case of oil and gas wells, "gross income from the property," as used in section 613(c)(1) of the Code, means the amount for which the taxpayer sells the oil or gas in the immediate vicinity of the well. However, if the oil or gas is not sold on the premises but is manufactured or converted into a refined product prior to sale, or is transported from the premises prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market or field price of the gas before conversion or transportation.

The premise underlying the use of the RMFP is that, when oil or gas is either processed or refined prior to sale, or is transported from the premises prior to sale, its value is increased. Under these circumstances, the sales price of the oil or gas will

exceed the gross income from the property. Thus, under the regulations, the RMFP is established as a ceiling on the income that the taxpayer may take into account for depletion purposes.

In the present case, however, the contract price for the delivered gas was less than the RMFP. Under these facts, the ceiling established by the RMFP is not relevant to the determination of the gross income from the property.

Moreover, it is well established that a producer is not entitled to an allowance for depletion based on gross income from the property that exceeds the price the producer actually receives. In *United States v. Henderson Clay Products*, 324 F.2d 7 (5th Cir. 1963), the taxpayer, an integrated clay mining and brick manufacturer, claimed percentage depletion based on the market price of shredded ball clay, which was in excess of the price for which the taxpayer sold its finished brick. The court differentiated between gross income in excess of income actually received and "hypothetical" gross income in excess of the actual gross income, noting that at no time was the taxpayer's actual gross income, unreduced by expenses incurred in production and selling, the higher market price of the shredded ball clay. The court consequently denied the taxpayer an allowance for depletion based on the market price of shredded ball clay.

Henderson Clay Products relies in part on *Crews v. Commissioner*, 89 F.2d 412 (10th Cir. 1937), in which the court noted that "income from the property is a gain, a profit, something of exchangeable value derived from the property, that is received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal." 89 F.2d at 415. The court further noted that

> to allow a deduction on the basis of income never received and therefore no part of the gross income, on the net part of which a tax is exacted would be manifestly unfair. . . .there should not be included in such gross income proceeds of oil never received by the taxpayer and no part of which became subject to income taxation.

89 F.2d at 416.

In the present case, *X* may not claim an allowance for percentage depletion based on the RMFP because this would allow a deduction calculated with respect to gross income that *X* never received.

HOLDING

If gas is sold after it is removed from the premises, for a price that is lower than the RMFP, gross income from the property for purposes of the allowance for percentage depletion is determined without regard to the RMFP.

Subchapter J.—Estates, Trusts, Beneficiaries, and Decedents

Part I.—Estates, Trusts, and Beneficiaries

Subpart A.—General Rules for Taxation of Estates and Trusts

Section 641.—Imposition of Tax

26 CFR 1.641(a)-0: Scope of Subchapter J.

Whether taxable year of a "grantor" trust is required to be the calendar year. See Rev. Rul. 90-55, page 161.

Section 642.—Special Rules for Credits and Deductions

26 CFR 1.642(c)-5: Definition of pooled income fund.

Pooled income fund; governing instruments; sample provisions. A trust does not meet the requirements for a pooled income fund under section 642(c)(5)(A) of the Code where the trustee is not prohibited from accepting or investing in depreciable property and the governing instrument does not provide that the trustee shall establish a depreciation reserve in accordance with Generally Accepted Accounting Principles. Rev. Rul. 82-38 amplified.

Rev. Rul. 90-103

ISSUE

1. If the trustee of a trust that otherwise qualifies as a pooled income fund is not required by the governing instrument or state law to establish a depreciation reserve fund with respect to any depreciable property held by the trust, does the trust meet the requirements for a pooled income fund under section 642(c)(5)-(A) of the Internal Revenue Code?

2. If the trustee of a trust that otherwise qualifies as a pooled income fund is required by the governing instrument to establish a depreciation reserve fund with respect to any depreciable property held by the trust, but additions to the reserve fund are not required to be determined in accordance with Generally Accepted Accounting Principles (GAAP), does the trust meet the requirements for a pooled income fund under section 642(c)(5)(A) of the Code?

FACTS

Situation 1. *N*, a public charity described in section 170(b)(1)(a)(ii) of the Code, established a trust, *P*, that is intended qualify as a pooled income fund under section 642(c)(5)(A). Neither the governing instrument of *P* nor applicable state law prohibits the trustee from accepting or investing in depreciable property. The governing instrument of *P* and applicable state law are silent as to whether the trustee must establish a depreciation reserve with respect to any depreciable property held by the trust.

Situation 2. The facts are the same as in *Situation 1* except that the governing instrument of *P* requires the trustee to establish a depreciation reserve with respect to any depreciable property held by the trust. However, the governing instrument does not require that additions to the depreciation reserve be determined in accordance with GAAP. Rather, the provision requires that amounts be added to the reserve at the trustee's discretion, based on estimates of changes in the fair market value of the depreciable property. No amount need be added in any period if, to the best of the trustee's knowledge, there has been no decrease in the fair market value of the property.

LAW AND ANALYSIS

Section 642(c)(5)(A) of the Code defines a pooled income fund as a trust to which each donor transfers property, contributing an irrevocable remainder interest in such property to or for the use of an organization described in section 170(b)(1)(A) (other than in clauses (vii) or (viii)), and retaining an income interest for the life of one or more noncharitable beneficiaries (living at the time of such transfer).

Section 1.642(c)-5(a)(2) of the Income Tax Regulations provides that a pooled income fund, and its beneficiaries, are taxable under the provisions of part I, subchapter J, chapter 1 of the Code.

Section 642(e) of the Code provides that an estate or trust shall be allowed a deduction for depreciation only to the extent not allowable to beneficiaries under section 167(h).

The regulations under sections 170, 2055, and 2522 of the Code provide that a deduction is allowed for a contribution to or for the use of a charity of a remainder interest in property transferred to a pooled income fund. The amount of the deduction is the present value of the remainder interest in the property transferred to the pooled income fund. Computed under the provisions of section 1.642(c)-6.

Section 1.642(c)-6(d)(2) of the regulations provides that the value of the remainder interest in property is determined by multiplying the factor given in the present value tables set forth in section 1.642(c)-6(d)(3) by the fair market value of the contributed property on the valuation date.

Section 1.642(c)-6(b)(1) of the regulations explains that the tables set forth in section 1.642(c)-6(d)(3) are based on actuarial projections of the life expectancy of the noncharitable beneficiaries.

Section 1.642(c)-6(b)(2) of the regulations provides that the yearly rate of return to be used in determining the applicable discount rate is equal to the highest yearly rate of return of the pooled income fund for the three taxable years immediately preceding the year of contribution.

The amount of the charitable deduction for a contribution to charity of a remainder interest in property transferred to a pooled income fund must be calculated from the present value tables set forth in section 1.642(c)-6(d)(3) of the regulations, and be based on two factors: a discount rate, based on the fund's recent performance, and the term of the income interest or the life expectancy of the income beneficiary. Although the present value tables do not factor in economic depreciation due to exhaustion, wear and tear, and obsolescence of property transferred to or acquired by the trust, the regulations assume that there will be a reasonable relationship between the value of the property upon which the charitable deduction is based in the year of the contribution and the value of the property that is to be received by the charitable remainderman in a later year. *See, e.g.*, H.R. Rep. No. 413, 91st Cong., 1st Sess., pt. 1, at 58 (1969), 1969-3 C.B. 200, at 237.

The only way to assure such a reasonable relationship is to establish a reserve to protect the value of the remainder interest. A depreciation reserve is designed "to protect the principal of the trust against loss due to the gradual shrinkage in value of the [depreciable property]. . .caused by obsolescence, wear and tear, and depreciation in value, which may occur even if ordinary repairs were constantly being made. . .." G. Bogert, *Trusts & Trustees*, Sec. 600 (Rev. 2d ed. 1980). In the absence of a reserve for depreciation, there is no certainty that the charity will receive anything of value on the termination of the noncharitable interests. The allowance of a deduction in respect of a contribution to a pooled income fund implies the need for a depreciation reserve to preserve the value of the fund's assets. Similarly, the method of valuing the deduction provided by section 1.642(c)-6 of the regulations assumes that the value of the properties will be preserved.

Accordingly, in *Situation 1*, because neither the governing instrument of *P* nor state law requires the trustee to establish a depreciation reserve with respect to any depreciable property held by the trust, *P* does not satisfy the requirements for a pooled income fund under section 642(c)(5)-(A).

In *Situation 2*, the governing instrument of *P* provides for a depreciation reserve. However, additions to the depreciation reserve are not required to be determined in accordance with GAAP.

As explained above, the purpose of establishing a depreciation reserve for a pooled income fund is the preservation of the value of the property which will pass to the charitable remainderman. This can be accomplished only by a method that systematically allocates the cost of a capital asset to the years in which the asset is expected to produce income. Depreciation based on GAAP is described as follows:

> Generally accepted accounting principles require that [the cost of depreciation] be spread over the expected useful life of [an asset] in such a way as to allocate it as equitably as possible to the periods during which services are obtained from the use of the asset. This procedure is known as depreciation accounting, a system of accounting that aims to distribute the cost or other basic value of tangible capital assets. . .over the estimated useful life of the unit. . .in a systematic and rational manner. It is a process of allocation, not of valuation. Financial Accounting Standards Board, *Accounting Standards, Current Text, General Standards*, Vol. I, Section D40.101 (1988).

It is, thus, appropriate for a pooled income fund to use a GAAP standard in calculating depreciation, since a GAAP method ensures that the cost of the asset will be allocated systematically over its useful life.

In *Situation 2*, under the governing instrument, additions to the reserve fund are determined at the trustee's discretion based on changes in the fair market value of the property. In the case of a pooled income fund, as in the case of a for-profit entity, it is the value of the property at the time of acquisition that must be preserved. Future increases in the fair market value of the property, due to inflation or market appreciation, are not relevant. A depreciation method that allows a trustee to charge depreciation at its discretion, or to take into account changes in the estimated market value of the property from time to time in determining the amount to be added to the depreciation reserve, does not ensure that the depreciable property will be turned over to charity undiminished by depreciation sustained.

Therefore, to ensure that the value of the remainder interest is preserved for the charitable remainderman, the governing instrument of a pooled income fund must provide for the creation of a depreciation reserve pursuant to GAAP, if the trustee either has the authority to accept or invest in, or is not specifically prohibited from accepting or investing in, depreciable property.

Accordingly, in *Situation 2*, *P* does not qualify as a pooled income fund, even though its governing instrument

provides for the establishment of a depreciation reserve, because additions to the reserve are not required to be determined in accordance with GAAP.

HOLDINGS

1. If the trustee of a trust that otherwise qualifies as a pooled income fund is not required by the governing instrument or state law to establish a depreciation reserve fund with respect to any depreciable property held by the trust, the trust does not meet the requirements for a pooled income fund under section 642(c)(5)(A) of the Code.

2. If the trustee of a trust that otherwise qualifies as a pooled income fund is required by the governing instrument to establish a depreciation reserve fund with respect to any depreciable property held by the trust, but the depreciation to be added to such reserve is not required to be determined in accordance with GAAP, the trust does not meet the requirements for a pooled income fund under section 642(c)(5)(A) of the Code.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 82-38, 1982-1 C.B. 96, amplified by Rev. Rul. 85-57, 1985-1 C.B. 182, serves as a guide for developing governing instruments for pooled income funds. It provides sample provisions that may be used to satisfy the requirements of section 642(c)(5) of the Code. This revenue ruling amplifies Rev. Rul. 82-38 to provide guidance to trustees so that provision can be made in the governing instrument for establishing a depreciation or depletion reserve in the event the trustee is not prohibited from accepting or investing in depreciable or depletable property.

Section 3 of Rev. Rul. 82-38 is amplified by adding the following paragraphs:

.06 In a case where the trustee of a pooled income fund is not prohibited by state law from accepting or investing in depreciable or depletable property, the governing instrument must provide either that the trustee shall establish a depreciation or depletion reserve in accordance with Generally Accepted Accounting Principles (GAAP) or that the trustee shall not accept or invest in any depreciable or depletable assets.

The following sample provisions will satisfy the requirements described in this section 3.06:

(1) If the trustee is permitted to accept or invest in depreciable or depletable assets:

If the trustee accepts or invests in depreciable or depletable property, it shall establish a depreciation or depletion reserve in accordance with Generally Accepted Accounting Principles (GAAP).

(2) If the trustee is prohibited from accepting or investing in depreciable or depletable assets:

The trustee shall not accept or invest in any depreciable or depletable assets.

EFFECTIVE DATE

This revenue ruling is effective with respect to all pooled income funds created after February 15, 1991, and all existing pooled income funds that accept additional donations after that date. Pooled income funds that were created before that date and that do not meet the requirements set forth herein must be amended to include a provision similar to either of the two sample provisions furnished by this revenue ruling prior to accepting any additional donations.

Section 643.—Definitions Applicable to Subparts A, B, C, and D

26 CFR 1.643(b)-1: Definition of "income".

If a trust holds mortgaged property, and payments of principal on the mortgage note are charged against the trust's income in determining the amounts to be distributed to the trust's beneficiaries, then should the depreciation deduction attributable to the mortgaged property be allocated, in part, to the trust? See Rev. Rul. 90-82, page 44.

Section 645.—Taxable Year of Trusts

(Also Sections 641, 671, 676; 1.641(a)-0, 1.671-3; 1.676(a)-1)

Taxable year of trusts. Trusts that are treated as wholly-owned by the grantor under the grantor trust rules of subpart E of subchapter J (sections 671-679 of the Code) are not required to adopt the calendar year as their tax year under section 645(a).

Rev. Rul. 90-55

ISSUE

If a trust is treated as wholly-owned by a grantor under the rules of subpart E, part I, of subchapter J, chapter 1, subtitle A of the Internal Revenue Code (sections 671-679), is the taxable year of the trust required to be the calendar year under section 645(a) of the Code?

FACTS

Pursuant to a trust agreement, corporation *X* established a trust and transferred money to bank *Y*, as trustee. The trust agreement provides that *X* may revoke the trust at any time. Corporation *X* is an accrual basis taxpayer and has a fiscal year accounting period, ending January 31.

LAW AND ANALYSIS

Section 645(a) of the Code provides that for purposes of subtitle A, the taxable year of any trust shall be the calendar year. Section 645(b) provides that subsection (a) shall not apply to a trust exempt from taxation under section 501(a) or a trust described in section 4947(a)(1).

Section 676(a) of the Code provides, in part, that the grantor shall be treated as the owner of any portion of a trust, where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a nonadverse party, or both.

Section 671 of the Code provides that subparts A through D, part I, subchapter J, chapter 1, subtitle A of the Code apply only to the portion of a trust that is not treated as owned by the grantor under the rules of subpart E, part I, subchapter J, chapter 1, subtitle A of the Code. Similarly, section 1.641-0(b) of the Income Tax Regulations provides that subpart A does not apply to the portion of corpus or income that is treated as owned by the grantor under the rules of subpart E. Section 645 of the Code is in subpart A, part I, subchapter J, chapter 1, subtitle A of the Code. Thus, although section 645 does not explicitly exclude grantor trusts from the reach of its provisions, the Code and regulations contemplate that the provisions generally applicable to trusts do not apply to grantor trusts.

The legislative history of section 645 of the Code indicates that the purpose of the provision was to limit the ability to defer income tax through selection of a taxable year for a trust that is different from the taxable year of the trust beneficiaries. This concern is not present in the case of a trust that is treated as wholly-owned by the grantor under subpart E, part I, subchapter J, chapter 1, subtitle A of the Code because the taxable year of the trust is disregarded and the grantor must report the gross income from the trust property as if the trust does not exist. *See* S. Rep. No. 313, 99th Cong., 2d Sess. 872 (1986), 1986-3 (Vol. 3) C.B. 872; section 1.671-3(a)(1) of the regulations; Rev. Rul. 57-390, 1957-2 C.B. 326.

Corporation *X*, as the grantor of the trust, is treated as the owner of the entire corpus and income of the trust under section 676(a) of the Code. Accordingly, section 645 does not apply to the trust because the entire trust is subject to the rules of subpart E, part I, subchapter J, chapter 1, subtitle A of the Code.

HOLDING

The taxable year of a trust that is treated as wholly-owned by a grantor under the rules of subpart E, part I, subchapter J, chapter 1, subtitle A of the Code is not required to be the calendar year under section 645(a).

Subpart E.—Grantors and Others Treated as Substantial Owners

Section 671.—Trust Income, Deductions, and Credits Attributable to Grantors and Others as Substantial Owners

26 CFR 1.671-1: Grantors and others treated as substantial owners; scope.
(Also Section 552; 1.552-1.)

Trust income attributable to transferor-owner of foreign trust. The tax consequences of income earned by a foreign trust from recording rights licensed to the trust by a personal service corporation of a resident alien entertainer are described. Rev. Rul. 80-74 amplified.

Rev. Rul. 90-106

ISSUES

Issue 1

What is the federal income tax treatment of the income earned by a trust established in a foreign country by a resident alien entertainer in the circumstances described in *Situation 1*?

Issue 2

What is the federal income tax treatment of the income earned by a foreign corporation in the circumstances described in *Situation 2*?

Issue 3

Is the foreign corporation described in *Situation 2* a foreign personal holding company within the meaning of section 552(a) of the Internal Revenue Code of 1986, and is the company's undistributed foreign personal holding company income includible in the entertainer's gross income pursuant to section 551(a) of the Code?

FACTS

Situation 1

A, a resident alien entertainer, organizes *PSC*, a domestic personal service corporation, and transfers to *PSC* the rights to one or more of his recordings in return for all of the stock of *PSC*. *A* also establishes a foreign trust, the beneficiaries of which are the individual members at any given time of a national association of entertainers of which *A* is also a member. The trustee, a nonadverse party under section 672(b) of the Code, has absolute discretion to manage and deal with the trust property (including selling or lending such property) in any fashion and on whatever terms the trustee chooses and to distribute income and corpus to any of the individual trust beneficiaries the trustee chooses. *A* has the unrestricted power to dismiss the trustee at any time and replace the trustee with whomever *A* chooses. No distributions have ever been made from the trust.

A transfers to the foreign trust all of the outstanding stock of a foreign corporation, *FC*, which is licensed by *PSC* through a royalty agreement to reproduce one or more of *A*'s re
ings. *FC* performs no significant
vices with respect to the reco
rights and relicenses the reco
rights to an unrelated company i
arm's-length transaction for a ro
that exceeds the royalty that *FC*
pay to *PSC* for the same rights.
derives all of its income from
royalties. A portion of the ro
income earned by *FC* is in turn
to *PSC* in the form of a royalty.
remainder of the earnings of *FC*
distributed annually to the trus
dividends.

Situation 2

The facts are the same as in S
tion 1, except that *FC*, instea
distributing its income to the tru
dividends, accumulates and re
the income.

LAW AND ANALYSIS

Situation 1

The substance, rather than
form, of a transaction in whic
taxpayer is involved governs the
consequences of the transaction.
for example, *Commissioner v. C
Holding Company*, 324 U.S.
(1945), 1945 C.B. 58; *Helverin
Clifford*, 309 U.S. 331 (1940), 19
C.B. 105; *Gregory v. Helvering*,
U.S. 465, XIV-1 C.B. 193 (1935)
Zmuda v. Commissioner, 79
714, 719 (1982), the Tax Court
served that

> [i]t is well established that a
> payer has the legal right to
> mize his taxes or avoid them to
> by any means which the law
> mits. *Gregory v. Helvering*,
> U.S. 465, 469 (1935). However,
> right does not bestow upon
> taxpayer the right to structu
> paper entity to avoid tax when
> entity does not stand on the
> foundation of economic re

A trust will be disregarded fo
purposes if it has no substance,
ty, or purpose, and the income o
trust will be included in the
income of the person who co
the trust. *Zmuda, supra*, at page

The facts and circumstances o
case indicate that *A* controls the
eign trust. The economic subst
therefore, is the same as if *PSC*
directly licensed the recording

to the unrelated company. Through *A*'s control of *PSC* and the trust and his indirect control of *FC* (through the trust), *A* retains effective control over the entire royalty income. The trust has no substance, utility, or purpose apart from tax considerations, so the income of the trust will be included in *A*'s gross income. See, for example, Rev. Rul. 80-74, 1980-1 C.B. 137. The fact pattern set forth in this ruling is one of many where a trust may be disregarded. Whenever the facts and circumstances indicate that the grantor controls the trust, the same analysis will apply.

Even if the trust withstood the foregoing analysis, sections 674(a), 675, and 677(a) of the Code generally require the grantor to be treated as the owner of any portion of a trust over which the grantor or a nonadverse party controls the beneficial enjoyment of the corpus or income, with respect to which the grantor or a nonadverse party retains certain powers enabling the grantor to deal with the trust property for less than full and adequate consideration or to borrow trust funds without adequate security, or the income of which may, in the discretion of the grantor or a nonadverse party, be distributed or accumulated for future distribution to the grantor. Under section 671 of the Code, if the transferor of property to a trust is treated as the owner of any portion of the trust as a result of application of the rules in subpart E, then the items of income, deduction, and credits that are attributable to that portion of the trust must be taken into account in computing the transferor's taxable income. Under the facts here, *A* will be treated as the owner of the trust under sections 674(a), 675 and 677(a) of the Code.

A also will be treated as owner of the trust under section 679 of the Code. Section 679 provides generally that a United States person who transfers, directly or indirectly, property to a foreign trust will be treated as the owner of the portion of the trust attributable to the transferred property for any year in which there is a United States beneficiary of any portion of the trust. The definition of "United States person" in section 7701(a)(3) includes a citizen or resident of the United States as well as a domestic corporation.

Section 482 of the Code provides that, in any case of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interest, the Secretary or his delegate may allocate gross income and deductions between such organizations, if he determines that such allocation is necessary to prevent evasion of taxes or to clearly reflect the income of the organizations. The definition of "organization" in section 1.482-1(a)(1) of the Income Tax Regulations includes a trust, whether domestic or foreign. Section 1.482-1(a)(3) of the regulations defines the term "controlled" as any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not the form or the mode or its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

In this case, *PSC* and *FC* are commonly controlled by *A*. An arm's length royalty for the recording rights in issue is established by the licensing agreement between *FC* and the unrelated company. Because *FC* performs no significant services, the payment by *FC* to *PSC* of a royalty that is less than the arm's-length royalty paid *FC* by the unrelated company distorts the true incomes of *PSC* and *FC*. Section 482 of the Code authorizes the Service to allocate income from *FC* to *PSC* to reflect the correct income of each corporation.

Situation 2

As in *Situation 1*, the licensing agreement between *FC* and the unrelated company establishes an arm's length royalty rate for the recording rights. Section 482 of the Code authorizes the Service to allocate income from *FC* to *PSC* to reflect the correct income of each corporation. The allocation authorized by section 482 of the Code in *Situation 2* is the same amount as may be allocated in *Situation 1* under section 482.

As an alternative to an allocation of income under section 482 of the Code, income will be reallocated in *Situation 2* under the foreign personal holding company provisions of the Code. Sections 551 through 554. In *Situation 2*, *FC* accumulates its income instead of distributing it in dividends to the trust. Since the trus is without substance and may be dis regarded for tax purposes, *A* retains effective control over the trust's property, including the stock in *FC* owned by the trust. Since *A* is deemed to own 100 percent of the outstanding stock of *FC* and well over 60 percent of *FC*'s gross income will be foreign personal holding company income, *FC* will be subject to deemed distributions of foreign personal holding company income under section 551(a) of the Code.

HOLDINGS

Issue 1

A must include in gross income the income earned by the foreign trust described in *Situation 1*.

Issue 2

The income of *FC* described in *Situation 2* may be allocated to *PSC* under section 482 of the Code to the extent necessary to reflect the correct income of each corporation.

Issue 3

In *Situation 2*, *FC* is a foreign personal holding company under section 552(a) of the Code, and its undistributed foreign personal holding company income is includible in *A*'s gross income.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 80-74, 1980-1 C.B. 137, is amplified.

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26 CFR 1.671-3: Attribution or inclusion of income, deductions, and credits against tax.

Whether taxable year of a "grantor" trust is required to be the calendar year. See Rev. Rul. 90-55, page 161.

Section 676.—Power to Revoke

26 CFR 1.676(a)-1: Power to revest title to portion of trust property in grantor; general rule.

Whether taxable year of a "grantor" trust is required to be the calendar year. See Rev. Rul. 90-55, page 161.

Subchapter K.—Partners and Partnerships
Part I.—Determination of Tax Liability

Section 702.—Partners, Not Partnership, Subject to Tax

If a foreign person engages in United States barter transactions through a partnership or through a dependent agent, is gain or loss recognized on each separate barter transaction? See Rev. Rul. 90-80, page 170.

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

Section 805.—General Deductions

An administrative procedure is provided whereby certain life insurance companies may expeditiously obtain the consent of the Commissioner to change their method of accounting for ceding commissions to comply with the principles of Rev. Rul. 82-69 and the Supreme Court decision in *Colonial American Life Insurance Co.* See Rev. Proc. 90-36, page 357.

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 1990. See Rev. Rul. 90-52, page 192.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1990. See Rev. Rul. 90-66, page 194.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1990. See Rev. Rul. 90-75, page 195.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1990. See Rev. Rul. 90-81, page 196.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1990. See Rev. Rul. 90-92, page 198.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1990. See Rev. Rul. 90-99, page 199.

Section 809.—Reduction in Certain Deductions of Mutual Life Insurance Companies

Mutual life insurance companies; differential earnings rate. The differential earnings rate for 1989 and the recomputed differential earnings rate for 1988 are set forth for use by mutual life insurance companies to compute their income tax liability for 1989.

Rev. Rul. 90-73

This revenue ruling contains the differential earnings rate for 1989 and the recomputed differential earnings rate for 1988. Under section 809 of the Internal Revenue Code, mutual life insurance companies use these rates in computing their income tax liability for 1989. This revenue ruling also contains some of the figures on which the determinations of these rates are based. Announcement 90-42, 1990-13 I.R.B. 24, contained tentative determinations of these same rates.

Section 809(a) of the Code provides that, in the case of any mutual life insurance company, the amount of the deduction allowable under section 808 for policyholder dividends shall be 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 section 808 shall be taken into account as a reduction in the closing balance of reserves under subsections (a) and (b) of section 807. The "differential earnings amount" for any taxable year is an 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 such 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 an amount which 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) of the Code 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 such taxable year, such excess shall be 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 such taxable year, such excess shall be 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 such 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.

For purposes of section 809 of the Code, the differential earnings rate for 1989, the rate used to calculate the recomputed differential earnings amount for 1988 (the recomputed differential earnings rate for 1988), and the figures on which these two rates are based are set forth in Table 1.

Rev. Rul 90-73 Table 1	
Differential earnings rate for 1989	4.206
Recomputed differential earnings rate for 1988	0.945
Imputed earnings rate for 1989	12.941
Base period stock earnings rate	18.221
Current stock earnings rate for 1989	14.291
Stock earnings rate for 1981	17.316
Stock earnings rate for 1982	18.812
Stock earnings rate for 1983	18.535
Stock earnings rate for 1984	16.731
Stock earnings rate for 1985	18.683
Stock earnings rate for 1986	20.279
Stock earnings rate for 1987	9.239
Stock earnings rate for 1988	13.355
Average mutual earnings rate for 1987	8.735
Average mutual earnings rate for 1988	13.604

Regulations under section 809 of the Code have not yet been issued, and when these regulations are issued, they may be effective prior to the date of their issuance. Even if that is the case, however, in determining the rates that are to be used in computing 1989 tax liability, the Internal Revenue Service will not change the administrative procedures that govern its determination of the rates announced in this revenue ruling. Moreover, the Service generally will not restate any of the rates announced in this ruling to reflect subsequent changes in the data on which the rate is based, such as a change resulting from the audit of a life insurance company. Regulations or other pronouncements, however, may result in a change in these and other procedures for determination of the rates to be used in computing the tax liability of subsequent years.

Subpart D.—Accounting, Allocation, and Foreign Provisions

Sections 811.—Accounting Provisions

An administrative procedure is provided whereby certain life insurance companies may expeditiously obtain the consent of the Commissioner to change their method of accounting for ceding commissions to comply with the principles of Rev. Rul. 82-69 and the Supreme Court decision in *Colonial American Life Insurance Co.* See Rev. Proc. 90-36, page 357.

Subpart E.—Definitions and Special Rules

Section 817.—Treatment of Variable Contracts

26 CFR 1.817-4(d): Certain other reinsurance transactions.

An administrative procedure is provided whereby certain life insurance companies may expeditiously obtain the consent of the Commissioner to change their method of accounting for ceding commissions to comply with the principles of Rev. Rul. 82-69 and the Supreme Court decision in *Colonial American Life Insurance Co.* See Rev. Proc. 90-36, page 357.

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 1990. See Rev. Rul. 90-52, page 192.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1990. See Rev. Rul. 90-66, page 194.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1990. See Rev. Rul. 90-75, page 195.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1990. See Rev. Rul. 90-81, page 196.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1990. See Rev. Rul. 90-92, page 198.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1990. See Rev. Rul. 90-99, page 199.

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 1.852-11T: Treatment of certain losses attributable to periods after October 31 of a taxable year of a regulated investment company (temporary).

What is the first tax year to which an election under section 4982(e)(4) of the Code applies for purposes of section 852(b)(3)(C)? See Rev. Rul. 90-57, page 247.

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26 CFR 1.852-11: Treatment of certain losses attributable to periods after October 31 of a taxable year.

T.D. 8320

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

Treatment of Certain Losses Attributable to Periods After October 31 of a Taxable Year of a Regulated Investment Company

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations concerning the treatment by a regulated investment company (RIC) of a net capital loss, a net long-term capital loss, or a net foreign currency loss attributable to periods after October 31 of its taxable year (a "post-October loss"). The

applicable tax law was amended by the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988. The final regulations provide guidance relating to the treatment of a post-October loss in determining a RIC's taxable income, the amount that a RIC may designate as capital gain dividends, and the RIC's earnings and profits.

EFFECTIVE DATE: The regulations are effective for taxable years of a regulated investment company ending after October 31, 1987.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in this final regulation have been reviewed and approved by the Office of Management and Budget in accordance with the requirements of the Paperwork Reduction Act (44 U.S.C. 3504(h)) under control number 1545-1094. The estimated annual burden per respondent varies from 10 minutes to 20 minutes, depending on individual circumstances, with an estimated average of 15 minutes.

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

Comments regarding the accuracy of this burden estimate and suggestions for reducing this burden should be directed to the Internal Revenue Service, Attention: IRS Reports Clearance officer T:FP, Washington, D.C. 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, D.C. 20503.

Background

On January 31, 1990, the Federal Register published a notice of proposed rulemaking (55 FR 3231) [FI-105-88, 1990-1 C.B. 630] by cross-reference to temporary regulations [T.D. 8287, 1990-1 C.B. 130] published in the Federal Register for the same day (55 FR 3211) under section 852 of the Internal Revenue Code of 1986. The temporary and proposed regulations reflected the addition of Code section 852(b)(8) and the amendment of Code sections 852(b)(3) and 852(c) by sections 651(b)(2) and (3) of the Tax Reform Act of 1986 (Pub. L. 99-514; 100 Stat. 2085 [1986-3 C.B. (Vol. 1) 1]) and sections 1006(l)(3), (4), and (7) of the Technical and Miscellaneous Revenue Act of 1988 (Pub. L. 100-647; 102 Stat. 3342 [1988-3 C.B. 1]).

The regulations were intended to improve the coordination between the income tax provisions applicable to a RIC under section 852 and the provisions of section 4982, which imposes an excise tax on a RIC that fails to distribute a certain amount of its income. Section 4982 uses a 12-month period ending on October 31 in determining capital gain net income subject to the excise tax distribution requirement for the calendar year. To avoid certain mismatches between the distribution requirements under the excise tax provisions and those under the income tax provisions, section 852 provides for special income tax treatment of a post-October loss.

The regulations provided guidance relating to the determination of the amount that a RIC may designate as capital gain dividends and to the determination of earnings and profits by a RIC when it has a post-October loss.

In addition, the regulations provided procedures by which a RIC could elect to defer part or all of a post-October loss to the succeeding year for purposes of determining its taxable income. The regulations also provided guidance relating to the proper calculation of taxable income and earnings and profits for the years affected by the election.

One public comment was received concerning these regulations. No public hearing was requested, and accordingly none was held. After consideration of the written comment, the temporary regulations are adopted as revised by this Treasury Decision and the notice of proposed rulemaking is withdrawn.

Public Comment

The commentator suggested that §1.852-11T(c) (relating to the definition of a post-October loss) be amended to clarify that post-October declines in value on instruments that are required to be marked to market on October 31 for section 4982 purposes will be treated as post-October losses.

The conference report to the Tax Reform Act of 1986 states that "the conferees understand that in applying this rule (for determining the RIC's capital gain net income for excise tax purposes), the period ending October 31 of each calendar year would be treated as the taxpayer's taxable year for purposes of the capital loss carryover provisions and for purposes of the year-end straddle and mark to market rules." H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-243 n. 29. Thus, all provisions that normally apply in determining a RIC's capital gains or losses for taxable income purposes on the last day of its taxable year also apply in determining its capital gain net income for excise tax purposes on October 31. In the case of assets that are required to be marked to market, for example, the amounts determined on October 31 then become the benchmark for future determinations of gains or losses for excise tax (but not income tax) purposes. Because of this, it is possible for an asset to have two separate adjusted bases—one for income tax purposes and another for excise tax purposes. This does not pose a problem if there is no post-October loss for the taxable year. However, if there is a post-October loss, there must be parallel treatment of gains and losses for both income tax and excise tax purposes so that the RIC's earnings and profits for the year will be adequate to treat all amounts distributed for excise tax purposes as dividends.

Accordingly, §1.852-11(c) of the final regulations provides that any item (other than a capital loss carryover) that is required to be taken into account or any rule that must be applied, for purposes of section 4982, on October 31 as if it were the last day of the RIC's taxable year must also be taken into account or applied both on October 31 and again on the last day of the RIC's taxable year for purposes of determining whether the RIC has a post-October loss for the taxable year. Thus, for example, if losses are not taken into account for purposes of section 4982 due to application of section 1092 on October 31

but are taken into account for purposes of determining the RIC's taxable income for the taxable year, the losses will be treated as sustained during the post-October period of the taxable year for purposes of determining whether the RIC has a post-October capital loss.

If, using this methodology, the RIC has a post-October loss, any item that must be marked to market for purposes of section 4982 on October 31 as if it were the last day of the RIC's taxable year must also be marked to market on October 31 and again on the last day of the RIC's taxable year for purposes of determining its taxable income. This rule does not apply, however, for purposes of determining the RIC's gross income for purposes of sections 851(b)(2) or (3).

The commentator also suggested that §1.852-11T(f) (relating to the elective deferral of post-October capital losses and post-October currency losses for purposes of determining taxable income) be amended to clarify that the deferral of a post-October loss for taxable income purposes causes such losses to be treated as arising on the first day of the RIC's next fiscal year for purposes of computing the capital loss carryforward period. In response to this comment, the regulations have been revised to clarify that a post-October loss deferred for purposes of determining a RIC's taxable income is treated as having actually arisen on the first day of the RIC's taxable year immediately succeeding the loss year not only for the loss year and the immediately succeeding year, but also for all years following. See §1.853-11(f).

The commentator further suggested that §1.852-11T(j) (relating to the transition rules) be amended to (1) permit year-to-year netting of overdistributions and underdistributions, and (2) permit a retroactive capital gain designation to be made solely for purposes of computing the RIC-level dividends paid deduction.

The purpose of the RIC excise tax is to match the timing of the shareholders' inclusion in taxable income of dividends received from a RIC to the calendar year in which the RIC earned the income. A RIC that has been forced to overdistribute or that did not designate the maximum amount allowable as capital gain dividends because no election was available at the time may nevertheless have paid out in total more than its actual income. Accordingly, the regulations are amended to provide that a RIC may "pay" a retroactive dividend under rules similar to the provisions for throwback (spillover) dividends under section 855 of the Code, either out of an overdistribution arising in the succeeding year as a result of the retroactive election or by paying a dividend on or before December 31, 1990. The regulations also provide that a RIC may recharacterize previously distributed dividends as capital gain dividends for purposes of determining its dividends paid deduction for the years affected.

Dividends "paid" by either method may be either ordinary or capital, within the limitations prescribed by section 852(b)(3)(C) of the Code and §1.852-11(e) of the regulations. A change in the timing or character of distributions may, however, apply for certain other purposes relating to dividend distributions for years affected by the retroactive election (as, for example, the determination of the RIC's distribution requirements under section 4982).

Furthermore, as of the date of these amendments, some RICs may have already paid a retroactive dividend in accordance with the rules set forth in temporary regulations §1.852-11T. Although the final regulations set forth in this Treasury Decision require a RIC to make an irrevocable election in order to pay a retroactive dividend, the manner in which a RIC must make a retroactive election and pay aretroactive dividend under §1.852-11T is the same as the method of making the election to pay an additional dividend required in the final rules. Therefore, if a RIC complies with the provisions of temporary regulations §1.852-11T(j), it also complies with the provisions of §1.852-11(j).

The regulations have also been revised to permit a retroactive capital gain designation to be made for purposes of computing the RIC-level dividends paid deduction.

Finally, the commentator recommended that the operation of the transition rules not affect the tax treatment of RIC shareholders. The Internal Revenue Service recognizes that the retroactive adjustments to RIC income and deductions are necessary because the regulations regarding deferral of post-October losses were not issued at the time the distributions were originally made. Thus, to the extent that a RIC's reporting position changes as a result of making a retroactive election, the Service views the adjustments made as being purely a matter of RIC accounting and having no effect on its shareholders.

The Internal Revenue Service has determined however that no amendment to the regulations is necessary under the circumstances and therefore no amendment to the regulations has been adopted.

Special Analyses

The Commissioner of Internal Revenue has determined that this final rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis therefore is not required.

Although a notice of proposed rulemaking that solicited public comment was issued, the Internal Revenue Service concluded when the notice was issued that the notice and public procedure requirements of 5 U.S.C. 553 did not apply. Accordingly, the final regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. Chapter 6).

* * * * *

Adoption of Amendments to the Regulations

Accordingly, Title 26, Parts 1 and 602 of the Code of Federal Regulations is amended as follows:

PART 1—INCOME TAX; TAXABLE YEARS ENDING AFTER OCTOBER 31, 1987

Paragraph 1. The authority for Part 1 is amended by removing the entry for §1.852–11T and adding the entry for §1.852–11:

Authority: 26 U.S.C. 7805; * * * Section 1.852-11 is also issued under 26 U.S.C. 852(b)(3)(C), 852(b)(8), and 852(c).

Par. 2. Section 1.852-11T is redesignated as §1.852-11 and the word "(Temporary)" is removed from the end of the section heading.

Par. 3. §1.852-11, as redesignated, is amended as follows:

1. The words "paragraph (c)(1) of this section" are removed from each place they appear in paragraphs (e)(2)(i), (f)(3)(i), and (f)(3)(ii)(A) and the words "paragraph (c)(1)(i) of this section" are added in their place.

2. The words "paragraph (c)(2) of this section" are removed from each place they appear in paragraphs (e)(2)(ii), (f)(3)(iii), and (f)(3)(iv) and the words "paragraph (c)(1)(ii) of this section" are added in their place.

3. The words "paragraph (c)(1) or (c)(2) of this section" are removed from paragraph (e)(3) and the words "paragraph (c)(1)(i) or (c)(1)(ii) of this section" are added in their place.

4. The words "from sales or exchanges after October 31 of" are removed from each place they appear in paragraphs (e)(2)(i), (e)(2)(ii), (f)(3)(i), (f)(3)(ii)(A), (f)(3)(iii), (f)(3)(iv), and (j)(1) and the words "taken into account in computing the post-October capital loss for" are added in their place.

5. The words "attributable to sales or exchanges after October 31 of" are removed from paragraph (f)(3)(ii)(B) and the words "taken into account in computing the post-October capital loss for" are added in their place.

6. The words "from sales or exchanges during" are removed from example (2) of paragraph (h) and the word "for" is added in their place.

7. The words "from sales or exchanges made during" are removed from examples (5) and (8) of paragraph (h) and the word "for" is added in their place.

8. The words "attributable to transactions after October 31 of" are removed from each place they appear in paragraphs (f)(3)(v) and (f)(3)(vi) and the words "taken into account in computing the post-October currency loss for" are added in their place.

9. The words "transactions during" are removed from example (11) of paragraph (h).

10. Paragraphs (a), (c), (d)(1), (f)(4), (j)(2)(i), (j)(4), and (j)(5) are revised to read as follows:

§1.852-11 Treatment of certain losses attributable to periods after October 31 of a taxable year.

(a) *Outline of provisions.* This paragraph lists the provisions of this section.

(a) Outline of provisions.

(b) Scope.

(1) In general.

(2) Limitation on application of section.

(c) Post-October capital loss defined.

(1) In general.

(2) Methodology.

(3) October 31 treated as last day of taxable year for purpose of determining taxable income under certain circumstances.

(i) In general.

(ii) Effect on gross income.

(d) Post-October currency loss defined.

(1) Post-October currency loss.

(2) Net foreign currency loss.

(3) Foreign currency gain or loss.

(e) Limitation on capital gain dividends.

(1) In general.

(2) Amount taken into account in current year.

(i) Net capital loss.

(ii) Net long-term capital loss.

(3) Amount taken into account in succeeding year.

(f) Regulated investment company may elect to defer certain losses for purposes of determining taxable income.

(1) In general.

(2) Effect of election in current year.

(3) Amount of loss taken into account in current year.

(i) If entire amount of net capital loss deferred.

(ii) If part of net capital loss deferred.

(A) In general.

(B) Character of capital loss not deferred.

(iii) If entire amount of net long-term capital loss deferred.

(iv) If part of net long-term capital loss deferred.

(v) If entire amount of post-October currency loss deferred.

(vi) If part of post-October currency loss deferred.

(4) Amount of loss taken into account in succeeding year and subsequent years.

(5) Effect on gross income.

(g) Earnings and profits.

(1) General rule.

(2) Special rule—treatment of losses that are deferred for purposes of determining taxable income.

(h) Examples.

(i) Procedure for making election.

(1) In general.

(2) When applicable instructions not available.

(j) Transition rules.

(1) In general.

(2) Retroactive election.

(i) In general.

(ii) Deadline for making election.

(3) Amended return required for succeeding year in certain circumstances.

(i) In general.

(ii) Time for filing amended return.

(4) Retroactive dividend.

(i) In general.

(ii) Method of making election.

(iii) Deduction for dividends paid.

(A) In general.

(B) Limitation on ordinary dividends.

(C) Limitation on capital gain dividends.

(D) Effect on other years.

(iv) Earnings and profits.

(v) Receipt by shareholders.

(vi) Foreign tax election.

(vii) Example.

(5) Certain distributions may be designated retroactively as capital gain dividends.

(k) Effective date.

* * * * *

(c) *Post-October capital loss defined*—(1) *In general.* For purposes of this section, the term "post-October capital loss" means—

(i) Any net capital loss attributable to the portion of a regulated investment company's taxable year after October 31; or

(ii) If there is no such net capital loss, any net long-term capital loss attributable to the portion of a regulated investment company's taxable year after October 31.

(2) *Methodology.* The amount of any net capital loss or any net long-term capital loss attributable to the portion of the regulated investment company's taxable year after October 31 shall be determined in accordance with general tax law principles (other than section 1212) by treating the period beginning on November 1 of the taxable year of the regulated investment company and ending on the last day of such taxable year as though it were the taxable year of the regulated investment company. For purposes of this paragraph (c)(2), any item (other than a capital loss carryover) that is required to be taken into

account or any rule that must be applied, for purposes of section 4982, on October 31 as if it were the last day of the regulated investment company's taxable year must also be taken into account or applied in the same manner as required under section 4982, both on October 31 and again on the last day of the regulated investment company's taxable year.

(3) *October 31 treated as last day of taxable year for purpose of determining taxable income under certain circumstances*—(i) *In general.* If a regulated investment company has a post-October capital loss for a taxable year, any item that must be marked to market for purposes of section 4982 on October 31 as if it were the last day of the regulated investment company's taxable year must also be marked to market on October 31 and again on the last day of the regulated investment company's taxable year for purposes of determining its taxable income. If the regulated investment company does not have a post-October capital loss for a taxable year, the regulated investment company must treat items that must be marked to market for purposes of section 4982 on October 31 as if it were the last day of the regulated investment company's taxable year as marked to market only on the last day of its taxable year for purposes of determining its taxable income.

(ii) *Effect on gross income.* The marking to market of any item on October 31 of a regulated investment company's taxable year for purposes of determining its taxable income under paragraph (c)(3)(i) of this section shall not affect the amount of the gross income of such company for such taxable year for purposes of section 851(b)(2) or (3).

(d) *Post-October currency loss defined.* For purposes of this section—

(1) *Post-October currency loss.* The term "post-October currency loss" means any net foreign currency loss attributable to the portion of a regulated investment company's taxable year after October 31. For purposes of the preceding sentence, principles similar to those of paragraphs (c)(2) and (c)(3) of this section shall apply.

* * * * *

(f) * * *

(4) *Amount of loss taken into account in succeeding year and subsequent years.* If a regulated investment company has a post-October capital loss or a post-October currency loss for any taxable year and an election under paragraph (f)(1) is made for that year, then, for purposes of determining the taxable income of the company for the succeeding year and all subsequent years, all capital gains and losses taken into account in determining the post-October capital loss, and all foreign currency gains and losses taken into account in determining the post-October currency loss, that are not taken into account under the rules of paragraph (f)(3) of this section in determining the taxable income of the regulated investment company for the taxable year in which the loss arose shall be treated as arising on the first day of the succeeding year.

* * * * *

(j) * * * (2) *Retroactive election*—(i) *In general.* A regulated investment company may make an election (a "retroactive election") under paragraph (f)(1) for a taxable year with respect to which it has filed an income tax return on or before May 1, 1990 (a "retroactive election year") by filing an amended return (including any necessary schedules) for the retroactive election year reflecting the appropriate amounts and by attaching a written statement to the return that complies with the requirements of paragraph (i)(2) of this section.

* * * * *

(4) *Retroactive dividend*—(i) *In general.* A regulated investment company that makes a retroactive election under this section for a retroactive election year may elect to treat any dividend (or portion thereof) declared and paid (or treated as paid under section 852(b)(7)) by the regulated investment company after the retroactive election year and on or before December 31, 1990, as having been paid during the retroactive election year (a "retroactive dividend"). This election shall be irrevocable with respect to the retroactive dividend to which it applies.

(ii) *Method of making election.* The election under this paragraph (j)(4) must be made by the regulated investment company by treating the dividend (or portion thereof) to which the election applies as a dividend paid during the retroactive election year in computing its deduction for dividends paid in its tax returns for all applicable years (including the amended return(s) required to be filed under paragraphs (j)(2) and (3) of this section).

(iii) *Deduction for dividends paid*—(A) *In general.* Subject to the rules of sections 561 and 562, a regulated investment company shall include the amount of any retroactive dividend in computing its deduction for dividends paid for the retroactive election year. No deduction for dividends paid shall be allowed under this paragraph (j)(4)(iii)(A) for any amount not paid (or treated as paid under section 852(b)(7)) on or before December 31, 1990.

(B) *Limitation on ordinary dividends.* The amount of retroactive dividends (other than retroactive dividends qualifying as capital gain dividends) paid for a retroactive election year under this section shall not exceed the increase, if any, in the investment company taxable income of the regulated investment company (determined without regard to the deduction for dividends paid (as defined in section 561)) that is attributable solely to the regulated investment company having made the retroactive election.

(C) *Limitation on capital gain dividends.* The amount of retroactive dividends qualifying as capital gain dividends paid for a retroactive election year under this section shall not exceed the increase, if any, in the amount of the excess described in section 852(b)(3)(A) (relating to the excess of the net capital gain over the deduction for capital gain dividends paid) that is attributable solely to the regulated investment company having made the retroactive election.

(D) *Effect on other years.* A retroactive dividend shall not be includible in computing the deduction for dividends paid for—

(1) The taxable year in which such distribution is actually paid (or treated as paid under section 852(b)(7)); or

(2) Under section 855(a), the taxable year preceding the retroactive election year.

(iv) *Earnings and profits.* A retroactive dividend shall be considered as paid out of the earnings and profits of the retroactive election year (computed with the application of sections

852(c) and 855, §1.852-5, §1.855-1, and this section), and not out of the earnings and profits of the taxable year in which the distribution is actually paid (or treated as paid under section 852(b)(7)).

(v) *Receipt by shareholders.* Except as provided in section 852(b)(7), a retroactive dividend shall be included in the gross income of the shareholders of the regulated investment company for the taxable year in which the dividend is received by them.

(vi) *Foreign tax election.* If a regulated investment company to which section 853 (relating to foreign taxes) is applicable for a retroactive election year elects to treat a dividend paid (or treated as paid under section 852(b)(7)) during the taxable year as a retroactive dividend, the shareholders of the regulated investment company shall consider the amounts described in section 853(b)(2) allocable to such distribution as paid or received, as thecase may be, in the shareholder's taxable year in which the distribution is made.

(vii) *Example.* The provisions of this paragraph (j)(4) may be illustrated by the following example:

Example. X is a regulated investment company that computes its income on a calendar year basis. No election is in effect under section 4982(e)(4). X has the following income for 1988:

FOREIGN CURRENCY GAINS AND LOSSES:

	Gains and Losses
Jan. 1 - Oct. 31	100
Nov. 1 - Dec. 31	(75)

CAPITAL GAINS AND LOSSES:

	Short-Term	*Long-Term*
Jan. 1 Oct. 31	100	100
Nov. 1 - Dec. 31	50	(100)

(A) X had investment company taxable income of $175 and no net capital gain for 1988 for taxable income purposes. X distributed $175 of investment company taxable income as an ordinary dividend for 1988.

(B) If X makes a retroactive election under this section to defer the entire $75 post-October currency loss and the entire $50 post-October capital loss for the post-October period of its 1988 taxable year for purposes of computing its taxable income, that deferral increases X's investment company taxable income for 1988 by $25 (due to an increase in foreign currency gain of $75 and a decrease in short-term capital gain of $50) to $200 and increases the excess described in section 852(b)(3)(A) for 1988 by $100 from $0 to $100. The amount that X may treat as a retroactive ordinary dividend is limited to $25, and the amount that X may treat as a retroactive capital gain dividend is limited to $100.

(5) *Certain distributions may be designated retroactively as capital gain dividends.* To the extent that a regulated investment company designated as capital gain dividends for a taxable year less than the maximum amount permitted under paragraph (e) of this section for that taxable year, the regulated investment company may designate an additional amount of dividends paid (or treated as paid under sections 852(b)(7) or 855, or paragraph (j)(4) of this section) for the taxable year as capital gain dividends, notwithstanding that a written noice was not mailed to its shareholders within 60 days after the close of the taxable year in which the distribution was paid (or treated as paid under section 852(b)(7)).

* * * * *

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 4. The authority citation for Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 5. The table of OMB control numbers in §602.101(c) is amended by removing the entry for §1.852-11T and adding an entry reading: "1.852-11 * * * 1545-1094".

Fred T. Goldberg, Jr.,
Commissioner of Internal Revenue.

Approved November 24, 1990.

Kenneth W. Gideon,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on November 29, 1990, 4:30 p.m., and published in the issue of the Federal Register for December 5, 1990, 55 F.R. 50174)

Subchapter N.—Tax Based on Income from Sources Within or Without the United States

Part II.—Nonresident Aliens and Foreign Corporations

Subpart A.—Nonresident Alien Individuals

Section 871.—Tax on Nonresident Alien Individuals

(Also Sections 702, 875, 894, 1001, 7701; 26 CFR 301.7701-2.)

Barter transactions of foreign persons. Foreign persons who engage in U.S. barter transactions through a partnership or through a dependent agent are subject to U.S. tax on gain from such transactions.

Rev. Rul. 90-80

ISSUE

Are the foreign persons in the two situations described below subject to United States tax on gain from barter transactions in the United States?

FACTS

Situation 1

A, a calendar year taxpayer, is a citizen and resident of the United States. *B* is a citizen and resident of *FC*, a foreign country that has an income tax convention with the United States (the Convention) identical with the draft United States Model Income Tax Convention of 1981.

On January 1, 1989, *A* and *B* entered into a written agreement (the Agreement) under which *A* and *B* will each contribute $10,000 to fund barter transactions in the United States. *A* will use the cash to purchase goods and services within the United States from sellers who have an oversupply of goods and services, and will then barter those goods and services for others with the intent of making a profit. The Agreement provides that *A* and *B* are jointly and severally liable for obligations arising under these barter transactions, and also, that any disputes arising between *A* and *B* under the Agreement will be governed by *FC* law. Further, under the Agreement, either party can terminate the venture at will and neither *A* or *B*'s interest can be transferred.

The Agreement allocates two-thirds of all profits and losses to *A* and one-third to *B*. In order to be able to distribute profits in cash, *A* will from time to time exchange some of the bartered goods and services for cash.

A will maintain an office in the United States to conduct the barter transactions and to store the goods obtained thereby. *A* will not trade in stocks, securities or commodities within the meaning of section 864(b)(2) of the Internal Revenue Code.

In January of 1989, *A* purchased goods and services from United States sellers with the $20,000. During the year, *A* entered into a large number of separate barter transactions. *A* did not exchange any goods or services for cash. The profit from all 1989 transactions was $90,000.

Situation 2

D, a citizen and resident of *FC* (described in *Situation 1*), wished to invest $20,000 in the United States. On January 1, 1989, *D* entered into a written agreement (the Agreement) with *C*, a citizen and resident of the United States. The Agreement gives *C* the authority to negotiate and conclude barter transactions in *D*'s name. *C* will act only on behalf of *D* in these transactions, will be under *D*'s management and control, and will have no other employment during 1989.

Acting under the Agreement, *C* maintained an office and performed bartering activities identical to those of *A* in *Situation 1*. After paying *C* for his services, *D* made a profit of $70,000 on the 1989 barter transactions.

LAW AND ANALYSIS

Under section 1001 of the Code, gain or loss will be recognized on each separate barter exchange. The amount of gain or loss will be the difference between the adjusted basis of the property exchanged and the fair market value of the property received.

Situation 1

The arrangement between *A* and *B* is a partnership (the Partnership) for United States tax purposes. *A* and *B* have contributed cash to conduct a profit-making activity; the profits and losses from that activity will be divided between them; they will be jointly and severally liable for obligations arising from the activity; the venture may be terminated at will by either party; and there is no free transferability by *A* or *B* of either of their interests. *See* section 7701(a)(2) of the Code and section 301.7701-2(a)(1), (2), and (3) of the Procedure and Administration Regulations.

Under Article 5 of the Convention, the Partnership has a permanent establishment in the United States by virtue of *A*'s barter activities performed in the United States on behalf of the Partnership and the United States office that *A* uses to conduct the barter transactions.

Article 5(1) of the Convention provides that the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on. Article 5(2)(c) provides that the term "permanent establishment" includes an office.

Article 5(5) of the Convention provides, in part, that notwithstanding the provisions of paragraph 1 and 2, where a person—other than an agent of an independent status—is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise. *A*'s activities performed on behalf of the Partnership are those of a general agent and therefore, come within the purview of Article 5(5).

Since the Partnership has a permanent establishment in the United States under Article 5 of the Convention, *B* is also treated as having a permanent establishment in the United States. in *Donroy, Ltd. v. United States*, 301 F.2d 200 (9th Cir. 1962), the court held that the general partner in a United States limited partnership was the general agent of the limited partners in the partnership, and that the office or permanent establishment of the partnership was the office of each of the partners—whether general or limited—for purposes of Article XI of the United States—Canadian Income Tax Convention of 1942. The decision in the *Donroy* case was recently relied upon by the Tax Court in *Unger v. Commissioner*, T.C.M. 1990-15. In that case, a Canadian limited partner in a United States limited partnership was found to have a permanent establishment in the United States because, under the first Protocol to the United States—Canadian Income Tax Convention of 1942, the limited partnership had a permanent establishment in the United States by virtue of its offices in Boston and its general partners' acting as its agents. *See also, Johnston v. Commissioner*, 24 T.C. 920 (1955). Also, Rev. Rul. 85-60, 1985-1 C.B. 187, held that income, received by a nonresident alien beneficiary of a foreign trust that is a limited partner in a U.S. partnership (which has a permanent establishment in the U.S.), is included in gross income of the beneficiary under section 871(b) of the Code and is not exempt from federal income tax under an income tax treaty because the beneficiary is considered to be in receipt of business profits attributable to that partnership's permanent establishment. *See also*, section 875(1) of the Code.

Under section 702 of the Code, *B*'s distributive share of the Partnership's 1989 income is $30,000 (one-third of $90,000). Since *B* is treated as having a permanent establishment in the United States for the taxable year 1989, *B*'s distributive share of the business profits of the Partnership that are attributable to the permanent establishment are taxable in the United States under Article 7(1) of the Convention. Article 7(1) provides that the profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. Article 7(1) further provides that if the enterprise carries on business as aforesaid, the business profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

The $30,000 profit is attributable to *B*'s permanent establishment and is therefore subject to United States taxation. Thus, *B* is subject to tax under section 871(b) of the Code on its $30,000 distributive share of the profits from the barter transactions. Under Section 871(b), *B*'s taxable income will be taxable as provided in section 1, or 55.

The Partnership, *A* and *B* must each file 1989 United States tax returns.

Situation 2

C has and habitually exercises in the United States the authority to conclude barter contracts and transactions in *D*'s name. *C* is not an independent agent because *C* has no other employment during 1989 and is under *D*'s management and control. Therefore, under Article 5 of the Convention, *D* has a permanent establishment in the United States in 1989 by virtue of the activities *C* undertakes for *D* and the office maintained by *C* for the purpose of conducting *D*'s barter transactions.

Since *D* is treated as having a permanent establishment in the United States, under Article 7(1) of the

Convention, the 1989 business profits of *D* that are attributable to its United States permanent establishment are taxable in the United States. The $70,000 profit that *D* derived from the barter transactions is attributable to *D*'s United States permanent establishment, and thus, those profits are subject to tax under section 871(b) of the Code. Under section 871(b), *D*'s taxable income will be taxable as provided in section 1 or 55.

D must file a 1989 United States tax return.

HOLDING

Situation 1

For 1989, *B* is subject to tax under section 871(b) of the Code on its $30,000 distributive share of the profits from the barter transactions.

Situation 2

For 1989, *D* is subject to tax under section 871(b) of the Code on its $70,000 profit from the barter transactions.

Section 874.—Allowance of Deductions and Credits

26 CFR 1.874-1: Allowance of deductions and credits to nonresident alien individuals.

T.D. 8322

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Untimely Filing of Income Tax Returns by Nonresident Alien Individuals and Foreign Corporations

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final Income Tax Regulations relating to denial of deductions and credits to nonresident alien individuals and foreign corporations that do not file true and accurate income tax returns by the time limits set forth in the final regulations. These regulations are necessary so that the income tax returns will be filed in a timely manner.

EFFECTIVE DATE: The amendments are effective July 31, 1990, for taxable years ending after July 31, 1990.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations at §§1.874-1 and 1.882-4 have been reviewed and approved by the Office of Management and Budget in accordance with the requirements of the Paperwork Reduction Act of 1980 (44 U.S.C. §3504 (h)) under control numbers 1545-0089 and 1545-0126. This information is required by the Internal Revenue Service to allow it to properly determine the taxable income of and tax owed by nonresident alien individuals and foreign corporations. The likely respondents are nonresident alien individuals and foreign corporations. The burdens on the nonresident alien individuals and foreign corporations are the burdens associated with Forms 1040NR and 1120F.

Comments concerning those burdens and suggestions for reducing those burdens should be directed to the Office of Management and Budget, Paperwork Reduction Project (1545-0089 and 1545-0126), Washington, D.C. 20503, with copies to the Internal Revenue Service, Attention: IRS Reports Clearance Officer T:FP, Washington, DC 20224.

Background

On July 31, 1989, (54 Fed. Reg. 31,545 (INTL-74-86, 1989-2 C.B. 823) the FEDERAL REGISTER published proposed amendments to the Income Tax Regulations (26 CFR Part 1) under sections 874 and 882 of the Internal Revenue Code. Written comments responding to this notice were received. A public hearing was not requested and none was held. After consideration of all comments regarding the proposed amendments, those amendments are adopted by this Treasury Decision with revisions in response to those comments. The comments and revisions are discussed below.

Explanation of Provisions

The proposed regulations at §1.874-1(b) with regard to nonresident alien individuals and §1.882-4(a)(3) with regard to foreign corporations provided that under sections 874(a) and 882(c)(2) otherwise allowable deductions and credits will be allowed only if a return is filed by the time limits as set forth in those regulations.

Under the proposed regulations, whether a return has been filed on a timely basis for purposes of section 874(a) or 882(c)(2) is dependent upon whether the nonresident alien individual or foreign corporation has filed a return for the taxable year immediately preceding the taxable year for which deductions or credits are claimed. If a return was filed for the immediately preceding taxable year, a return for the current taxable year must be filed within one year of the extended due date, as set forth in sections 6072 and 6081, for filing that return. If a return has not been filed for the immediately preceding taxable year, or if the current year is the first year for which a return is required under section 874(a) or 882(c)(2), the current year's return must have been filed no later than the earlier of the date which is one year after the extended due date, as set forth in sections 6072 and 6081, for filing that return or the date the Internal Revenue Service mails a notice informing the taxpayer that a tax return has not been filed and that no deductions or credits may be claimed.

Commenters questioned the validity of the filing deadlines as set forth in the proposed regulations. The filing deadlines were not eliminated in the final regulations, however, since the statute clearly provides for the denial of deductions and credits if returns are not filed in a timely manner. This requirement is justified because of different administrative and compliance concerns with regard to nonresident alien individuals and foreign corporations.

In response to a commenter's suggestion, the final regulations modify the filing deadline for the first taxable year for which a return is required to be filed. Under the final regulations, the filing deadline for those returns will be the same as if a return was filed for the immediately preceding taxable year.

A new §1.882-4(a)(3)(v) provides that in order to be eligible for any deductions and credits for purposes of computing the accumulated earn-

ings tax of section 531, a foreign corporation must file a true and accurate return, on a timely basis, in the manner as set forth in paragraphs (a)(2) and (3) of that section.

In response to commenters' suggestions, several provisions of the proposed regulations have been clarified. The references to the filing deadlines have been clarified so as to set forth a specific number of months (*i.e.*, 16 months for nonresident alien individuals and 18 months for foreign corporations) rather than referring, as in the proposed regulations, to one year after the extended due date. Paragraph (b)(3) of §1.874-1 clarifies that the filing deadlines of that paragraph apply to a nonresident alien individual who has a permanent establishment or fixed base in the United States. Likewise, as provided in §1.882-4(a)-(3)(iii), the filing deadlines also apply to a foreign corporation which has a permanent establishment in the United States. Sections 1.874-1(b)(4) and 1.882-4(a)(3)(iv) have been clarified to provide that neither deductions nor credits need be reported on the protective returns filed pursuant to those sections.

Special Analyses

It has been determined that these rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. 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 final Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking for the regulations was submitted to the Administrator of the Small Business Administration for comment on their impact on small business. The collections of information contained in this document, for which no substantive changes were proposed, are currently approved by the Office of Management and Budget under the Paperwork Reduction Act (OMB Control Nos. 1545-0089 and 1545-0126).

* * * * *

Adoption of amendments to the regulations

Accordingly, 26 CFR Part 1 is amended as follows:

PART 1—INCOME TAX REGULATIONS

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

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

Par. 2. The heading and text for §1.874-1 are revised to read as follows:

§1.874-1 Allowance of deductions and credits to nonresident alien individuals.

(a) *Return required.* A nonresident alien individual shall receive the benefit of the deductions and credits otherwise allowable with respect to the income tax, only if the nonresident alien individual timely files or causes to be filed with the Philadelphia Service Center, in the manner prescribed in subtitle F, a true and accurate return of the income which is effectively connected, or treated as effectively connected, with the conduct of a trade or business within the United States by the nonresident alien individual. No provision of this section (other than paragraph (c)(2)) shall be construed, however, to deny the credits provided by sections 31, 32, 33, 34 and 852(b)(3)(D)(ii). In addition, notwithstanding the requirement that a nonresident alien must file a timely return in order to receive the benefit of the deductions and credits otherwise allowable with respect to the income tax, the nonresident alien individual may, for purposes of determining the amount of tax to be withheld under section 1441 from remuneration paid for labor or personal services performed within the United States, receive the benefit of the deduction for personal exemptions provided in section 151, to the extent allowable under section 873(b)(3) and paragraph (c)(3) of §1.873-1, or in any applicable tax convention, by filing a claim therefore with the withholding agent. The amount of the deduction for the personal exemptions and the amount of the tax to be withheld under those circumstances shall be determined in accordance with paragraph (e)(2) of §1.1441-3. The deductions and credits allowed such a nonresident alien individual electing under a tax convention to be subject to tax on a net basis may be obtained by filing a return of income in the manner prescribed in the regulations (if any) under the tax convention or under any other guidance issued by the Commissioner.

(b) *Filing deadline for return*—(1) *General rule.* As provided in paragraph (a) of this section, for purposes of computing the nonresident alien individual's taxable income for any taxable year, otherwise allowable deductions and credits will be allowed only if a true and accurate return for that taxable year is filed by the nonresident alien individual on a timely basis. For taxable years of a nonresident alien individual ending after July 31, 1990, whether a return for the current taxable year has been filed on a timely basis is dependent upon whether the nonresident alien individual filed a return for the taxable year immediately preceding the current taxable year. If a return was filed for that immediately preceding taxable year, or if the current taxable year is the first taxable year of the nonresident alien individual for which a return is required to be filed, the required return for the current taxable year must be filed within 16 months of the due date, as set forth in section 6072 and the regulations under that section, for filing the return for the current taxable year. If no return for the taxable year immediately preceding the current taxable year has been filed, the required return for the current taxable year (other than the first taxable year of the nonresident alien individual for which a return is required to be filed) must have been filed no later than the earlier of the date which is 16 months after the due date, as set forth in section 6072, for filing the return for the current taxable year or the date the Internal Revenue Service mails a notice to the nonresident alien individual advising the nonresident alien individual that the current year tax return has not been filed and that no deductions or credits (other than those provided in sections 31, 32, 33, 34 and 852(b)(3)(D)(ii)) may be claimed by the nonresident alien individual.

(2) *Waiver.* The filing deadlines set forth in paragraph (b)(1) of this section may be waived by the District Director or Assistant Commissioner (International) in rare and unusual circumstances if good cause for such waiver, based on the facts and circumstances, is established by the nonresident alien individual.

(3) *Income tax treaties.* A nonresident alien individual who has a permanent establishment or fixed base, as defined in an income tax treaty between the United States and the country of residence of the nonresident alien individual, in the United States is subject to the filing deadlines as set forth in paragraph (b)(1) of this section.

(4) *Protective return.* If a nonresident alien individual conducts limited activities in the United States in a taxable year which the nonresident alien individual determines does not give rise to gross income which is effectively connected with the conduct of a trade or business within the United States as defined in sections 871(b) and 864(b) and (c) and the regulations under those sections, the nonresident alien individual may nonetheless file a return for that taxable year on a timely basis under paragraph (b)(1) of this section and thereby protect the right to receive the benefit of the deductions and credits attributable to that gross income if it is later determined, after the return was filed, that the original determination was incorrect. On that timely filed return, the nonresident alien individual is not required to report any gross income as effectively connected with a United States trade or business or any deductions or credits, but should attach a statement indicating that the return is being filed for the reason set forth in this paragraph (b)(4). If the nonresident alien individual determines that part of the activities which he or she conducts in the United States in a taxable year gives rise to gross income which is effectively connected with the conduct of a trade or business and part does not, the nonresident alien individual must timely file a return for that taxable year to report the gross income determined to be effectively connected, or treated as effectively connected, with the conduct of that trade or business within the United States and the deductions and credits attributable to the gross income. In addition, the nonresident alien individual should attach to that return the statement described in this paragraph (b)(4) with regard to the other activities. The nonresident alien individual may follow the same procedure if the nonresident alien individual determines initially that he or she has no United States tax liability under the provisions of an applicable income tax treaty. In the event the nonresident alien individual relies on the provisions of an income tax treaty to reduce or eliminate the income subject to taxation, or to reduce the rate of tax to which that income is subject, disclosure may be required pursuant to section 6114.

(c) *Allowed deductions and credits*—(1) *In general.* Except for losses of property located within the United States, charitable contributions and personal exemptions (*see* section 873 (b)), deductions are allowed to a nonresident alien individual only to the extent they are connected with gross income which is effectively connected, or treated as effectively connected, with the conduct of the nonresident alien individual's trade or business in the United States. Other than credits allowed by sections 31, 32, 33, 34 and 852(b)(3)(D)(ii), the nonresident alien individual is entitled to credits only if they are attributable to effectively connected income. *See* paragraph (a) of this section for the requirement that a return be timely filed. Except as provided by section 906, a nonresident alien individual shall not be allowed the credit against the tax for taxes of foreign countries and possessions of the United States allowed by section 901.

(2) *Verification.* At the request of the Internal Revenue Service, a nonresident alien individual claiming deductions from gross income which is effectively connected, or treated as effectively connected, with the conduct of a trade or business in the United States and credits attributable to that income must furnish at the place designated pursuant to §301.7605-1(a) information sufficient to establish that the nonresident alien individual is entitled to the deductions and credits in the amounts claimed. All information must be furnished in a form suitable to permit verification of the claimed deductions and credits. The Internal Revenue Service may require, as appropriate, that an English translation be provided with any information in a foreign language. If a nonresident alien individual fails to furnish sufficient information, the Internal Revenue Service may in its discretion disallow any claimed deductions and credits in full or in part.

(d) *Return by Internal Revenue Service.* If a nonresident alien individual has various sources of income within the United States, so that from any one source, or from all sources combined, the amount of income shall call for the assessment of a tax greater than that withheld at the source in the case of that individual, and a return of income has not been filed in the manner prescribed by subtitle F, including the filing deadlines set forth in paragraph (b)(1) of this section, the Internal Revenue Service shall:

(1) Cause a return of income to be made,

(2) Include on the return the income described in §1.871-7 or §1.871-8 of that individual from all sources concerning which it has information, and

(3) Assess the tax.

If the nonresident alien individual is not engaged in, or does not receive income that is treated as being effectively connected with, a United States trade or business and §1.871-7 is applicable, the tax shall be assessed on the basis of gross income without allowance for deductions or credits (other than the credits provided by sections 31, 32, 33, 34 and 852(b)(3)-(D)(ii)) and collected from one or more sources of income within the United States. If the nonresident alien individual is engaged in a United States trade or business or is treated as having effectively connected income and §1.871-8 applies, the tax on the income of the nonresident alien individual that is not effectively connected, or treated as effectively connected, with the conduct of a United States trade or business shall be assessed on the basis of gross income, determined in accordance with the rules of §1.871-7, without allowance for deductions or credits (other than the credits provided by sections 31, 32, 33, 34 and 852(b)(3)-(D)(ii)) and collected from one or more of the sources of income within the United States. Tax on income that is effectively connected, or treated as effectively connected, with the conduct of a United States trade or business shall be assessed in accordance with either section 1, 55 or 402(e)(1) without allowance for deductions or credits (other than the credits provided by sections 31, 32, 33, 34 and 852(b)(3)(D)(ii)) and col-

lected from one or more of the sources of income within the United States.

(e) *Alien resident of Puerto Rico, Guam, American Samoa, or the Commonwealth of the Northern Mariana Islands.* This section shall not apply to a nonresident alien individual who is a bona fide resident of Puerto Rico, Guam, American Samoa, or the Commonwealth of the Northern Mariana Islands during the entire taxable year. *See* section 876 and §1.876-1.

Par. 3. The heading and text for §1.882-4 are revised to read as follows:

§1.882-4 Allowance of deductions and credits to foreign corporations.

(a) *Foreign corporations*—(1) *In general.* A foreign corporation that is engaged in, or receives income treated as effectively connected with, a trade or business within the United States is allowed the deductions which are properly allocated and apportioned to the foreign corporation's gross income which is effectively connected, or treated as effectively connected, with its conduct of a trade or business within the United States. The foreign corporation is entitled to credits which are attributable to that effectively connected income. No provision of this section (other than paragraph (b)(2)) shall be construed to deny the credits provided by sections 33, 34 and 852(b)(3)(D)(ii) or the deduction allowed by section 170.

(2) *Return necessary.* A foreign corporation shall receive the benefit of the deductions and credits otherwise allowed to it with respect to the income tax, only if it timely files or causes to be filed with the Philadelphia Service Center, in the manner prescribed in subtitle F, a true and accurate return of its taxable income which is effectively connected, or treated as effectively connected, for the taxable year with the conduct of a trade or business in the United States by that corporation. The deductions and credits allowed such a corporation electing under a tax convention to be subject to tax on a net basis may be obtained by filing a return of income in the manner prescribed in the regulations (if any) under the tax convention or under any other guidance issued by the Commissioner.

(3) *Filing deadline for return.* (i) As provided in paragraph (a)(2) of this section, for purposes of computing the foreign corporation's taxable income for any taxable year, otherwise allowable deductions (other than that allowed by section 170) and credits (other than those allowed by sections 33, 34 and 852(b)(3)(D)(ii)) will be allowed only if a return for that taxable year is filed by the foreign corporation on a timely basis. For taxable years of a foreign corporation ending after July 31, 1990, whether a return for the current taxable year has been filed on a timely basis is dependent upon whether the foreign corporation filed a return for the taxable year immediately preceding the current taxable year. If a return was filed for that immediately preceding taxable year, or if the current taxable year is the first taxable year of the foreign corporation for which a return is required to be filed, the required return for the current taxable year must be filed within 18 months of the due date as set forth in section 6072 and the regulations under that section, for filing the return for the current taxable year. If no return for the taxable year immediately preceding the current taxable year has been filed, the required return for the current taxable year (other than the first taxable year of the foreign corporation for which a return is required to be filed) must have been filed no later than the earlier of the date which is 18 months after the due date, as set forth in section 6072, for filing the return for the current taxable year or the date the Internal Revenue Service mails a notice to the foreign corporation advising the corporation that the current year tax return has not been filed and that no deductions (other than that allowed under section 170) or credits (other than those allowed under sections 33, 34 and 852(b)(3)(D)-(ii)) may be claimed by the taxpayer.

(ii) The filing deadlines set forth in paragraph (a)(3)(i) of this section may be waived by the District Director or Assistant Commissioner (International), in rare and unusual circumstances if good cause for such waiver, based on the facts and circumstances, is established by the foreign corporation.

(iii) A foreign corporation which has a permanent establishment, as defined in an income tax treaty between the United States and the foreign corporation's country of residence, in the United States is subject to the filing deadlines set forth in paragraph (a)(3)(i) of this section.

(iv) If a foreign corporation conducts limited activities in the United States in a taxable year which the foreign corporation determines does not give rise to gross income which is effectively connected with the conduct of a trade or business within the United States as defined in sections 882(b) and 864(b) and (c) and the regulations under those sections, the foreign corporation may nonetheless file a return for that taxable year on a timely basis under paragraph (a)(3)(i) of this section and thereby protect the right to receive the benefit of the deductions and credits attributable to that gross income if it is later determined, after the return was filed, that the original determination was incorrect. On that timely filed return, the foreign corporation is not required to report any gross income as effectively connected with a United States trade or business or any deductions or credits but should attach a statement indicating that the return is being filed for the reason set forth in this paragraph (a)(3). If the foreign corporation determines that part of the activities which it conducts in the United States in a taxable year gives rise to gross income which is effectively connected with the conduct of a trade or business and part does not, the foreign corporation must timely file a return for that taxable year to report the gross income determined to be effectively connected, or treated as effectively connected, with the conduct of the trade or business within the United States and the deductions and credits attributable to the gross income. In addition, the foreign corporation should attach to that return the statement described in this paragraph (b)(3) with regard to the other activities. The foreign corporation may follow the same procedure if it determines initially that it has no United States tax liability under the provisions of an applicable income tax treaty. In the event the foreign corporation relies on the provisions of an income tax treaty to reduce or eliminate the income subject to taxation, or to reduce the rate of tax, disclosure may be required pursuant to section 6114.

(v) In order to be eligible for any deductions and credits for purposes of computing the accumulated earnings tax of section 531, a foreign corporation must file a true and accurate return, on a timely basis, in the manner as set forth in paragraph (a)(2) and (3) of this section.

(4) *Return by Internal Revenue Service.* If a foreign corporation has various sources of income within the United States and a return of income has not been filed, in the manner prescribed by subtitle F, including the filing deadlines set forth in paragraph (a)(3) of this section, the Internal Revenue Service shall:

(i) Cause a return of income to be made,

(ii) Include on the return the income described in §1.882-1 of that corporation from all sources concerning which it has information, and

(iii) Assess the tax and collect it from one or more of those sources of income within the United States, without allowance for any deductions (other than that allowed by section 170) or credits (other than those allowed by sections 33, 34 and 852(b)(3)(D)(ii)).

If the income of the corporation is not effectively connected with, or if the corporation did not receive income that is treated as being effectively connected with, the conduct of a United States trade or business, the tax will be assessed under §1.882-1(b)(1) on a gross basis, without allowance for any deduction (other than that allowed by section 170) or credit (other than the credits allowed by sections 33, 34 and 852(b)(3)(D)-(ii)). If the income is effectively connected, or treated as effectively connected, with the conduct of a United States trade or business, tax will be assessed in accordance with either section 11, 55 or 1201(a) without allowance for any deduction (other than that allowed by section 170) or credit (other than the credits allowed by sections 33, 34 and 852(b)(3)(D)-(ii)).

(b) *Allowed deductions and credits*—(1) *In general.* Except for the deduction allowed under section 170 for charitable contributions and gifts (*see* section 882(c)(1)(B)), deductions are allowed to a foreign corporation only to the extent they are connected with gross income which is effectively connected, or treated as effectively connected, with the conduct of a trade or business in the United States. Deductible expenses (other than interest expense) are properly allocated and apportioned to effectively connected gross income in accordance with the rules of §1.861-8. For the method of determining the interest deduction allowed to a foreign corporation, see §1.882-5. Other than the credits allowed by sections 33, 34 and 852(b)(3)(D)(ii), the foreign corporation is entitled to credits only if they are attributable to effectively connected income. *See* paragraph (a)(2) of this section for the requirement that a return be filed. Except as provided by section 906, a foreign corporation shall not be allowed the credit against the tax for taxes of foreign countries and possessions of the United States allowed by section 901.

(2) *Verification.* At the request of the Internal Revenue Service, a foreign corporation claiming deductions from gross income which is effectively connected, or treated as effectively connected, with the conduct of a trade or business in the United States or credits which are attributable to that income must furnish at the place designated pursuant to §301.7605-1(a) information sufficient to establish that the corporation is entitled to the deductions and credits in the amounts claimed. All information must be furnished in a form suitable to permit verification of claimed deductions and credits. The Internal Revenue Service may require, as appropriate, that an English translation be provided with any information in a foreign language. If a foreign corporation fails to furnish sufficient information, the Internal Revenue Service may in its discretion disallow any claimed deductions and credits in full or in part. For additional filing requirements and for penalties for failure to provide information, see also section 6038A.

Fred T. Goldberg, Jr.,
Commissioner of Internal Revenue.

Approved November 13, 1990.

Kenneth W. Gideon,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 10, 1990, 8:45 a.m., and published in the issue of the Federal Register for December 11, 1990, 55 F.R. 50827)

Section 875.—Partnerships; Beneficiaries of Estates and Trusts

If a foreign person engages in U.S. barter transactions through a partnership or through a dependent agent, is gain or loss recognized on each separate barter transaction? See Rev. Rul. 90-80, page 170.

Subpart D.—Miscellaneous Provisions

Section 894.—Income Affected by Treaty

If a foreign person engages in United States barter transactions through a partnership or through a dependent agent, is gain or loss recognized on each separate barter transaction? See Rev. Rul. 90-80, page 170.

Section 897.—Disposition of Investment in United States Real Property

26 CFR 1.897-5T: Corporate distributions (temporary).

Foreign corporation; successive liquidations of U.S. real property; gain. A foreign corporation must recognize gain under section 1.897-5T(c)-(2)(ii)(B) of the regulations on the distribution in a liquidation of a U.S. real property interest acquired in another liquidation from a purchased foreign corporation.

Rev. Rul. 90-76

ISSUE

Does a foreign corporation recognize gain on the distribution of a United States real property interest under section 1.897-5T(c)(2)(ii)(B) of the Income Tax Regulations, as in effect prior to August 1, 1989, where the foreign corporation acquired the U.S. real property interest in a liquidating distribution under section 332(a) of the Internal Revenue Code from another foreign corporation, the stock of which it purchased from a foreign person or entity that was not subject to U.S. income taxation on the disposition?

FACTS

R, a domestic corporation, has owned all of the outstanding stock of *FP*, a Country J corporation, since the incorporation of *FP* in 1986. The

only asset owned by *FP* is all of the outstanding stock of *FS*, a Country J corporation.

The *FS* stock was purchased by *FP* in 1986 from *X*, an unrelated nonresident alien individual. *X* was not subject to U.S. income taxation on the gain from the disposition of the *FS* stock.

The only asset ever owned by *FS* is Parcel *P*, a U.S. real property interest as defined in section 897(c)(1)(A)(i) of the Code which it purchased in 1983. Parcel *P* has a fair market value of $500y, and *FS* has a basis of $100y in Parcel *P*.

FS liquidated under section 332(a) of the Code in June 1988, and distributed Parcel *P* to *FP*. *FP* liquidated under section 332(a) in June 1989, and distributed Parcel *P* to *R*. *FP* did not choose to apply the rules of Notice 89-85, 1989-2 C.B. 403, to the distribution of Parcel *P* to *R*, nor could *R* and *FP* enter into a closing agreement pursuant to Rev. Proc. 90-19, 1990-1 C.B. 495.

LAW AND ANALYSIS

The distributions of Parcel *P* by *FS* to *FP* and by *FP* to *R* are transfers described in section 897(d)(1) of the Code. Section 897(d)(1) provides generally that gain shall be recognized by a foreign corporation on the distribution of a U.S. real property interest in a liquidation. *See* also section 1.897-5T(c)(1) of the regulations. However, gain shall not be recognized by a distributing foreign corporation under section 897(d)(1) if, at the time of the receipt of the distributed U.S. real property interest, the distributee is also a foreign corporation; the distributee would be subject to U.S. income taxation on a subsequent disposition of the U.S. real property interest in accordance with the rules of section 1.897-5T(d)(1); the basis of the distributed U.S. real property interest in the hands of the distributee is no greater than the adjusted basis of such property before the distribution, increased by the amount of gain (if any) recognized by the distributing corporation upon the distribution and added to the adjusted basis under the otherwise applicable provisions; and the distributing corporation complies with the filing requirements of section 1.897-5T(d)(1)(iii). *See* section 897(d)(2) and section 1.897-5T(c)(2)(ii)(A).

The distribution of Parcel *P* by *FS* to *FP* will not cause recognition of gain by *FS* if *FS* complies with the filing requirements of section 1.897-5T(d)(1)(iii) of the regulations. This is because *FP* is a foreign corporation, it will be subject to U.S. income taxation on a subsequent disposition of Parcel *P* under the rules of section 1.897-5T(d)(1), and it takes a carryover basis of $100y in Parcel *P* under section 334(b)(1) of the Code.

Whether *FP* must recognize gain on the distribution of Parcel *P* to *R* is determined under section 1.897-5T(c)(2)(ii)(B) of the regulations as in effect prior to August 1, 1989. That section provided that a foreign corporation shall recognize gain on its distribution after May 5, 1988, of a U.S. real property interest to a domestic corporation meeting the stock ownership requirements of section 332(b) of the Code where the following conditions are satisfied: the foreign corporation has not made an election under section 897(i); any gain on the stock in the foreign corporation would be subject to U.S. taxation if an election were made on the date of the liquidation; and the distribution of the U.S. real property interest by the foreign corporation to the domestic corporation pursuant to section 332(a) occurs less than five years after the date of the last realization of gain from the disposition of stock of the foreign corporation that would be subject to payment of tax under section 1.897-3(d)(2)(i) if an election under section 897(i) were made by the foreign corporation on the date of its liquidation. A foreign corporation may make an election under section 897(i) to be treated as a domestic corporation for purposes of sections 897, 1445, and 6039C only if the foreign corporation holds a U.S. real property interest, and under any treaty obligation of the United States the foreign corporation is entitled to nondiscriminatory treatment with respect to that interest. The recognition rule of section 1.897-5T(c)(2)(ii)(B), as in effect prior to August 1, 1989, applied even if the distributing foreign corporation could not make an election under section 897(i) because it was not entitled to treaty benefits in regard to nondiscrimination.

FP recognizes gain on the distribution of Parcel *P* under section 1.897-5T(c)(2)(ii)(B) of the regulations because all of the conditions of that paragraph were met. *FP* distributed Parcel *P* after May 5, 1988, and did not make an election under section 897(i) of the Code. Even though there were no prior dispositions of the *FP* stock, gain on the *FP* stock would have been subject to U.S. taxation if an election were made by *FP* on the date of the liquidation, because the provisions of section 1.897-3(d)(2) are subject to the anti-abuse rule of section 1.897-3(e), discussed below. The distribution of the U.S. real property interest by *FP* to *R* pursuant to section 332(a) occurred in June 1989, which is less than five years after the date (1986) of the last realization of gain from the disposition of stock of the foreign corporation that would be subject to payment of tax under section 1.897-3(d)(2)(i).

When a foreign corporation makes an election under section 897(i) of the Code, section 1.897-3(d)(2) of the regulations provides that, if there has been a disposition of an interest in the foreign corporation during the period described in section 1.897-3(c)(5) and such disposition would have been subject to section 897(a) if the election had been made before that disposition, then there must be a payment of an amount equal to any taxes which would have been imposed by section 897 upon all persons who had disposed of interests in the foreign corporation during such period had the corporation made the election prior to such dispositions, together with any interest that would have accrued had tax actually been due with respect to the disposition. *See* Notice 89-85, 1989-2 C.B. 403, concerning changes in the period described in section 1.897-3(c)(5) for elections after July 31, 1989.

The rule of section 1.897-3(d)(2) of the regulations is amplified by the anti-abuse rule of section 1.897-3(e). Section 1.897-3(e)(1) and (2) provides that a foreign corporation making an election under section 897(i) must pay an amount equal to the tax on the full amount of gain realized by the transferors of the stock of the foreign corporation or of any corporation controlled by the foreign corporation, plus interest that would have accrued had tax actually been due, if three conditions are met. The conditions are that prior to receipt of a U.S. real property interest by the foreign cor-

poration seeking to make the election, stock in such corporation (or in any corporation controlled by such corporation) was acquired in a transaction in which the person acquiring such stock obtained an increase in basis in the stock over the adjusted basis of the stock in the hands of the person from whom it was acquired; the full amount of gain realized by the person from whom the stock was acquired was not subject to U.S. tax; and the corporation seeking to make the election received the U.S. real property interest in a transaction or series of transactions to which section 897(d)-(1)(B) (current section 897(d)(2)) or section 897(e)(1) applied to allow for nonrecognition of gain.

FP would have had to pay an amount equal to the tax on the full amount of gain realized by *X* on the sale of the *FS* stock to *FP* under section 1.897-3(e) of the regulations, plus accrued interest, if *FP* had made an election under section 897(i) of the Code. This is because, prior to the receipt of the U.S. real property interest (Parcel *P*) by *FP* from *FS*, the *FS* stock was acquired by *FP* from *X* with a cost basis; the gain realized by *X* on the sale of the *FS* stock was not subject to U.S. tax; and *FP* received the U.S. real property interest (Parcel *P*) in a transaction to which section 897(d)(2) applied.

Under section 334(b)(1) of the Code, *R* takes a fair market value basis of $500y in Parcel *P*.

HOLDING

A foreign corporation must recognize gain on the distribution of a U.S. real property interest under section 1.897-5T(c)(2)(ii)(B) of the regulations as in effect prior to August 1, 1989, where the foreign corporation acquired the U.S. real property interest in a liquidating distribution under section 332(a) from another foreign corporation, the stock of which it purchased from a foreign person or entity that was not subject to U.S. income taxation on the disposition. This holding also applies to any liquidation after July 31, 1989, if the rules of section 1.897-5T(c)(2)(ii)(B), as in effect prior to August 1, 1989, apply to such liquidation. *See* Notice 89-85. The result would be similar under the modified provision of section 1.897-5T(c)(2)(ii)(B) as in effect after July 31, 1989. *See* Notice 89-85.

Part III.—Income From Sources Without the United States
Subpart A.—Foreign Tax Credit

Section 901.—Taxes of Foreign Countries and of Possessions of United States

(Also Sections 902, 952, 960.)

Foreign tax credit; South Africa. The foreign tax credit allowed under section 901 of the Code is denied for taxes paid on income derived in South Africa attributable to taxable years beginning after December 31, 1987. Income derived from sources inside South Africa is subpart F income. Rev. Rul. 87-35 supplemented.

Rev. Rul. 90-53

Rev. Rul. 87-35, 1987-1 C.B. 182, lists countries the income from which is subject to certain special tax rules. This revenue ruling supplements that ruling in light of recent legislation.

Section 901

LAW AND ANALYSIS

Section 901 of the Internal Revenue Code allows U.S. taxpayers to claim a foreign tax credit for income, war profits, and excess profits taxes paid or accrued (or deemed paid or accrued under sections 902 and 960) to any foreign country or to any possession of the United States. Section 901(j) denies the credit for taxes paid on income derived in certain countries, which are listed in Rev. Rul. 87-35. Section 10231 of the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330 (1987), 1987-3 C.B. 1, added South Africa to the list of countries to which section 901(j) applies. For purposes of section 901(j), the term South Africa has the meaning given to it by paragraph (6) of section 3 of the Comprehensive Anti-Apartheid Act of 1986, Pub. L. 99-440, 100 Stat. 1086. This revenue ruling supplements Rev. Rul. 87-35 by adding South Africa to the list of countries in that ruling.

HOLDING

Section 901(j) describes the following countries:

Aghanistan	North Korea
Albania	People's Democratic Republic of Yeman
Angola	
Cambodia	
Cuba	South Africa
Iran	Syria
Libya	Vietnam

Section 952

LAW AND ANALYSIS

The income of a foreign corporation with United States shareholders is generally not taxed to the shareholders until the income is repatriated. Section 951 of the Code, however, provides that this deferral of United States tax is not available to shareholders of controlled foreign corporations with certain types of income ("subpart F income"). Section 952(a)(5) of the Code provides that subpart F income includes income derived by a controlled foreign corporation from sources inside a foreign country while section 901(j) applies to that country. The countries to which section 901(j) applies are listed above.

HOLDING

Section 952(a)(5) applies to income derived from sources inside South Africa. Therefore, such income is subpart F income.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 87-35 is supplemented.

EFFECTIVE DATE

Rev. Rul. 89-44, 1989-1 C.B. 237, states that section 901(j)(2)(C) of the Code (which provides a special rule for South Africa) is effective for taxes paid or accrued with respect to income attributable to taxable years beginning after December 31, 1987. In accordance with that ruling (and in addition to any period during which section 901(j) would otherwise apply to South Africa), this revenue ruling applies during the period beginning January 1, 1988, and ending on the date the Secretary of State certifies to the Secretary of the Treasury that South Africa meets the requirements of section 311(a) of the Comprehensive Anti-Apartheid Act of 1986.

Foreign tax credit; Brazilian investment certificates. This revenue ruling describes the foreign tax credit consequences attendant to the receipt and disposition of Brazilian investment certificates.

Rev. Rul. 90-107

ISSUE

What are the foreign tax credit consequences of the receipt of a Brazilian investment certificate obtained in connection with the payment of a creditable Brazilian income tax?

FACTS

P, a domestic corporation, owns all of the stock of *FS*, a Brazilian corporation.

In order to increase development, Brazil offers a special income tax incentive to companies investing in certain government approved projects. Under the incentive program, companies may designate annually a portion of their Brazilian income tax to one of several investment funds, which coordinate development programs in Brazil. Once the designation and full payment of the tax are made, the investment fund issues to the company an investment certificate in an amount equal to the tax designation. The recipient of an investment certificate has three options: it may 1) retain the investment certificate and thereby become a shareholder in the investment fund; 2) convert the investment certificate, through a government regulated exchange, into a direct ownership interest in certain other companies participating in the investment fund; or 3) sell the investment certificate on one of the country's public stock exchanges.

FS's Brazilian income tax liability for year 1 was 100x cruzados. In January of year 2, *FS* timely paid its Brazilian income tax, and, as a participant in a Brazilian development program, *FS* designated 25x cruzados to an investment fund. Later in year 2, *FS* received a 25x investment certificate. In the same year, *FS* paid a dividend to *P*, which, pursuant to section 902, claimed a foreign tax credit with respect to the Brazilian income tax paid by *FS*.

LAW AND ANALYSIS

Sections 901(a) and 902(a) of the Internal Revenue Code generally allow a domestic corporation to claim a foreign tax credit with respect to the amount of foreign income taxes paid by the corporation's subsidiary to a foreign country. Section 1.901-2(e)(2)-(i) of the Income Tax Regulations states that "[a]n amount is not tax paid to a foreign country to the extent it is reasonably certain that the amount will be refunded, credited, rebated, abated, or forgiven." Example 4 to this regulation illustrates that to the extent that the rebate is in the form of property, the amount of tax paid for section 901 purposes is the difference between the initial amount of tax paid and the fair market value of the property received.

When *FS* made its 100x cruzado payment to the Brazilian authorities in January of year 2, it was reasonably certain that a portion of this amount would be refunded to *FS* in the form of property, an investment certificate. Accordingly, pursuant to section 1.901-2(e)(2)(i) of the regulations, the amount of Brazilian income tax paid by *FS* for year 1 is 100x cruzados less the fair market value of the investment certificate ascertained at the time of payment of the tax.

Section 905(c) provides that if any foreign tax previously claimed as a credit on an income tax return is refunded in whole or in part, the taxpayer shall notify the Secretary, who shall redetermine the amount of tax for the year or years affected. The receipt or disposition of an investment certificate is not an event that triggers a redetermination of the taxpayer's liability under section 905(c) because it does not involve an adjustment to the amount of tax claimed as a credit.

HOLDING

The amount of creditable foreign tax deemed paid for sections 901 and 902 purposes is the initial amount of tax paid, reduced by the fair market value of the investment certificate ascertained at the time of payment of the tax.

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26 CFR 1.901-1: Allowance of credit for taxes.

In the case of taxpayers that are deemed, under section 902 of the Code, to have paid income taxes to the United Kingdom, and that have chosen to credit the income taxes described in section 901 of the Code, Rev. Proc. 80-18, 1980-1 C.B. 623, is amplified with respect to the computation of the deemed paid foreign tax credit attributable to Advance Corporation Tax imposed by the United Kingdom. The creditable taxes attributable to Advance Corporation Tax computed under this amplification may be subject to a subsequent adjustment under section 905(c) of the Code, as provided in Rev. Proc. 80-18. See Rev. Proc. 90-61, page 657.

Section 902.—Deemed Paid Credit Where Domestic Corporation Owns 10 Percent or More of Voting Stock of Foreign Corporation

An indirect foreign tax credit allowed under section 902 of the Code is denied for taxes deemed paid on income derived in South Africa attributable to taxable years beginning after December 31, 1987. See Rev. Rul. 90-53, page 178.

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26 CFR 1.902-1: Credit for domestic corporate shareholder of a foreign corporation.

In the case of taxpayers that are deemed, under section 902 of the Code, to have paid income taxes to the United Kingdom, and that have chosen to credit the income taxes described in section 901 of the Code, Rev. Proc. 80-18, 1980-1 C.B. 623, is amplified with respect to the computation of the deemed paid foreign tax credit attributable to Advance Corporation Tax imposed by the United Kingdom. The creditable taxes attributable to Advance Corporation Tax computed under this amplification may be subject to a subsequent adjustment under section 905(c) of the Code, as provided in Rev. Proc. 80-18. See Rev. Proc. 90-61, page 657.

Section 904.—Limitation on Credit

26 CFR 1.904(f)-12: Transition rules.

T.D. 8306

Section 904(f) Transition Rules For Overall Foreign Losses Incurred Before and After the Tax Reform Act of 1986

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final Income Tax Regulations relating to transition rules for implementing the changes made to section 904(f) of the Internal Revenue Code of 1954 by the Tax Reform Act of 1986. These final regulations provide rules for the recapture of overall foreign losses incurred in taxable years beginning before January 1, 1987, and rules for the treatment of overall foreign losses that are part of net operating losses incurred in taxable years beginning

after December 31, 1986, which are carried back to taxable years beginning before January 1, 1987.

EFFECTIVE DATE: These regulations are effective for taxable years beginning after December 31, 1986. However, taxpayers may choose to apply the rules set forth in §1.904(f)-13T for taxable years beginning before January 1, 1990.

SUPPLEMENTARY INFORMATION:

BACKGROUND

On May 17, 1988, the Federal Register published temporary regulations (53 FR 17461) [T.D. 8201, 1988-1 C.B. 291] and proposed amendments (53 FR 17472) [INTL-932-86, 1988-1 C.B. 915] to the Income Tax Regulations (26 CFR Part 1) under new paragraph (5) of section 904(f), which was added to the Code by Section 1203 of the Tax Reform Act of 1986 (100 Stat. 2085 [1986-3 C.B. (Vol. 1) 1, 448]). Written comments responding to this notice were received. After consideration of all comments regarding the proposed amendments, those amendments are adopted by this Treasury Decision with revisions in response to those comments. The comments and revisions are discussed below.

EXPLANATION OF PROVISIONS

The proposed and temporary regulations dealt with transition rules for implementing the changes made to section 904(f) of the Internal Revenue Code of 1954 by the Tax Reform Act of 1986. The comments received focused primarily on the rule of §1.904(f)-12(a)(2) that provides that, unless an exception applies, overall foreign losses incurred in the general limitation category in taxable years beginning before January 1, 1987 (pre-effective date years), and recaptured in taxable years beginning after December 31, 1986 (post-effective date years), are recaptured pro rata from general limitation income, financial services income, shipping income, and dividends from each noncontrolled section 902 corporation. Commentors asserted that this rule unfairly limits recapture of a pre-effective date general limitation overall foreign loss from post-effective date passive income or high withholding tax interest. They state that the rule is unfair because passive income and high withholding tax interest income may have been included in general limitation income in pre-effective date years. Accordingly, the commentors contend, taxpayers should be permitted to recapture pre-effective date general limitation overall foreign losses from post-effective date passive income and high withholding tax interest income as well as from general limitation income, financial services income, shipping income and dividends from each noncontrolled section 902 corporation.

This suggestion was rejected because post-effective date passive income and high withholding tax interest income could include substantial amounts of income that would have been separate limitation interest in pre-effective date years. Thus, a general rule that permitted taxpayers to recapture pre-effective date overall foreign losses out of post-effective date passive income or high withholding tax interest income likely would result in taxpayers recapturing those losses out of income that the loss would not have been allowed to offset if the income had been earned in a pre-effective date year.

In addition, it was decided not to permit taxpayers to divide their passive income and high withholding tax interest income into income that would have been separate limitation interest if earned in a pre-effective date year and income that would have been general limitation income if earned in a pre-effective date year. The reason for this decision was to avoid frequent, difficult audit and allocation issues and to limit the continuing application of the law as in effect for taxable years beginning before January 1, 1987. Because overall foreign losses do not expire but continue until fully recaptured, adoption of a rule that permitted or required taxpayers to divide their passive income and high withholding tax interest income earned in post-effective date years into income that would have been separate limitation interest income and income that would have been general limitation income if earned in pre-effective date years would have continued the application of old law rules indefinitely.

Paragraph (a)(2)(ii) of §1.904(f)-12 permits taxpayers to trace a pre-effective date overall foreign loss in the general limitation category to one or more specific post-effective date income categories if the taxpayer can demonstrate that the loss is attributable to one or more separate categories of section 904(d)(1), as in effect for post-effective date taxable years. Commentors suggested that an example be included in the regulations to illustrate the application of this tracing rule to the recapture of a pre-effective date overall foreign loss from post-effective date passive income and high withholding tax interest. It has been determined that an example illustrating the tracing rule would be too dependent on its particular facts and circumstances to be useful. However, the text of paragraph (a)(2)(ii) has been clarified to state that taxpayers may trace a pre-effective date overall foreign loss in the general limitation category to any post-effective date separate category including passive income or high withholding tax interest income.

Commentors were also concerned that the general reference to section 904(f)(5) in the last sentence of §1.904(f)-12(a)(2)(i) that provides for the recapture of pre-effective date general limitation overall foreign losses after the application of section 904(f)(5) means that those losses will be recaptured after post-effective date separate limitation income is recharacterized pursuant to section 904(f)(5)(C). This interpretation is incorrect. Overall foreign losses, whether from pre-effective date or post-effective date years, will always be recaptured before the recharacterization of separate limitation income pursuant to section 904(f)(5)(C). Accordingly, paragraph (a)(2)(i) has been amended to provide that the recapture of pre-effective date losses shall be made after allocation of separate limitation losses and before the recharacterization of post-effective date separate limitation income. Section 1.904(f)-12(a)(3) provides that pre-effective date overall foreign losses shall be recaptured to the extent thereof before post-effective date overall foreign losses are recaptured.

SPECIAL ANALYSES

It has been determined that these rules are not major rules as defined in

Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. 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 final Regulatory Flexibility Analysis is not required.

* * * * *

Adoption of amendments to the regulations

Accordingly, 26 CFR Part 1 is amended as follows:

PART 1—INCOME TAX REGULATIONS

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

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

Par. 2. Section 1.904(f)-13T is removed.

Par. 3. New §1.904(f)-12 is added in the appropriate place to read as follows:

§1.904(f)-12 Transition rules.

(a) *Recapture in years beginning after December 31, 1986, of overall foreign losses incurred in taxable years beginning before January 1, 1987*—(1) *In general.* If a taxpayer has a balance in an overall foreign loss account at the end of its last taxable year beginning before January 1, 1987 (pre-effective date years), the amount of that balance shall be recaptured in subsequent years by recharacterizing income received in the income category described in section 904(d) as in effect for taxable years beginning after December 31, 1986 (post-effective date years), that is analogous to the income category for which the overall foreign loss account was established, as follows:

(i) Interest income as defined in section 904(d)(1)(A) as in effect for pre-effective date taxable years is analogous to passive income as defined in section 904(d)(1)(A) as in effect for post-effective date years;

(ii) Dividends from a DISC or former DISC as defined in section 904(d)(1)(B) as in effect for pre-effective date taxable years are analogous to dividends from a DISC or former DISC as defined in section 904(d)(1)(F) as in effect for post-effective date taxable years;

(iii) Taxable income attributable to foreign trade income as defined in section 904(d)(1)(C) as in effect for pre-effective date taxable years is analogous to taxable income attributable to foreign trade income as defined in section 904(d)(1)(G) as in effect for post-effective date years;

(iv) Distributions from a FSC (or former FSC) as defined in section 904(d)(1)(D) as in effect for pre-effective date taxable years are analogous to distributions from a FSC (or former FSC) as defined in section 904(d)(1)(H) as in effect for post-effective date taxable years;

(v) For general limitation income as described in section 904(d)(1)(E) as in effect for pre-effective date taxable years, see the special rule in paragraph (a)(2) of this section.

(2) *Rule for general limitation losses*—(i) *In general.* Overall foreign losses incurred in the general limitation category of section 904(d)(1)(E), as in effect for pre-effective date taxable years, that are recaptured in post-effective date taxable years shall be recaptured from the taxpayer's general limitation income, financial services income, shipping income, and dividends from each noncontrolled section 902 corporation. If the sum of the taxpayer's general limitation income, financial services income, shipping income and dividends from each noncontrolled section 902 corporation for a taxable year subject to recapture exceeds the overall foreign loss to be recaptured, then the amount of each type of separate limitation income that will be treated as U.S. source income shall be determined as follows:

$$\text{Overall foreign loss subject to recapture} \times \frac{\text{Amount of income in each separate category from which the loss may be recaptured}}{\text{Sum of income in all separate categories from which the loss may be recaptured.}}$$

This recapture shall be made after the allocation of separate limitation losses pursuant to section 904(f)(5)(B) and before the recharacterization of post-effective date separate limitation income pursuant to section 904(f)(5)(C).

(ii) *Exception.* If a taxpayer can demonstrate to the satisfaction of the district director that an overall foreign loss in the general limitation category of section 904(d)(1)(E), as in effect for pre-effective date taxable years, is attributable, in sums certain, to losses in one or more separate categories of section 904(d)(1) (including for this purpose the passive income category and the high withholding tax interest category), as in effect for post-effective date taxable years, then the taxpayer may recapture the loss (in the amounts demonstrated) from those separate categories only.

(3) *Priority of recapture of overall foreign losses incurred in pre-effective date taxable years.* An overall foreign loss incurred by a taxpayer in pre-effective date taxable years shall be recaptured to the extent thereof before the taxpayer recaptures an overall foreign loss incurred in a post-effective date taxable year.

(4) *Examples.* The following examples illustrate the application of this paragraph (a).

Example (1). X corporation is a domestic corporation which operates a branch in Country Y. For its taxable year ending December 31, 1988, X has $800 of financial services income, $100 of general limitation income and $100 of shipping income. X has a balance of $100 in its general limitation overall foreign loss account which resulted from an overall foreign loss incurred during its 1986 taxable year. X is unable to demonstrate to which of the income categories set forth in section 904(d)(1) as in effect for post-effective date taxable years the loss is attributable. In addition, X has a balance of $100 in its shipping overall foreign loss account attributable to a shipping loss incurred during its 1987 taxable year. X has no other overall foreign loss accounts. Pursuant to section 904(f)(1), the full amount in each of X corporation's overall foreign loss accounts is subject to recapture since $200 (the sum of those amounts) is less than 50% of X's foreign source taxable income for its 1988 taxable year, or $500. X's overall foreign loss incurred during its 1986 taxable year is recaptured before the overall foreign loss incurred during its 1987 taxable year, as follows: $80 ($100 x 800/1000) of X's financial services income, $10 ($100 x 100/1000) of X's general limitation income, and $10 ($100 x 100/1000) of X's shipping income will be treated as U.S. source income. The remaining $90 of X corporation's 1988 shipping income will be treated as U.S. source income for the purpose of recapturing X's $100 overall foreign loss attributable to the shipping loss incurred in 1987. $10 remains in X's shipping overall foreign loss account for recapture in subsequent taxable years.

Example (2). The facts are the same as in *Example* (1) except that X has $800 of financial services income, $100 of general limitation income, a $100 dividend from a noncontrolled section 902 corporation and a ($100) shipping loss for its taxable year ending December 31, 1988. Separate limitation losses are allocated

pursuant to the rules of section 904(f)(5) before the recapture of overall foreign losses. Therefore, the ($100) shipping loss incurred by X will be allocated to its separate limitation income as follows: $80 ($100 x 800/1000) will be allocated to X's financial services income, $10 ($100 x 100/1000) will be allocated to its general limitation income and $10 ($100 x 100/1000) will be allocated to X's dividend from the noncontrolled section 902 corporation. Accordingly, after allocation of the 1988 shipping loss, X has $720 of financial services income, $90 of general limitation income, and a $90 dividend from the noncontrolled section 902 corporation. Pursuant to section 904(f)(1), the full amount in each of X corporation's overall foreign loss accounts is subject to recapture since $200 (the sum of those amounts) is less than 50% of X's net foreign source taxable income for its 1988 taxable year, or $450. X's overall foreign loss incurred during its 1986 taxable year is recaptured as follows: $80 ($100 x 720/900) of X's financial services income, $10 ($100 x 90/900) of its general limitation income and $10 ($100 x 90/900) of its dividend from the noncontrolled section 902 corporation will be treated as U.S. source income. Accordingly, after application of section 904(f), X has $100 of U.S. source income, $640 of financial services income, $80 of general limitation income and a $80 dividend from the noncontrolled section 902 corporation for its 1988 taxable year. X must establish a separate limitation loss account for each portion of the 1988 shipping loss that was allocated to its financial services income, general limitation income and dividends from the noncontrolled section 902 corporation. X's overall foreign loss account for the 1986 general limitation loss is reduced to zero. X still has $100 balance in its overall foreign loss account that resulted from the 1987 shipping loss.

Example (3). Y is a domestic corporation which has a branch operation in Country Z. For its 1988 taxable year, Y has $5 of shipping income, $15 of general limitation income and $100 of financial services income. Y has a balance of $100 in its general limitation overall foreign loss account attributable to its 1986 taxable year. Y has no other overall foreign loss accounts. Pursuant to section 904(f)(1), $60 of the overall foreign loss is subject to recapture since 50% of Y's foreign source income for 1988 is less than the balance in its overall foreign loss account. Y can demonstrate that the entire $100 overall foreign loss was attributable to a shipping limitation loss incurred in 1986. Accordingly, only Y's $5 of shipping limitation income received in 1988 will be treated as U.S. source income. Because Y can demonstrate that the 1986 loss was entirely attributable to a shipping loss, none of Y's general limitation income or financial services income received in 1988 will be treated as U.S. source income.

Example (4). The facts are the same as in *Example* (3) except that Y can only demonstrate that $50 of the 1986 overall foreign loss account was attributable to a shipping loss incurred in 1986. Accordingly, Y's $5 of shipping limitation income received in 1988 will be treated as U.S. source income. The remaining $50 of the 1986 overall foreign loss that Y cannot trace to a particular separate limitation will be recaptured and treated as U.S. source income as follows: $43 ($50 x 100/115) of Y's financial services income will be treated as U.S. source income and $7 (50 x 15/115) of Y's general limitation income will be treated as U.S. source income. Y has $45 remaining in its overall foreign loss account to be recaptured from shipping income in a future year.

(b) *Treatment of overall foreign losses that are part of net operating losses incurred in pre-effective date taxable years which are carried forward to post-effective date taxable years*—(1) *Rule.* An overall foreign loss that is part of a net operating loss incurred in a pre-effective date taxable year which is carried forward, pursuant to section 172, to a post-effective date taxable year will be carried forward under the rules of section 904(f)(5) and the regulations under that section. *See also* Notice 89-3, 1989-1 C.B. 623. For this purpose the loss must be allocated to income in the category analogous to the income category set forth in section 904(d) as in effect for pre-effective date taxable years in which the loss occurred. The analogous category shall be determined under the rules of paragraph (a) of this section.

(2) *Example.* The following example illustrates the rule of paragraph (b)(1) of this section.

Example. Z is a domestic corporation which has a branch operation in Country D. For its taxable year ending December 31, 1988, Z has $100 of passive income and $200 of general limitation income. Z also has a $60 net operating loss which was carried forward pursuant to section 172 from its 1986 taxable year. The net operating loss resulted from an overall foreign loss attributable to the general limitation income category. Z can demonstrate that the loss is a shipping loss. Therefore, the net operating loss will be treated as a shipping loss for Z's 1988 taxable year. Pursuant to section 904(f)(5), the shipping loss will be allocated as follows: $20 ($60 x 100/300) will be allocated to Z's passive income and $40 ($60 x 200/300) will be allocated to Z's general limitation income. Accordingly, after application of section 904(f), Z has $80 of passive income and $160 of general limitation income for its 1988 taxable year. Although no addition to Z's overall foreign loss account for shipping income will result from the NOL carry forward, shipping income earned by Z in subsequent taxable years will be subject to recharacterization as passive income and general limitation income pursuant to the rules set forth in section 904(f)(5).

(c) *Treatment of overall foreign losses that are part of net operating losses incurred in post-effective date taxable years which are carried back to pre-effective date taxable years*—(1) *Allocation to analogous income category.* An overall foreign loss that is part of a net operating loss incurred by the taxpayer in a post-effective date taxable year which is carried back, pursuant to section 172, to a pre-effective date taxable year shall be allocated first to income in the pre-effective date income category analogous to the income category set forth in section 904(d) as in effect for post-effective date taxable years in which the loss occurred. Except for the general limitation income category, the pre-effective date income category that is analogous to a post-effective date income category shall be determined under paragraphs (a)(1)(i) through (iv) of this section. The general limitation income category for pre-effective date years shall be treated as the income category that is analogous to the post-effective date categories for general limitation income, financial services income, shipping income, dividends from each noncontrolled section 902 corporation and high withholding tax interest income. If the net operating loss resulted from separate limitation losses in more than one post-effective date income category and more than one loss is carried back to pre-effective date general limitation income, then the losses shall be allocated to the pre-effective date general limitation income based on the following formula:

$$\text{Pre-effective date general limitation income} \times \frac{\text{Loss in each post-effective date separate limitation category that is analogous to pre-effective date general limitation income}}{\text{Losses in all post-effective categories that are analogous to pre-effective date general limitation income.}}$$

(2) *Allocation to U.S. source income.* If an overall foreign loss is carried back to a pre-effective date taxable year and the loss exceeds the foreign source income in the analogous category for the carry back year, the remaining loss shall be allocated against U.S. source income as set forth in §1.904(f)-3. The amount of the loss that offsets U.S. source income must be added to the taxpayer's overall foreign loss account. In addition to an overall foreign loss account resulting from the carry back of a net operating loss incurred by a taxpayer

in a post-effective date taxable year shall be treated as having been incurred by the taxpayer in the year in which the loss arose and shall be subject to recapture pursuant to section 904(f) as in effect for post-effective date taxable years.

(3) *Allocation to other separate limitation categories.* To the extent that an overall foreign loss that is carried back as part of a net operating loss exceeds the separate limitation income to which it is allocated and the U.S. source income of the taxpayer for the taxable year to which the loss is carried, the loss shall be allocated pro rata to other separate limitation income of the taxpayer for the taxable year. However, there shall be no recharacterization of separate limitation income pursuant to section 904(f)(5) as a result of the allocation of such a net operating loss to other separate limitation income of the taxpayer.

(4) *Examples.* The following examples illustrate the rules of paragraph (c) of this section.

Example (1). X is a domestic corporation which has a branch operation in Country A. For its taxable year ending December 31, 1987, X has a $60 net operating loss which is carried back pursuant to section 172 to its taxable year ending December 31, 1985. The net operating loss resulted from a shipping loss; X had no U.S. source income in 1987. X had $20 of general limitation income, $40 of DISC limitation income and $10 of U.S. source income for its 1985 taxable year. The $60 NOL is allocated first to X's 1985 general limitation income to the extent thereof ($20) since the general limitation income category of section 904(d) as in effect for pre-effective date taxable years is the income category that is analogous to shipping income for post-effective date taxable years. Therefore, X has no general limitation income for its 1985 taxable year. Next, pursuant to section 904(f) as in effect for pre-effective date taxable years, the remaining $40 of the NOL is allocated first to X's $10 of U.S. source income and then to $30 of X's DISC limitation income for its 1985 taxable year. Accordingly, X has no U.S. source income and $10 of DISC limitation income for its 1985 taxable year after allocation of the NOL. X has a $10 balance in its shipping overall foreign loss account which is subject to recapture pursuant to section 904(f) as in effect for post-effective date taxable years. X will not be required to recharacterize, pursuant to section 904(f)(5), subsequent shipping income as DISC limitation income.

Example (2). Y is a domestic corporation which has a branch operation in Country B. For its taxable year ending December 31, 1987, X has a $200 net operating loss which is carried back pursuant to section 172 to its taxable year ending December 31, 1986. The net operating loss resulted from a ($100) general limitation loss and a ($100) shipping loss. Y had $100 of general limitation income and $200 of U.S. source income for its taxable year ending December 31, 1986. The separate limitation losses for 1987 are allocated pro rata to Y's 1986 general limitation income as follows: $50 of the ($100) general limitation loss ($100 x 100/200) and $50 of the ($100) shipping loss ($100 x 100/200) is allocated to Y's $100 of 1986 general limitation income. The remaining $50 of Y's general limitation loss and the remaining $50 of Y's shipping loss are allocated to Y's 1986 U.S. source income. Accordingly, Y has no foreign source income and $100 of U.S. source income for its 1986 taxable year. Y has a $50 balance in its general limitation overall foreign loss account and a $50 balance in its shipping overall foreign loss account, both of which will be subject to recapture pursuant to section 904(f) as in effect for post-effective date taxable years.

(d) *Recapture of FORI and general limitation overall foreign losses incurred in taxable years beginning before January 1, 1983.* For taxable years beginning after December 31, 1986, and before January 1, 1991, the rules set forth in §1.904(f)-6 shall apply for purposes of recapturing general limitation and foreign oil related income (FORI) overall foreign losses incurred in taxable years beginning before January 1, 1983 (pre-1983). For taxable years beginning after December 31, 1990, the rules set forth in this section shall apply for purposes of recapturing pre-1983 general limitation and FORI overall foreign losses.

(e) *Recapture of pre-1983 overall foreign losses determined on a combined basis.* The rules set forth in paragraph (a)(2) of this section shall apply for purposes of recapturing overall foreign losses incurred in taxable years beginning before January 1, 1983, that were computed on a combined basis in accordance with §1.904(f)-1(c)(1).

(f) *Transition rules for taxable years beginning before December 31, 1990.* For transition rules for taxable years beginning before January 1, 1990, see 26 CFR §1.904(f)-13T as it appeared in the Code of Federal Regulations revised as of April 1, 1990.

Fred T. Goldberg, Jr.,
Commissioner of Internal Revenue.

Approved June 14, 1990.

Kenneth W. Gideon,
Assistant Secretary of the Treasury.

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Section 905.—Applicable Rules

26 CFR 1.905-3T: Adjustments to the pools of foreign taxes and earnings and profits when the allowable foreign tax credit changes (temporary).

In the case of taxpayers that are deemed, under section 902 of the Code, to have paid income taxes to the United Kingdom, and that have chosen to credit the income taxes described in section 901 of the Code, Rev. Proc. 80-18, 1980-1 C.B. 623, is amplified with respect to the computation of the deemed paid foreign tax credit attributable to Advance Corporation Tax imposed by the United Kingdom. The creditable taxes attributable to Advance Corporation Tax computed under this amplification may be subject to a subsequent adjustment under section 905(c) of the Code, as provided in Rev. Proc. 80-18. See Rev. Proc. 90-61, page 657.

Subpart B.—Earned Income of Citizens or Residents of United States

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Section 911.—Citizens or Residents of the U.S. Living Abroad

26 CFR 1.911-1: Partial exclusion for earned income from sources within a foreign country and foreign housing costs.

Section 911(a) provides that a qualified individual may elect to exclude the individual's foreign earned income and housing cost amount from the individual's gross income for the taxable year. A qualified individual generally includes an individual who leaves a foreign country because of war, civil unrest, or similar adverse conditions. See Rev. Proc. 90-55, page 638.

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26 CFR 1.911-7: Procedural rules.

Revocation of elections. A qualified individual's claiming of a foreign tax credit with respect to foreign earned income eligible for exclusion under section 911 of the Code and that the taxpayer has elected to exclude is inconsistent with the previously made election or elections and generally will result in the revocation of one or both elections.

Rev. Rul. 90-77

ISSUE

If a taxpayer does not file a statement revoking a previously made election under section 911 of the In-

ternal Revenue Code of 1986, but the taxpayer chooses to take a foreign tax credit with respect to foreign taxes paid on foreign earned income eligible for exclusion under section 911(a) in a year in which he has an election to exclude foreign earned income in effect, does that choice constitute a revocation of the election under section 911(e)(2)?

FACTS

Situation 1

From January 1, 1984, through February 28, 1986, *A* was a qualified individual as defined in section 911(d)(1). As of March 1, 1986, *A* was no longer a qualified individual. *A* made a valid election to exclude foreign earned income under section 911(a)(1) and claimed the exclusion for the 1984 and 1985 taxable years. In the tax return for the 1986 taxable year, *A* did not claim the exclusion for which he was eligible for the period of beginning January 1, 1986, and ending February 28, 1986. Instead, *A* reported all gross income earned during the year and claimed a foreign tax credit for foreign taxes paid on foreign earned income. *A* did not file a statement with his 1986 tax return specifically revoking the section 911(a)(1) election.

Situation 2

The facts are the same as in *Situation 1*, except that *A* also made a valid election under section 911(a)(2) of the Code to exclude his housing cost amount and claimed that exclusion for 1984 and 1985.

Situation 3

B is a qualified individual under section 911(d)(1) for the period from January 1, 1986, through March 31, 1987. In 1987, *B* is eligible for a housing cost amount exclusion of 6x. However, as the result of an inadvertent miscalculation, *B* only claims a housing cost amount of 5x on his return and claims a foreign tax credit for 1x against foreign earned income which was excludable but due to the miscalculation was not excluded.

LAW AND ANALYSIS

Section 911(a) of the Code allows qualified citizens or residents of the United States living abroad to elect to exclude from gross income the foreign earned income and housing cost amounts of such individuals. The elections must be made separately with respect to each amount. Section 911(a). A taxpayer who has made either election may not deduct or credit foreign taxes paid or accrued with respect to the excluded amounts. Section 911(d)(6). Section 911(e)(1) of the Code provides that the elections apply to the taxable year for which made and to all subsequent taxable years unless the taxpayer revokes them. Section 911(e)(2) of the Code permits such a revocation, but provides that, without the consent of the Secretary, the taxpayer may not make another election before the sixth taxable year after the year for which the revocation was effective.

Section 1.911-7(b) of the Income Tax Regulations sets forth a procedure for revoking a section 911 election. An election may be revoked by filing a statement with the income tax return or amended return for the taxable year for which the revocation is to take effect. The revocation is effective for that year and all subsequent years. Each election claimed under section 911(a) of the Code must be revoked separately.

Situation 1

Although the regulations under section 911 of the Code prescribe a method by which a taxpayer may revoke an election to exclude foreign earned income, they do not purport to provide the exclusive method for revoking such an election. Taxpayers are required to revoke their elections and to obtain the consent of the Secretary to reelections to prevent them from abusing the tax benefits provided by section 911 through alternating between electing section 911 benefits and claiming foreign tax credits. Thus, to ensure that the taxpayer cannot abuse the benefits of section 911, the election made under section 911 will be considered revoked because the taxpayer's inclusion of income and the claiming of the foreign tax credit in a subsequent year is inconsistent with that election.

Situation 2

Section 1.911-7(b) of the regulations requires a separate revocation for each section 911 election. If the taxpayer has elected both exclusions, then claiming the foreign tax credit may result in the revocation of one or both of the exclusions, depending on the amount of the foreign tax credit claimed. For example, in 1986, *A* has foreign earned income of 12x. *A* may claim a section 911(a)(1) exclusion of 10x, and a housing cost exclusion pursuant to section 911(a)(2) of 2x. Instead of excluding foreign earned income, *A* claims a foreign tax credit with respect to foreign earned income of 12x. That will be inconsistent with both elections and will serve to revoke them both. If, however, the foreign tax credit had been claimed with respect to foreign earned income of an amount greater than 2x, but less than or equal to 10x, then the section 911(a)(1) election would be revoked but the housing cost exclusion would not be revoked and could be exercised in the future without the consent of the Secretary. If the foreign tax credit had been claimed with respect to foreign earned income of 2x or less, then *A* would be able to choose which election has been revoked. See §1.911-6(c) and (d) for rules and examples concerning the extent to which a deduction or credit for foreign taxes is disallowed when a taxpayer has foreign earned income that exceeds the amount that may be excluded under section 911(a)(1) and (2).

Situation 3

If the Secretary determines that such errors were made in good faith, computational errors made in determining the amount of foreign earned income that is excludable, which may affect the amount of the allowable foreign tax credit, will not be considered a revocation of a section 911 election.

HOLDING

If a taxpayer who is a qualified individual for a period claims a foreign tax credit with respect to foreign earned income that is eligible for exclusion under section 911(a) instead of excluding that income, then, because claiming the foreign tax credit is inconsistent with the previously made election or elections (the election or elections under section 911(d)(1)), one or both of the previously made elections will be considered revoked under section 911(e)(2). Computational errors made in good

faith in determining the amount of foreign earned income that is excludable, which may affect the amount of the allowable foreign tax credit, however, will not be considered a revocation of a section 911 election.

Section 912.—Exemption for Certain Allowances

Whether the value of lodging furnished to a "principal representative" of the U.S. is excludable from the gross income of the principal representative under section 119(a)(2) of the Code. Also, whether amounts deducted from the salary of the principal representative to pay for usual household expenses that must be borne personally by the representative are excludable from the gross income of the principal representative or allowable as a deduction. See Rev. Rul. 90-64, page 35.

Subpart C.—Taxation of Foreign Sales Corporations

Section 922.—FSC Defined

26 CFR 1.921-2: Foreign sales corporation—general rules.

Multiple FSCs and FSC bank account. A FSC and small FSC may both be members of a controlled group of corporations provided that they do not exist at the same time during the taxable year of the controlled group. When switching from a small FSC to FSC, the corporation has 30 days from the effective date of the FSC election to establish a principal FSC bank account.

Rev. Rul. 90-108

ISSUES

1. Does the phrase "newly created or organized corporation" contained in section 1.924(c)-1(c)(4) of the Income Tax Regulations include an existing corporation that revokes its small FSC status and makes a FSC election within the first 90 days of its taxable year?

2. Will the prohibition in section 922(b)(2) of the Internal Revenue Code and section 1.921-2(b), Q&A-3, of the regulations that a small FSC may not be member, at any time during the taxable year, of a controlled group of corporations, which includes a FSC unless such FSC is a small FSC be violated only if a FSC and small FSC exist at the same time during the taxable year of the controlled group?

FACTS

X, a domestic corporation, organized *Y*, a wholly owned subsidiary, in the U.S. Virgin Islands on January 1, 1985. *Y* began doing business on that date. On January 15, 1985, *Y* elected to be treated as a small foreign sales corporation (FSC) pursuant to sections 922(b)(1) and 927(f)(1) of the Code and section 1.921-1T(b)(1), Q&A-1, of the regulations. The election was effective as of January 1, 1985. Both *X* and *Y* are calendar year corporations.

Situation 1. On February 27, 1989, *Y* revoked its small FSC election pursuant to section 927(f)(3)(A) of the Code and section 1.927(f)-1(b), Q&A-14, of the regulations and elected pursuant to sections 922(a)(2) and 927(f)(1) and section 1.921-1T(b)(1), Q&A-1, to be treated as a FSC. Both the revocation of small FSC status and the election of FSC status were effective as of January 1, 1989. *Y* established a principal bank account, as that term is defined in section 924(c)(2) and section 1.924(c)-1(c), in the U.S. Virgin Islands on January 30, 1989.

Situation 2. On May 15, 1989, *X* liquidated *Y*. On the next day, May 16, 1989, *X* organized *Z*, a wholly owned subsidiary, in the U.S. Virgin Islands. On that date, *Z* began doing business and elected to be treated as a FSC pursuant to sections 922(a)(2) and 927(f)(1) of the Code and section 1.921-1T(b)(1), Q&A-1, of the regulations. The election was effective as of May 16, 1989. *Z* established a principal bank account, as that term is defined in section 924(c)(2) and section 1.924(c)-1(c), in the U.S. Virgin Islands on June 2, 1989.

LAW AND ANALYSIS

Situation 1.

Section 927(f)(1)(A) of the Code provides that an election by a corporation under section 922(a)(2) to be treated as a FSC, and an election under section 922(b)(1) to be treated as a small FSC, shall be made by the corporation for a taxable year at any time during the 90 day period immediately preceding the beginning of the taxable year, except that the Secretary may consent to the making of an election at other times as the Secretary may designate.

Section 1.921-1T(b)(1), Q&A-1, of the regulations sets forth exceptions and provides that an election of a new corporation to be treated as a small FSC or FSC, such as *Y* on January 15, 1985, may be made within 90 days after the beginning of the corporation's first taxable year. In addition, that regulation provides that an election to be a FSC (or a small FSC), such as the election made by *Y* on February 27, 1989, may be made during the first 90 days of any taxable year if the corporation had in a prior taxable year elected small FSC (or FSC) status and the corporation revokes the small FSC (or FSC) election within the 90 day period. If the election is made within that 90 day period, the election will be effective as of the first day of the taxable year.

Similarly, a revocation of a small FSC or FSC election made within the first 90 days of a year, other than the first taxable year, will be effective as of the first day of the taxable year. A revocation made after that 90 day period will be effective on the first day of the subsequent taxable year. *See* section 1.927(f)-1(b), Q&A-12 of the regulations.

Accordingly, *Y*'s small FSC election was effective on January 1, 1985; its revocation of its small FSC election was effective on January 1, 1989; and its election was effective on January 1, 1989.

Pursuant to sections 921 through 927 of the Code, a corporation that has elected FSC status will receive foreign sales corporation benefits on its foreign trading gross receipts. Under section 924(b)(1)(A), a FSC will have foreign trading gross receipts for the taxable year only if the management of the corporation during the year takes places outside the U.S. The requirements of section 924(b)(1)(A) do not apply to small FSCs such as *Y* during its taxable years 1985 through 1988. *See* section 1.921-2(b), Q&A-4, of the regulations. The requirements would apply, however, to *Y* during its taxable year 1989 since *Y* had elected FSC status for that year.

Section 1.924(c)-1 of the regulations sets forth the various management activities that must take place

outside the U.S. in order to satisfy the requirement of section 924(b)(1)-(A) of the Code. One of the requirements, as set forth in section 1.924(c)-1(c), is that the FSC maintain at all times during the taxable year, as its principal bank account, a bank account in a qualifying foreign country or in an eligible possession of the U.S., as defined in section 927(e)(3) and section 1.922-1(d) and (e).

If a newly created or organized corporation opens a qualifying principal bank account within 30 days of the effective date of the corporation's election to be treated as a foreign sales corporation and if it maintains that principal bank account for the remainder of the year, it will have satisfied the requirement that it maintain a principal bank account at all times during the year. *See* section 1.924(c)-1(c)(4) of the regulations. Therefore, although an election to be a foreign sales corporation made within the first 90 days of the corporation's taxable year will be effective as of the first day of that taxable year, the corporation will not have foreign trading gross receipts for that taxable year unless the corporation opens a principal bank account within 30 days of the first day of the taxable year.

The phrase "newly created or organized corporation" contained in section 1.924(c)-1(c)(4) of the regulations includes an existing corporation that revokes its small FSC status and makes a FSC election within the first 90 days of its taxable year. Accordingly, that corporation will have 30 days from the start of its taxable year, the date its election of FSC status becomes effective, to open a principal bank account.

Situation 2.

Pursuant to section 922(b)(2) of the Code and section 1.921-2(b), Q&A-3, of the regulations a small FSC may not be a member, at any time during the taxable year, of a controlled group of corporations, which includes a FSC unless such FSC is a small FSC.

In *Situation 2*, since *X* liquidated *Y* on May 15, 1989, and organized on the next day, May 16, 1989, a new wholly-owned subsidiary *Z* which elected to be treated as a FSC on that date, at no time during *X*'s taxable year did *X*'s controlled group include both a small FSC and FSC. Accordingly, *Z*'s FSC election is valid and is effective as of May 16, 1989.

Y will receive FSC benefits as a small FSC for the period from January 1, 1989, through May 15, 1989, but the $5 million small FSC limitation will be reduced to the amount which bears the same ratio to the $5 million as the number of days in the short year created by the liquidation bears to 365.

HOLDINGS

Situation 1. The phrase "newly created or organized corporation" contained in section 1.924(c)-1(c)(4) of the regulations includes an existing corporation that revokes its small FSC status and makes a FSC election within the first 90 days of its taxable year. Accordingly, that corporation will have 30 days from the start of its taxable year, the date its election of FSC status becomes effective, to open a principal bank account.

Situation 2. The prohibition in section 922(b)(2) of the Code and section 1.921-2(b), Q&A-3, of the regulations that a small FSC may not be a member, at any time during the taxable year, of a controlled group of corporations, which includes a FSC unless such FSC is a small FSC will be violated only if a FSC and small FSC exist at the same time during the taxable year of the controlled group.

Subpart D.—Possessions of the United States

Section 936.—Puerto Rico and Possession Tax Credit

26 CFR 1.936-7: Manner of making election under section 936(h)(5).

A taxpayer who has made an election to use the cost sharing method may change to the profit split method or the method permitted under section 936(h)(1)-(h)(4) for all taxable years beginning after December 31, 1986. See Rev. Proc. 90-50, page 624.

Subpart F.—Controlled Foreign Corporations

Section 952.—Subpart F Income Defined

Income derived from sources inside South Africa is subpart F income. See Rev. Rul. 90-53, page 178.

Section 953.—Insurance Income

Guidance is provided for a corporation whose section 953(d) election for its first taxable year beginning after December 31, 1987, was due before September 15, 1989, and that failed to make a timely election for that first taxable year. Following this guidance, such a corporation may make an election under section 953(d) that is effective as of the first day of its first taxable year beginning after December 31, 1987, if the election is made on or before March 15, 1991, and if the corporation has previously made an election for its second taxable year beginning after December 31, 1987. See Rev. Proc. 90-65, page 677.

Section 956.—Investment of Earnings in United States Property

26 CFR 1.956-1: Shareholder's pro rata share of a controlled foreign corporation's increase in earnings invested in United States property.

U.S. property owned by a partnership. For purposes of section 956 of the Code, real property located in the U.S. and owned by a partnership in which a controlled foreign corporation (CFC) is a partner constitutes U.S. property held by the CFC.

Rev. Rul. 90-112

ISSUE

Does a controlled foreign corporation hold "United States property" within the meaning of section 956 of the Internal Revenue Code when it is a partner in a partnership that owns real property located in the United States?

FACTS

S, a wholly owned Country *X* subsidiary of *P*, a domestic corporation, is a controlled foreign corporation (CFC) as defined in section 957 of the Code. *S* reports its income on a calendar year basis. *S* is not engaged in any United States business activity and does not earn any income that is effectively connected with a United States trade or business. *PRS*, an entity classified as a partnership for United States federal tax purposes, is organized under the laws of Country *X*. *S* owns a 25 percent interest in the capital and profits of *PRS*, which it purchased in 1987. The remaining 75 percent interest in *PRS* is owned by an unrelated Country *X* corporation. In 1988, *PRS* purchased undeveloped land in the United States. The land is not subject to any mortgages or other liabilities.

LAW AND ANALYSIS

Under section 956(a) of the Code, the amount of earnings of a CFC invested in United States property at the close of any taxable year is the aggregate amount of such property held, directly or indirectly, by the CFC at the close of the taxable year, to the extent such amount would have constituted a dividend if it had been distributed. Under section 956(b)(1), "United States property" is defined as any tangible property located in the United States. "Tangible property" includes undeveloped land. *See* section 1.956-2(a)(1)(i) of the Income Tax Regulations.

Section 956 of the Code, and the regulations thereunder, do not specifically address the treatment of a CFC's investment in United States property through a partnership. Whether a CFC partner is treated as holding, on the last day of its taxable year, a portion of the United States property owned by the partnership depends upon whether the partnership is viewed as an "entity" separate from its partners or as an "aggregate" of its partners for purposes of section 956. There is no exclusive rule as to when a partnership will be treated as an entity or as an aggregate for purposes outside of subchapter K. The resolution depends upon which approach is more appropriate to the specific Code section involved. *See, e.g.*, Rev. Rul. 89-72, 1989-1 C.B. 257, (a CFC's distributive share of income from a non-controlled partnership is treated as foreign base company sales income, if it would have been treated as such had it been realized directly by the CFC). *See also* Rev. Rul. 89-85, 1989-2 C.B. 218, and the authorities cited therein.

For purposes of section 956 of the Code, a CFC is considered to hold United States property if it holds the property directly or indirectly. *See* section 956(a)(1). This rule is a specific application of the general principle that section 956 is concerned with the substance of a transaction and not merely its form. *See* Rev. Rul. 89-73, 1989-1 C.B. 258. The House Report on the Revenue Act of 1962, which adopted section 956, stated that an objective of that section was "to prevent the repatriation of income to the United States in a manner which does not subject it to U.S. taxation." H.R. Rep. No. 1447, 87th Cong., 2d Sess. (1962), at 58, 1962-3 C.B. 405, 462. While taxpayers with excess foreign tax credits may desire to trigger a section 956 inclusion, it is still appropriate to construe section 956 in a manner consistent with this statement under these facts.

The purpose of section 956 of the Code would be frustrated if it were construed not to reach the United States property held by a CFC through a partnership. Thus, in the context of section 956, it is appropriate to apply the aggregate view of a partnership so that the United States property of the CFC includes United States property held by the CFC through a partnership. This result applies section 956 according to the substance of the arrangement, without regard to whether the form of the ownership is direct or indirect.

Therefore, for purposes of section 956 of the Code, *S* is considered to hold on the last day of its 1988 taxable year, a 25 percent interest in the undeveloped land that is owned by *PRS* on such date. The amount taken into account, for purposes of section 956, with respect to *S*'s 25 percent interest in the undeveloped land will be 25 percent of *PRS*'s adjusted basis in the land, limited by *S*'s total basis in *PRS*. See section 1.956-1(e)(1) of the regulations. The result would be the same if *PRS* were a domestic partnership. *See* Tax Equity & Fiscal Responsibility Act of 1982 (TEFRA), section 404, 1982-2 C.B. 462, 596, and section 6031 and the regulations thereunder, for the return filing requirements for partnerships.

HOLDING

Real property located in the United States that is owned by a partnership in which a controlled foreign corporation is a partner constitutes United States property held by the CFC for purposes of section 956(b) of the Code.

Section 960.—Special Rules for Foreign Tax Credits

The indirect foreign tax credit allowed under section 960 of the Code is denied for taxes deemed paid on income attributable to taxable years beginning after December 31, 1987. See Rev. Rul. 90-53, page 178.

Subpart J.—Foreign Currency Transactions

Section 988.—Treatment of Certain Foreign Currency Transactions

26 CFR 1.988-1T(a): Certain definitions and special rules (temporary).
(Also Section 165; 1.165-1.)

Currency gain or loss recognition; mortgage gain or loss; personal residence. Gain or loss realized by a U.S. citizen from the sale of a personal residence may not be offset by loss or gain realized from the repayment of a nonfunctional currency denominated mortgage loan used to finance the purchase of the residence.

Rev. Rul. 90-79

ISSUE

Can an individual U.S. citizen offset the gain (or loss) realized from the sale of a personal residence with a loss (or gain) realized from the repayment of a nonfunctional currency denominated mortgage loan used to finance the purchase of the residence?

FACTS

In 1986 *A*, an individual U.S. citizen, purchased property in country *X* that *A* used exclusively as a personal residence. The purchase price was 95,000*y*. *A* financed the purchase with a loan of 85,000*y* when $1 equaled 1*y*, and 10,000*y* cash payment. In 1989 *A* sold the personal residence for 142,500*y*, and used 85,000*y* of the sale proceeds to repay the outstanding principal balance of the mortgage. At the time of the sale and repayment, $1 equaled .95*y*.

A's basis in the personal residence is $95,000 (95,000*y* at $1 equals 1*y*). The amount realized upon the sale of the residence is $150,000 (142,500*y* at $1 equals .95*y*); therefore, *A* realizes a gain of $55,000 ($150,000—$95,000).

A's functional currency under section 985(b)(1) of the Internal Revenue Code is the United States dollar (dollar). The *y* is a nonfunctional currency with respect to *A*. None of the expenses incurred by *A* in connection with the purchase, financing, or sale of the personal residence were deductible under section 162 (relating to trade or business expenses) or section 212(1) or (2) (relating to expenses for the production of income).

LAW ANALYSIS

Section 985(a) of the Code generally provides that all income tax determinations shall be made in a taxpayer's functional currency. An individual may have a qualified business unit (QBU) that has a non-dollar functional currency. *See* section 1.989(a)-1(b) of the Income Tax Regulations. However, an activity that does not generate expenses that are deductible under either section 162 or section 212(1) or (2) does not qualify as a QBU. *See* section 1.989(a)-1(c) of the regulations. Therefore, *A* must make all income tax determinations with respect to the purchase, financing, and sale of the personal residence in the dollar.

Section 988 of the Code provides rules for the treatment of "section 988 transactions" including becoming an obligor under a mortgage. Section 988(c)(1)(B)(i). However, under section 988(e), the rules of section 988 apply to a transaction entered into by an individual only to the extent expenses allocable to the transaction meets the requirements of section 162 or section 212(1) or (2). Because there are no expenses properly allocable to the mortgage that meet the requirements of either section 162 or section 212(1) or (2), the rules of section 988 do not apply to *A*'s becoming an obligor under the mortgage. Therefore, the law predating section 988 governs. *See* S. Rep. No. 99-313, 99th Cong., 2d Sess. 468-69 (1986), 1986-3 C.B. (Vol. 3) 468-69.

Under the law predating section 988, the borrowing and repayment of the mortgage loan is a separate transaction from the purchase and sale of the personal residence. *See Helburn v. Commissioner*, 214 F.2d 815, 818-19 (1st Cir. 1954); *Church's English Shoes, Ltd.*, 24 T.C. 56, 59 (1955), *aff'd per curiam* 229 F.2d 957 (2nd Cir. 1956); Rev. Rul. 78-281, 1978-2 C.B. 204. The repayment of the mortgage by *A* constitutes a closed, and therefore, taxable transaction. *See Church's English Shoes, supra*; and Rev. Rul. 78-281.

Since the *y* increased in value against the dollar between the time *A*'s liability was fixed (at the time of the borrowing) and the time *A* repaid the loan, the amount of dollars required to retire the debt exceeded the dollar value of the amount originally borrowed. Therefore, *A* realized a loss on the loan repayment. The amount of the loss is $4,474. (The dollar value of 85,000*y* borrowed: $85,000, less the dollar value of 85,000*y* used to repay the loan: $89,474.)

Section 165(a) of the Code provides generally that a deduction shall be allowed for losses sustained during a taxable year and not compensated for by insurance or otherwise. Section 165(c) limits the loss deduction for individuals to losses incurred in a trade or business, losses incurred in any transaction entered into for profit, and casualty losses. Thus, an individual is not allowed to deduct all realized losses. *See Billman v. Commissioner*, 73 T.C. 139 (1979), where the Tax Court denied an individual a loss resulting from the devaluation of a foreign currency.

A's loss was not incurred in an activity or as the result of an event described in section 165(c) of the Code. Therefore *A* may not deduct the $4,474 realized loss. Similarly, if *A* had realized a loss on the sale of the personal residence and a gain on the repayment of the mortgage, *A* could not deduct the loss.

HOLDING

An individual may not offset the gain (or loss) realized from the sale of a personal residence with a loss (or gain) realized on the repayment of a nonfunctional currency denominated mortgage loan used to finance the purchase of the residence.

Part IV.—Domestic International Sales Corporations
Subpart B.—Treatment of Distributions to Shareholders

Section 995.—Taxation of DISC Income to Shareholders

Taxation of DISC income to shareholder. The "base period T-bill rate" for the period ending September 30, 1990, is published, as required by section 995(f)(4) of the Code.

Rev. Rul. 90-96

Section 995(f)(l) of the Internal Revenue Code provides that a shareholder of a DISC shall pay interest each taxable year in an amount equal to the product of the shareholder's DISC-related deferred tax liability for the year and the "base period T-bill rate." Under section 995(f)(4), the base period T-bill rate is the annual rate of interest determined by the Secretary to be equivalent to the average investment yield of United States Treasury bills with maturities of 52 weeks which were auctioned during the one-year period ending on September 30 of the calendar year ending with (or of the most recent calendar year ending before) the close of the taxable year of the shareholder. The base period T-bill rate for the period ending September 30, 1990, is 8.02 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 1990 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; and Rev. Rul. 89-116, 1989-2 C.B. 197.

ANNUAL RATE, COMPOUNDED DAILY

DAYS	8.02 PERCENT FACTOR
1	0.000219726
2	0.000439500
3	0.000659323
4	0.000879194
5	0.001099113

ANNUAL RATE, COMPOUNDED DAILY		ANNUAL RATE, COMPOUNDED DAILY		ANNUAL RATE, COMPOUNDED DAILY	
DAYS	8.02 PERCENT FACTOR	DAYS	8.02 PERCENT FACTOR	DAYS	8.02 PERCENT FACTOR
6	0.001319081	56	0.012379303	106	0.023561693
7	0.001539096	57	0.012601749	107	0.023786596
8	0.001759161	58	0.012824244	108	0.024011548
9	0.001979273	59	0.013046788	109	0.024236550
10	0.002199434	60	0.013269381	110	0.024461602
11	0.002419643	61	0.013492022	111	0.024686703
12	0.002639901	62	0.013714713	112	0.024911853
13	0.002860207	63	0.013937452	113	0.025137053
14	0.003080562	64	0.014160241	114	0.025362302
15	0.003300965	65	0.014383078	115	0.025587601
16	0.003521416	66	0.014605965	116	0.025812949
17	0.003741916	67	0.014828900	117	0.026038347
18	0.003962464	68	0.015051884	118	0.026263794
19	0.004183061	69	0.015274917	119	0.026489291
20	0.004403706	70	0.015498000	120	0.026714838
21	0.004624399	71	0.015721131	121	0.026940434
22	0.004845142	72	0.015944312	122	0.027166079
23	0.005065932	73	0.016167541	123	0.027391774
24	0.005286771	74	0.016390819	124	0.027617519
25	0.005507659	75	0.016614147	125	0.027843313
26	0.005728595	76	0.016837523	126	0.028069157
27	0.005949580	77	0.017060949	127	0.028295051
28	0.006170613	78	0.017284424	128	0.028520994
29	0.006391695	79	0.017507948	129	0.028746987
30	0.006612826	80	0.017731521	130	0.028973029
31	0.006834005	81	0.017955143	131	0.029199121
32	0.007055232	82	0.018178814	132	0.029425263
33	0.007276508	83	0.018402535	133	0.029651455
34	0.007497833	84	0.018626304	134	0.029877696
35	0.007719207	85	0.018850123	135	0.030103987
36	0.007940629	86	0.019073991	136	0.030330328
37	0.008162100	87	0.019297908	137	0.030556718
38	0.008383619	88	0.019521874	138	0.030783158
39	0.008605187	89	0.019745889	139	0.031009648
40	0.008826804	90	0.019969954	140	0.031236188
41	0.009048470	91	0.020194068	141	0.031462777
42	0.009270184	92	0.020418231	142	0.031689416
43	0.009491947	93	0.020642444	143	0.031916105
44	0.009713758	94	0.020866706	144	0.032142844
45	0.009935619	95	0.021091016	145	0.032369633
46	0.010157528	96	0.021315377	146	0.032596471
47	0.010379486	97	0.021539786	147	0.032823360
48	0.010601493	98	0.021764245	148	0.033050298
49	0.010823548	99	0.021988753	149	0.033277286
50	0.011045652	100	0.022213311	150	0.033504324
51	0.011267805	101	0.022437918	151	0.033731411
52	0.011490007	102	0.022662574	152	0.033958549
53	0.011712258	103	0.022887280	153	0.034185737
54	0.011934557	104	0.023112035	154	0.034412974
55	0.012156906	105	0.023336839	155	0.034640262

ANNUAL RATE, COMPOUNDED DAILY		ANNUAL RATE, COMPOUNDED DAILY		ANNUAL RATE, COMPOUNDED DAILY	
DAYS	8.02 PERCENT FACTOR	DAYS	8.02 PERCENT FACTOR	DAYS	8.02 PERCENT FACTOR
156	0.034867599	206	0.046298387	256	0.057855435
157	0.035094987	207	0.046528286	257	0.058087873
158	0.035322424	208	0.046758235	258	0.058320363
159	0.035549911	209	0.046988235	259	0.058552903
160	0.035777448	210	0.047218286	260	0.058785495
161	0.036005036	211	0.047448387	261	0.059018138
162	0.036232673	212	0.047678539	262	0.059250831
163	0.036460360	213	0.047908741	263	0.059483576
164	0.036688098	214	0.048138994	264	0.059716373
165	0.036915885	215	0.048369297	265	0.059949220
166	0.037143722	216	0.048599651	266	0.060182118
167	0.037371610	217	0.048830056	267	0.060415068
168	0.037599547	218	0.049060511	268	0.060648069
169	0.037827535	219	0.049291017	269	0.060881121
170	0.038055573	220	0.049521574	270	0.061114224
171	0.038283660	221	0.049752181	271	0.061347378
172	0.038511798	222	0.049982839	272	0.061580584
173	0.038739986	223	0.050213547	273	0.061813841
174	0.038968225	224	0.050444306	274	0.062047149
175	0.039196513	225	0.050675116	275	0.062280508
176	0.039424852	226	0.050905977	276	0.062513919
177	0.039653240	227	0.051136888	277	0.062747381
178	0.039881679	228	0.051367851	278	0.062980894
179	0.040110168	229	0.051598863	279	0.063214459
180	0.040338707	230	0.051829927	280	0.063448075
181	0.040567297	231	0.052061041	281	0.063681742
182	0.040795937	232	0.052292207	282	0.063915460
183	0.041024627	233	0.052523423	283	0.064149230
184	0.041253367	234	0.052754689	284	0.064383052
185	0.041482157	235	0.052986007	285	0.064616924
186	0.041710998	236	0.053217375	286	0.064850848
187	0.041939889	237	0.053448795	287	0.065084824
188	0.042168830	238	0.053680265	288	0.065318851
189	0.042397822	239	0.053911786	289	0.065552929
190	0.042626864	240	0.054143358	290	0.065787059
191	0.042855956	241	0.054374980	291	0.066021240
192	0.043085099	242	0.054606654	292	0.066255472
193	0.043314292	243	0.054838379	293	0.066489757
194	0.043543535	244	0.055070154	294	0.066724092
195	0.043772829	245	0.055301980	295	0.066958479
196	0.044002173	246	0.055533858	296	0.067192918
197	0.044231567	247	0.055765786	297	0.067427408
198	0.044461012	248	0.055997765	298	0.067661949
199	0.044690507	249	0.056229795	299	0.067896542
200	0.044920053	250	0.056461877	300	0.068131187
201	0.045149649	251	0.056694009	301	0.068365883
202	0.045379296	252	0.056926192	302	0.068600631
203	0.045608993	253	0.057158426	303	0.068835430
204	0.045838740	254	0.057390711	304	0.069070281
205	0.046068538	255	0.057623048	305	0.069305184

DAYS	ANNUAL RATE, COMPOUNDED DAILY 8.02 PERCENT FACTOR
306	0.069540138
307	0.069775144
308	0.070010201
309	0.070245311
310	0.070480471
311	0.070715684
312	0.070950948
313	0.071186264
314	0.071421631
315	0.071657050
316	0.071892521
317	0.072128044
318	0.072363618
319	0.072599245
320	0.072834923
321	0.073070652
322	0.073306434
323	0.073542267
324	0.073778152
325	0.074014089
326	0.074250078
327	0.074486119
328	0.074722212
329	0.074958356
330	0.075194552
331	0.075430801
332	0.075667101
333	0.075903453
334	0.076139857
335	0.076376313
336	0.076612821
337	0.076849380
338	0.077085992
339	0.077322656
340	0.077559372
341	0.077796140
342	0.078032960
343	0.078269831
344	0.078506755
345	0.078743731
346	0.078980760
347	0.079217840
348	0.079454972
349	0.079692156
350	0.079929393
351	0.080166681
352	0.080404022
353	0.080641415
354	0.080878860
355	0.081116357

DAYS	ANNUAL RATE, COMPOUNDED DAILY 8.02 PERCENT FACTOR
356	0.081353907
357	0.081591508
358	0.081829162
359	0.082066868
360	0.082304626
361	0.082542437
362	0.082780300
363	0.083018215
364	0.083256182
365	0.083494201
366	0.083732273
367	0.083970397
368	0.084208574
369	0.084446803
370	0.084685084
371	0.084923418

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

If a foreign person engages in U.S. barter transactions through a partnership or through a dependent agent, is gain or loss recognized on each separate barter transaction? See Rev. Rul. 90-80, page 170.

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26 CFR 1.1001-1: Computation of gain or loss.
(Also Section 1035; 1.1035-1.)

Change of insured. If a life insurance policy provides the policyholder with an option to change the insured, the exercise of the option is a sale or other disposition under section 1001 of the Code and section 1035 does not apply.

Rev. Rul. 90-109

ISSUE

If a life insurance policy provides the policyholder with an option to change the insured, is the exercise of the option a sale or other disposition of the policy under section 1001 of the Internal Revenue Code? If so, do the nonrecognition provisions of section 1035 apply to the transaction?

FACTS

In 1987, *X*, a corporation, purchased a key person insurance policy on the life of *A*, an employee of the corporation. *X* was the sole beneficiary under the policy. The policy provided that *X* had the option to change the insured.

In 1988, *A* ceased to be employed by *X*. Thereafter, *X* hired *B* to replace *A* and exercised the option in the policy to change the insured from *A* to *B*. The insurance company thereupon substituted *B* for *A* as the person insured under the policy. The benefits and premiums under the policy were not changed.

LAW AND ANALYSIS

Section 1001(c) of the Code provides that, except as otherwise provided in subtitle A, the entire amount of the gain or loss on the sale or exchange of property shall be recognized.

Section 1001(a) of the Code provides that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

Section 1035 of the Code provides that no gain or loss shall be recognized on the exchange of a contract of life insurance for another contract of life insurance.

In order for a contract to be considered a life insurance contract for purposes of the Code, the contract must satisfy the requirements of section 7702 of the Code. To be considered a life insurance contract for purposes of section 1035, the contract must also satisfy the definition of "life insurance contract" in section 1035(b)(3). That section defines the term "life insurance contract" for purposes of section 1035 to mean a contract with an insurance company which depends in part on the life expectancy of the insured but which is not ordinarily payable in full during the life of the insured.

Section 1.1035-1 of the Income Tax Regulations provides that an exchange of a contract of life insurance for another contract of life insurance does not qualify for nonrecognition

treatment under section 1035 if the policies exchanged do not relate to the same insured.

A change in contractual terms effected through an option provided in the original contract is treated as an exchange under section 1001 if there is a sufficiently fundamental or material change that the substance of the original contract is altered through the exercise of the option. Under such circumstances, the old contract is treated as if it were actually exchanged for a new one. *Cf.* Rev. Rul. 69-135, 1969-1 C.B. 198 (recognition of realized gain or loss under former section 1002 where bonds of one corporation are converted into stock of another corporation pursuant to an option contained in the bonds). *See also* Rev. Rul. 79-155, 1979-1 C.B. 153 (addition of new parent as obligor is a change which, together with other changes, constitutes a material change for purposes of section 1001).

In the present situation, *X* exercised an option in its key person insurance policy that permitted it to change the insured from *A*, the original insured under the policy, to *B*, the new insured. This resulted in a change in the fundamental substance of the original contract because the essence of a life insurance contract is the life that is insured under the contract. Thus, *X*'s exercise of the change-of-insureds option is substantively the same as an actual exchange of contracts and is a sale or other disposition for purposes of section 1001.

Section 1.1035-1 of the regulations expressly excludes from the application of section 1035 exchanges of policies that do not relate to the same insured and thus prevents policy owners from deferring indefinitely recognition of gain with respect to the policy value. Had *X* actually assigned a life insurance policy on *A* to the insurance company as consideration for a new life insurance policy on *B*, any gain realized on the exchange would have been ineligible for nonrecognition treatment under section 1035 of the Code. *X* cannot avoid the same-insured limitations of section 1035 simply by placing terms in its original documents that obviate the need for an actual exchange but nevertheless effect a de facto exchange of the original contract for a new contract on a different insured. For example, the result would be the same if *X* insured a person holding a particular position and, thus, no formal substitution is made when a new person occupies that position.

HOLDING

The exercise of an option in an insurance policy to change the insured constitutes a sale or other disposition under section 1001 of the Code, and this disposition does not qualify as a tax-free exchange of insurance policies under section 1035.

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 under optional standard mileage rate method for business use of an automobile. See Rev. Proc. 90-59, page 644.

Part III.—Common Nontaxable Exchanges

Section 1035.—Certain Exchanges of Insurance Policies

26 CFR 1.1035-1: Certain exchanges of insurance policies.

If a life insurance policy provides the policyholder with an option to change the insured, is the exercise of the option a sale or other disposition of the policy under section 1001 of the Code? If so, do the nonrecognition provisions of section 1035 apply to the transaction? See Rev. Rul. 90-109, page 191.

Subchapter P.—Capital Gains or Losses

Part IV.—Special Rules for Determining Capital Gains and Losses

Section 1231.—Property Used in the Trade or Business and Involuntary Conversions

26 CFR 1.1231-1: Gains and losses from the sale or exchange of certain property used in the trade or business.

Whether the death of planted timber tree seedlings as a result of an abnormal drought is treated as an involuntary conversion under section 1231(a)(4)(B) of the Code. See Rev. Rul. 90-61, page 39.

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, 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 1990.

Rev. Rul. 90-52

This revenue ruling provides various prescribed rates for federal income tax purposes for July 1990 (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 sets forth the blended annual rate for 1990 for purposes of section 7872.

REV. RUL. 90-52 TABLE 1

Applicable Federal Rates (AFR) for July 1990

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	8.47%	8.30%	8.22%	8.16%
110% AFR	9.34%	9.13%	9.03%	8.96%
120% AFR	10.21%	9.96%	9.84%	9.76%
Mid-Term				
AFR	8.74%	8.56%	8.47%	8.41%
110% AFR	9.64%	9.42%	9.31%	9.24%
120% AFR	10.53%	10.27%	10.14%	10.06%
150% AFR	13.25%	12.84%	12.64%	12.51%
175% AFR	15.54%	14.98%	14.71%	14.53%
Long-Term				
AFR	8.73%	8.55%	8.46%	8.40%
110% AFR	9.63%	9.41%	9.30%	9.23%
120% AFR	10.52%	10.26%	10.13%	10.05%

REV. RUL. 90-52 TABLE 2

Adjusted AFR for July 1990

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	6.10%	6.01%	5.97%	5.94%
Mid-term adjusted AFR	6.44%	6.34%	6.29%	6.26%
Long-term adjusted AFR	6.95%	6.83%	6.77%	6.73%

REV. RUL. 90-52 TABLE 3

Rates Under Section 382 for July 1990

Adjusted federal long-term rate for the current month	6.95%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months).	7.19%

REV. RUL. 90-52 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for July 1990

Appropriate percentage for the 70% present value low-income housing credit	9.07%
Appropriate percentage for the 30% present value low-income housing credit	3.89%

REV. RUL. 90-52 TABLE 5

Rate under section 7520 for July 1990

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	10.6%

REV. RUL. 90-52 TABLE 6

Blended Annual Rate for 1990

Section 7872(e)(2) blended annual rate for 1990	8.19%

(Also Sections 42, 280G, 382, 412, 467, 468, 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 1990.

Rev. Rul. 90-66

This revenue ruling provides various prescribed rates for federal income tax purposes for August 1990. 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. 90-66 TABLE 1

Applicable Federal Rates (AFR) for August 1990

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	8.40%	8.23%	8.15%	8.09%
110% AFR	9.25%	9.05%	8.95%	8.88%
120% AFR	10.12%	9.88%	9.76%	9.68%
Mid-Term				
AFR	8.66%	8.48%	8.39%	8.33%
110% AFR	9.55%	9.33%	9.22%	9.15%
120% AFR	10.44%	10.18%	10.05%	9.97%
150% AFR	13.12%	12.72%	12.52%	12.40%
175% AFR	15.39%	14.84%	14.57%	14.40%
Long-Term				
AFR	8.67%	8.49%	8.40%	8.34%
110% AFR	9.56%	9.34%	9.23%	9.16%
120% AFR	10.45%	10.19%	10.06%	9.98%

REV. RUL. 90-66 TABLE 2

Adjusted AFR for August 1990

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	6.10%	6.01%	5.97%	5.94%
Mid-term adjusted AFR	6.44%	6.34%	6.29%	6.26%
Long-term adjusted AFR	7.00%	6.88%	6.82%	6.78%

REV. RUL. 90-66 TABLE 3

Rates Under Section 382 for August 1990

Adjusted federal long-term rate for the current month	7.00%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months).	7.19%

REV. RUL. 90-66 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for August 1990

Appropriate percentage for the 70% present value low-income housing credit	9.05%
Appropriate percentage for the 30% present value low-income housing credit	3.88%

REV. RUL. 90-66 TABLE 5

Rate under section 7520 for August 1990

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	10.4%

(Also Sections 42, 280G, 382, 412, 467, 468, 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 1990.

Rev. Rul. 90-75

This revenue ruling provides various prescribed rates for federal income tax purposes for September 1990 (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. 90-75 TABLE 1

Applicable Federal Rates (AFR) for September 1990

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	8.08%	7.92%	7.84%	7.79%
110% AFR	8.90%	8.71%	8.62%	8.56%
120% AFR	9.73%	9.50%	9.39%	9.32%
Mid-Term				
AFR	8.53%	8.36%	8.27%	8.22%
110% AFR	9.41%	9.20%	9.10%	9.03%
120% AFR	10.28%	10.03%	9.91%	9.83%
150% AFR	12.93%	12.54%	12.35%	12.22%
175% AFR	15.17%	14.63%	14.37%	14.20%

REV. RUL. 90-75 TABLE 1

Applicable Federal Rates (AFR) for September 1990

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Long-Term				
AFR	8.74%	8.56%	8.47%	8.41%
110% AFR	9.64%	9.42%	9.31%	9.24%
120% AFR	10.53%	10.27%	10.14%	10.06%

REV. RUL. 90-75 TABLE 2

Adjusted AFR for September 1990

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	6.04%	5.95%	5.91%	5.88%
Mid-term adjusted AFR	6.35%	6.25%	6.20%	6.17%
Long-term adjusted AFR	6.93%	6.81%	6.75%	6.72%

REV. RUL. 90-75 TABLE 3

Rates Under Section 382 for September 1990

Adjusted federal long-term rate for the current month	6.93%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months).	7.00%

REV. RUL. 90-75 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for September 1990

Appropriate percentage for the 70% present value low-income housing credit	9.05%
Appropriate percentage for the 30% present value low-income housing credit	3.88%

REV. RUL. 90-75 TABLE 5

Rate under section 7520 for September 1990

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	10.2%

(Also Sections 42, 280G, 382, 412, 467, 468, 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 1990.

Rev. Rul. 90-81

This revenue ruling provides various prescribed rates for federal income tax purposes for October 1990 (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. 90-81 TABLE 1

Applicable Federal Rates (AFR) for October 1990

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	8.16%	8.00%	7.92%	7.87%
110% AFR	8.99%	8.80%	8.71%	8.64%
120% AFR	9.83%	9.60%	9.49%	9.41%
Mid-Term				
AFR	8.82%	8.63%	8.54%	8.48%
110% AFR	9.72%	9.49%	9.38%	9.31%
120% AFR	10.63%	10.36%	10.23%	10.14%
150% AFR	13.37%	12.95%	12.75%	12.61%
175% AFR	15.67%	15.10%	14.83%	14.65%
Long-Term				
AFR	9.12%	8.92%	8.82%	8.76%
110% AFR	10.05%	9.81%	9.69%	9.62%
120% AFR	10.99%	10.70%	10.56%	10.47%

REV. RUL. 90-81 TABLE 2

Adjusted AFR for October 1990

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	6.16%	6.07%	6.02%	5.99%
Mid-term adjusted AFR	6.56%	6.46%	6.41%	6.37%
Long-term adjusted AFR	7.12%	7.00%	6.94%	6.90%

REV. RUL. 90-81 TABLE 3

Rates Under Section 382 for October 1990

Adjusted federal long-term rate for the current month	7.12%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months).	7.12%

REV. RUL. 90-81 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for October 1990

Appropriate percentage for the 70% present value low-income housing credit	9.13%
Appropriate percentage for the 30% present value low-income housing credit	3.91%

REV. RUL. 90-81 TABLE 5

Rate under section 7520 for October 1990

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	10.6%

(Also Sections 42, 280G, 382, 412, 467, 468, 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 1990.

Rev. Rul. 90-92

This revenue ruling provides various prescribed rates for federal income tax purposes for November 1990 (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. 90-92 TABLE 1

Applicable Federal Rates (AFR) for November 1990

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	8.04%	7.88%	7.80%	7.75%
110% AFR	8.86%	8.67%	8.58%	8.52%
120% AFR	9.68%	9.46%	9.35%	9.28%
Mid-Term				
AFR	8.78%	8.60%	8.51%	8.45%
110% AFR	9.68%	9.46%	9.35%	9.28%
120% AFR	10.59%	10.32%	10.19%	10.10%
150% AFR	13.32%	12.90%	12.70%	12.57%
175% AFR	15.62%	15.05%	14.78%	14.60%
Long-Term				
AFR	9.13%	8.93%	8.83%	8.77%
110% AFR	10.06%	9.82%	9.70%	9.62%
120% AFR	11.01%	10.72%	10.58%	10.49%

REV. RUL. 90-92 TABLE 2

Adjusted AFR for November 1990

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	6.21%	6.12%	6.07%	6.04%
Mid-term adjusted AFR	6.56%	6.46%	6.41%	6.37%
Long-term adjusted AFR	7.21%	7.08%	7.02%	6.98%

REV. RUL. 90-92 TABLE 3

Rates Under Section 382 for November 1990

Adjusted federal long-term rate for the current month	7.21%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months).	7.21%

REV. RUL. 90-92 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for November 1990

Appropriate percentage for the 70% present value low-income housing credit	9.13%
Appropriate percentage for the 30% present value low-income housing credit	3.91%

REV. RUL. 90-92 TABLE 5

Rate under section 7520 for November 1990

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	10.6%

(Also Sections 42, 280G, 382, 412, 467, 468, 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 1990.

Rev. Rul. 90-99

This revenue ruling provides various prescribed rates for federal income tax purposes for December 1990 (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 annual rate for purposes of section 846 and section 807.

REV. RUL. 90-99 TABLE 1

Applicable Federal Rates (AFR) for December 1990

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	7.80%	7.65%	7.58%	7.53%
110% AFR	8.60%	8.42%	8.33%	8.28%
120% AFR	9.39%	9.18%	9.08%	9.01%
Mid-Term				
AFR	8.50%	8.33%	8.25%	8.19%
110% AFR	9.37%	9.16%	9.06%	8.99%
120% AFR	10.25%	10.00%	9.88%	9.80%
150% AFR	12.89%	12.50%	12.31%	12.19%
175% AFR	15.11%	14.58%	14.32%	14.16%
Long-Term				
AFR	8.87%	8.68%	8.59%	8.53%
110% AFR	9.78%	9.55%	9.44%	9.37%
120% AFR	10.69%	10.42%	10.29%	10.20%

REV. RUL. 90-99 TABLE 2

Adjusted AFR for December 1990

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	6.00%	5.91%	5.87%	5.84%
Mid-term adjusted AFR	6.35%	6.25%	6.20%	6.17%
Long-term adjusted AFR	7.08%	6.96%	6.90%	6.86%

REV. RUL. 90-99 TABLE 3

Rates Under Section 382 for December 1990

Adjusted federal long-term rate for the current month	7.08%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months).	7.21%

REV. RUL. 90-99 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for December 1990

Appropriate percentage for the 70% present value low-income housing credit	9.06%
Appropriate percentage for the 30% present value low-income housing credit	3.88%

REV. RUL. 90-99 TABLE 5

Rate under section 7520 for December 1990

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	10.2%

REV. RUL. 90-99 TABLE 6

Rate Under Sections 846 and 807

Applicable Rate of Interest for 1991 for purposes of sections 846 and 807.	8.42%

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 1990 calendar year. See Rev. Rul. 90-68, below.

Section 1274A.—Special Rules for Certain Transactions Where Stated Principal Amount Does Not Exceed $2,800,000

(Also Sections 1274, 483.)

Inflation adjustment; qualified debt instrument; cash method debt instrument. This revenue ruling provides inflation-adjusted stated principal amounts for qualified debt instruments and cash method debt instruments for sales or exchanges occurring in the 1990 calendar year.

Rev. Rul. 90-68

This revenue ruling provides the dollar amounts, increased by the 1990 inflation adjustment, for section 1274A of the Internal Revenue Code.

BACKGROUND

In general, sections 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 section 1274 is taken into account under the original issue discount provisions of the Code. Section 1274A, however, modifies the rules under sections 483 and 1274 for certain types of debt instruments.

In the case of a "qualified debt instrument," the discount rate used for purposes of sections 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 section 38 property within the meaning of section 48(b)) if the stated

principal amount of the instrument does not exceed the amount specified in section 1274A(b). For 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 section 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, section 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 section 1274A(c), and (D) An election under section 1274A(c) is jointly made with respect to the debt instrument by the borrower and lender.

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 section 1274A(b) and section 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 the calendar year.

INFLATION-ADJUSTED AMOUNTS

For debt instruments arising out of sales or exchanges after December 31, 1989, the inflation-adjusted amounts under section 1274A are shown in Table 1.

Rev. Rul. 90-68 Table 1
Inflation-Adjusted Amounts Under Section 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

Note: These inflation adjustments were computed using the All-Urban, Consumer Price Index, 1982-1984 base, published by the Bureau of Labor Statistics.

Subpart C.—Discount on Short-Term Obligations

Section 1281.—Current Inclusion in Income of Discount on Certain Short-Term Obligations

Procedures are provided under which certain taxpayers are deemed to have obtained the approval of the Commissioner to a change in method of accounting for reporting interest income on short-term loans to customers to the method required by section 1281 of the Code. See Rev. Proc. 90-37, page 361.

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 1990. See Rev. Rul. 90-52, page 192.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1990. See Rev. Rul. 90-66, page 194.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1990. See Rev. Rul. 90-75, page 195.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1990. See Rev. Rul. 90-81, page 196.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1990. See Rev. Rul. 90-92. page 198.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1990. See Rev. Rul. 90-99, page 199.

Chapter 3.—Withholding of Tax on Nonresident Aliens and Foreign Corporations

Subchapter A.—Nonresident Aliens and Foreign Corporations

Section 1445.—Withholding of Tax on Dispositions of United States Real Property Interests

26 CFR 1.1445-5: Special rules concerning distributions and other transactions by corporations, partnerships, trusts, and estates.

T.D. 8321

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

Withholding upon Proceeds of Dispositions of U.S. Real Property Interests by Publicly Traded Partnerships, Publicly Traded Trusts and Real Estate Investment Trusts

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final Regulations.

SUMMARY: This document contains final Income Tax Regulations relating to the withholding that is required upon the disposition of a U.S. real property interest by publicly traded partnerships, publicly traded trusts, and real estate investment trusts. These final regulations enable publicly traded partnerships, publicly traded trusts and real estate investment trusts, by meeting certain notice requirements, to shift the responsibility for withholding on proceeds from the disposition of U.S. real property interests to a nominee where such an entity does not make a payment directly to a foreign person.

DATES: This document is effective with respect to distributions after March 7, 1991. However, at the option of any person who would be treated by these final regulations as a withholding agent, that person may apply these regulations to any distributions occurring on an earlier date which is after December 7, 1990, as long as no other person also acts as a withholding agent with respect to the same distribution.

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 requirements of the Paperwork Reduction Act (44 U.S.C. §3504(h)) under control number 1545-0096. The estimated annual burden per respondent/recordkeeper varies from 3 minutes to 9 minutes, depending on individual circumstances, with an estimated average of 6 minutes.

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

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be directed to the Internal Revenue Service, Attention: IRS Reports Clearance Officer, TR:FP, Washington, DC 20224, and to the Office of Management and Budget, Paperwork Reduction Project (RIN: 1545-AM50), Washington, DC 20503.

BACKGROUND

On December 24, 1986, the FEDERAL REGISTER published proposed and temporary amendments (51 FR 46651 [T.D. 8114, 1987-1 C.B. 291]) to the Income Tax Regulations (26 CFR Part 1) under section 1445, which was added to the Internal Revenue Code (98 Stat. 494) by section 129(a) of the Tax Reform Act of 1984 [Pub. L. 98-369, 1984-3 C.B. (Vol. 1) 1, 163]. Written comments responding to this notice were received. A public hearing was not requested or held. After consideration of the comments regarding the proposed and temporary amendments, one recommendation has been adopted as an amendment in this Treasury Decision. The comments and revision are discussed below.

PUBLIC COMMENTS

The proposed and temporary regulations establish a mechanism whereby the withholding obligation on FIRPTA distributions by publicly traded partnerships, publicly traded trusts and REITs is, under certain conditions, shifted to those who are in a position to know the foreign status of an interest holder. Section 1.1445-8T(c) provides rules governing the amount to be withheld with respect to such distributions by such entities. Due to the unique rules of section 857 governing the taxation of REITs, a distinction was drawn between them and publicly traded partnerships and trusts. Proposed and temporary regulation §1.1445-8T(c)-(2)(ii) provides that, in the case of a REIT, the amount subject to withholding under section 1445 is the amount of any distribution, determined with respect to each share or certificate of beneficial interest, which the REIT designates as a capital gain dividend (as defined in section 857(b)(3)(C)) multiplied by the number of shares or certificates of beneficial interest held by the foreign person.

The language of the proposed and temporary regulation is largely adopted except for some clarifying changes. The final regulations clarify that, in the case of a publicly traded partnership, compliance with the withholding requirements of §1446 satisfies the partnership's withholding requirements under §1.1445-8. Also, the repeal, for taxable years beginning after 1986, of the former preferential rates of taxation for long term capital gains (subject to certain transition rules) made it necessary to adjust the withholding rules with respect to REITs, which are based on capital gain dividend designations. The new rules are reflected in §1.1445-8(c)(2)-(ii) and §1.1445-8(h).

The elimination of the preferential rate for net capital gains may remove an incentive for REITs to designate capital gain dividends. In this context it should be observed that, under the rules of the proposed and temporary regulations, FIRPTA withholding would be avoided if no portion of a dividend were designated as a capital gain dividend.

A commentator suggested that this potential concern could be avoided by amending regulation §1.1445-8T(c)(2)-(ii) to require deemed capital gain dividend treatment for distributions that could be, but are not, designated as a capital gain dividend by a REIT. The suggestion has been adopted. Therefore, the largest amount of any distribution occurring March 7, 1991, that could be designated as a capital gain dividend will be deemed to have been designated by the publicly traded REIT as a capital gain dividend for purposes of §1.1445-8, thereby making it automatically subject to withholding under this §1.1445-8. However, the liability for withholding on a distribution will shift to a nominee under the rules of §1.1445-8(b)(3) if and only to the extent the REIT makes an actual designation of a capital gain distribution. If the REIT does not make an actual designation, it remains liable for withholding on all distributions deemed designated under this final regulation as capital gain dividends.

If, subsequent to these regulations, a provision for preferential treatment is enacted for net capital gains, the deemed capital gain dividend provision in §1.1445-8(c)(2)(ii) will be amended in accordance with and to reflect the enactment of such preferential treatment.

The final regulations reserve on the issue of whether and how to impose

withholding pursuant to §1.1445-8 with respect to a dividend distributed by a REIT, which is not a capital gain dividend but is attributable to net short-term capital gain realized from the disposition of U.S. real property interests by the REIT. The Internal Revenue Service invites comments on this issue.

SPECIAL ANALYSES

It has been determined that these rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. 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 final Regulatory Flexibility Analysis is not required.

* * * * *

Adoption of amendments to the regulations

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

INCOME TAX REGULATIONS 26 CFR Part 1

Paragraph 1. The authority for Part 1 is amended by removing the authorities for §1.1445-8T and adding the following citation:

Authority: 26 U.S.C. 7805. *** Section 1.1445-8 also issued under 26 U.S.C. 1445(e)(6).

Par. 2. Section 1.1445-5(c)(3) is amended as follows:

1. By revising paragraph (c)(3)(i) to read as follows,

2. By removing paragraph (c)(3)(v), and

3. By redesignating paragraph (c)(3)(vi) as paragraph (c)(3)(v).

§1.1445-5 Special rules concerning distributions and other transactions by corporations, partnerships, trusts, and estates.

* * * * *

(c) *Dispositions of U.S. real property interests by domestic partnerships, trusts, and estates.*

* * * * *

(3) *Large partnerships or trusts*—(i) *In general.* If a partnership or trust has more than 100 partners or beneficiaries, then the partnership or fiduciary of the trust may elect to withhold in accordance with the provisions of this §1.1445-5(c)(3) in lieu of withholding in the manner required by §1.1445-5(c)(1). However, the rules of this §1.1445-5(c)(3) shall not apply to any partnership or trust interests in which are regularly traded on an established securities market except as described in §1.1445-8(c)(1). The rules of this §1.1445-5(c)(3) shall not apply to any real estate investment trust. See §1.1445-8.

* * * * *

Par. 3. Section 1.1445-8T is removed.

Par. 4. New §1.1445-8 is added in the appropriate place to read as follows:

§1.1445-8 Special rules regarding publicly traded partnerships, publicly traded trusts and real estate investment trusts (REITs).

(a) *Entities to which this section applies.* The rules of this section apply to—

(1) Any partnership or trust, interests in which are regularly traded on an established securities market (regardless of the number of its partners or beneficiaries), and

(2) Any REIT (regardless of the form of its organization).

For purposes of paragraph (a)(1) of this section, the rules of section 1445(e)(1) and this section shall not apply to a publicly traded partnership (as defined in section 7704) which is treated as a corporation under section 7704(a), or to those entities that are classified as "associations" and taxed as corporations. See §301.7701-2.

(b) *Obligation to withhold*—(1) *In general.* An entity described in paragraph (a) of this section is not required to withhold under the provisions of §1.1445-5(c), which states the withholding requirements of domestic partnerships, trusts and estates upon the disposition of U.S. real property interests. Except as otherwise provided in this paragraph (b), an entity described in paragraph (a) of this section shall be liable to withhold tax upon the distribution of any amount attributable to the disposition of a U.S. real property interest, with respect to each holder of an interest in the entity that is a foreign person. The amount to be withheld is described in paragraph (c) of this section.

(2) *Publicly traded partnerships.* Publicly traded partnerships which comply with the withholding procedures under section 1446 will be deemed to have satisfied their withholding obligations under this paragraph (b).

(3) *Special rule for certain distributions to nominees.* In the case of a person that—

(i) Is a nominee (as defined in paragraph (d) of this section),

(ii) Receives a distribution attributable to the disposition of a U.S. real property interest directly from an entity described in paragraph (a) of this section or indirectly from such entity through a nominee,

(iii) Receives the distribution for payment to any foreign person, or the account of any foreign person, and

(iv) Receives a qualified notice pursuant to paragraph (f) of this section,

then the obligation to withhold in accordance with the general rules of section 1445(e)(1) and this paragraph (b) shall be imposed solely on that person to the extent of the amount specified by the qualified notice. A person obligated to withhold by reason of this paragraph (b)(3) is referred to as a withholding agent.

(4) *Person designated to act for withholding agent.* The rules stated in §1.1441-7(b)(1) and (2) regarding a person designated to act for a withholding agent shall apply for purposes of this section.

(5) *Effect of withholding exemption granted under §1.1441-4(f).* A letter issued by a district director under the provisions of §1.1441-4(f), which exempts a person from withholding under section 1441 or section 1442, shall also exempt that person from withholding under this paragraph (b), if—

(i) The letter identifies another person as the withholding agent for purposes of section 1441 or 1442, and

(ii) Such other person enters into a written agreement, with the district director who issued the letter, to be the withholding agent for purposes of this paragraph (b).

The exemption granted, and the corresponding withholding obligation imposed, by this paragraph (b)(5) shall apply with respect to the first distribution made after execution of the agreement described in the preceding sentence and shall continue to apply

to all distributions made during the period in which the exemption granted under §1.1441-4(f) is in effect.

(6) *Payment other than in money.* The rule stated in §1.1441-7(c) regarding payment other than in money shall apply for purposes of this section.

(c) *Amount to be withheld*—(1) *Distribution from a publicly traded partnership or publicly traded trust.* The amount to be withheld under this section with respect to a distribution by a publicly traded partnership or publicly traded trust shall be computed in the manner described in §1.1445-5(c)(3)(ii) and (iii), subject to the rules of this section.

(2) *REITs*—(i) *In general.* The amount to be withheld with respect to a distribution by a REIT, under this section shall be equal to 34 percent (28 percent in the case of a distribution occurring before January 1, 1987) of the amount described in paragraph (c)(2)(ii) of this section.

(ii) *Amount subject to withholding*—(A) *In general.* Except as otherwise provided in paragraph (c)(2)(ii)-(C) of this section, the amount subject to withholding is the amount of any distribution, determined with respect to each share or certificate of beneficial interest, designated by a REIT as a capital gain dividend, multiplied by the number of shares or certificates of beneficial interest owned by the foreign person. Solely for purposes of this paragraph, the largest amount of any distribution occurring after March 7, 1991, that could be designated as a capital gain dividend under section 857(b)(3)(C) shall be deemed to have been designated by a REIT as a capital gain dividend regardless of the amount actually designated.

(B) *Distribution attributable to net short-term capital gain from the disposition of a U.S. real property interest.* [Reserved]

(C) *Designation of prior distribution as capital gain dividend.* If a REIT makes an actual designation of a prior distribution, in whole or in part, as a capital gain dividend, such prior distribution shall not be subject to withholding under this section. Rather, a REIT must characterize and treat as a capital gain dividend distribution (solely for purposes of section 1445(e)(1)) each distribution, determined with respect to each share or certificate of beneficial interest, made on the day of, or any time subsequent to, such designation as a capital gain dividend until such characterized amounts equal the amount of the prior distribution designated as a capital gain dividend. The provisions of this paragraph shall not be applicable in any taxable year in which the REIT adopts a formal or informal resolution or plan of complete liquidation.

(iii) *Example. The following example illustrates the rules of paragraph (c)(2)(ii)(C) of this section.*

In the first quarter of 1988, XYZ REIT makes a dividend distribution of $2X. In the second quarter of 1988, XYZ sells real property, recognizing a long term capital gain of $15X, and makes a dividend distribution of $5X. In the third quarter of 1988, XYZ makes a distribution of $3X. In the fourth quarter of 1988, XYZ sells real property recognizing a long term capital loss of $2X. Within 30 days after the close of the taxable year, XYZ designates a capital gain dividend for the year of $13X. It subsequently makes a fourth quarter distribution of $7X. Since XYZ has made an actual designation of prior distributions during the taxable year as capital gain dividends, withholding on those prior distributions will not be required. However, the REIT must characterize, solely for purposes of §1445 (e)(1), a total amount of $13X of dividend distributions as capital gain dividends. Therefore, the fourth quarter dividend distribution of $7X must be characterized as a capital gain dividend subject to withholding under this section. In addition, XYZ will be required to characterize an additional $6X of subsequent dividend distributions as capital gain dividends.

(d) *Definition of nominee.* For purposes of this section, the term "nominee" means a domestic person that holds an interest in an entity described in paragraph (a) of this section on behalf of another domestic or foreign person.

(e) *Determination of non-foreign status by withholding agent.* A withholding agent may rely on a certificate of non-foreign status pursuant to §1.1445-2(b) or on the statements and address provided to it on Form W-9 or a form that is substantially similar to such form, to determine whether an interest holder is a domestic person. Reliance on these documents will excuse the withholding agent from liability imposed under section 1445(e)(1) in the absence of actual knowledge that the interest holder is a foreign person. A withholding agent may also employ other means to determine the status of an interest holder, but, if the agent relies on such other means and the interest holder proves, in fact, to be a foreign person, then the withholding agent is subject to any liability imposed pursuant to section 1445 and the regulations thereunder for failure to withhold.

(f) *Qualified notice.* A qualified notice for purposes of paragraph (b)(3)(iv) of this section is a notice given by a partnership, trust or REIT regarding a distribution that is attributable to the disposition of a U.S. real property interest in accordance with the notice requirements with respect to dividends described in 17 C.F.R. 240.10b-17(b)(1) or (3) issued pursuant to the Securities Exchange Act of 1934, 15 U.S.C. §78a *et seq.* In the case of a REIT, a qualified notice is only a notice of a distribution, all or any portion of which the REIT actually designates, or characterizes in accordance with paragraph (c)(2)(ii)(C) of this section, as a capital gain dividend in accordance with 17 C.F.R. 240.10b-17(b)(1) or (3), with respect to each share or certificate of beneficial interest. A deemed designation under paragraph (c)(2)(ii)(A) of this section may not be the subject of a qualified notice under this paragraph (f). A person described in paragraph (b)(3) of this section shall be treated as receiving a qualified notice at the time such notice is published in accordance with 17 C.F.R. 240.10b-17(b)(1) or (3).

(g) *Reporting and paying over withheld amounts.* With respect to an amount withheld under this section, a withholding agent is not required to conform to the requirements of §1.1445-5(b)(5) but is required to report and pay over to the Internal Revenue Service any amount required to be withheld pursuant to the rules and procedures of section 1461, the regulations thereunder and §1.6302-2. Forms 1042 and 1042S are to be used for this purpose.

(h) *Early refund procedure not available.* The early refund procedure set forth in §1.1445-6(g) shall not apply to amounts withheld under the rules of this section. For adjustment of over-withheld amounts, see §1.1461-4.

(i) *Liability upon failure to withhold.* For rules regarding liability upon failure to withhold under

§1.1445(e) and this section, see §1.1445-1(e).

OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT
(26 CFR Part 602)

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

Authority: 26 U.S.C. 7805

Par. 6. Section 602.101(c) is amended by removing in the table "§1.1445-8T...1545-0096" and by adding in the appropriate place in the table "§1.1445-8...1545-0096."

Fred T. Goldberg, Jr.,
Commissioner of Internal Revenue.

Approved November 14, 1990.

Kenneth W. Gideon,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 6, 1990, 8:45 a.m., and published in the issue of the Federal Register for December 7, 1990, 55 F.R. 50552)

Chapter 6.—Consolidated Returns
Subchapter A.—Returns and Payment of Tax

Section 1502.—Regulations

26 CFR 1.1502-33: Earnings and profits.

For a procedure for an affiliated group filing a consolidated return to elect or to change its method of allocating the consolidated federal income tax liability to members of the group. See Rev. Proc. 90-39, page 365.

26 CFR 1.1502-75T: Temporary regulations for filing consolidated returns; coordination with section 338(h)(10) and section 833 (temporary).

T.D. 8310

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Consolidated Return Regulations—Coordination With Section 833

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations that add a new §1.1502-75T(d)(5) of the consolidated return regulations. The regulations supplement the existing consolidated return regulations by providing rules relating to the removal of the tax-exempt status of organizations described in section 833 of the Internal Revenue Code (relating to certain Blue Cross or Blue Shield organizations and certain other health insurers). The rules are needed because, as a result of the loss of tax-exempt status, such organizations are, for taxable years beginning after 1986, includible corporations under section 1504(b) of the Code. The text of the temporary regulations set forth in this document also serves as the text of the proposed regulations cross-referenced in the notice of proposed rulemaking in *** [CO-26-89, page 680, this Bulletin].

EFFECTIVE DATE: The regulations are effective for taxable years beginning after December 31, 1986.

SUPPLEMENTARY INFORMATION:

Background

This document adds new §1.1502-75T(d)(5) to Part 1 of Title 26 of the Code of Federal Regulations. Section 1012 of the Tax Reform Act of 1986 ("1986 Act") [Pub. L. 99-514, 1986-3 C.B. (Vol. 1) 1, 307] denied, for taxable years beginning after December 31, 1986, tax-exempt status to certain organizations described in section 833(c) of the Internal Revenue Code ("section 833 organizations"), relating to certain Blue Cross or Blue Shield organizations and certain other health insurers. As a result, such organizations now are includible corporations under section 1504(b) of the Code. Under §1.1502-75(d)(1), as a result of a section 833 organization becoming the new common parent of an existing consolidated group ("old group"), the old group terminates and a new affiliated group with the section 833 organization as the new common parent is created.

There is no indication that Congress intended the termination of the old group and the creation of a new affiliated group as a consequence of the denial of tax-exempt status to section 833 organizations. Therefore, on September 14, 1988, the Service announced in Notice 88-107, 1988-2 C.B. 445, that it would promulgate regulations ameliorating the harsh results that would follow from the termination of the old groups.

Explanation Of Provisions

The regulations published in this document adopt a neutrality principle which is intended to preclude treating members of an old group better or worse by reason of the enactment of section 833. Thus, some of the tax consequences parallel those applicable to a reverse acquisition as described in §1.1502-75(d)(3).

The regulations allow an affiliated group created as a result of the enactment of section 833 to elect to be treated as a continuation of the old group. For this election to apply, all old groups having the same new common parent must make the election. If, as a result of the enactment of section 833, a section 833 organization became the new common parent of an affiliated group that did not file a consolidated return before 1987, the old affiliated group is treated as an old group for purposes of this regulation. Such an affiliated group and its new section 833 organization common parent may elect to file consolidated returns and to be treated as a continuation of the old group.

The election to continue is deemed to have been made if the parent section 833 organization and all the members of all the old groups file a consolidated (or amended consolidated) return without filing a Form 1122. Alternatively, an election to file as a new group is deemed to have been made if the parent section 833 organization and all the members of all the old groups file a consolidated (or amended consolidated) return and file a Form 1122. If the latter choice is selected, a waiver is granted under section 1504(a)(3) of the Code.

Any group wishing to revoke an election either to be treated as a continuation of the old group or as a new group may do so if the election was made before September 5, 1990. In addition, an old group may make a delayed election to file a consolidated return as a continuing group or as a new group.

If an election to continue is made, the section 833 organization will become the common parent without causing a termination of any old group. If the section 833 organization is itself owned by a section 833 organization, the parent section 833 organization will become the new common parent without causing a

termination of any old group. Allowing old groups to continue in existence prevents the restoration of gain or loss from deferred intercompany transactions, excess loss accounts and other consequences which follow the termination of a consolidated group.

Under the neutrality principle, application of the separate return limitation year principles of the existing consolidated return rules to carryovers from taxable years beginning before 1987 is modified by the new temporary regulations if an election to continue the old group or groups is made. Under this modification, a taxable year beginning before 1987 of a member of the old group is not treated as a separate return limitation year with respect to any corporation that was a member of the old group for each day of that taxable year. Additional guidance may be issued regarding the general application of the separate return limitation year rules. The existing consolidated return rules with respect to carrybacks apply without modification.

The neutrality principle also applies to any life-nonlife consolidated return election under section 1504(c)(2). If the old group elects to continue in existence, the life-nonlife election will also continue. In addition, if an old group was eligible to make a life-nonlife election, it will remain eligible. If a life-nonlife election could not have been made prior to the inclusion of the section 833 organization in the affiliated group, then, for purposes of determining whether a life insurance company or other corporation is a member of a group for the 5-year base period under §1.1502-47(d)(12), periods of affiliation before the effective date of section 833 are taken into account without excluding, under section 1504(b)(1), the section 833 organization. Thus, for example, if before January 1, 1987, a section 833 organization's only subsidiary was a life insurance company, the five-year period under sections 1503(c)(2) and 1504(c)(2) will commence as of the time the section 833 organization first owned the life insurance company and, after December 31, 1986, they may file an election under section 1504(c)(2) if the section 833 organization has the requisite five-year stock ownership. If the life insurance subsidiary has been held for less than five years, credit will be given for the years it was held.

Under section 1012(c)(3)(A)(ii) of the 1986 Act, the basis of an existing Blue Cross or Blue Shield organization (as defined in section 833(c)(2)) in its assets, including subsidiary stock, is the fair market value of the asset as of the first date on which section 833 applies to the organization. Therefore, absent a special rule, if, for example, an old group elects to continue in existence, a deemed dividend election by the group under §1.1502-32(f)(2) would further increase the organization's basis in its subsidiary's stock to the extent the subsidiary's earnings and profits were accumulated in a consolidated return year before January 1, 1966. This would be appropriate if the Blue Cross or Blue Shield organization had a basis in its subsidiary's stock that reflected only its original cost of the stock; in that case a deemed dividend election would prevent a Blue Cross or Blue Shield organization from realizing gain on the sale of the subsidiary stock attributable to amounts accumulated in consolidated return years before January 1, 1966, which are not reflected in the basis of the subsidiary's stock. However, because the Blue Cross or Blue Shield organization's basis in its subsidiary's stock is equal to its fair market value on January 1, 1987, the basis already reflects the subsidiary's earnings and profits accumulated before that date and should not be increased further by a deemed dividend election. New §1.1502-75T(d)(5)(viii) provides that one consequence of filing consolidated returns after 1986 is that all distributions (whether actual or deemed) by the former common parent of an old group or by a corporation that was not a member of an old group out of earnings and profits accumulated before 1987 to the section 833 organization are deemed made out of earnings and profits accumulated in pre-affiliation years. Thus, such a distribution will result in a negative adjustment under §1.1502-32(b)-(2)(iii)(c) or (c)(2)(iii) to the section 833 organization's basis in the stock of the distributing corporation.

If an election to file as a new group is made then the consequences which follow from the termination of a consolidated group apply. In addition, the five-year period for a life-nonlife consolidated return election under section 1504(c)(2) will commence as of the time the new group came into existence.

Special Analyses

It has been determined that these rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. 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 for the regulations will be submitted to the Administrator 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:

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

Authority: 26 U.S.C. 7805; * * * §1.1502-75T also issued under 26 U.S.C. 1502.

Par. 2. Section 1.1502-75T is amended by revising the heading and by adding and reserving paragraph (c) and adding new paragraph (d) to read as follows:

§1.1502-75T. Temporary regulations for filing consolidated returns; coordination with section 338(h)(10) and section 833 (Temporary).

* * * * *

(c) [Reserved.]

(d) *When group remains in existence.*

(1)—(4) [Reserved.]

(5) *Coordination with section 833*—(i) *Election to continue old group.* If, solely by reason of the enactment of section 833 (relating to certain Blue Cross or Blue Shield organizations and certain other health insurers), an organization to which section 833 applies (a "section 833 organization") became the new common parent of an old group on January 1, 1987, the old group may elect to continue in existence with that

section 833 organization as its new common parent, provided all the old groups having the same section 833 organization as their new common parent elect to continue in existence. To revoke this election, see paragraph (d)(5)(x) of this section. To file as a new group, see paragraph (d)(5)(v) of this section.

(ii) *Old group.* For purposes of this paragraph (d)(5), an old group is a group which, for its last taxable year ending in 1986, either filed a consolidated return or was eligible to (but did not) file a consolidated return.

(iii) *Manner of electing to continue*—(A) *Deemed election.* If all the members of all the old groups having the same section 833 organization as their new common parent are included for the first taxable year beginning after December 31, 1986, on the same consolidated (or amended consolidated) return and a Form 1122 was not filed, the old groups are deemed to have elected under paragraph (d)(5)(i) of this section to continue in existence.

(B) *Delayed election.* If a deemed election to continue in existence was not made under paragraph (d)(5)(iii)(A) of this section, all the members of all the old groups having the same section 833 organization as their new common parent may make a delayed election under paragraph (d)(5)(i) of this section to continue in existence by

(*1*) Filing an appropriate consolidated (or amended consolidated) return or returns for each taxable year beginning after December 31, 1986, (notwithstanding §1.1502-75(a)(1)) on or before January 3, 1991, and

(*2*) On the top of any such return prominently affixing a statement containing the following declaration: "THIS RETURN" (or, if applicable, "AMENDED RETURN") "REFLECTS A DELAYED ELECTION TO CONTINUE UNDER §1.1502-75T(d)(5)(iii)(B)". A delayed election to continue in existence automatically revokes a deemed election to file as a new group which was made under paragraph (d)(5)(vi) of this section.

(iv) *Effects of election to continue in existence.* If an old group or groups elect to continue in existence under paragraph (d)(5)(i) of this section, the following rules apply:

(A) *Taxable years.* Each member that filed returns other than on a calendar year basis shall close its taxable year on December 31, 1986, and change to a calendar year beginning on January 1, 1987. See section 843 and §1.1502-76(a)(1).

(B) *Carryovers from separate return limitation years.* For purposes of applying the separate return limitation year rules to carryovers from taxable years beginning before 1987 to taxable years beginning after 1986, the following rules apply:

(*1*) Any taxable year beginning before 1987 of a corporation that was not a member of an old group (including a section 833 organization) will be treated as a separate return limitation year;

(*2*) Any taxable year beginning before 1987 of a corporation that was a member of an old group that, without regard to this section and the enactment of section 833, was a separate return limitation year will continue to be treated as a separate return limitation year;

(*3*) Any taxable year beginning before 1987 of a member of an old group (other than a separate return limitation year described in paragraph (d)(5)(iv)(B)(*2*) of this section) will not be treated as a separate return limitation year with respect to any corporation that was a member of such group for each day of that taxable year; and

(*4*) Any taxable year beginning before 1987 of a member of an old group will be treated as a separate return limitation year with respect to any corporation that was not a member of such group for each day of that taxable year (*e.g.*, a corporation that was not a member of an old group, including a section 833 organization, or a corporation that was a member of another old group).

(C) *Five-year rules for life-nonlife groups.* Any life-nonlife election under section 1504(c)(2) in effect for an old group remains in effect. Any old group which was eligible to make a life-nonlife election will remain eligible to make the election. For purposes of section 1503(c), a nonlife member is treated as ineligible under §1.1502-47(d)(13) with respect to a life member, unless both were members of the same affiliated group (determined without regard to the exclusions in section 1504(b)(1) and (2)) for five taxable years immediately preceding the taxable year in which the loss arose. See paragraph (d)(5)(ix) of this section for a tacking rule.

(v) *Election to file as a new group.* If, solely by reason of the enactment of section 833, a section 833 organization became the new common parent of an old group on January 1, 1987, the application of the five-year prohibition on reconsolidation in section 1504(a)(3)(A) to the old group is waived and the old group together with the new section 833 organization common parent may elect to file as a new group provided that all includible corporations elect to file a consolidated (or amended consolidated) return as a new group for the first taxable year beginning after December 31, 1986. To revoke this election, see paragraph (d)(5)(x) of this section.

(vi) *Manner of electing to file as a new group*— (A) *Deemed election.* The old group or groups and the section 833 organization are deemed to have elected under paragraph (d)(5)(v) of this section to file as a new group by filing, for the first taxable year beginning after December 31, 1986, a Form 1122 and a consolidated (or amended consolidated) tax return.

(B) *Delayed election.* If a deemed election to file as a new group was not made pursuant to paragraph (d)(5)(vi)(A) of this section, the old group or groups and the section 833 organization may make a delayed election under paragraph (d)(5)(v) of this section to file as a new group by:

(*1*) Filing an appropriate consolidated (or amended consolidated) return or returns for each taxable year beginning after December 31, 1986, (notwithstanding §1.1502-75(a)(1)) on or before January 3, 1991, and

(*2*) On the top of any such return prominently affixing a statement containing the following declaration: "THIS RETURN" (or, if applicable, "AMENDED RETURN") "REFLECTS A DELAYED ELECTION TO FILE AS A NEW GROUP UNDER §1.1502-75T(d)(5)(vi)(B)". A delayed election to file as a new group automatically revokes any deemed election to continue in existence which was made under paragraph (d)(5)(iii) of this section.

(vii) *Effects of election to file as a*

new group. If an old group or groups elect to file as a new group under paragraph (d)(5)(v) of this section, the following rules apply:

(A) *Termination.* Each old group is treated as if it terminated on January 1, 1987, and the termination is not treated as resulting from the acquisition by a nonmember of all of the stock of the common parent.

(B) *Taxable years.* Each member that filed returns other than on a calendar year basis shall close its taxable year on December 31, 1986, and change to a calendar year beginning on January 1, 1987. See section 843 and §1.1502-76(a)(1).

(C) *Separate return limitation year and life-nonlife groups.* For purposes of §1.1502-1(f), sections 1503(c) and 1504(c), and §1.1502-47, the group is treated as coming into existence as a new group on January 1, 1987. Thus, for example, paragraphs (d)(5)(iv)(B) and (C) of this section do not apply.

(viii) *Earnings and profits.* All distributions after January 1, 1987, by a corporation, whether or not such corporation was a member of an old group, to an existing Blue Cross or Blue Shield organization (as defined in section 833(c)(2)) out of earnings and profits accumulated before 1987 are deemed made out of earnings and profits accumulated in pre-affiliation years. See §1.1502-32(b)(2)(iii)(c) and (c)(2)(iii).

(ix) *Five-year tacking rules for certain life-nonlife groups.* For purposes of applying §1.1502-47(d)(5) and (12) to any taxable year ending after 1986 to a corporation, whether or not the corporation was a member of an old group, (A) The determination of whether the corporation was in existence and a member or tentatively treated as a member of a group, for taxable years ending before 1987, is made without regard to the exclusions under section 1504(b)(1) and (2) of any section 833 organization or life insurance company (as the case may be) and (B) A section 833 organization is not treated as having a change in tax character solely by reason of the loss of its tax-exempt status due to the enactment of section 833. This paragraph (d)(5)(ix) does not apply if an election to file as a new group under paragraph (d)(5)(v) of this section is made.

(x) *Time to revoke elections made before September 5, 1990.* An election by an old group to continue in existence or to file as a new group that was made (or deemed made) before September 5, 1990, may be revoked by filing an appropriate return (or returns) on or before January 3, 1991. For purposes of this paragraph (d)(5)(x), appropriate returns include separate returns filed by each member of the group or consolidated returns filed in accordance with a delayed election either under paragraph (d)(5)(iii)(B) or (vi)(B) of this section.

(xi) *Examples.* The following examples illustrate this paragraph (d)(5). In these examples, each corporation uses the calendar year as its taxable year.

Example 1. B is a section 833 organization. For several years, B has owned all of the outstanding stock of X, Y, and Z. X has owned all the outstanding stock of X1 throughout X1's existence and Y has owned all of the outstanding stock of Y1 throughout Y1's existence. For 1986, X and X1 filed a consolidated federal income tax return but Y and Y1 filed separate returns. Under paragraph (d)(5)(ii) of this section, X and X1 and Y and Y1 each constitute an old group because they either filed a consolidated return or were eligible to file a consolidated return for 1986. The X and Y groups may elect under paragraph (d)(5)(i) of this section to continue in existence. If they elect to continue, under paragraph (d)(5)(iv)(B) of this section, the separate return limitation year rules apply as follows: any taxable year of B or Z beginning before 1987 is treated as a separate return limitation year with respect to each other and to all other members of the group; any taxable year of X or X1 beginning before 1987 is treated as a separate return limitation year with respect to B, Z, Y and Y1, but not with respect to each other; and any taxable year of Y or Y1 beginning before 1987 is treated as a separate return limitation year with respect to B, Z, X and X1, but not with respect to each other.

Example 2. The facts are the same as in Example 1 except that B is owned by C, another section 833 organization. If the X and Y groups elect to continue, the results are the same as in Example 1, except that, under paragraph (d)(5)(iv)(B)(*1*) of this section, for purposes of applying the separate return limitation year rules, any taxable year of C beginning before 1987 is also treated as a separate return limitation year with respect to all other members of the group.

Example 3. The facts are the same as in Example 1 except that Y purchased Y1 on January 1, 1985. If the X and Y groups elect to continue, the results are the same as in Example 1, except that, under paragraph (d)(5)-(iv)(B)(*2*) of this section, for purposes of applying the separate return limitation year rules, any taxable year of Y1 beginning before 1985 is treated as a separate return limitation year with respect to Y as well as with respect to all other members of the group.

Example 4. B, a section 833 organization, has owned all the stock of X since November 1984. X has owned all the stock of L, a life insurance company, throughout L's existence. In 1986, X and L properly filed a life-nonlife consolidated return. Under paragraph (d)(5)(i) of this section, the X group elects to continue in existence. Under paragraph (d)(5)(iv)(C) of this section, the life-nonlife election will remain in effect. However, losses of B which arise before 1990 cannot be used to offset the income of L. See section 1503(c)(2) and §1.1502-47(d)(13) and paragraph (d)(5)(iv)(C) of this section. Under paragraph (d)(5)(iv)(B) of this section, the separate return limitation year rules apply as follows: any taxable year of B beginning before 1987 is treated as a separate return limitation year with respect to all other members of the group; and any taxable year of X or L beginning before 1987 is treated as a separate return limitation year with respect to B, but not with respect to each other.

Example 5. The facts are the same as Example 4 except that, on January 1, 1984, B formed L1, a life insurance company. Under paragraph (d)(5)(ix) of this section and section 1504(c), the first year L1 is eligible to join in B's life-nonlife election is 1989.

Example 6. The facts are the same as in Example 4 except that B and the X group elect under paragraph (d)(5)(v) of this section to file as a new group. The X group will be considered to have terminated under §1.1502-75(d)(1) on December 31, 1986. X and L are each separately subject to the separate return limitation year rules of §1.1502-1(f). The first year L and L1 are eligible to join the new group in a life-nonlife election is 1992 (five years after the new group is formed). See section 1504(c)(2) and paragraphs (d)(5)(vii)(C) and (ix) of this section.

The provisions contained in this Treasury decision are needed to immediately amend the consolidated return regulations in response to changes made by section 1012 of the Tax Reform Act of 1986. It is therefore found impracticable and contrary to the public interest to issue this Treasury decision with notice and public procedure under section 553(b) of Title 5 of the United States Code or subject to the effective date limitations of section 553(d) of Title 5, United State Code.

Michael J. Murphy,
Acting Commissioner of Internal Revenue.

Approved August 24, 1990.

Kenneth W. Gideon,
Assistant Secretary to the Treasury.

(Filed by the Office of the Federal Register on August 30, 1990, 11:30 a.m., and published in the issue of the Federal Register for September 5, 1990, 55 F.R. 36274)

Section 1504.—Definitions

26 CFR 1.1504-1: Definitions.

For a procedure for a consolidated group to obtain a waiver of the general rule of section 1504(a)(3)(A) of the Code without filing an advance ruling request. See Rev. Proc. 90-53, page 636.

Subchapter B.—Related Rules
Part I.—In General

Section 1552.—Earnings and Profits

26 CFR 1.1552-1: Earnings and profits.

For a procedure for an affiliated group filing a consolidated return to elect or to change its method of allocating the consolidated federal income tax liability to members of the group. See Rev. Proc. 90-39A, page 367.

Subtitle B.—Estate and Gift Taxes
Chapter 11.—Estate Tax
Subchapter A.—Estates of Citizens or Residents
Part II.—Credits Against Tax

Section 2010.—Unified Credit Against Estate Tax

Rev. Rul. 81-303, 1981-2 C.B. 255, which held that the term "specific exemption" referred to in the estate tax convention between the United States and Switzerland may not be construed to include the section 2010 unified credit, is revoked. See Rev. Rul. 90-101, page 315.

Subchapter B.—Estates of Nonresidents Not Citizens

Section 2102.—Credits Against Tax

Rev. Rul. 81-303, 1981-2 C.B. 255, which held that the term "specific exemption" referred to in the estate tax convention between the United States and Switzerland may not be construed to include the section 2010 unified credit, is revoked. See Rev. Rul. 90-101, page 315.

Chapter 12.—Gift Tax
Subchapter B.—Transfers

Section 2518.—Disclaimers

26 CFR 25.2518-1: Qualified disclaimers of property.

Disclaimer by a trustee. A trustee's disclaimer that is ineffective under state law does not constitute a qualified disclaimer for purposes of section 2518 of the Code.

Rev. Rul. 90-110

ISSUE

If a trustee acting solely in a fiduciary capacity disclaims a power to invade trust corpus for the benefit of a specific beneficiary and the disclaimer is ineffective under state law, is the disclaimer a qualified disclaimer for purposes of section 2518(b) of the Internal Revenue Code?

FACTS

D died testate in 1988. *D*'s will provided for the creation of a trust for the lifetime benefit of *S*, *D*'s surviving spouse. Under the terms of the trust instrument, *S* is to receive all of the trust income annually. The trustee has the power to invade corpus for the benefit of *C*, who is a grandchild of *S* and *D*. The trustee may consider *C*'s other sources of income. Upon the death of *S*, the remainder is to be distributed to or for the benefit of *C*.

Within 7 months of *D*'s death, the trustee executed and delivered to the executor of *D*'s estate a declaration to disclaim the power to invade corpus for the benefit of *C*. *C* neither consented to the trustee's disclaimer declaration nor made an individual disclaimer. *D*'s will does not authorize the trustee to make such a disclaimer. Under the laws of the state in which *D*'s estate is being administered, the trustee's attempt to disclaim this type of power to invade corpus is ineffective without the written consent of the beneficiary or an express grant of authority to make such a disclaimer in the governing instrument.

LAW AND ANALYSIS

Section 2518(a) of the Code provides that, if a person makes a qualified disclaimer of an interest in property, the estate, gift, and generation-skipping tax provisions will apply to that interest as if it had never been transferred to such person. Under section 2518(b), the term "qualified disclaimer" means an irrevocable and unqualified refusal by a person to accept an interest in property, provided certain requirements are met. Section 2518(c)(2) provides that a power with respect to property is to be treated as an interest in the property. Section 2518(c)(3) provides that a written transfer of the transferor's entire interest in the property is treated as a qualified disclaimer if: (1) it is made with the time limits specified in section 2518(b)(2), (2) the transferor has not accepted the interest or any of its benefits, and (3) it is to a person or persons who would have received the property had the transferor made a qualified disclaimer.

Under general principles of trust law, a trust consists of separate interests: the equitable interests of the beneficiary and the legal interests of the trustee. The trust form allows the settlor to protect the beneficiary from the burdens of ownership. The equitable owner (the beneficiary) is entitled through equity to compel the legal owner (the trustee) to act in accordance with trust obligations. Under the law of most jurisdictions, a trustee cannot make a unilateral disclaimer of a fiduciary power that affects the rights of a beneficiary unless the trust instrument expressly authorizes such a disclaimer or the affected beneficiary consents to the disclaimer. G. Bogart, *The Law of Trust and Trustees*, section 150 (Rev. 2nd Ed. 1979); *Restatement (Second) of Trusts*, section 102(4) (1959).

The legislative history of section 2518(c)(3) of the Code states that if a disclaimer does not qualify under local law, it will nonetheless qualify under section 2518 if the person entitled to the interest has not accepted the interest or any of its benefits and timely transfers the interest to the person who would have otherwise received the property if an effective disclaimer had been made. *See* H. R. Rep. No. 97-201, 97th Cong. 1st Sess. 190 (1981), 1981-2 C.B. 352, 392.

In this case, because neither local law nor the governing instrument authorizes the trustee to make a unilateral disclaimer of a fiduciary power, the trustee's attempted renunciation of the power to invade trust corpus for the benefit of *C* is not qualified under local law and therefore is not a qualified disclaimer within the meaning of section 2518(b) of the Code.

Section 2518(c)(3) of the Code does not apply under the facts of this ruling because the trustee acting alone, cannot transfer the beneficial property interest to the person who would have received such interest had the trustee and the beneficiary together made an effective disclaimer.

HOLDING

If a trustee acting solely in a fidu-

ciary capacity disclaims a power to invade trust corpus for the benefit of a specific beneficiary and the disclaimer is ineffective under state law, the disclaimer is not a qualified disclaimer for purposes of section 2518(b) of the Code. Further, section 2518(c)(3) is not applicable where the trustee, acting alone, cannot transfer the beneficial interest to the person who would have received the interest had an effective disclaimer been made.

Subtitle C.—Employment Taxes

Chapter 21.—Federal Insurance Contributions Act

Subchapter C.—General Provisions

Section 3121.—Definitions

Do supplemental unemployment compensation benefits constitute wages for purposes of the Federal Unemployment Tax Act, and compensation for purposes of the Railroad Retirement Tax Act? See Rev. Rul. 90–72, page 211.

26 CFR 31.3121(d)-1: Who are employees.

Is a full-time life insurance salesman who is an employee within the meaning of section 3121(d)(3) of the Code, an employee for purposes of sections 62 and 67? See Rev. Rul. 90–93, page 33.

Chapter 22.—Railroad Retirement Tax Act

Subchapter A.—Tax on Employees

Section 3201.—Rate of Tax

26 CFR 31.3201-1: Measure of employee tax.

Do supplemental unemployment compensation benefits constitute wages for purposes of the Federal Insurance Contributions Act and the Federal Unemployment Tax Act, and compensation for purposes of the Railroad Retirement Tax Act? See Rev. Rul. 90–72, page 211.

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, 1990, shall be at the rate of 26 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, 1990, 31.4 percent of the taxes collected under sections 3211(b) and 3221(c) of the Railroad Retirement Tax Act shall be credited to the Railroad Retirement Account and 68.6 percent of the taxes collected under such sections 3211(b) and 3221(c) plus 100 percent of the taxes collected under section 3221(d) of the Railroad Retirement Tax Act shall be credited to the Railroad Retirement Supplemental Account.

Dated: June 12, 1990.

By Authority of the Board.

Beatrice Ezerski,
Secretary to the Board.

(Filed by the Office of the Federal Register on June 18, 1990, 8:45 a.m., and published in the issue of the Federal Register for June 19, 1990, 55 F.R. 24952)

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 October 1, 1990, shall be at the rate of 26 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, 1990, 33.5 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 66.5 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: September 7, 1990.

By Authority of the Board.

Beatrice Ezerski,
Secretary to the Board.

(Filed by the Office of the Federal Register on September 13, 1990, 8:45 a.m., and published in the issue of the Federal Register for September 14, 1990, 55 F.R. 37993)

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 January 1, 1991, shall be at the rate of 26 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, 1991, 33.2 percent of the taxes collected under sections 3221(b) and 3221(c) of the Railroad Retirement Tax Act shall be credited to the Railroad Retirement Account and 66.8 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: November 27, 1990.

Beatrice Ezerski,
Secretary to the Board.

(Filed by the Office of the Federal Register on December 3, 1990, 8:45 a.m., and published in the issue of the Federal Register for December 4, 1990, 55 F.R. 50069)

Subchapter D.—General Provisions

Section 3231.—Definitions

Do supplemental unemployment compensation benefits constitute wages for purposes of the Federal Insurance Contributions Act and

the Federal Unemployment Tax Act, and compensation for purposes of the Railroad Retirement Tax Act? See Rev. Rul. 90–72, below.

Chapter 23.—Federal Unemployment Tax Act

Section 3306.—Definitions

Do supplemental unemployment compensation benefits constitute wages for purposes of the Federal Insurance Contributions Act and the Federal Unemployment Tax Act, and compensation for purposes of the Railroad Retirement Tax Act? See Rev. Rul. 90–72, below.

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.
(Also Sections 501, 3121, 3201, 3231, 3306, 3402, 7805; 1.501(c)(17)-1, 31.3201-1, 31.3402(o)-1, 301.7805-1.)

Tax treatment of supplemental unemployment compensation benefits. This revenue ruling provides that supplemental unemployment compensation benefits (SUB pay) must be linked to the receipt of state unemployment compensation and must not be received in a lump sum in order to be excludable from the definition of wages for Federal Insurance Contributions Act and Federal Unemployment Tax Act purposes. SUB pay must also meet the same criteria in order to be excludable from the definition of compensation for Railroad Retirement Tax Act purposes. Rev. Rul. 65-251 amplified and Rev. Rul. 77-347 revoked in part.

Rev. Rul. 90-72

ISSUES

Are payments made to employees under Plans (1), (3), and (5) described below wages for purposes of the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and federal income tax withholding? Are payments to railroad employees under Plans (2), (4), and (6) described below compensation for purposes of the Railroad Retirement Tax Act (RRTA)?

FACTS

Plan (1). Company *X* established a trust to fund its obligations under a plan (Plan (1)). The trust qualifies for exemption from federal income tax as a supplemental unemployment compensation benefit (SUB) trust described in section 501(c)(17) of the Internal Revenue Code. Plan (1) provides weekly benefits to former employees involuntarily separated from the service of Company *X* due to a plant closing, layoff, or reduction in force. Benefits paid under the plan are designed to supplement the receipt of state unemployment compensation and are not payable in the form of a lump sum.

Eligibility for benefits under Plan (1) depends upon a former employee meeting certain prescribed conditions following temporary or permanent separation from employment with Company X. Under the terms of the plan, a worker on layoff or former employee must be unemployed and must meet the requirements necessary to receive state unemployment compensation benefits, except in three limited situations. The former employee may still receive benefits under the plan if: (1) the employee is ineligible for state unemployment compensation benefits because the employee has insufficient wage credits under the state law, (2) the employee has exhausted the duration of benefits under the state law, or (3) the employee has not met the waiting period required under state law. Even in these three situations, in order to receive benefits under the plan, the employee must be otherwise eligible for state unemployment compensation.

In addition, under Plan (1), the duration of benefits depends in part on the fund level and the employee's seniority; benefits are not attributable to the rendering of any particular services; and no employee has any right, title, or interest in the fund until such employee is qualified and eligible to receive benefits.

Plan (2). Company *X* also established a plan (Plan (2)) and trust identical to those described in *Plan (1)*, except that the benefits paid under the plan are paid to railroad employees and are designed to supplement the receipt of benefits under the Railroad Unemployment Insurance Act (RUIA).

Plan (3). Company *Y* established a plan (Plan (3)) and trust identical to those described in *Plan (1)*, except that the benefits paid under the plan are paid in a lump sum, rather than in the form of periodic payments.

Plan (4). Company Y also established a plan (Plan (4)) and trust identical to those described in Plan (3), except that the benefits paid under the plan are paid to railroad employees and are designed to supplement the receipt of benefits under the Railroad Unemployment Insurance Act (RUIA).

Plan (5). Company Z established a trust to fund its obligations under a plan (Plan (5)). The trust qualifies for exemption from federal income tax as a SUB trust described in section 501(c)(17) of the Code. The plan provides benefits to former employees involuntarily separated from the service of Company Z. Other than requiring an involuntary separation from employment with Company Z, the plan places no conditions on the former employees' eligibility to receive benefits under the plan.

Plan (6). Company Z also established a plan (Plan (6)) and trust identical to those described in Plan (5), except that the benefits paid under the plan are paid to railroad employees.

LAW AND ANALYSIS

Sections 3121(a) and 3306(b) of the Code define the term "wages" for FICA and FUTA purposes, respectively, as all remuneration for employment, with certain limited exceptions. Section 3401(a) of the Code, relating to federal income tax withholding, contains a similar definition.

Section 3402(o) of the Code extends income tax withholding to any supplemental unemployment compensation benefit paid to an individual, regardless of whether it would otherwise be considered wages. Section 3402(o)(2)(A) defines supplemental unemployment compensation benefits as amounts paid to an employee pursuant to a plan to which the employer is a party, because of an employee's involuntary separation from employment (whether or not such separation is temporary) resulting directly from a reduction in force, the discontinuance of a plant or operations, or other similar conditions, but only to the extent such benefits are includible in the employee's gross income. The definition of SUB pay under section 3402(o) is not applicable for FICA or FUTA purposes. For FICA and FUTA purposes, SUB pay is defined solely through a series of administra-

tive pronouncements published by the Service.

Section 3231(e)(1) of the Code defines the term "compensation" for RRTA purposes as any form of money remuneration paid to an individual for services rendered as an employee to one or more employers, also with certain limited exceptions.

Sections 31.3121(a)-1(b), 31.3306(b)-1(b), and 31.3401(a)-1(a)(1) of the Employment Tax Regulations provide that the term "wages" means all remuneration for employment unless specifically excepted. Sections 31.3121(a)-1(i), 31.3306(b)-1(i), and 31.3401(a)-1(a)(5) of the regulations further provide that remuneration for employment, unless specifically excepted, constitutes wages even though at the time paid the individual is no longer an employee.

Section 3201(a) and (b) of the Code (the tier 1 and tier 2 taxes, respectively) impose on the income of each railroad employee a tax equal to a specified percentage of the compensation received during any calendar year by such employee for services rendered by such employee.

Section 31.3401(a)-1(b)(4) of the regulations specifically provides that for purposes of federal income tax withholding, any payments made by an employer to an employee on account of dismissal (*i.e.*, involuntary separation from the service of the employer) constitute wages regardless of whether the employer is legally bound by contract, statute, or otherwise to make such payments. Although there are no similar provisions in the regulations relating to FICA and FUTA, the same conclusion generally applies. H.R. Rep. No. 1300, 81st Cong., 1st. Sess. 124 (1949), 1950-2 C.B. 255, 277, & 300.

Rev. Rul. 56-249, 1956-1 C.B. 488, provides a limited exception from the definition of wages for FICA, FUTA, and federal income tax withholding purposes for certain payments made upon the involuntary separation of an employee from the service of the employer, but only if the payments are designed to supplement the receipt of state unemployment compensation.

Rev. Rul. 56-249 holds that benefits paid to individuals by trustees of a trust created pursuant to the provisions of a SUB plan are not wages for FICA, FUTA, or federal income tax withholding purposes. The ruling summarizes the following eight features of the plan: (1) benefits are paid only to unemployed former employees who are laid off by the employer; (2) eligibility for benefits depends upon meeting prescribed conditions after terminating employment with the employer; (3) benefits are paid by trustees of independent trusts; (4) the amount of weekly benefits payable is based upon state unemployment benefits, other compensation allowable under state laws, and the amount of straight-time weekly pay; (5) the duration of the benefits is affected by the fund level and the employee's seniority; (6) the right to benefits does not accrue until a prescribed period after termination of employment; (7) the benefits are not attributable to the rendering of particular services; and (8) no employee has any right, title, or interest in the fund until such employee is qualified and eligible to receive benefits.

Subsequent revenue rulings have broadened the scope of Rev. Rul. 56-249. Rev. Rul. 58-128, 1958-1 C.B. 89, concludes that the wage conclusions in Rev. Rul. 56-249 would be the same if the plan had been unilaterally instituted by the employer. Rev. Rul. 60-330, 1960-2 C.B. 46, further concludes that the fact that benefits are not paid from a trust does not alter the conclusion of Rev. Rul. 56-249.

Rev. Rul. 71-408, 1971-2 C.B. 340, holds that payments to employees pursuant to an agreement with a union upon the termination of their employment due to the discontinuance of the company's operations constitute wages for FICA, FUTA, and federal income tax withholding purposes. The payments described in Rev. Rul. 71-408 do not meet the eligibility factors described in Rev. Rul. 56-249 and are not designed to provide a supplement to unemployment compensation.

Rev. Rul. 77-347, 1977-2 C.B. 362, amplifies and modifies Rev. Ruls. 56-249 and 58-128. Rev. Rul. 77-347 provides that benefits under a plan do not have to be tied to state unemployment compensation benefits in order for the benefits to constitute SUB pay for FICA, FUTA, and federal income tax withholding purposes.

Rev. Rul. 65-251, 1965-2 C.B. 395, holds that certain lump sum separation and severance allowances paid to laid-off employees in the railroad industry constitute compensation for RRTA purposes and wages for income tax withholding purposes.

HOLDINGS

The portion of Rev. Rul. 77-347 concluding that benefits do not have to be linked to state unemployment compensation in order to be excluded from the definition of wages for FICA and FUTA tax purposes is inconsistent with the underlying premises for the exclusion and is therefore hereby revoked. This action restores the distinction between SUB pay and dismissal pay by re-establishing the link between SUB pay and state unemployment compensation set forth in Rev. Rul. 56-249. Since the receipt of supplemental unemployment benefits in the form of a lump sum rather than periodic payments allows the same amount of benefits to be received regardless of how long an individual remains unemployed, benefits provided in the form of a lump sum are not considered linked to state unemployment compensation for this purpose, and are therefore not excludable from wages as SUB pay.

The definition of compensation for RRTA purposes is similar to the definition of wages for FICA purposes. Therefore, the same conclusions apply for RRTA purposes.

In view of the foregoing, benefits provided under the plans described above are treated as follows:

Plan (1). Benefits paid under Plan (1) are designed to supplement the receipt of state unemployment compensation and are not wages for purposes of the FICA and FUTA taxes. Under section 3402(o), benefits paid under Plan (1) are treated as wages for purposes of federal income tax withholding.

Plan (2). Benefits paid under Plan (2) are designed to supplement the receipt of unemployment compensation under the RUIA and are not compensation for purposes of the RRTA.

Plans (3) and (5). Benefits paid under Plans (3) and (5) are wages for FICA, FUTA, and federal income tax withholding purposes.

Plans (4) and (6). Benefits paid under Plans (4) and (6) are compensation for RRTA purposes.

These holdings also apply to plans similar in all material respects to

Plans (1), (2), (3), (4), (5), and (6) that are not funded by trusts or are maintained pursuant to a collective bargaining agreement.

EFFECT ON OTHER REVENUE RULINGS

The portion of Rev. Rul. 77-347 that concludes that SUB pay does not have to be tied to state unemployment benefits in order to receive non-wage treatment for purposes of the FICA and FUTA taxes is revoked. Also, Rev. Rul. 65-251, 1965-2 C.B. 395, is amplified.

PROSPECTIVE APPLICATION

Under the authority of section 7805(b) of the Code, this revenue ruling applies to benefits paid on or after January 1, 1991, pursuant to a plan described above. For such plans maintained pursuant to a collective bargaining agreement in effect on September 4, 1990, this revenue ruling applies to all benefits paid after the later of January 1, 1991, or the date on which the particular collective bargaining agreement expires.

Section 3402.—Income Tax Collected at Source

26 CFR 31.3402(o)-1: Extension of withholding to supplemental unemployment compensation benefits.

Do supplemental unemployment compensation benefits constitute wages for purposes of the Federal Insurance Contributions Act and the Federal Unemployment Tax Act, and compensation for purposes of the Railroad Retirement Tax Act? See Rev. Rul. 90-72, page 211.

Section 3406.—Backup Withholding

26 CFR 35a.3406-1: Imposition of backup withholding due to notification of an incorrect taxpayer identification number.

T.D. 8309

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 35a

Imposition of Backup Withholding Due to Notification of an Incorrect Taxpayer Identification Number

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains amendments to §35a.3406-1 of the Temporary Income Tax Regulations under section 3406 of the Internal Revenue Code of 1986 (the "Code"). The amendments liberalize certain rules concerning the requirement for payors to backup withhold under section 3406(a)(1)(B) of the Code on certain reportable payments due to notification of an incorrect taxpayer identification number. These amendments affect payors, brokers, and payees of certain reportable payments and provide guidance necessary to comply with the law. The substance of §35a.3406-1 of the regulations, as amended by this document, is included in the proposed regulations under section 3406 of the Code set forth in the notice of proposed rulemaking in *** [IA-224-82, page 739, this Bulletin].

EFFECTIVE DATE: These amendments are effective on and after January 1, 1989.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

This regulation is being issued without prior notice and public procedure pursuant to the Administrative Procedure Act (5 U.S.C. 553). The collection(s) of information contained in this regulation have been reviewed and approved by the Office of Management and Budget (OMB) under control number 1545-0969.

The estimated average annual burden per respondent/recordkeeper, depending on individual circumstances, is .25 hours. These estimates are an approximation of the average time expected to be necessary for a collection of information. They are based on such information as is available to the Internal Revenue Service. Individual respondents/recordkeepers may require greater or less time, depending on their particular circumstances.

For further information concerning the collection of information, and where to submit comments on this collection of information, the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble of the notice of proposed rulemaking in the *** [IA-224-82, page 739, this Bulletin].

Background

This document contains amendments to Part 35a of Title 26 of the Code of Federal Regulations ("CFR"). The amendments provide guidance relating to the requirement under section 3406(a)(1)(B) of the Code that a payor backup withhold 20 percent from reportable payments due to an incorrect taxpayer identification number. This provision was added to the Code by section 104 of the Interest and Dividend Tax Compliance Act of 1983 (Pub. L. 98-67, 97 Stat. 369, 371) [1983-2 C.B. 352]. On November 23, 1987, the Internal Revenue Service published in the Federal Register temporary regulations (26 CFR Part 35a.3406-1, T.D. 8163, 52 FR 44861) [1987-2 C.B. 226] concerning the requirement to backup withhold under section 3406(a)(1)(B). Amendments to these temporary regulations were published in the Federal Register on April 11, 1989 (T.D. 8248, 54 FR 14341) [1989-1 C.B. 280].

This issue *** contains a notice of proposed rulemaking [IA-224-82, page 739, this Bulletin] containing proposed regulations that, in large measure, would reorganize and restate in traditional regulation form various temporary regulations issued under section 3406. The substance of §35a.3406-1, as amended by this Treasury decision, is included in such proposed regulations. Accordingly, the notice of proposed rulemaking provides an opportunity for the public to comment on all of the amendments made by this document.

EXPLANATION OF PROVISIONS

Overview of the law prior to the amendments made by this Treasury decision.

Section 3406(a)(1)(B) of the Code requires a payor to institute backup withholding at a rate of 20 percent on any reportable payment to a payee if the Service or a broker notifies the payor that the taxpayer identification number ("TIN") provided by the payee is incorrect. After a payor receives a "B" notice from the Service or a broker, (i) the payor must promptly furnish a copy to the payee, (ii) the payor must commence backup withholding on reportable payments no later than the 30th day after receipt of the "B" notice, and (iii) the payee may prevent backup withholding from commencing or terminate backup withholding, as the case may be, by furnishing the payor with

a name/TIN combination in the appropriate manner. Section 3406(e)(2), (e)(5), and (h)(8). If the payor receives two "B" notices for the payee within any three-year period, the payee may prevent backup withholding from commencing or terminate backup withholding, as the case may be, only by obtaining a notice from the Service that a correct name/TIN combination has been provided (the "2/3 rule"). Section 3406(h)(2).

Pursuant to the "B" notice temporary regulations, an incorrect TIN exists if the name/TIN combination provided on an information return does not match a name/TIN combination in the records of the Service or the Social Security Administration (the "match requirement"). Backup withholding applies to all reportable payments to accounts of the payee that have the same incorrect name/TIN combination as the one contained on the "B" notice and that the payor can locate using reasonable care (the "reasonable care requirement"). §35a.3406-1(b)(3) and (5).

The "B" notice temporary regulations require that a payor send a notice to the payee within 5 business days of having received the "B" notice (the "5-day requirement"). §35a.3406-1(c)(2). However, the preamble to the April 11, 1989, amendments to the "B" notice temporary regulations states that the Service will mail "B" notices 2 to 3 weeks in advance of the date that they will be considered to be effective. 54 FR 14342.

The "B" notice temporary regulations also provide, in part, that, with respect to accounts of the payee identified by the payor as having the same name/TIN combination, the payor must withhold 20 percent of either (i) withdrawals made after 7 business days following the payor's receipt of the "B" notice (to the extent of reportable payments made since such receipt) or (ii) reportable payments made after the 7-day period ("the 7-day requirement"). §35a.3406-1(d).

In addition, the "B" notice temporary regulations apply the 2/3 rule on a payee basis — that is, they require a payor to identify and backup withhold on any account of a payee with the incorrect TIN and for whom the payor has received two "B" notices. §5a.3406-1(f).

The amendments to the "B" notice temporary regulations made by this Treasury decision.

Comments on the "B" notice temporary regulations have primarily focused on the match requirement, the reasonable care requirement, the 5-day requirement, the 7-day requirement, and the application of the 2/3 rule. The amendments contained in this Treasury decision are intended to address these concerns. The Service recognizes, however, that further changes in these and other areas of the "B" notice temporary regulations may be appropriate. Accordingly, the substance of the "B" notice temporary regulations, as amended by this Treasury decision, is included in the proposed regulations in the notice of proposed rulemaking under section 3406 of the Code in *** [IA-224-82, page 739, this Bulletin]. This will allow persons to comment on areas where further changes might be appropriate.

The match requirement and certain multi-name fiduciary and nominee accounts. Certain payors have informed the Service that they are likely to receive substantial numbers of "B" notices with respect to accounts maintained by fiduciaries or nominees even though the proper TIN for the ultimate taxpayer has been provided. These payors indicate that this may result, for example, because the Service's processing system does not read the full registration on certain multi-name fiduciary accounts (*i.e.*, it reads only the first 80 characters of any registration) or because only the name of the fiduciary or nominee and the TIN of the beneficial owner are listed on the account. Accordingly, the "B" notice temporary regulations are amended to provide that, until final regulations are issued with respect to this issue, backup withholding under section 3406(a)(1)(B) will not apply to accounts with respect to which at least one person named in the registration is identified as acting in the capacity as nominee or as administrator, conservator, custodian, receiver, tutor, curator, committee, executor, guardian, trustee, or other fiduciary capacity recognized under governing law. Prior to the issuance of final regulations on this issue, for purposes of section 3406(a)(1)(B), payors are requested, but not required, to send copies of the "B" notices (or an acceptable substitute therefor) to the payees of such fiduciary and nominee accounts. The Service invites comments from payors on how fiduciary and nominee accounts can be formatted on information returns so that the correct name/TIN combination is identified.

Notwithstanding the exemption from backup withholding provided for fiduciary and nominee accounts described above, payors continue to be required to file information returns for reportable payments made to such accounts and to be subject to the penalty under section 6721 of the Code for providing an incorrect TIN on such an information return. However, the fact that a payor sends a copy of the "B" notice (or an acceptable substitute therefor) and other prescribed information to the payee of a fiduciary or nominee account exempted from backup withholding will be considered strong evidence of (but not a requirement for) qualification for the reasonable cause exception to the penalty under section 6721 for information returns filed subsequent to receipt of the "B" notice.

The match requirement and legal impediments to correcting a name or TIN on an account. Some payors have informed the Service that there may be situations in which there are legal impediments to correcting a name or TIN on an account. For example, state law may prohibit a payor from changing the name on a negotiable instrument without proper authorization from the holder of the instrument. The Service requests comments on how to accommodate these situations.

The reasonable care requirement. Certain payors have requested a less costly and time-consuming procedure for determining accounts of the payee that are potentially subject to backup withholding. Accordingly, the "B" notice temporary regulations are amended to provide that, where the "B" notice contains an account number or designation, backup withholding applies only to the account or accounts corresponding to that number or designation and containing the incorrect name/TIN combination. In a case where the "B" notice does not contain the account number or designation (because no account number

or designation was provided on the related information return), backup withholding applies to all reportable payments made to accounts of the payee with the incorrect name/TIN combination that the payor can locate with reasonable care.

The 5-day requirement. Several payors have informed the Service that, in a substantial number of cases, they will be unable to comply with the 5-day requirement even where the Service mails the "B" notices by 2 to 3 weeks in advance of their effective date because of the many tasks required of payors after receipt of "B" notices. However, lengthening the period allowed for a payor to notify a payee decreases day-for-day the period allowed for the payee to provide a certified TIN to the payor and prevent backup withholding from starting. The Service believes that 15 business days should serve the interests of both payors and payees. Therefore, the "B" notice temporary regulations are amended to provide that the period in which payors must notify payees of their incorrect TINs for purposes of backup withholding under section 3406(a)(1)(B) of the Code is extended from 5 to 15 business days.

The 7-day requirement. The Service is concerned that the 7-day requirement may have the effect of eliminating any chance that a payee could provide a new name/TIN combination (or correct an error) prior to the payor's commencing backup withholding. Accordingly, the 7-day requirement is eliminated. Payors are required to commence backup withholding only after the close of 30 business days following receipt of the "B" notice, although payors may still elect to impose backup withholding at any time after receipt of the notice. The Service will consider other enforcement measures, rather than requiring backup withholding on withdrawals, in collecting the appropriate tax from payees who withdraw funds during the 30-day grace period.

The 2/3 rule. Several payors have indicated that it is not feasible for them to apply the 2/3 rule on a payee basis. This requires them over time to correlate a payee with all accounts of the payee whether or not they have the same name/TIN combination as the one indicated on a "B" notice. This is especially difficult where the payor does not have a direct relationship with the payee. Accordingly, the 2/3 rule is amended to apply on an account, rather than a payee, basis. The 2/3 rule thus applies only where a payor receives a "B" notice twice within 3 calendar years with respect to the same account.

Concluding Comments

The amendments made by this Treasury decision are effective on and after January 1, 1989. Thus, a payor is only required to notify payees and backup withhold on payee accounts as required by these regulations if the payor receives a notice of an incorrect taxpayer identification number from the Internal Revenue Service on or after January 1, 1990. In this connection payors may notify payees by sending an acceptable substitute of the notice set forth in the appendix to §35a.3406-1. For this purpose, the notice set forth in the Federal Register on November 23, 1987 (52 FR 44871), or such notice as amended on April 11, 1989 (54 FR 14345) or an acceptable substitute of either will satisfy the requirement that the payor send a "B" notice to a payee.

Special Analyses

These rules are not major rules as defined in Executive Order 12291 because the economic or other consequences are a direct result of a statute. Therefore, a Regulatory Impact Analysis is not required. It has also been determined that section 553(b) of the Administrative Procedures 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 final Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations will be submitted to the Administrator of the Small Business Administration for comment on their impact on small businesses.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR Part 35a is amended as follows:

Part 35a — TEMPORARY EMPLOYMENT TAX REGULATIONS UNDER THE INTEREST AND DIVIDEND TAX COMPLIANCE ACT OF 1983

Par. 1. The authority citation for Part 35a is amended by adding the following citation:

Authority: 26 U.S.C. 7805*** §35a.3406-1 also issued under 26 U.S.C. 3406(a), (b), (e), (g), (h), and (i); 26 U.S.C. 6109; 26 U.S.C. 6676; and 26 U.S.C. 6721.

§35a.3406-1 [Amended]

Par. 2. Section 35a.3406-1 is amended as follows:

1. Paragraph (a)(1) is amended by removing the last two sentences and adding the following new sentence in their place: "See section 6721 for the penalty that may be imposed on a payor for providing an incorrect taxpayer identification number on an information return filed with the Internal Revenue Service unless there is reasonable cause for the error.".

2. Paragraph (b)(2) is amended by removing the last sentence of the concluding text and adding the following sentence in its place: "See paragraph (b)(5)(ii) of this section for accounts of the payee with respect to which the broker is required to notify a payor under this paragraph (b)(2).".

3. Paragraph (b)(5)(i)(B), second sentence, is amended by removing the words "name, taxpayer identification number, and the account number" and adding in their place the following words: "name and taxpayer identification number".

4. The concluding text following paragraph (c)(1)(ii) is amended by removing the words "Federal Register on November 23, 1987 (52 FR 44871)" in the second and third sentences and adding in their place the words "appendix to this section".

5. Paragraph (c)(2)(i) is amended by removing the word "5" and by adding in its place the word "15".

6. Paragraph (c)(3) introductory text, second sentence, is amended by removing the words "Federal Register on November 23, 1987 (52 FR 44871)" and adding in their place the words "appendix to this section".

7. Paragraph (c)(3)(vii) is amended by adding the word "and" at the end thereof.

8. Paragraph (c)(3)(viii) is amended by removing the words "; and" at the end thereof and adding a period

in their place.

9. Paragraph (c)(3)(ix) is removed.

10. Paragraph (d)(2)(i) is amended by removing the words "paragraph (d)(1)(i)" and adding the words "paragraph (d)(1)" in their place in the first sentence, and by removing the last sentence.

11. Paragraph (f)(2)(ii) is amended by removing the word "an" and by adding in its place the word "the" immediately before the words "account with the payor;".

12. Paragraph (f)(2)(iii) is amended by removing the words "to existing accounts with the payor;" and by adding in their place the words "to the account;".

13. Paragraph (f)(4)(i) is amended by removing the words "paragraph (f)(3)(i)" and inserting in their place the words "paragraph (f)(3)", and by removing the last sentence.

14. Paragraph (g) is amended by adding the words "with respect to the same account" immediately after the words "provided an incorrect taxpayer identification number".

15. The first paragraph of the Appendix to §35a.3406-1 is amended by removing the words "notice published in the Federal Register on November 23, 1987 (52 FR 44871) or to the".

16. The second paragraph of the "Notice of Backup Withholding" in the Appendix to §35a.3406-1 is amended by removing the word "6676" and adding in its place the word "6723".

17. The text in the "Notice of Backup Withholding" in the Appendix to §35a.3406-1 entitled "Remember" is amended by removing the last sentence in the first paragraph. 18. Paragraph (a)(3)(x) is added; and paragraphs (b)(3), (b)(5)(i) introductory text, and (b)(5)(ii); (c)(3)(vi); (d)(1); (f)(1) introductory text, (f)(1)(i), (f)(1)(ii), (f)(1)(iii), (f)(2)(iv), and (f)(3); and (j) are revised. The added and revised provisions read as follows:

§35a.3406-1 Imposition of backup withholding due to notification of an incorrect taxpayer identification number.

(a) *Requirement that a payor backup withhold due to notification of an incorrect taxpayer identification number.* ***

* * * * *

(3) *Reportable payments excluded from backup withholding.* ***

* * * * *

(x) *Payments to certain fiduciary and nominee accounts.* Payments to a fiduciary or nominee account. For purposes of this paragraph, a fiduciary or nominee account means an account with respect to which at least one person named in the registration is identified as acting in the capacity as nominee or of administrator, conservator, custodian, receiver, tutor, curator, committee, executor, guardian, trustee, or other fiduciary capacity recognized under governing law.

* * * * *

(b) *Notice regarding an incorrect taxpayer identification number.* ***

* * * * *

(3) *Accounts subject to backup withholding.* After receiving notice from the Internal Revenue Service or from a broker, as provided in paragraph (b)(1) and (2) of this section, the payor is required to notify the payee in accordance with paragraph (c) of this section and to institute backup withholding as prescribed in paragraph (d) of this section on all reportable payments subject to backup withholding that are made to the account or accounts of the payee containing the incorrect taxpayer identification number. See paragraph (f) of this section for the rules that apply when a payor has received two notifications of an incorrect taxpayer identification number with respect to an account of the payee from the Internal Revenue Service or a broker within 3 calendar years. See paragraph (b)(5) of this section for the determination of the account or accounts of the payee containing the incorrect taxpayer identification number.

* * * * *

(5) *Determination of the account or accounts of the payee containing the incorrect taxpayer identification number*— (i) *Payors.* If an account number or designation is provided in the notice received under paragraph (b)(1) or (2) of this section, the payor need only determine whether the account or accounts corresponding to that number or designation contain the same name and incorrect taxpayer identification number provided in the notice. If no account number or designation is provided in the notice received under paragraph (b)(1) or (2) of this section, the payor must locate, using reasonable care, all accounts of the payee containing the same name and incorrect taxpayer identification number provided in the notice. A payor who satisfies the following two-part facts and circumstances test will be considered to have exercised reasonable care.

* * * * *

(ii) *Brokers.* Brokers are required to use the information and follow the procedures described in paragraph (b)(5)(i) of this section to locate accounts of the payee with respect to which a broker is required to notify a payor pursuant to paragraph (b)(2) of this section.

(c) *Notice from payors of backup withholding due to an incorrect taxpayer identification number.* * * *

* * * * *

(3) *Requirements of substitute notice to the payee.* ***

* * * * *

(vi) Advises the payee that as a result of providing an incorrect taxpayer identification number, the payor is required under section 3406(a)(1)(B) of the Internal Revenue Code to begin backup withholding 20 percent of the reportable payments made to the account of the payee no later than after the close of the day 30 business days after the date that the payor is notified of the incorrect taxpayer identification number by the Internal Revenue Service or a broker if the payor has not received the required Form W-9 (or an acceptable substitute form) as described in paragraph (e) of this section;

* * * * *

(d) *Period during which backup withholding is required due to notification of an incorrect taxpayer identification number*—(1) *In general.* Except as provided in paragraph (d)(2) of this section, upon receiving a notice described in paragraph (b)(1) or (2) of this section, the payor must impose backup withholding on all reportable payments made to the account of the payee that are subject to backup withholding after the close of the 30th business day after the date the payor receives the notice described in paragraph (b)(1) or (2) of this section and on or before the close of the 30th calendar day after the day the payor receives from the payee the certified Form W-9 (or acceptable substitute form) as described in paragraph (e) of this section.

* * * * *

(f) *Notification of two incorrect taxpayer identification numbers within a 3-year period*—(1) *In general.* If a payor receives a notification as described in paragraph (b)(1) or (2) of this section twice within 3 calendar years, and in each case the payor pursuant to paragraph (b)(5) of this section identifies the same account as containing the incorrect taxpayer identification number, then the payor shall—

(i) Disregard any future certifications (described in paragraph (e) of this section) furnished by the payee with respect to the account;

(ii) Send the notice described in paragraph (f)(2) of this section to the payee (and not the notice required under paragraph (c) of this section) within 15 business days after the date that the payor receives the second notice described in this paragraph (f), and

(iii) Impose backup withholding on the account containing the incorrect taxpayer identification number for the period described in paragraph (f)(3) of this section.

* * * * *

(2) *Notice to payee who has provided two incorrect taxpayer identification numbers within 3 years.* ***

* * * * *

(iv) As a result of providing an incorrect taxpayer identification number, the payor is required under section 3406(a)(1)(B) to begin backup withholding 20 percent of reportable payments made to the account of the payee no later than after the close of the day 30 business days after the date that the payor is notified of the incorrect taxpayer identification number if the Internal Revenue Service has not notified the payor that the payee provided a correct taxpayer identification number to the Internal Revenue Service as described in paragraph (h) of this section; and

* * * * *

(3) *Period during which backup withholding is required due to a second notification of an incorrect number within 3 years.* Upon receiving the second notice of an incorrect taxpayer identification number from the Internal Revenue Service or a broker as described in paragraph (f)(1) of this section, the payor must backup withhold on all reportable payments subject to backup withholding made to the account of the payee after the close of the 30th business day after the day on which the payor receives a notice described in paragraph (b)(1) or (2) of this section and on or before the close of the 30th calendar day after the payor receives the notification from the Internal Revenue Service as described in paragraph (h) of this section.

* * * * *

(j) *Examples.* The application of the provisions of this section may be illustrated by the following examples:

Example (1). D opened an account with Bank O prior to 1984 and furnished a taxpayer identification number to O at the time he opened the account. O is open for business Monday through Friday. O pays interest on the account at the end of each calendar month and the account is a pre-1984 account as described in A-34 of §35a.9999-1 and A-20 of §35a.9999-3. On October 1, 1990, the Internal Revenue Service notifies Bank O that the taxpayer identification number provided by D is incorrect. O timely sends the notice information to D as required in paragraph (c)(1) of this section. O does not receive a certified Form W-9 or an acceptable substitute form (hereinafter "certification") from D as described in paragraph (e) of this section. O is required to backup withhold 20 percent of all reportable payments made after November 14, 1990 (which is 30 business days after the date the Internal Revenue Service notified O). Therefore, O is not required to backup withhold on the reportable payment made on October 31, 1990, but is required to backup withhold on the reportable payment made on November 30, 1990. O is required to continue to backup withhold under section 3406(a)(1)(B) until O receives the certification described in paragraph (e) of this section from D.

Example (2). Assume the same facts as in Example (1) except that D furnishes a new taxpayer identification number to O on November 1, 1990, but does not certify, under penalties of perjury, that it is his correct taxpayer identification number as required in paragraph (e) of this section. Even though the account is a pre-1984 account, O is required to withhold 20 percent of all reportable payments made after November 14, 1990 (which is 30 business days after the date the Internal Revenue Service notified O), and before the date O receives the certification described in paragraph (e) of this section from D.

Example (3). Assume the same facts as in Example (2) except that D provides O with the certification described in paragraph (e) of this section on November 20, 1990. D elects pursuant to paragraph (d)(2)(ii) of this section to treat the certification as received on November 20, 1990. Even though D did not provide the certification to O within 30 business days after the Internal Revenue Service notified O that D provided an incorrect taxpayer identification number, O is not required to backup withhold under section 3406(a)(1)(B) because O did not make any reportable payment to D after 30 business days after notification of an incorrect taxpayer identification number and before O received D's certification in the manner required in paragraph (e) of this section. Pursuant to section 3406(e)(5)(B), O may elect to treat the certification as having been received at any time within 30 calendar days after it is provided by D.

Example (4). Individual F has two post-1983 accounts with Bank R that pay reportable interest: a savings account and a money market account. The money market account was opened in 1986, and the savings account was opened on February 1, 1991. R treats each of these accounts as a separate account with the Bank. F provided R with the certifications as described under A-32 of §35a.9999-1 at the time each account was opened. On October 1, 1990, the Internal Revenue Service notified R pursuant to paragraph (b)(1) of this section that F furnished an incorrect taxpayer identification number with respect to the money market account. R timely sends F the notice required under paragraph (b)(1) of this section and receives the certification required under paragraph (e) of this section from F on November 1, 1990. On October 1, 1991, the Internal Revenue Service notifies R that F furnished an incorrect taxpayer identification number with respect to the money market account. Further, R determines from its business records that two notifications of an incorrect taxpayer identification number have been received with respect to the money market account within 3 calendar years. R must send F the notice required under paragraph (f)(2) of this section and must commence backup withholding on reportable interest paid on the money market account pursuant to paragraph (f)(3) of this section after November 14, 1991 (which is 30 business days after R received the second notice). R must continue to backup withhold on the money market account until R receives from the payee a copy of the notice that was provided to the payee by the Internal Revenue Service as described in paragraph (h) of this section. R is not required to backup withhold on the savings account until it receives notice under paragraph (b)(1) or (2) of this section with respect to the savings account.

* * * * *

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

Michael J. Murphy,
Acting Commissioner of Internal Revenue.

Approved August 27, 1990.

Kenneth W. Gideon,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on September 20, 1990, 10:53 a.m., and published in the issue of the Federal Register for September 27, 1990, 55 F.R. 39399)

Subtitle D.—Miscellaneous Excise Taxes
Chapter 31.—Retail Excise Taxes
Subchapter A.—Special Fuels

Section 4041.—Imposition of Tax

26 CFR 48.4041-1: Taxes on diesel fuel, special motor fuel, and fuel used in noncommercial aviation.

Pursuant to the Convention on the Privileges and Immunities of the United Nations, the United Nations may make purchases for its official use free of certain federal excise taxes. See Rev. Rul. 90-83, page 219.

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26 CFR 48.4041-21: Election to have certain diesel fuel taxes imposed on sales to retailers.

T.D. 8303

Election to Have Certain Diesel Fuel Taxes Imposed on Sales to Retailers

AGENCY: Internal Revenue Service, Treasury

ACTION: Final Regulations

SUMMARY: This document adopts as final regulations temporary regulations published in the FEDERAL REGISTER on March 1, 1988, relating to the collection of excise taxes on diesel fuel under an election provided by section 4041(n) of the Code. Changes to the applicable law were made by the Tax Reform Act of 1986.

EFFECTIVE DATES: The regulations are effective April 1, 1987, and apply to sales of diesel fuel for use in diesel-powered highway vehicles made after March 31, 1987, and before April 1, 1988, with the exception of the following provisions, which are effective as of March 1, 1988:

§48.4041-21(g);
§48.4041-21(h)(1) following "section 4041(a)(1),";
§48.4041-21(h)(2);
§48.4041-21(i)(3); and
§48.4041-21(k)(1).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information requirements contained in this final regulation have been reviewed and approved by the Office of Management and Budget in accordance with the requirements of the Paperwork Reduction Act (44 U.S.C. 3504(h)) under control number 1545-0977. The estimated average burden associated with the collection of information requirements in this final rule is 19 minutes per respondent/recordkeeper.

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

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be directed to the Internal Revenue Service, Washington, D.C. 20224, Attention: IRS Reports Clearance Officer TR:FP, and to the Office of Management and Budget, Paperwork Reduction Project, (RIN: 1545-AJ13), Washington, D.C. 20503.

Background

On March 1, 1988, the Federal Register published temporary regulations [T.D. 8181] (53 FR 6518) [1988-1 C.B. 344] under section 4041(n) of the Internal Revenue Code relating to the collection of excise taxes on diesel fuel under an election provided by section 4041(n) of the Code. The text of those temporary regulations also served as a notice of proposed rulemaking published in the Federal Register for the same day [LR-114-86] (53 FR 6524) [1988-1 C.B. 925]. No written comments were received. A public hearing was not requested. Accordingly, the notice of proposed rulemaking is withdrawn, and the temporary regulations are adopted as redesignated by this Treasury decision.

In General

Section 1702 of the Tax Reform Act of 1986 (Pub. L. No. 99-514, 100 Stat. 2773 [1986-3 C.B. (Vol. 1) 1, 690]) added section 4041(n) to the Code effective for sales of diesel fuel on or after April 1, 1987. Section 4041(n) allowed a qualified diesel fuel retailer to elect to shift the liability for the tax imposed by section 4041(a)(1) to the seller of the fuel to that retailer. A qualified retailer was not required to make the election with respect to all its sellers in order for the election to become effective. The qualified retailer remained liable, however, for any tax imposed on the subsequent sale of diesel fuel purchased tax-free from a seller not covered by a valid election. Section 4041(n) was subsequently repealed by section 10502(b)(4) of the Omnibus Budget Reconciliation Act of 1987 (Pub. L. No. 100-203, 101 Stat. 1330 [1987-3 C.B. 1, 162]), effective for sales of diesel fuel on or after April 1, 1988. These regulations therefore do not reflect changes made to the diesel fuel excise tax by the Omnibus Budget Reconciliation Act of 1987.

Special Analyses

Although a notice of proposed rulemaking that solicited public comment was issued, the Internal Revenue Service concluded when the notice was issued that the regulations are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 did not apply. Accordingly, the final regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

The Commissioner of Internal Revenue has determined that this final rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis therefore is not required.

* * * * *

Adoption of amendments to the regulations

Accordingly, 26 CFR Parts 48 and 602 are amended as follows:

Paragraph 1. The authority for Part 48 is amended:

(a) by removing the following citation:

"Section 48.4041-21T is also issued under 26 U.S.C. 4041(n).";

and

(b) by adding the following citation:

"Section 48.4041-21 is also issued under 26 U.S.C. 4041(n)."

Par. 2. 26 C.F.R. Part 48 is amended by redesignating §48.4041-21T as §48.4041-21, and removing the word "(Temporary)" from the end of the section heading.

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

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

Par. 4. The table of OMB control numbers in section 602.101(c) is amended as follows:

The entry reading:

"48.4041-21T. . .1545-0977" is revised to read:

"48.4041-21. . .1545-0977".

Fred T. Goldberg, Jr.,
Commissioner of Internal Revenue.

Approved May 11, 1990.

Kenneth W. Gideon,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on June 5, 1990, 8:45 a.m., and published in the issue of the Federal Register for June 6, 1990, 55 F.R. 23076)

Subchapter B.—Heavy Trucks and Trailers

Section 4051.—Imposition of Tax on Heavy Trucks and Trailers Sold at Retail

26 CFR 145.4051-1: Imposition of tax on heavy trucks and trailers sold at retail.

Pursuant to the Convention on the Privileges and Immunities of the United Nations, the United Nations may make purchases for its official use free of certain federal excise taxes. See Rev. Rul. 90-83, this page.

Chapter 32.—Manufacturers Excise Taxes
Subchapter A.—Automotive and Related Items
Part I.—Gas Guzzlers

Section 4064.—Gas Guzzlers Tax

26 CFR 48.4064-1: Gas guzzler tax.

Pursuant to the Convention on the Privileges and Immunities of the United Nations, the United Nations may make purchases for its official use free of certain federal excise taxes. See Rev. Rul. 90-83, this page.

Part II.—Tires

Section 4071.—Imposition of Tax

26 CFR 48.4071-1: Imposition and rate of tax.

Pursuant to the Convention on the Privileges and Immunities of the United Nations, the United Nations may make purchases of its official use free of certain federal excise taxes. See Rev. Rul. 90-83, this page.

Part III.—Petroleum Products
Subpart A.—Gasoline

Section 4081.—Imposition of Tax

26 CFR 48.4081-1: Imposition and rate of tax.

Pursuant to the Convention on the Privileges and Immunities of the United Nations, the United Nations may make purchases for its official use free of certain federal excise taxes. See Rev. Rul. 90-83, below.

Subpart B.—Diesel Fuel and Aviation Fuel

Section 4091.—Imposition of Tax

(Also Sections 4041, 4051, 4064, 4071, 4081, 4121, 4131, 4161, 4181, 4611, 4661, 4671, 4681; 26 CFR 48.4041-1, 145.4051-1, 48.4064-1, 48.4071-1, 48.4081-1, 48.4121-1, 48.4181-1, 52.4681-IT.)

Sales to the United Nations; applicability of federal excise taxes. Pursuant to the Convention on the Privileges and Immunities of the United Nations, the United Nations may make purchases for its official use free of certain federal excise taxes. Current taxes for which the privilege is, or is not, accorded are listed.

Rev. Rul. 90-83

ISSUE

Do the federal excise taxes imposed under chapters 31, 32 and 38 of the Internal Revenue Code apply to sales to the United Nations?

LAW AND ANALYSIS

The Convention on the Privileges and Immunities of the United Nations, 21 U.S.T. 1418, T.I.A.S. No. 6900, (the Convention) was entered into force with respect to the United States on April 29, 1970. Article II, section 8 of the Convention states as follows:

> While the United Nations will not, as a general rule, claim exemption from excise duties and from taxes on the sale of movable and immovable property which form part of the price to be paid, nevertheless when the United Nations is making important purchases for official use of property on which such duties and taxes have been charged or are chargeable, Members will, whenever possible, make appropriate administrative arrangements for the remission or return of the amount of duty or tax.

Thus, under the Convention, the United States has agreed that it will make administrative arrangements, whenever possible, for remission or return of certain duties and taxes when the United Nations makes purchases for its official use. The Internal Revenue Service has considered this issue and has determined that administrative arrangements can be made for remission or return of certain excise taxes under chapters 31 and 32 of the Code. In determining which excise taxes could be remitted or returned, the United Nations has been accorded tax treatment similar to that of a state of the United States.

HOLDING

The United Nations may purchase articles subject to the excise taxes listed below either tax free or at a tax-excluded price, provided that the *Required Procedures* are followed.

(1) Section 4041(a)—Special motor fuels

(2) Section 4041(c)—Gasoline sold for use in noncommercial aviation

(3) Section 4051(a)—Heavy trucks and trailers sold at retail

(4) Section 4071(a)—Tires

(5) Section 4081(a)—Gasoline

(6) Section 4091(a)—Diesel fuel and aviation fuel

(7) Section 4161(a)—Sport fishing equipment

(8) Section 4161(b)—Bows and arrows, etc.

(9) Section 4181—Firearms

The following federal excise taxes imposed under chapters 32 and 38 of the Code apply to sales to the United Nations. The Internal Revenue Service will not make administrative arrangements to remit or return these taxes because states are not accorded such treatment.

(1) Section 4064(a)—Gas guzzler tax

(2) Section 4121(a)—Coal

(3) Section 4131(a)—Vaccines

(4) Section 4611—Tax on petroleum

(5) Section 4661—Tax on certain chemicals

(6) Section 4671—Tax on certain imported substances

(7) Section 4681—Tax on ozone-depleting chemicals

It should be noted, however, that purchases by the United Nations are eligible for any otherwise available statutory exemptions from these excise taxes, such as the exemption for certain goods to be exported.

REQUIRED PROCEDURES—ARTICLES OTHER THAN FUELS

The United Nations is not required

to register with the Service in order to purchase articles free of federal excise taxes. However, to support a tax-free sale of an otherwise taxable article, a signed statement must be furnished to the seller by the United Nations identifying the authorizing official by name and title and indicating that the taxable article or articles are being purchased for the official use of the United Nations. In the case of a retailers excise tax, the statement must be furnished to the dealer from whom the purchase is being made, or to the manufacturer in the case of a sale by the manufacturer direct to United Nations. If the manufacturers or retailers excise tax has been paid on an article sold by the manufacturer or retailer directly to the United Nations, a credit or refund is available to the manufacturer or retailer, as the case may be, under section 6402 of the Code, provided that such manufacturer or retailer either has not included the tax in its price to the United Nations and has not collected such tax from the United Nations, has repaid the amount of the tax to the United Nations, or has obtained the written consent of the United Nations to the credit or refund.

Where an article ordinarily subject to a manufacturers excise tax is sold tax free by the manufacturer to a dealer for resale to the United Nations, the manufacturer must receive proof from the dealer of resale of the article to the United Nations for its official use, evidenced by either a copy of the statement provided to the dealer by the United Nations, or a statement from the dealer similar to that required under section 48.4221-2(c)(2)(i) of the Manufacturers and Retailers Excise Tax Regulations for tax-free sales of taxable articles to a purchaser for resale to a second purchaser for further manufacture. Under such circumstances, no tax will apply to the sale to the dealer. However, the exemption will cease to apply in respect of the sale of such article if, within a 6-month period which begins on the date of the sale by the manufacturer (or, if earlier, on the date of shipment by the manufacturer), the manufacturer does not receive proof that the article has been resold to the United Nations for its official use. On the day following the close of the 6-month period, if such proof has not been received, the manufacturer shall become liable for the tax at that time at the rate in effect when the sale was made, but otherwise in the same manner as if the article had been sold by it on such first day at a taxable price equivalent to that at which the article was actually sold. If the manufacturer later obtains such proof, a credit or refund of the tax under section 6402 of the Code is available provided that the manufacturer has either not collected the tax from such dealer, or has either repaid the tax to such dealer to obtained a written consent from such dealer to the allowance of a credit or refund.

If the article being purchased by the United Nations (at a price reduced by an amount equal to the tax) from the dealer is one that was sold tax paid by the manufacturer to the dealer, upon receipt of the requisite statement from the United Nations, the dealer should notify, and provide such statement to, the manufacturer, who, pursuant to section 6402 of the Code, may then seek a credit or refund, provided that the manufacturer has either repaid the amount of the tax to the dealer or has obtained the written consent of such dealer to the allowance of a credit or refund.

REQUIRED PROCEDURES FOR CERTAIN FUELS TAXES

To purchase fuels tax free or at a tax-excluded price, the United Nations must follow the procedures applicable to purchases of fuels by states set forth under sections 4041, 4093, and 6416 of the Code.

Subchapter B.—Coal

Section 4121.—Imposition of Tax

26 CFR 48.4121-1: Imposition and rate of tax on coal.

Pursuant to the Convention on the Privileges and Immunities of the United Nations, the United Nations may make purchases for its official use free of certain federal excise taxes. See Rev. Rul. 90-83, page 219.

Subchapter C.—Certain Vaccines

Section 4131.—Imposition of Tax

Pursuant to the Convention on the Privileges and Immunities of the United Nations, the United Nations may make purchases for its official use free of certain federal excise taxes. See Rev. Rul. 90-83, page 219.

Subchapter D.—Recreational Equipment
Part I.—Sporting Goods

Section 4161.—Imposition of Tax

Pursuant to the Convention on the Privileges and Immunities of the United Nations, the United Nations may make purchases for its official use free of certain federal excise taxes. See Rev. Rul. 90-83, page 219.

Part III.—Firearms

Section 4181.—Imposition of Tax

26 CFR 48.4181-1: Imposition and rates of tax.

Pursuant to the Convention on the Privileges and Immunities of the United Nations, the United Nations may make purchases for its official use free of certain federal excise taxes. See Rev. Rul. 90-83, page 219.

Chapter 36.—Certain Other Excise Taxes
Subchapter B.—Transportation by Water

Section 4471.—Imposition of Tax

26 CFR 43.4471-1T: Imposition of tax (temporary).

T.D. 8314

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 43 and 47

Final and Temporary Regulations Regarding the Tax on Transportation by Water

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final and Temporary Regulations.

SUMMARY: This document contains temporary regulations that implement the tax on the transportation of passengers on covered voyages by certain vessels under section 4471 of the Internal Revenue Code as enacted by section 7504 of the Revenue Reconciliation Act of 1989 (Pub. L. 101-239, 103 Stat. 2106, 2362) [1990-1 C.B. 210, 246]. This document also removes the existing regulations under 26 CFR Part 47 (relating to documentary stamp taxes), which are obsolete.

EFFECTIVE DATES: These regulations are effective for voyages beginning on or after January 1, 1990.

SUPPLEMENTARY INFORMATION:

Background

This document contains temporary regulations on the Excise Tax on Transportation by Water (26 CFR Part 43) under sections 4471 and 4472 of the Internal Revenue Code relating to the excise tax on the initial embarkation or disembarkation of passengers on certain commercial passenger vessels and on certain other commercial vessels transporting passengers engaging in gambling.

As a final action this document also removes the existing regulations under 26 CFR Part 47 (relating to documentary stamp taxes), which are obsolete.

Need for Temporary Regulations

Immediate guidance is needed on the imposition of tax on transportation of persons by water. Therefore, good cause is found to dispense with the public notice requirement of 5 U.S.C. 553(b) and the delayed effective date requirement of 5 U.S.C. 553(d).

Explanation of Provisions

The temporary regulations provide taxpayers with rules for complying with the tax imposed by section 4471 of the Code. Section 4471 of the Code imposes a tax of $3 per passenger on a covered voyage, as that term is defined in section 4472, to be paid by the person providing the covered voyage. The tax is to be imposed only once for each passenger on a covered voyage, either at the time of first embarkation or disembarkation in the United States. Under section 4472(1) of the Code, the term "covered voyage" means a voyage of (a) a commercial passenger vessel that extends over one or more nights, or (b) a commercial vessel transporting passengers engaged in gambling aboard the vessel beyond the territorial waters of the United States. A passenger vessel is any vessel with stateroom or berth accommodations for more than 16 passengers.

Requirements for Filing Returns, Paying Tax, and Using Government Depositaries

Sections 6011 (relating to requiring returns), 6071 (relating to the time for filing returns), and 6302 (relating to the use of government depositaries) provide that regulations are required in order to impose rules for filing returns and making deposits of tax.

Under temporary §43.6011(a)-1T, any person liable for the tax imposed by section 4471 must file Form 720, *Quarterly Federal Excise Tax Return*, to report that liability. The procedures for filing are contained in the instructions to the form. Temporary §43.6071(a)-1T(a) provides that returns must be filed by the last day of the month following the end of a calendar quarter.

Under temporary §43.6302(c)-1T, semimonthly deposits of tax are required to be made by all persons liable for the tax imposed under section 4471. The deposit for each semimonthly period is due on or before the 9th day of the following semimonthly period.

Temporary §§43.6071(a)-1T(c) and 43.6151(a)-1T provide special rules for filing returns and for paying the tax due for the period January 1, 1990, through November 15, 1990.

In *** [PS-3-90, page 879, this Bulletin], the Internal Revenue Service is issuing a companion Notice of Proposed Rulemaking that announces proposed regulations to address additional issues not addressed in these temporary regulations.

Special Analyses

It has been determined that these rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. 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 final Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of the proposed rulemaking for the regulations was submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR, Ch. I, is amended as follows:

Paragraph 1. A new Part 43 of the Code of Federal Regulations is added as follows:

PART 43—EXCISE TAX ON TRANSPORTATION BY WATER

§43.4471-1T Imposition of tax (temporary).
§43.6011(a)-1T Returns (temporary).
§43.6011(a)-2T Final returns (temporary).
§43.6071(a)-1T Time for filing returns (temporary).
§43.6091-1T Place for filing returns (temporary).
§43.6101-1T Period covered by returns (temporary).
§43.6109(a)-1T Identifying numbers (temporary).
§43.6151(a)-1T Time and place for paying tax shown on return (temporary).
§43.6302(c)-1T Use of government depositaries (temporary).

Authority: 26 U.S.C. 7805. §§43.6011(a)-1T and 43.6011(a)-2T also issued under 26 U.S.C. 6011; §43.6071(a)-1T also issued under 26 U.S.C. 6071; §43.6091-1T also issued under 26 U.S.C. 6091; §43.6109-1T also issued under 26 U.S.C. 6109; §43.6302(c)-1T also issued under 26 U.S.C. 6302.

§43.4471-1T Imposition of tax (temporary).

(a) *In general.* Section 4471 imposes a tax of $3 per passenger on a covered voyage as is defined in section 4472.

(b) *By whom paid.* The tax is imposed on the person providing the covered voyage (the operator of the vessel).

§43.6011(a)-1T Returns (temporary).

(a) *In general.* Liability for tax imposed under section 4471 shall be reported on Form 720, *Quarterly Federal Excise Tax Return*, (or any other form designated by the Commissioner subsequent to publication of these regulations for reporting such liability). Except as provided in paragraph (b) of this section and §43.6071(a)-1T(c), a return shall be made for a period of one calendar quarter. A return shall be filed for the first calendar quarter in which the person incurs liability for tax imposed under section 4471, and for each subsequent calendar quarter, whether or not liability was incurred under section 4471 during that quarter, until the person has filed a final return in accordance with §43.6011(a)-2T.

(b) *Monthly and semimonthly returns*—(1) *Requirement.* If the district director determines that any person that is required to make deposit

of taxes under the provisions of §43.6302(c)-1T has failed to timely deposit those taxes, that person shall be required, if so notified in writing by the district director, to file a monthly or semimonthly return. Every person so notified by the district director shall make a return for the calendar month or semimonthly period (as defined in §43.6302(c)-1T(c)) in which the notice is received and for each calendar month or semimonthly period thereafter until that person has filed a final return (as defined in §43.6011(a)-2T) or is notified to make returns for a different return period as provided in paragraph (b)(2) of this section.

(2) *Change of requirement.* As circumstances dictate, the district director may notify a person in writing that the person is required to make quarterly or monthly returns instead of semimonthly returns or to make quarterly or semimonthly returns instead of monthly returns.

(3) *Return for period change takes effect.* The first return required pursuant to the notice of a change of requirement shall include all prior periods for which the person has not filed a return.

(c) *Cross reference.* For provisions relating to the time to file returns, see §43.6071(a)-1T. For provisions relating to the place for filing returns, see §43.6091-1T. For provisions relating to use of government depositaries, see §43.6302(c)-1T.

§43.6011(a)-2T Final returns (temporary).

Any person required by §43.6011(a)-1T to make a return who in any return period ceases operations in respect of which a return is required, shall make a final return in accordance with the instructions to the return. Each final return shall be marked "Final Return" by the person filing the return. A person who has only temporarily ceased to incur liability for tax shall not make a final return but shall continue to file returns.

§43.6071(a)-1T Time for filing returns (temporary).

(a) *Quarterly returns.* Each return required to be made under §43.6011(a)-1T(a) for a return period of one calendar quarter shall be filed on or before the last day of the first calendar month following the close of the quarter for which it is made.

(b) *Monthly and semimonthly returns*—(1) *Monthly returns.* Each return required to be made under §43.6011(a)-1T(b) for a monthly period shall be filed not later than the last day of the month following the period for which it is made.

(2) *Semimonthly returns.* Each return required to be made under §43.6011(a)-1T(b) for a semimonthly period shall be filed not later than the last day of the semimonthly period following the period for which it is made.

(c) *Returns for the period January 1, 1980, through September 30, 1990.* Liability for tax incurred during the period January 1, 1990, through September 30, 1990, shall be reported on a single return filed not later than November 30, 1990.

(d) *Cross reference.* For provisions relating to timely mailing treated as timely filing and paying, see section 7502. For provisions relating to time for performance of acts where the last day falls on Saturday, Sunday, or a legal holiday, see section 7503.

§43.6091-1T Place for filing returns (temporary).

(a) *Quarterly returns.* Quarterly returns shall be filed according to the instructions applicable to those returns.

(b) *Monthly and semimonthly returns.* Monthly and semimonthly returns required under §43.6011(a)-1T(b) shall be filed in accordance with the instructions of the district director requiring such filing.

§43.6101-1T Period covered by returns (temporary).

See §43.6011(a)-1T for the rules relating to the period covered by the return.

§43.6109(a)-1T Identifying numbers (temporary).

Every person required by §43.6011(a)-1T to make a return shall provide the taxpayer identifying number required by the instructions applicable to the return.

§43.6151(a)-1T Time and place for paying tax shown on return (temporary).

The tax required to be reported on each tax return under this subpart is due and payable at the time prescribed in §43.6071(a)-1T and the place prescribed in §43.6091-1T for filing the return. The tax required to be reported for the period January 1, 1990, through November 15, 1990, shall be due and payable not later than November 30, 1990. See the applicable sections in Part 301 of this chapter (Regulations on Procedure and Administration) for provisions relating to interest on underpayments, additions to tax, and penalties. For provisions relating to the use of Federal Reserve banks and authorized financial institutions in depositing the taxes, see §43.6302(c)-1T.

§43.6302(c)-1T Use of government depositaries (temporary).

(a) *In general.* This section provides rules relating to deposits of tax imposed by section 4471. The provisions of this section shall not apply to taxes for the month or the semimonthly period in which the taxpayer receives notice from the district director that returns are required under §43.6011(a)-1T(b), or for any subsequent month or semimonthly period for which such a return is required.

(b) *Semimonthly deposits*—(1) *In general.* Each person required by §43.6011(a)-1T(a) to file a return shall make semimonthly deposits of the tax imposed by section 4471. The taxes payable under section 4471 for a semimonthly period (as defined in paragraph (c) of this section) shall be deposited (except as provided in paragraph (d) of this section) on or before the 9th day of the semimonthly period following the semimonthly period for which the taxes are reportable.

(2) *Safe harbor rule.* A person will be considered to have complied with the semimonthly deposit requirement if the deposit for such semimonthly period is not less than 1/6 (16.67 percent) of the total tax liability under section 4471 for the second preceding calendar quarter, and the person deposits any underpayment for the current quarter on or before the last day of the first calendar month following the end of the quarter. This safe harbor rule does not apply to any person who did not report liability for tax under section 4471 for the second preceding quarter.

(c) *Semimonthly period.* The term "semimonthly period" means the first 15 days of a calendar month or the portion of a calendar month following the 15th day of that month.

(d) *No deposits of tax for the period January 1, 1990, through November 15, 1990.* No person required to file an excise tax return for any part of the period beginning January 1, 1990, and ending November 15, 1990, is required under this section to deposit the amount of liability for excise taxes imposed under section 4471 incurred during that period, but shall make payment of the tax as provided by §43.6151(a)-1T. Any person required to file a return to report taxes incurred under section 4471 for any part of the period beginning January 1, 1990 and ending November 15, 1990, may, however, deposit the amount of that liability with a Federal Reserve bank or authorized financial institution on or before November 30, 1990.

(e) *Depositary forms and procedures*—(1) *In general.* A person required by this section to make deposits may make one or more remittances with respect to the amount required to be deposited. An amount of tax that is not otherwise required by this section to be deposited may, nevertheless, be deposited if the person liable for the tax so desires.

(2) *Remittance of deposits.* Each deposit shall be accompanied by Form 8109, *Federal Tax Deposit Coupon* (or any other form designated by the Commissioner for making deposits) and remitted in accordance with the instructions applicable to that form and to the return.

(3) *Procurement of prescribed forms.* Copies of the Federal Tax Deposit Coupon will be furnished, so far as possible, to persons required to make deposits under this section. Those persons will not be excused from making a deposit, however, if no coupon has been furnished. A person not supplied with the coupon is required to apply for it in ample time to make the required deposits within the time prescribed. Copies of the Federal Tax Deposit Coupon may be obtained by applying for them with the district director or the director of a service center.

Par. 2. Title 26, Part 47, of the Code of Federal Regulations is removed.

PART 47—[Removed]

Charles H. Brennan,
Acting Commissioner of Internal Revenue.

Approved October 1, 1990.

Kenneth W. Gideon,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on October 5, 1990, 4:34 p.m., and published in the issue of the Federal Register for October 12, 1990, 55 F.R. 41519 as corrected by 55 F.R. 46667)

Chapter 38.—Environmental Taxes

Subchapter A.—Tax on Petroleum

Section 4611.—Imposition of Tax

Pursuant to the Convention on the Privileges and Immunities of the United Nations, the United Nations may make purchases for its official use free of certain federal excise taxes. See Rev. Rul. 90-83, page 219.

Section 4612.—Definitions and Special Rules

Interest rates to be used in computing the credit under section 4612(d) are set forth. See Rev. Proc. 90-45, page 521.

Subchapter B.—Tax on Certain Chemicals

Section 4661.—Imposition of Tax

Pursuant to the Convention on the Privileges and Immunities of the United Nations, the United Nations may make purchases for its official use free of certain federal excise taxes. See Rev. Rul. 90-83, page 219.

Subchapter C.—Tax on Certain Imported Substances

Section 4671.—Imposition of Tax

Pursuant to the Convention on the Privileges and Immunities of the United Nations, the United Nations may make purchases for its official use free of certain federal excise taxes. See Rev. Rul. 90-83, page 219.

Subchapter D.—Ozone Depleting Chemicals, Etc.

Section 4681.—Imposition of Tax

26 CFR 52.4681-OT: Table of contents (temporary).

T.D. 8311

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 52 and 602

Excise Tax on Chemicals that Deplete the Ozone Layer and on Products Containing such Chemicals

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains temporary regulations relating to the tax on chemicals that deplete the ozone layer and on products containing such chemicals. These temporary regulations reflect changes to the law made by the Omnibus Budget Reconciliation Act of 1989. These temporary regulations affect manufacturers and importers of ozone-depleting chemicals, manufacturers of rigid foam insulation, and importers of products containing or manufactured with ozone-depleting chemicals. In addition, these temporary regulations affect persons, other than manufacturers and importers of ozone-depleting chemicals, holding such chemicals for sale or for use in further manufacture on January 1, 1990, and on subsequent tax-increase dates. The text of the temporary regulations set forth in this document also serves as the text of the proposed regulations for the notice of proposed rulemaking on this subject in *** [PS-73-89, page 878, this Bulletin].

EFFECTIVE DATES: These regulations are effective January 1, 1990. Section 52.4682-3T(f)(2)(ii) provides, however, that listings preceded by a double asterisk (**) in the Imported Products Table set forth in §52.4682-3T(f)(6) are effective October 1, 1990. In addition, §52.6302(c)-2T (relating to use of Government depositaries) is effective July 1, 1990, for deposits relating to the calendar quarter beginning July 1, 1990.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

These regulations are being issued without prior public notice procedures pursuant to the Administrative Procedure Act (5 U.S.C. 553). For this reason, the requirements for collecting information contained in these regulations have been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget (OMB) under control number 1545-1153. The estimated average annual burden per recordkeeper is 0.5 hour. The estimated average annual

burden per respondent is 0.4 hour.

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

For further information concerning this collection of information, and where to submit comments on this collection of information, the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble to the cross-referencing notice of proposed rulemaking published in *** [PS-73-89, page 878, this Bulletin].

Background

This document contains amendments to the Environmental Tax Regulations (26 CFR Part 52) relating to sections 4681 and 4682 of the Internal Revenue Code. These sections were added to the Code by the Omnibus Budget Reconciliation Act of 1989, Public Law No. 101-239 [1990-1 C.B. 210].

Need for Temporary Regulations

Immediate guidance is needed on the tax imposed with respect to ozone-depleting chemicals. Therefore, good cause is found to dispense with the public notice requirement of 5 U.S.C. 553(b) and the delayed effective date requirement of 5 U.S.C. 553(d).

Previous Notices

Notices 90-8, 1990-1 C.B. 305, and 90-9, 1990-1 C.B. 312, provided initial guidance on the taxes imposed with respect to ozone-depleting chemicals. Notice 90-35, 1990-1 C.B. 342, informed taxpayers that the first payment of tax under section 4681 would be due April 30, 1990, that taxpayers would avoid interest charges if the amount of the tax was deposited by that date, that no return of taxes imposed under sections 4681 and 4682 would be due until 30 days after the date of publication of temporary regulations, and that no penalty would be imposed on account of failure to file or failure to pay the tax under section 4681 before the due date for filing the return, as extended.

These temporary regulations generally incorporate the rules provided in the Notices, but also include a number of changes and additions to those rules. The new provisions in the temporary regulations include: (1) a rule providing that the loss or destruction of ozone-depleting chemicals or imported taxable products is not treated as a taxable use of such chemicals or products; (2) a rule under which the tax on an imported taxable product may be deferred until an article incorporating that product is sold; (3) a revised Imported Products Table; and (4) rules for filing returns, paying tax, and making deposits.

Except as provided in section I of Notice 90-9 (relating to reliance on the Imported Products Table contained in the Notice), the rules in the Notices are superseded by these temporary regulations. The Internal Revenue Service will, however, grant relief under section 7805(b) to a taxpayer adversely affected by the retroactive application of any change from the rules described in the Notices, but only if a request for such relief is submitted before January 1, 1991.

Explanation of Provisions

In General

Section 4681 imposes a tax on an ozone-depleting chemical (ODC) when the ODC is sold or used by its manufacturer or importer. That section also imposes a tax on an imported product containing or manufactured with ODCs when the product is sold or used by its importer.

Section 4682(h) imposes a floor stocks tax on ODCs that are held for sale or for use in further manufacture on January 1 of 1990, 1991, 1992, 1993, or 1994 by any person other than the manufacturer or importer of the ODC.

Sale or Use

The terms "sale" and "use" are defined in §52.4681-1T(c)(6) and (7). Under §52.4681-1T(c)(7)(ii), loss, destruction, warehousing, or packaging is not a use. In addition, §52.4682-1T(b)(2)(iii) permits manufacturers and importers of ODCs to elect to treat the sale or use of mixtures containing ODCs as the first sale or use of the ODCs contained in the mixture.

Ozone-depleting Chemicals

Section 4682(a)(2) lists the chemicals that are subject to tax. The listed chemicals, which also were identified as ozone-depleting under the Montreal Protocol, are CFC-11, CFC-12, CFC-113, CFC-114, CFC-115, Halon-1211, Halon-1301, and Halon-2402.

Under section 4682(d)(1), there is no tax on ODCs that are recovered in the United States as part of a recycling process (and not as part of the original manufacturing process). Section 4682(d)(2) provides that there is no tax on ODCs used or sold for use as a feedstock. Section 4682(d)(3) provides that some ODCs may be exported tax free. Section 4682(g) provides a phase-in of tax on Halons and on ODCs used or sold for use in the manufacture of rigid foam insulation. Under the phase-in rule, no tax is imposed in 1990, and tax is imposed at a reduced rate of approximately $0.25 per pound in 1991, 1992, and 1993. Sales to State and local governments, to the Federal Government, and to nonprofit educational organizations are not exempt from the tax.

Exemption for ODCs Used as a Feedstock

Section 4682(d) provides an exemption from the tax imposed under section 4681 for ODCs used or sold for use as a feedstock. Under §52.4682-1T(c)(3), an ODC is used as a feedstock only if the ODC is entirely consumed in the manufacture of another chemical (within the meaning of 40 CFR 82.3(s) (relating to the definition of production in connection with regulations on the protection of atmospheric ozone)).

Section 52.4682-2T(a) sets forth rules relating to tax-free sales of ODCs for use as a feedstock. Under these rules, the buyer must certify to the supplier that the ODCs will be used as a feedstock, but a submission to the Internal Revenue Service is not required. Section 52.4682-2T(d) sets forth the form of the certificate to be used to support tax-free sales of ODCs for use as a feedstock.

ODCs Used in the Manufacture of Rigid Foam Insulation

Under section 4682(g), ODCs used or sold for use in the manufacture of rigid foam insulation are not taxed in

1990 and are taxed at a reduced rate in 1991, 1992, and 1993. Section 52.4682-1T(d)(3) provides that the term "rigid foam" means any closed cell polymeric foam (whether or not rigid) in which chlorofluorocarbons are used to fill voids within the polymer. The term "rigid foam insulation" means any rigid foam that is designed for use as thermal insulation. The design of a product, and not the manner in which it is actually used, determines whether the product is rigid foam insulation.

Section 52.4682-2T(a) and (d) sets forth rules and certification requirements relating to tax-free and tax-reduced sales under the phase-in provision. In all material respects, these rules and certification requirements are the same as those applicable to tax-free sales for use as a feedstock.

Imported Taxable Products

Section 4681 imposes a tax on an imported product containing or manufactured with ODCs when the product is sold or used by its importer. Section 4681(b)(2) provides that the tax imposed on an imported product is based on the weight of the ODCs used in its manufacture (ODC weight). Section 52.4682-3T(f)(6) sets forth an Imported Products Table (Table) that contains an exclusive list of the products subject to the tax. The Table, which is based on information supplied by industry representatives, identifies products that are subject to tax by name and Harmonized Tariff Schedule heading. In addition, Table ODC weights are provided for most products. These weights are used to compute the tax when the importer cannot determine the weight of the ODCs actually used in the product's manufacture.

In some cases, no Table ODC weight is provided because information is not currently available. If an importer cannot determine the weight of ODCs actually used in the manufacture of a product for which no Table ODC weight is provided, the tax is determined under section 4681(b)(2) and §52.4682-3T(e)(4). Section 4681(b)(2) provides that the tax in such cases is determined under rules similar to those of section 4671(b)(2) (relating to the default tax rate for purposes of the Superfund), and §52.4682-3T(e)(4) prescribes a rate of one percent of the entry value of the product.

Section 52.4682-3T(f)(7) grants the Commissioner the authority to modify the initial Table set forth in the regulations. If the Commissioner determines that the Table should be modified, a revenue procedure providing a superseding Table will be published. Manufacturers may request modifications by following the procedures described in the regulations.

ODCs used in the manufacture of protective packaging are neither incorporated into the protected product nor released into the atmosphere during its manufacture. Accordingly, §52.4682-3T(d)(3) provides that such ODCs are not treated as ODCs used in the manufacture of the protected product. Although it may be appropriate to treat protective packaging as a separate product that is used during the shipment and storage of the protected product, this rule presents significant administrative difficulties and is not included in the temporary regulations. The Internal Revenue Service invites public comment on whether and how protective packaging should be taxed under section 4681.

Floor Stocks Tax

Section 4682(h) imposes floor stocks taxes on January 1 of 1990, 1991, 1992, 1993, and 1994. Section 52.4682-4T(b)(1) provides that these taxes apply only to ODCs that are held (other than by the manufacturer or importer of the ODC) for sale or for use in further manufacture on the date the floor stocks tax is imposed. For this purpose, an ODC may be held for sale or for use in further manufacture without regard to the type or size of the container in which it is stored.

Section 52.4682-4T(b)(2) identifies ODCs on which the floor stocks tax is not imposed. These include ODCs that have been recycled or reclaimed and ODCs that have been incorporated, before the date on which the tax is imposed, into a mixture or into a manufactured article in which the ODCs will be used for their intended purpose.

ODCs that have been incorporated into a mixture include all ODCs that have been mixed with other ingredients, even if that mixture is held for sale in bulk quantities. For floor stocks taxes imposed after 1990, however, the mixture exemption does not apply unless the other ingredients contribute to the purpose for which the mixture will be used.

An ODC has been incorporated into a manufactured article in which it will be used for its intended purpose if, as in the case of ODCs contained in the cooling coils of an air conditioner, it is used for its intended purpose within the article. On the other hand, an ODC is not exempt from the floor stocks tax if it will not be used for its intended purpose within the article into which it is incorporated. For example, CFC-12 that will be used to charge an air conditioner is not exempt from the floor stocks tax solely because it is contained in a 14-ounce can.

Under §52.4682-4T(e) the tax is imposed on ODCs held by a person only if the tax is imposed on a date on which the person holds at least a specified amount of ODCs to which the tax would otherwise apply. For 1990, 1992, and 1993, the amount specified is 400 pounds. In determining whether this 400-pound threshold is met, Halons and ODCs that will be used in the manufacture of rigid foam insulation are disregarded. For 1991, the amount specified is also 400 pounds, but only Halons and ODCs that will be used in the manufacture of rigid foam insulation are taken into account. In 1994, the tax is imposed only if the person holds at least 200 pounds of ODCs that will be used in the manufacture of rigid foam insulation or at least 20 pounds of Halons.

Section 52.4682-4T(c) provides that the person holding ODCs on the date the floor stocks tax is imposed is liable for the tax. Section 52.4682-4T(f) requires inventories of ODCs that a person (other than the manufacturer of importer of the ODCs) holds for sale or for use in further manufacture. Inventories of such ODCs must be taken by the person holding the ODCs on January 1 of 1990, 1991, 1992, 1993, and 1994.

General Requirements for Filing Returns, Paying Tax, and Using Government Depositaries

Sections 6011 (relating to requiring returns), 6071 (relating to time for filing returns), and 6302(c) (relating

to use of Government depositaries), authorize the Secretary to prescribe regulations imposing rules for filing returns and making deposits of tax. These temporary regulations revise and amend the provisions of the Environmental Tax Regulations relating to procedural rules so that such provisions also apply under sections 4681 and 4682.

Under §52.6011(a)-1T, any person liable for the taxes imposed under sections 4681 or 4682 must file Form 720 (or other form designated by the Commissioner subsequent to publication of these regulations) to report that liability. The procedures relating to filing are provided in the instructions to the form. Section 52.6071(a)-2T(a)(1) provides that the return must be filed by the last day of the second month following the end of a calendar quarter. Importers of products that neither contain nor are manufactured with ODCs are not required to file a return reporting tax imposed under section 4681 with respect to such products.

Persons required by regulations to file a Form 720 on an earlier date than the date provided in these temporary regulations in order to report other taxes do not file two Forms 720 but instead file one Form 720 with respect to all excise taxes reportable on Form 720 on or before the date provided under section 4681. This rule allows persons filing a Form 720 with respect to taxes imposed by section 4681 or 4682 to defer filing their Form 720 until two months after the end of the calendar quarter, even if such persons must also report on their Form 720 excise taxes with respect to which the Form 720 is ordinarily filed one month after the end of the calendar quarter (*e.g.*, Superfund taxes). However, this rule does not extend the time for making deposits or paying any other excise tax. Thus, a person that must make an additional deposit of excise taxes to pay any balance due at the time for filing the Form 720 for that quarter must make the required deposit on or before the date the Form 720 for such excise taxes would ordinarily be filed; the payment is due at that time even though the Form 720 may, under the above rule, be filed a month later.

Under §52.6302(c)-2T(b), semimonthly deposits of tax are required to be made by all persons liable for the tax imposed under section 4681. The deposit for each semimonthly period is due on or before the last day of the second following semimonthly period. Section 52.6302(c)-2T(c) provides a safe harbor. In general, a taxpayer is considered to have met the semimonthly deposit requirement if the deposit for each semimonthly period is not less than 1/6 of the total tax liability under section 4681 for the second preceding quarter, and any underpayment for the current quarter is deposited by the due date of the return. This safe harbor rule is modified to take into account predictable increases in tax liability due to increases in the base tax amount or due to the phase-in of tax on Halons and ODCs used in the manufacture of rigid foam insulation. For example, for the first two calendar quarters of 1991, the safe harbor will be based on the taxpayer's tax liability for the second preceding calendar quarter, but calculated as if Halons and ODCs used in the manufacture of rigid foam insulation had been subject to tax for such preceding calendar quarters.

Under section 4682(h)(3), the floor stocks tax must be paid by April 1 of each year in which the tax is imposed. The full amount of the floor stocks tax for any year in which the tax is imposed must be deposited by April 1 of such year, and must be reported on the Form 720 (or other form designated by the Commissioner subsequent to the publication of these regulations) for the first calendar quarter of such year.

Special Rules for Returns and Payments of Tax under Section 4681 for the First and Second Calendar Quarters of 1990.

First Calendar Quarter of 1990.

Section 52.6071(a)-2T(a)(3) provides that the Form 720 reporting tax imposed under section 4681 for the first calendar quarter of 1990 is due April 30, 1990, but the due date is extended (without application) until October 9, 1990. No penalty will be imposed on account of failure to file the return before the date for filing, as extended.

The payment of tax for the first calendar quarter of 1990 is due April 30, 1990. No penalty will be imposed on account of failure to pay the tax imposed under section 4681 for the first calendar quarter of 1990 before the date for filing the return, as extended. Interest on any underpayment of such tax will be imposed from April 30, 1990.

Second Calendar Quarter of 1990.

Section 52.6071(a)-2T(a)(4) provides that the Form 720 reporting tax imposed under section 4681 for the second calendar quarter of 1990 is due September 7, 1990, but the due date is extended (without application) until October 9, 1990. No penalty will be imposed on account of failure to file the return before the date for filing, as extended.

The payment of tax for the second calendar quarter of 1990 is due September 7, 1990. No penalty will be imposed on account of failure to pay the tax imposed under section 4681 for the second calendar quarter of 1990 before the date for filing the return, as extended. Interest on any underpayment of such tax will be imposed from September 7, 1990.

Special Rule for Returns under Section 4682 for 1990.

Section 52.6071(a)-3T(a) provides that the Form 720 reporting floor stocks tax imposed under section 4682 on January 1, 1990, is due April 30, 1990, but the due date is extended (without application) until October 9, 1990. No penalty will be imposed on account of failure to file the return before the date for filing, as extended.

The payment of tax is due on April 1, 1990.

Special rule for deposits relating to the first three semimonthly periods of the third calendar quarter of 1990.

Section 52.6302(c)-2T(b)(3) provides that the deposit of tax relating to section 4681 liability for the first three semimonthly periods of the third calendar quarter of 1990 is due September 27, 1990.

Special Analyses

It has been determined that these rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. 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 final Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking that cross-references to these regulations will be submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, Title 26, Parts 52 and 602 of the Code of Federal Regulations are amended as follows:

Paragraph 1. The heading for Part 52 is revised to read as follows:

PART 52—ENVIRONMENTAL TAXES

Par. 2. The authority for Part 52 is revised to read as follows:

Authority: 26 U.S.C. 7805. Section 52.4682-3T also issued under 26 U.S.C. 4682(c)(2); §§52.6011(a)-1T and 52.6011(a)-2T also issued under 26 U.S.C. 6011(a); §§52.6071(a)-1, 52.6071(a)-2T, and 52.6071(a)-3T also issued under 26 U.S.C. 6071(a); §52.6091-1T also issued under 26 U.S.C. 6091; §52.6101-1T also issued under 26 U.S.C. 6101; §52.6109(a)-1T also issued under 26 U.S.C. 6109(a); §§52.6302(c)-1, and 52.6302(c)-2T also issued under 26 U.S.C. 6302(a).

Par. 3. New §§52.4681-0T, 52.4681-1T, 52.4682-1T, 52.4682-2T, 52.4682-3T, and 52.4682-4T are added to read as follows.

§52.4681-0T Table of Contents (temporary).

This section lists captions contained in §§52.4681-1T, 52.4682-1T, 52.4682-2T, 52.4682-3T, and 52.4682-4T.

§52.4681-1T Taxes imposed with respect to ozone-depleting chemicals (temporary).

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§52.4682-1T Ozone-depleting chemicals (temporary).

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§52.4682-2T Qualifying sales (temporary).

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  (1) Special rules applicable to certain sales
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  (1) In general
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§52.4682-3T Imported taxable products (temporary).

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  (1) In general
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§52.4682-4T Floor stocks tax (temporary).

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  (1) ODCs that are held for sale or for use in further manufacture

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(e) De minimis exemption
(1) 1990, 1992, and 1993
(2) 1991
(3) 1994
(4) Examples
(f) Inventory
(g) Time for paying tax

§52.4681-1T Taxes imposed with respect to ozone-depleting chemicals (temporary).

(a) *Taxes imposed.* Sections 4681 and 4682 impose the following taxes with respect to ozone-depleting chemicals (ODCs):

(1) *Tax on ODCs.* Section 4681(a)(1) imposes a tax on ODCs that are sold or used by the manufacturer or importer thereof. Except as otherwise provided in §52.4682-1T (relating to the tax on ODCs), the amount of the tax is equal to the product of—

(i) The weight (in pounds) of the ODC;

(ii) The base tax amount (determined under section 4681(b)(1)(B) or (C)) for the calendar year in which the sale or use occurs; and

(iii) The ozone-depletion factor (determined under section 4682(b)) for the ODC.

(2) *Tax on imported taxable products.* Section 4681(a)(2) imposes a tax on imported taxable products that are sold or used by the importer thereof. Except as otherwise provided in §52.4682-3T (relating to the tax on imported taxable products), the tax is computed by reference to the weight of the ODCs used as materials in the manufacture of the product. The amount of tax is equal to the tax that would have been imposed on the ODCs under section 4681(a)(1) if the ODCs had been sold in the United States on the date of the sale or use of the imported product. The weight of such ODCs is determined under §52.4682-3T.

(3) *Floor stocks tax*—(i) *Imposition of tax.* Section 4682(h) imposes a floor stocks tax on ODCs that—

(A) Are held by any person other than the manufacturer or importer of the ODC on a date specified in paragraph (a)(3)(ii) of this section; and

(B) Are held on such date for sale or for use in further manufacture.

(ii) *Dates on which tax imposed.* The floor stocks tax is imposed on January 1 of 1990, 1991, 1992, 1993, and 1994.

(iii) *Amount of tax.* Except as otherwise provided in §52.4682-4T (relating to floor stocks tax), the amount of the floor stocks tax is equal to the excess of—

(A) The tax that would be imposed on the ODC under section 4681(a)(1) if a sale or use of the ODC by its manufacturer or importer occurred on the date the floor stocks tax is imposed (the tentative tax amount), over

(B) The sum of the taxes previously imposed on the ODC under sections 4681 and 4682.

(b) *Cross-references*—(1) *Tax on ODCs.* Additional rules relating to the tax on ODCs are contained in §§52.4682-1T and 52.4682-2T.

(2) *Tax on imported taxable products.* Additional rules relating to the tax on imported taxable products are contained in §52.4682-3T.

(3) *Floor stocks tax.* Additional rules relating to the floor stocks tax are contained in §52.4682-4T.

(4) *Filing returns, paying tax, and making deposits.* Rules requiring returns reporting the taxes imposed under sections 4681 and 4682 are contained in §§52.6011(a)-1T and 52.6011(a)-2T. Rules relating to the time for filing such returns are contained in §§52.6071(a)-2T and 52.6071(a)-3T. Rules relating to the use of Government depositaries in connection with taxes imposed under section 4681 are contained in §52.6302(c)-2T.

(c) *Definitions of general application.* The following definitions set forth the meaning of certain terms for purposes of the regulations under sections 4681 and 4682:

(1) *Ozone-depleting chemical.* The term "ozone-depleting chemical" (ODC) means any chemical listed in section 4682(a)(2).

(2) *United States.* The term "United States" has the meaning given such term by section 4612(a)(4). Under section 4612(a)(4)—

(i) The term "United States" means the 50 States, the District of Columbia, the Commonwealth of Puerto Rico, any possession of the United States, the Commonwealth of the Northern Mariana Islands, and the Trust Territory of the Pacific Islands; and

(ii) The term includes—

(A) Submarine seabed and subsoil that would be treated as part of the United States (as defined in paragraph (c)(2)(i) of this section) under the principles of section 638 relating to continental shelf areas; and

(B) Foreign trade zones of the United States.

(3) *Manufacture; manufacturer.* The term "manufacture" when used with respect to any ODC or imported product includes its production, and the term "manufacturer" includes a producer.

(4) *Entry into United States for consumption, use, or warehousing*—(i) *In general.* Except as otherwise provided in this paragraph (c)(4), the term "entered into the United States for consumption, use, or warehousing" when used with respect to any goods means—

(A) Brought into the customs territory of the United States (the customs territory) if applicable customs law requires that the goods be entered into the customs territory for consumption, use, or warehousing;

(B) Admitted into a foreign trade zone for any purpose if like goods brought into the customs territory for such purpose would be entered into the customs territory for consumption, use, or warehousing; or

(C) Imported into any other part of the United States (as defined in paragraph (c)(2) of this section) for any purpose if like goods brought into the customs territory for such purpose would be entered into the customs territory for consumption, use, or warehousing.

(ii) *Entries described in two or more provisions.* In the case of any goods with respect to which entries are described in two or more provi-

sions of paragraph (c)(4)(i) of this section, only the first such entry is taken into account. Thus, if the admission of goods into a foreign trade zone is an entry into the United States for consumption, use, or warehousing, the subsequent entry of such goods into the customs territory will not be treated as an entry into the United States for consumption, use, or warehousing.

(iii) *Certain imported products not entered for consumption, use, or warehousing.* Imported products that are entered into the United States for consumption, use, or warehousing do not include any imported products that—

(A) Are entered into the customs territory under Harmonized Tariff Schedule (HTS) heading 9801, 9802, 9803, or 9813;

(B) Would, if entered into the customs territory, be entered under any such heading; or

(C) Are brought into the United States by an individual if the product is brought in for use by the individual and is not expected to be used in a trade or business other than a trade or business of performing services as an employee.

(5) *Importer.* The term "importer" means the person that first sells or uses goods after their entry into the United States for consumption, use, or warehousing (within the meaning of paragraph (c)(4) of this section).

(6) *Sale.* The term "sale" means the transfer of title or of substantial incidents of ownership (whether or not delivery to, or payment by, the buyer has been made) for consideration which may include money, services, or property. The determination as to the time a sale occurs shall be made under applicable local law.

(7) *Use*—(i) *In general.* Except as otherwise provided in regulations under sections 4681 and 4682, ODCs and imported taxable products are used when—

(A) Used as a material in the manufacture of an article, whether by incorporation into such article, chemical transformation, release into the atmosphere, or otherwise; or

(B) Put into service in a trade or business or for production of income.

(ii) *Loss, destruction, packaging, warehousing, and repair.* The loss, destruction, packaging, warehousing, or repair of ODCs and imported taxable products is not a use of the item lost, destroyed, packaged, warehoused, or repaired.

(iii) *Cross-references to exceptions.* For exceptions to the rule contained in paragraph (c)(7)(i) of this section, see—

(A) §52.4682-1T(b)(2)(iii) (relating to the mixture election);

(B) §52.4682-3T(c)(2) (relating to the election to treat entry of an imported taxable product as use); and

(C) §52.4682-3T(c)(3) (relating to treating sale of an article incorporating an imported taxable product as the first sale or use of the product).

(8) *Pound.* The term "pound" means a unit of weight that is divided into 16 ounces.

(d) *Effective date.* The regulations under sections 4681 and 4682 are effective as of January 1, 1990, and apply to—

(1) ODCs that the manufacturer or importer thereof first sells or uses after December 31, 1989;

(2) Imported taxable products that the importer thereof first sells or uses after December 31, 1989; and

(3) ODCs held for sale or for use in further manufacture by any person other than the manufacturer or importer thereof on January 1 of 1990, 1991, 1992, 1993, or 1994.

§52.4682-1T Ozone-depleting chemicals (temporary).

(a) *Overview.* This section provides rules relating to the tax imposed on ozone-depleting chemicals (ODCs) under section 4681, including rules for identifying taxable ODCs and determining when the tax is imposed and rules prescribing special treatment for certain ODCs (i.e., ODCs used as feedstocks, ODCs used in the manufacture of rigid foam insulation, and Halons). See §52.4681-1T(a)(1) and (c) for general rules and definitions relating to the tax on ODCs.

(b) *Taxable ODCs; taxable event*—(1) *Taxable ODCs*—(i) *In general.* Except as provided in paragraphs (c) through (g) of this section, an ODC is taxable if—

(A) It is listed in section 4682(a)(2) on the date it is sold or used by its manufacturer or importer; and

(B) It is manufactured in the United States or entered into the United States for consumption, use, or warehousing.

(ii) *Storage containers.* An ODC described in paragraph (b)(1)(i) of this section is taxable without regard to the type or size of storage container in which the ODC is held.

(2) *Taxable event*—(i) *In general.* The tax on an ODC is imposed when the ODC is first sold or used (as defined in §52.4681-1T(c)(6) and (7)) by its manufacturer or importer.

(ii) *Mixtures.* Except as otherwise provided in paragraph (b)(2)(iii) of this section, the creation of a mixture containing two or more ingredients is treated as a use of the ODCs contained in the mixture. Thus, except as otherwise provided in paragraph (b)(2)(iii) of this section—

(A) The tax on the ODCs contained in mixtures created after December 31, 1989, is imposed when the mixture is created and not on any subsequent sale or use of the mixture; and

(B) No tax is imposed under section 4681 on the ODCs contained in mixtures created before January 1, 1990.

(iii) *Mixture election*—(A) *In general.* A manufacturer or importer may elect to treat the sale or use of mixtures containing ODCs as the first sale or use of the ODCs contained in the mixtures. If an election under this paragraph (b)(2)(iii) applies to a mixture sold or used after December 31, 1989 (including any such mixture created before January 1, 1990), the tax on the ODCs contained in the mixture is imposed on the date of such sale or use.

(B) *Applicability of election.* The only election permitted under this paragraph (b)(2)(iii) is an election for the first calendar quarter beginning after December 31, 1989, and all subsequent periods. Any such election applies to all mixtures sold or used by the manufacturer or importer after December 31, 1989 (including any such mixture created before January 1, 1990). Except as provided in §52.6071(a)-2T(a)(3), the election may be revoked only with the consent of the Commissioner.

(C) *Making the election.* An election under this paragraph (b)(2)(iii) shall be made in accordance with the instructions for the return on which the manufacturer or importer reports liability for tax under section 4681.

(c) *ODCs used as a feedstock*—(1) *Exemption from tax.* No tax is im-

posed on an ODC if the manufacturer or importer of the ODC—

(i) Uses the ODC as a feedstock in the manufacture of another chemical; or

(ii) Sells the ODC in a qualifying sale (as defined in §52.4682-2T) for use as a feedstock.

(2) *Excess payments*—(i) *In general.* Under section 4682(d)(2), a credit or refund is allowed to a person if—

(A) The person uses an ODC as a feedstock; and

(B) The amount of any tax paid with respect to the ODC under section 4681 or 4682 was not determined under section 4682(d)(2).

(ii) *Procedural rules.* See section 6402 and the regulations thereunder for rules relating to claiming a credit or refund of tax paid with respect to ODCs that are used as a feedstock. A credit against the income tax is not allowed for the amount determined under section 4682(d)(2).

(3) *Definition.* An ODC is used as a feedstock only if the ODC is entirely consumed in the manufacture of another chemical (within the meaning of 40 CFR 82.3(s) (relating to the definition of production in connection with regulations on the protection of atmospheric ozone)). Thus, the transformation of an ODC into one or more new compounds (such as the transformation of CFC-113 into chlorotrifluoroethylene (CTFE or 1113) or of CFC-113 into CFC-115 and CFC-116)) is treated as use as a feedstock. On the other hand, the ODCs used in a mixture (including an azeotrope such as R-500 or R-502) are not used as a feedstock.

(4) *Qualifying sale.* A sale of ODCs for use as a feedstock is a qualifying sale if the requirements of §52.4682-2T(b)(1) are satisfied with respect to such sale.

(d) *ODCs used in the manufacture of rigid foam insulation*—(1) *Phase-in of tax*—(i) *In general.* The amount of tax imposed on an ODC is determined under section 4682(g) if the manufacturer or importer of the ODC—

(A) Uses the ODC during 1990, 1991, 1992, or 1993 in the manufacture of rigid foam insulation; or

(B) Sells the ODC in a qualifying sale (as defined in §52.4682-2T) during 1990, 1991, 1992, or 1993.

(ii) Amount of tax. Under section 4682(g), ODCs described in paragraph (d)(1)(i) of this section are not taxed if sold or used during 1990 and are taxed at a reduced rate if sold or used during 1991, 1992, or 1993.

(2) *Excess payments*—(i) *In general.* Under section 4682(g)(3), a credit against income tax or a refund is allowed to a person if—

(A) The person uses an ODC during 1990, 1991, 1992, or 1993 in the manufacture of rigid foam insulation; and

(B) The amount of any tax paid with respect to the ODC under section 4681 or 4682 was not determined under section 4682(g).

(ii) *Procedural rules*—(A) The amount determined under section 4682(g)(3) shall be treated as a credit described in section 34(a) (relating to credits for gasoline and special fuels) unless a claim for refund has been filed.

(B) See section 6402 and the regulations thereunder for rules relating to claiming a credit or refund of the tax paid with respect to ODCs that are used in the manufacture of rigid foam insulation.

(3) *Definition*—(i) *Rigid foam insulation.* The term "rigid foam insulation" means any rigid foam that is designed for use as thermal insulation in buildings, equipment, appliances, tanks, railcars, trucks, or vessels, or on pipes, including any such rigid foam actually used for purposes other than insulation. Information such as test reports on R-values and advertising material reflecting R-value claims for a particular rigid foam may be used to show that such rigid foam is designed for use as thermal insulation.

(ii) *Rigid foam*—(A) *In general.* The term "rigid foam" means any closed cell polymeric foam (whether or not rigid) in which chlorofluorocarbons are used to fill voids within the polymer.

(B) *Examples of rigid foam products.* Rigid foam includes extruded polystyrene foam, polyisocyanurate foam, spray and pour-in-place polyurethane foam, polyethylene foam, phenolic foam, and any other product that the Commissioner identifies as rigid foam in a pronouncement of general applicability. The form of a product identified under this paragraph (d)(3)(ii)(B) does not affect its character as rigid foam. Thus, such products are rigid foam whether in the form of a board, sheet, backer rod, or wrapping, or in a form applied by spraying, pouring, or frothing.

(4) *Use in manufacture.* An ODC is used in the manufacture of rigid foam insulation if it is incorporated into such product or is expended as a propellant or otherwise in the manufacture or application of such product.

(5) *Qualifying sale.* A sale of an ODC for use in the manufacture of rigid foam insulation is a qualifying sale if the requirements of §52.4682-2T(b)(2) are satisfied with respect to such sale.

(e) *Halons; phase-in of tax.* The amount of tax imposed on Halon-1211, Halon-1301, or Halon-2402 (Halon) is determined under section 4682(g) if the manufacturer or importer of the Halon sells or uses the Halon during 1990, 1991, 1992, or 1993. Under section 4682(g), Halons are not taxed if sold or used during 1990 and are taxed at a reduced rate if sold or used during 1991, 1992, or 1993.

(f) *Recycling.* [Reserved]

(g) *Exports.* [Reserved]

§52.4682-2T Qualifying sales (temporary).

(a) *In general*—(1) *Special rules applicable to certain sales.* Special rules apply to sales of ODCs in the following cases:

(i) Under section 4682(d)(2), §52.4682-1T(c), and §52.4682-4T(d)-(2)(i) (relating to ODCs used as a feedstock), ODCs sold in qualifying sales are not taxed.

(ii) Under section 4682(g), §52.4682-1T(d), and §52.4682-4T(d)-(2)(ii) (relating to ODCs used in the manufacture of rigid foam insulation), ODCs sold in qualifying sales are not taxed in 1990 and are taxed at a reduced rate in 1991, 1992, and 1993.

(2) Qualifying sales. A sale of ODCs is not a qualifying sale unless the requirements of this section are satisfied. Although submission of a document to the Internal Revenue Service is not required to establish that a sale of ODCs is a qualifying sale, the registration certificates re-

quired by this section shall be made available for inspection by internal revenue agents and officers.

(b) *Requirements for qualification*—(1) *Use as a feedstock.* A sale of ODCs is a qualifying sale for purposes of §§52.4682-1T(c) and 52.4682-4T(d)(2)(i) if the manufacturer or importer of the ODCs—

(i) Obtains a registration certificate in substantially the form set forth in paragraph (d)(2) of this section from the purchaser of the ODCs; and

(ii) Relies on the certificate in good faith.

(2) *Use in the manufacture of rigid foam insulation.* A sale of ODCs is a qualifying sale for purposes of §§52.4682-1T(d) and 52.4682-4T(d)(2)(ii) if the manufacturer or importer of the ODCs—

(i) Obtains a registration certificate in substantially the form set forth in paragraph (d)(3) of this section from the purchaser of the ODCs; and

(ii) Relies on the certificate in good faith.

(c) *Good faith reliance*—(1) *In general.* The requirements of paragraph (b) of this section are not satisfied with respect to a sale of ODCs and the sale is not a qualifying sale if at the time of the sale—

(i) The manufacturer or importer has reason to believe that the purchaser will use the ODCs other than for the purpose set forth in the certificate; or

(ii) The Internal Revenue Service has notified the manufacturer or importer that the purchaser's right to provide a certificate has been withdrawn.

(2) *Withdrawal of right to provide a certificate.* The Internal Revenue Service may withdraw the right of a purchaser to provide a certificate to its supplier if such purchaser uses the ODCs to which its certification applies other than for the purpose set forth in such certificate. The Internal Revenue Service may notify the supplier to whom the purchaser provided the certificate that the purchaser's right to provide a certificate has been withdrawn.

(d) Registration certificate—(1) *In general.* This paragraph (d) sets forth the form of the registration certificates that satisfy the requirements of paragraph (b)(1) and (2) of this section. The registration certificate shall consist of a statement executed and signed by the purchaser under penalties of perjury. A certificate may apply to a single purchase or may cover purchases for up to four years from its effective date. A new certificate must be given to the supplier if any information on the current certificate changes. The certificate may be included as part of any business records normally used to document a sale.

(2) *Certificate relating to ODCs used as a feedstock*—(i) *ODCs that will be resold for use by the second purchaser as a feedstock.* If the purchaser will resell the ODCs to a second purchaser for use by such second purchaser as a feedstock, the certificate provided by the purchaser must be in substantially the following form:

CERTIFICATE OF PURCHASER OF CHEMICALS THAT WILL BE RESOLD FOR USE BY THE SECOND PURCHASER AS A FEEDSTOCK

(To support tax-free sales under section 4682(d)(2) of the Internal Revenue Code.)

Effective Date _____

Expiration Date _____

The undersigned purchaser ("Purchaser") hereby certifies under penalties of perjury that the following percentage of ozone-depleting chemicals purchased from

_____

(name and address of seller)

will be resold by Purchaser to persons (Second Purchasers) that certify to Purchaser that they are purchasing the ozone-depleting chemicals for use as a feedstock (as defined in §52.4682-1T(c)(3) of the Environmental Tax Regulations).

PRODUCT	*PERCENTAGE*
CFC-11	_____
CFC-12	_____
CFC-113	_____
CFC-114	_____
CFC-115	_____

This certificate applies to (check and complete as applicable):

_____ All shipments to Purchaser at the following location(s):

_____

_____

_____

_____ All shipments to Purchaser under the following Purchaser account number(s):

_____

_____

_____

_____ All shipments to Purchaser under the following purchase order(s):

_____

_____

_____

_____ One or more shipments to Purchaser identified as follows:

_____

_____

_____

Purchaser will not claim a credit or refund under section 4682(d)(2)(B) of the Internal Revenue Code for any ozone-depleting chemicals covered by this certificate.

Purchaser understands that any use by Purchaser of the ozone-depleting chemicals to which this certificate applies other than for the purpose set forth in this certificate may result in the withdrawal by the Internal Revenue Service of Purchaser's right to provide a certificate.

Purchaser will retain the business records needed to document the sales covered by this certificate and will make such records available for inspection by Government officers. Purchaser also will retain and make available for inspection by Government officers the certificates of its Second Purchasers.

Purchaser has not been notified by the Internal Revenue Service that its right to provide a certificate has been withdrawn. In addition, the Internal Revenue Service has not notified Purchaser that the right to provide a certificate has been withdrawn from any Second Purchaser who will purchase ozone-depleting chemicals to which this certificate applies.

Purchaser understands that the fraudulent use of this certificate may subject Purchaser and all parties making such fraudulent use of this certificate to a fine or imprisonment, or both, together with the costs of prosecution.

_____

Signature of Purchaser or agent representing Purchaser

Title

Name of Purchaser

Address

Taxpayer Identification Number

(ii) *ODCs that will be used by the purchaser as a feedstock.* If the purchaser will use the ODCs as a feedstock, the certificate provided by the purchaser must be in substantially the following form:

CERTIFICATE OF PURCHASER OF CHEMICALS THAT WILL BE USED BY THE PURCHASER AS A FEEDSTOCK

(To support tax-free sales under section 4682(d)(2) of the Internal Revenue Code.)

Effective Date _____

Expiration Date _____

The undersigned purchaser ("Purchaser") hereby certifies under penalties of perjury that the following percentage of ozone-depleting chemicals purchased from

_____

(name and address of seller)

will be used by Purchaser as a feedstock (as defined in §52.4682-1T(c)(3) of the Environmental Tax Regulations).

PRODUCT	*PERCENTAGE*
CFC-11	
CFC-12	
CFC-113	
CFC-114	
CFC-115	

This certificate applies to (check and complete as applicable):

_____ All shipments to Purchaser at the following location(s):

_____

_____

_____

_____ All shipments to Purchaser under the following Purchaser account number(s):

_____

_____

_____

_____ All shipments to Purchaser under the following purchase order(s):

_____

_____

_____

_____ One or more shipments to Purchaser identified as follows:

_____

_____

_____

Purchaser will not claim a credit or refund under section 4682(d)(2)(B) of the Internal Revenue Code for any ozone-depleting chemicals covered by this certificate.

Purchaser understands that any use of the ozone-depleting chemicals to which this certificate applies other than as a feedstock may result in the withdrawal by the Internal Revenue Service of Purchaser's right to provide a certificate.

Purchaser will retain the business records needed to document the use as a feedstock of the ozone-depleting chemicals to which this certificate applies and will make such records available for inspection by Government officers.

Purchaser has not been notified by the Internal Revenue Service that its right to provide a certificate has been withdrawn.

Purchaser understands that the fraudulent use of this certificate may subject Purchaser and all parties making such fraudulent use of this certificate to a fine or imprisonment, or both, together with the costs of prosecution.

_____

Signature of Purchaser or agent representing Purchaser

_____

Title

_____

Name of Purchaser

_____

Address

_____

_____

Taxpayer Identification Number

(3) *Certificate relating to ODCs used in the manufacture of rigid foam insulation*—(i) *ODCs that will be resold to a second purchaser for use by the second purchaser in the manufacture of rigid foam insulation.* If the purchaser will resell the ODCs to a second purchaser for use by such second purchaser in the manufacture of rigid foam insulation, the certificate provided by the purchaser must be in substantially the following form:

CERTIFICATE OF PURCHASER OF CHEMICALS THAT WILL BE RESOLD FOR USE BY THE SECOND PURCHASER IN THE MANUFACTURE OF RIGID FOAM INSULATION

(To support tax-free or tax-reduced sales under section 4682(g) of the Internal Revenue Code.)

Effective Date _____

Expiration Date _____

The undersigned purchaser ("Purchaser") hereby certifies under penalties of perjury that the following percentage of ozone-depleting chemicals purchased from

_____

(name and address of seller)

will be resold by Purchaser to persons (Second Purchasers) that certify to Purchaser that they are purchasing the ozone-depleting chemicals for use in the manufacture of rigid foam insulation (as defined in §52.4682-1T(d)(3) and (4) of the Environmental Tax Regulations).

PRODUCT	*PERCENTAGE*
CFC-11	
CFC-12	
CFC-113	
CFC-114	
CFC-115	

This certificate applies to (check and complete as applicable):

_____ All shipments to Purchaser at the following location(s):

_____

_____

_____

_____ All shipments to Purchaser under the following Purchaser account number(s):

_____

_____

_____

_____ All shipments to Purchaser under the following purchase order(s):

_____

_____

_____

_____ One or more shipments to Purchaser identified as follows:

_____

_____

_____

Purchaser will not claim a credit or refund under section 4682(g)(3) of the Internal Revenue Code for any ozone-depleting chemicals covered by this certificate.

Purchaser understands that any use by Purchaser of the ozone-depleting

chemicals to which this certificate applies other than for the purpose set forth in this certificate may result in the withdrawal by the Internal Revenue Service of Purchaser's right to provide a certificate.

Purchaser will retain the business records needed to document the sales covered by this certificate and will make such records available for inspection by Government officers. Purchaser also will retain and make available for inspection by Government officers the certificates of its Second Purchasers.

Purchaser has not been notified by the Internal Revenue Service that its right to provide a certificate has been withdrawn. In addition, the Internal Revenue Service has not notified Purchaser that the right to provide a certificate has been withdrawn from any Second Purchaser who will purchase ozone-depleting chemicals to which this certificate applies.

Purchaser understands that the fraudulent use of this certificate may subject Purchaser and all parties making such fraudulent use of this certificate to a fine or imprisonment, or both, together with the costs of prosecution.

_____

Signature of Purchaser or agent representing Purchaser

_____

Title

_____

Name of Purchaser

_____

Address

_____

_____

Taxpayer Identification Number

(ii) *ODCs that will be used by the purchaser in the manufacture of rigid foam insulation.* If the purchaser will use the ODCs in the manufacture of rigid foam insulation, the certificate provided by the purchaser must be in substantially the following form:

CERTIFICATE OF PURCHASER OF CHEMICALS THAT WILL BE USED BY THE PURCHASER IN THE MANUFACTURE OF RIGID FOAM INSULATION

(To support tax-free or tax-reduced sales under section 4682(g) of the Internal Revenue Code.)

Effective Date _____

Expiration Date _____

The undersigned purchaser ("Purchaser") hereby certifies under penalties of perjury that the following percentage of ozone-depleting chemicals purchased from

_____

(name and address of seller)

will be used by Purchaser in the manufacture of rigid foam insulation (as defined in §52.4682-1T(d)(3) and (4) of the Environmental Tax Regulations).

PRODUCT	*PERCENTAGE*
CFC-11	_____
CFC-12	_____
CFC-113	_____
CFC-114	_____
CFC-115	_____

This certificate applies to (check and complete as applicable):

_____ All shipments to Purchaser at the following location(s):

_____

_____

_____

_____ All shipments to Purchaser under the following Purchaser account number(s):

_____

_____

_____

_____ All shipments to Purchaser under the following purchase order(s):

_____

_____ One or more shipments to Purchaser identified as follows:

_____

_____

_____

Purchaser will not claim a credit or refund under section 4682(g)(3) of the Internal Revenue Code for any ozone-depleting chemicals covered by this certificate.

Purchaser understands that any use by Purchaser of the ozone-depleting chemicals to which this certificate applies other than in the manufacture of rigid foam insulation may result in the withdrawal by the Internal Revenue Service of Purchaser's right to provide a certificate.

Purchaser will retain the business records needed to document the use in the manufacture of rigid foam insulation of the ozone-depleting chemicals to which this certificate applies and will make such records available for inspection by Government officers.

Purchaser has not been notified by the Internal Revenue Service that its right to provide a certificate has been withdrawn.

Purchaser understands that the fraudulent use of this certificate may subject Purchaser and all parties making such fraudulent use of this certificate to a fine or imprisonment, or both, together with the costs of prosecution.

_____

Signature of Purchaser or agent representing Purchaser

_____

Title

_____

Name of Purchaser

_____

Address

_____

_____

Taxpayer Identification Number

§52.4682-3T Imported taxable products (temporary).

(a) *Overview; references to Tables*—(1) *Overview.* This section provides rules relating to the tax imposed on imported taxable products under section 4681, including rules for identifying imported taxable products, determining the weight of the ozone-depleting chemicals (ODCs) used as materials in the manufacture of such products, and computing the amount of tax on such products. See §52.4681-1T(a)(2) and (c) for general rules and definitions relating to the tax on imported taxable products.

(2) *References to Tables.* When used in this section—

(i) The term "Imported Products Table" (Table) refers to the initial Table set forth in paragraph (f)(6) of this section and any superseding Table issued under paragraph (f)(7) of this section; and

(ii) The term "current Imported Products Table" (current Table) used with respect to a product refers to the Table in effect on the date such product is first sold or used by the importer thereof.

(b) *Imported taxable products*—(1) *In general.* Except as provided in paragraph (b)(2) of this section, the term "imported taxable product" means any product that—

(i) Is entered into the United States for consumption, use, or warehousing; and

(ii) Is listed in the current Table.

(2) *Exceptions*—(i) *In general.* A product is not treated as an imported taxable product if—

(A) The product is listed in Part I of the current Table and the adjusted tax with respect to the product is *de minimis* (within the meaning of paragraph (b)(2)(ii) of this section); or

(B) The product is listed in Part II of the current Table, the adjusted tax with respect to the product is *de minimis* (within the meaning of paragraph (b)(2)(ii) of this section), and the ODCs used as materials in the manufacture of the product were not used for purposes of refrigeration or air conditioning, creating an aerosol or foam, or manufacturing electronic components.

(ii) *De minimis adjusted tax.* The adjusted tax with respect to a product is *de minimis* if such tax is less than one/tenth of one percent of the importer's cost of acquiring such product. The term "adjusted tax" means the tax that would be imposed under section 4681 on the ODCs used as materials in the manufacture of such product if such ODCs were sold in the United States and the base tax amount were $1.00.

(c) *Taxable event*—(1) *In general.* Except as otherwise provided in paragraph (c)(2) and (3) of this section, the tax on an imported taxable product is imposed when the product is first sold or used (as defined in §52.4681-1T(c)(6) and (7)) by its importer.

(2) *Election to treat importation as use*—(i) *In general.* An importer may elect to treat the entry of products into the United States as the use of such products. In the case of imported taxable products to which an election under this paragraph (c)(2) applies—

(A) Tax is imposed on the products on the date of entry (as determined under paragraph (c)(2)(ii) of this section) if the products are entered into the United States after the election becomes effective;

(B) Tax is imposed on the products on the date the election becomes effective if the products were entered into the United States after December 31, 1989, and before the election becomes effective; and

(C) No tax is imposed if the products were entered into the United States before January 1, 1990.

(ii) *Date of entry.* The date of entry is determined by reference to customs law. If the actual date is unknown, the importer may use any reasonable and consistent method to determine the date of entry, provided that such date is within 10 business days of arrival of products in the United States.

(iii) *Applicability of election.* An election under this paragraph (c)(2) applies to all imported taxable products that are held (and have not been used) by the importer at the time the election becomes effective and all imported taxable products that are entered into the United States by the importer after the election becomes effective. An election under this paragraph (c)(2) becomes effective at the beginning of the first calendar quarter to which the election applies. Except as provided in §52.6071(a)-2T(a)(3) and (4), the election may be revoked only with the consent of the Commissioner.

(iv) *Making the election.* An election under this paragraph (c)(2) shall be made in accordance with the instructions for the return on which the importer is required to report liability for tax under section 4681.

(3) *Treating the sale of an article incorporating an imported taxable product as the first sale or use of such product*—(i) *In general.* In the case of articles to be sold, an importer may treat the sale of an article manufactured or assembled in the United States as the first sale or use of an imported taxable product incorporated in such article, but only if the importer—

(A) Has consistently treated the sale of similar articles as the first sale or use of similar imported taxable products; and

(B) Has not made an election under paragraph (c)(2) of this section.

(ii) *Similar articles and imported taxable products.* An importer may establish any reasonable criteria for determining whether articles or imported taxable products are similar for purposes of this paragraph (c)(3).

(iii) *Establishment of consistent treatment.* An importer has consistently treated the sale of similar articles as the first sale or use of similar imported taxable products only if such treatment is reflected in the computation of tax on the importer's returns for all prior calendar quarters in which such treatment would affect tax liability.

(iv) *Example.* The following example illustrates the application of this paragraph (c)(3):

Example. (A) An importer of printed circuits and other electronic components uses those products in assembling television receivers in the United States and also uses the printed circuits in assembling VCRs in the United States. Under the importer's criteria for determining similarity, printed circuits are similar to other printed circuits, but not to the other electronic components. In addition, television receivers are similar to other television receivers, but not to VCRs. The importer has not made an election under paragraph (c)(2) of this section.

(B) Under this paragraph (c)(3), the importer may treat the sale of the television receivers as the first sale or use of the imported printed circuits incorporated into the television receivers. In that case, the tax on the printed circuits would be imposed when the television receivers are sold rather than when the printed circuits are used in assembling the television receivers.

(C) The importer may treat the sale of the television receivers as the first sale or use of the printed circuits incorporated into the television receivers even if the sale of the television receivers is not treated as the first sale or use of the other electronic components incorporated into the television receivers and even if the sale of VCRs is not treated as the first sale or use of the printed circuits incorporated into the VCRs. Under paragraph (c)(3)(i)(A) of this section, however, the importer must have consistently treated the sale of television receivers as the first sale or use of printed circuits incorporated into the receivers. Thus, in the case of television receivers that were assembled before January 1, 1990, and sold after December 31, 1989, the importer must have treated the sale of the television receivers as the first sale or use of the printed circuits incorporated into the television receivers when reporting tax under section 4681 with respect to such printed circuits.

(d) *ODCs used as materials in the manufacture of imported taxable products*—(1) *ODC weight.* The tax imposed on an imported taxable product under section 4681 is computed by reference to the weight of the ODCs used as materials in the manufacture of the product (ODC weight). The ODC weight of a product includes the weight of ODCs used as materials in the manufacture of any components of the product.

(2) *ODCs used as materials in the manufacture of a product.* Except as provided in paragraph (d)(3) of this section, an ODC is used as a material in the manufacture of a product if the ODC is—

(i) Incorporated into the product;

(ii) Released into the atmosphere in the process of manufacturing the product; or

(iii) Otherwise used in the manufacture of the product (but only to the extent the cost of the ODC is properly allocable to the product).

(3) *Protective packaging.* ODCs used in the manufacture of the protective material in which a product is packaged are not treated as ODCs used as materials in the manufacture of such product.

(4) *Example.* The provisions of this paragraph (d) may be illustrated by the following example:

Example. A, a manufacturer located outside the United States, uses ODCs as a solvent to clean the printed circuits it manufactures and as a coolant in the air-conditioning system of the factory in which the printed circuits are manufactured. The ODCs used as a solvent are released into the atmosphere, and, under paragraph (d)(2)(ii) of this section, are used as materials in the manufacture of the printed circuits. The ODCs used as a coolant in the air-conditioning system are also used in the manufacture of the printed circuits. Under paragraph (d)(2)(iii) of this section, these ODCs are used as materials in the manufacture of the printed circuits only to the extent the cost of the ODCs is properly allocable to the printed circuits.

(e) *Methods of determining ODC weight; computation of tax*—(1) *In general.* This paragraph (e) sets forth the methods to be used for determining the ODC weight of an imported taxable product and a method to be used in computing the tax when the ODC weight cannot be determined. The amount of tax is computed separately for each imported taxable product and the method to be used in determining the ODC weight or otherwise computing the tax is separately determined for each such product. Thus, an importer may use one method in computing the tax on some imported taxable products and different methods in computing the tax on other products. For example, an importer of telephone sets may compute the tax using the exact method described in paragraph (e)(2) of this section for determining the ODC weight of telephone sets supplied by one manufacturer and using the Table method described in paragraph (e)(3) of this section for telephone sets supplied by other manufacturers that have not provided sufficient information to allow the importer to use the exact method.

(2) *Exact method.* If the importer determines the weight of each ODC used as a material in the manufacture of an imported taxable product and supports that determination with sufficient and reliable information, the ODC weight of the product is the weight so determined. Representations by the manufacturer of the product to the importer as to the weight of the ODCs used as materials in the manufacture of the product may be sufficient and reliable information for this purpose. Thus, a letter to the importer signed by the manufacturer may constitute sufficient and reliable information if the letter adequately identifies the product and states the weight of each ODC used as a material in the product's manufacture.

(3) *Table method*—(i) *In general.* If the ODC weight of an imported taxable product is not determined using the exact method described in paragraph (e)(2) of this section and the current Table specifies the Table ODC weight of the product, the ODC weight of the product is the Table ODC weight. In computing the amount of tax, the Table ODC weight shall not be rounded.

(ii) *Special rules*—(A) *Articles assembled in the United States.* An importer that assembles finished articles in the United States may compute the amount of tax imposed on the imported taxable products incorporated into the finished article by using the Table ODC weight specified for the article instead of the Table ODC weights specified for the components. For example, if an importer uses 600 imported camcorder subassemblies to manufacture 100 camcorders, the importer may compute the amount of tax on the subassemblies by using the Table ODC weight specified for camcorders. Thus, the tax imposed on the 600 subassemblies is equal to the tax that would be imposed on 100 camcorders.

(B) *Combination method.* This paragraph (e)(3)(ii)(B) applies to an imported taxable product if the current Table specifies weights for two or more ODCs with respect to the product and the importer of the product can determine the weight of any such ODC (and of any ODC used as a substitute for such ODC) and can support such determination with sufficient and reliable information. In determining the ODC weight of any such product, the importer may replace the weight specified in the Table for such ODC with the weight of such ODC and its substitutes (as determined by the importer). For example, if an importer has sufficient and reliable information to determine the amount of CFC-12 included in a product as a coolant (and to determine that no ODCs have been used as substitutes for CFC-12) but cannot determine the amount of CFC-113 used in manufacturing the product's electronic components, the importer may use the weight specified in the Table for CFC-113 and the actual weight determined by the importer for CFC-12 in determining the ODC weight of the product.

(C) *ODCs used in the manufacture of rigid foam insulation.* In computing the tax using the method described in this paragraph (e)(3), any ODC for which the Table specifies a weight followed by an asterisk (*) shall be treated as an ODC used in the manufacture of rigid foam insulation (as defined in §52.4682-1T(d)(3) and (4)).

(4) *Value method.* If the importer cannot determine the ODC weight of an imported taxable product under the exact method described in paragraph (e)(2) of this section and the Table ODC weight of the product is not specified, the tax imposed on the product under section 4681 is one percent of the entry value of the product.

(5) *Adjustment for prior taxes*—(i) *In general.* If any manufacture with respect to an imported taxable product occurred in the United States or the product incorporates a taxed component or a taxed chemical was used in its manufacture, the product's ODC weight (or value) attributable to manufacture within the United States or to taxed components or taxed chemicals shall be disregarded in computing the tax on such product using a method described in paragraph (e)(2), (3), or (4) of this section.

(ii) *Taxed component.* The term "taxed component" means any component that previously was subject to tax as an imported taxable product or that would have been so taxed if section 4681 had been in effect for periods before January 1, 1990.

(iii) *Taxed chemical.* The term "taxed chemical" means any ODC that previously was subject to tax.

(f) *Imported Products Table*—(1) *In general.* This paragraph (f) con-

tains rules relating to the Imported Products Table (Table) and sets forth the initial Table. The Table lists all the products that are subject to the tax on imported taxable products and specifies the Table ODC weight of each product for which such a weight has been determined.

(2) *Applicability of initial Table*—(i) *In general.* Except as provided in paragraph (f)(2)(ii) of this section, the Table contained in paragraph (f)(6) of this section is effective on January 1, 1990, and will remain in effect until superseded by a revenue procedure issued under paragraph (f)(7) of this section.

(ii) *Treatment of certain products.* Products included in a listing that is preceded by a double asterisk (**) in the initial Table shall not be treated as imported taxable products until October 1, 1990.

(3) *Identification of products*—(i) *In general.* Each listing in the Table identifies a product by name and includes only products that are described by that name. Most listings identify a product by both name and Harmonized Tariff Schedule (HTS) heading. In such cases, a product is included in that listing only if the product is described by that name and the rate of duty on the product is determined by reference to that HTS heading. For example, the Table lists "radios—8527.19" and "radio combinations—8527.31." Therefore, a radio entered under HTS heading 8527.19 is not included within the listing for radio combinations.

(ii) *Electronic items not listed by specific name*—(A) *In general.* Part II of the Table contains a listing for electronic items that are not included within any other listing in the Table. An imported product is included in this listing only if the product is a component whose operation involves the use of nonmechanical amplification or switching devices such as tubes, transistors, and integrated circuits or more than 15 percent of the cost of the product is attributable to such components. Such components do not include passive electrical devices such as resistors and capacitors.

(B) *Certain items not included.* Items such as screws, nuts, bolts, plastic parts, and similar specially fabricated parts that may be used to construct an electronic item are not themselves included in the listing for electronic items.

(4) *Rules for listing products.* Products are listed in the Table in accordance with the following rules:

(i) *Listing in Part I.* A product is listed in Part I of the Table if the Commissioner has determined that—

(A) The ODC weight of the product is not *de minimis* when the product is produced using the predominant method of manufacturing the product; and

(B) None of the ODCs used as materials in the manufacture of the product under the predominant method are used for purposes of refrigeration or air conditioning, creating an aerosol or foam, or manufacturing electronic components.

(ii) *Listing in Part II.* A product is listed in Part II of the Table if the Commissioner has determined that the ODCs used as materials in the manufacture of the product under the predominant method are used for purposes of refrigeration or air conditioning, creating an aerosol or foam, or manufacturing electronic components.

(iii) *Listing in Part III.* A product is listed in Part III of the Table if the Commissioner has determined that the product is not an imported taxable product and the product would otherwise be included within a listing in Part II of the Table. For example, floppy disk drive units are listed in Part III because they are not imported taxable products and they would, but for their listing in Part III, be included within the Part II listing for electronic items not specifically identified.

(5) *Table ODC weight.* The Table ODC weight of a product is the weight, determined by the Commissioner, of the ODCs that are used as materials in the manufacture of the product under the predominant method of manufacturing. The Table ODC weight is given in pounds per single unit of product unless otherwise specified.

(6) *Initial Table.* The initial Table is set forth below:

IMPORTED PRODUCTS TABLE
PART I

Product Name	*Harmonized Tariff Schedule Heading*	*ODC*	*ODC Weight*
Mixtures containing ODCs, such as— -anti-static sprays -automotive products such as "carburetor cleaner," "stop leak," "oil charge" -cleaning solvents -contact cleaners -degreasers -dusting sprays -electronic circuit board coolants -electronic solvents -fire extinguisher preparations and charges -flux removers for electronics -insect and wasp sprays -propellants -refrigerants			
Ethylene oxide/CFC-12 mixture		CFC-12	0.88lb/lb

PART II

Product Name	*Harmonized Tariff Schedule Heading*	*ODC*	*ODC Weight*
Rigid foam insulation defined in §52.4682-1T(d)(3))			
Foams made with ODCs, other than foams defined in §52.4682-1T(d)(3))			
Scrap flexible foam made with ODCs			
Medical products containing ODCs— -surgical staplers -cryogenic medical instruments -drug delivery systems -inhalants			
Dehumidifiers, household	8415.82.00.50	CFC-12	0.344
Chillers:	8415.82.00.65		
charged with CFC-12		CFC-12	1600.
charged with CFC-114		CFC-114	1250.
charged with R-500		CFC-12	1920.
Refrigerator-freezers, household:			
not >184 liters	8418.10.00.10	CFC-11	1.08*
		CFC-12	0.13
>184 liters but not >269 liters	8418.10.00.20	CFC-11	1.32*
		CFC-12	0.26
>269 liters but not >382 liters	8418.10.00.30	CFC-11	1.54*
		CFC-12	0.35
>382 liters	8418.10.00.40	CFC-11	1.87*
		CFC-12	0.35
Refrigerators, household			
not >184 liters	8418.21.00.10	CFC-11	1.08*
		CFC-12	0.13
>184 liters but not >269 liters	8418.21.00.20	CFC-11	1.32*
		CFC-12	0.26
>269 liters but not >382 liters	8418.21.00.30	CFC-11	1.54*
		CFC-12	0.35
>382 liters	8418.21.00.90	CFC-11	1.87*
		CFC-12	0.35
Freezers, household	8418.30	CFC-11	2.0*
		CFC-12	0.4
Freezers, household	8418.40	CFC-11	2.0*
		CFC-12	0.4
Refrigerating display counters not >227 kg	8418.50	CFC-11	50.0*
		CFC-12	260.0
Icemaking machines:	8418.69		
charged with CFC-12		CFC-12	1.4
charged with R-502		CFC-115	3.39
Drinking water coolers:	8418.69		
charged with CFC-12		CFC-12	0.21
charged with R-500		CFC-12	0.22

Product Name	*Harmonized Tariff Schedule Heading*	*ODC*	*ODC Weight*
Centrifugal chiller, hermetic:	8418.69		
charged with CFC-12		CFC-12	1600.
charged with CFC-114		CFC-114	1250.
charged with R-500		CFC-12	1920.
Reciprocating chiller:	8418.69		
charged with CFC-12		CFC-12	200.
Mobile refrigeration systems:	8418.99		
containers		CFC-12	15.
trucks		CFC-12	11.
trailers		CFC-12	20.
Refrigeration condensing units:			
not >746W	8418.99.00.05	CFC-12	0.3
>746W but not >2.2KW	8418.99.00.10	CFC-12	1.0
>2.2KW but not >7.5KW	8418.99.00.15	CFC-12	3.0
>7.5KW but not >22.3KW	8418.99.00.20	CFC-12	8.5
>22.3 KW	8418.99.00.25	CFC-12	17.0
Fire extinguishers, charged w/ODCs	8424		
Electronic typewriters and word processors	8469	CFC-113	0.2049
Electronic calculator	8470.10	CFC-113	0.0035
Electronic calculator w/printing device	8470.21	CFC-113	0.0057
Electronic calculator	8470.29	CFC-113	0.0035
Account machines	8470.40	CFC-113	0.1913
Cash registers	8470.50	CFC-113	0.1913
Digital automatic data processing machine w/cathode ray tube, not included in subheading 8471.20.90	8471.20	CFC-113	0.3663
Laptops, notebooks, and pocket computers	8471.20.90	CFC-113	0.03567
Digital processing unit w/entry value >$100K	8471.91	CFC-113	27.6667
Digital processing unit w/entry value not >$100K	8471.91	CFC-113	0.4980
Combined input/output unit (terminal)	8471.92	CFC-113	0.3600
Keyboard	8471.92	CFC-113	0.0742
Display unit	8471.92	CFC-113	0.0386
Printer unit	8471.92	CFC-113	0.1558
Input or output unit	8471.92	CFC-113	0.1370
Magnetic disk drive unit for a disk of a diameter over 21 cm (8¼ inches)	8471.93.10	CFC-113	4.0067
Hard magnetic disk drive unit not included in subheading 8471.93.10—			
for a disk of a diameter >9 cm (3½ inches) but not >21 cm (8¼ inches)	8471.93	CFC-113	1.1671
for a disk of a diameter not >9 cm (3½ inches)	8471.93	CFC-113	0.2829
Nonmagnetic storage unit w/ entry value >$1,000	8471.93	CFC-113	2.7758

Product Name	*Harmonized Tariff Schedule Heading*	*ODC*	*ODC Weight*
Power supply	8471.99.30	CFC–113	0.0655
Electronic office machines	8472	CFC–113	0.001
Populated card for digital processing unit in subheading 8471.91 valued over $100K	8473.30	CFC–113	4.82
Populated card for digital processing unit in subheading 8471.91 valued $100K and under	8473.30	CFC–113	0.1408
Automatic goods-vending machines with refrigerating device	8476.11	CFC–12	0.45
Microwave ovens with electronic controls, with capacity of:	8516.50		
0.99 cu. ft. or less		CFC–113	0.0300
1.0 through 1.3 cu. ft		CFC–113	0.0441
1.31 cu. ft. or greater		CFC–113	0.0485
Microwave oven combination with electronic controls	8516.60.40.60	CFC–113	0.0595
Telephone sets—			
w/entry value >$11.00	8517.10	CFC–113	0.1
w/entry value not >$11.00	8517.10	CFC–113	0.0225
Teleprinters & teletypewriters	8517.20	CFC–113	0.1
Switching equipment not included in subheading 8517.30.20	8517.30	CFC–113	0.1267
Private branch exchange switching equipment	8517.30.20	CFC–113	0.0753
Modems	8517.40	CFC–113	0.0225
Intercoms	8517.81	CFC–113	0.0225
Facsimile machines	8517.82	CFC–113	0.0225
Loudspeakers, microphones, headphones, & electric sound amplifier sets, not included in subheading 8518.30.10	8518	CFC–113	0.0022
Telephone handsets	8518.30.10	CFC–113	0.042
Turntables, record players, cassette players, and other sound reproducing apparatus	8519	CFC–113	0.0022
Magnetic tape recorders & other sound recording apparatus, not included in subheading 8520.20	8520	CFC–113	0.0022
Telephone answering machines	8520.20	CFC–113	0.1
Color video recording/reproducing apparatus	8521.10.00.20	CFC–113	0.0586
Videodisc players	8521.90	CFC–113	0.0106
Cordless handset telephones	8525.20.50	CFC–113	0.1
Cellular communication equipment	8525.20.60	CFC–113	0.4446
TV cameras	8525.30	CFC–113	1.423
Camcorders	8525.30	CFC–113	0.0586
Radio combinations	8527.11	CFC–113	0.0022
Radios	8527.19	CFC–113	0.0014

Product Name	*Harmonized Tariff Schedule Heading*	*ODC*	*ODC Weight*
Motor vehicle radios with or w/o tape player	8527.21	CFC-113	0.0021
Radio combinations	8527.31	CFC-113	0.0022
Radios	8527.32	CFC-113	0.0014
Tuner w/o speaker	8527.39.00.20	CFC-113	0.0022
Television receivers	8528	CFC-113	0.0386
VCR	8528.10.40	CFC-113	0.0586
Home satellite earth stations	8528.10.80.55	CFC-113	0.0106
Electronic assemblies for HTS headings 8525, 8527, & 8528	8529.90	CFC-113	0.0816
Indicator panels incorporating liquid crystal devices or light emitting diodes	8531.20	CFC-113	0.0146
Printed circuits	8534	CFC-113	0.001
Computerized numerical controls	8537.10.00.30	CFC-113	0.1306
Diodes, crystals, transistors and other similar discrete semiconductor devices	8541	CFC-113	0.0001
Electronic integrated circuits and microassemblies	8542	CFC-113	0.0002
Signal generators not included in subheadings 8543.90.40 and 8543.90.80	8543	CFC-113	0.6518
Avionics	8543.90.40	CFC-113	0.915
Signal generators subassemblies	8543.90.80	CFC-113	0.1265
Insulated or refrigerated railway freight cars	8606	CFC-11	100.*
Passenger automobiles:	8703		
foams (interior)		CFC-11	0.8
foams (exterior)		CFC-11	0.7
—with fully charged a/c		CFC-12	2.0
—without charged a/c		CFC-12	0.2
electronics		CFC-113	0.5
Light trucks:	8704		
foams (interior)		CFC-11	0.6
foams (exterior)		CFC-113	0.1
—with fully charged a/c		CFC-11	2.0
—without charged a/c		CFC-12	0.2
electronics		CFC-12	0.4
**Heavy trucks and tractors, with GVW 33,001 lbs or more:	8704		
foams (interior)		CFC-11	0.6
foams (exterior)		CFC-11	0.1
—with fully charged a/c		CFC-12	3.0
—without charged a/c		CFC-12	0.2
electronics		CFC-113	0.4
Motorcycles with seat foamed with ODCs	8711	CFC-11	0.04
Bicycles with seat foamed with ODCs	8712	CFC-11	0.04
Seats foamed with ODCs	8714.95	CFC-11	0.04

Product Name	*Harmonized Tariff Schedule Heading*	*ODC*	*ODC Weight*
Aircraft	8802	CFC-12	0.25 lb/1000 lbs Operating Empty Weight (OEW)
		CFC-113	30.0 lbs/1000 lbs OEW
Optical fibers	9001	CFC-12	0.005 lb/thousand feet
Electronic cameras	9006	CFC-113	0.01
Photocopiers	9009	CFC-113	0.0426
Avionics	9014.20	CFC-113	0.915
Electronic drafting machine	9017	CFC-113	0.12
Complete patient monitoring systems	9018.19.80	CFC-12	0.94
		CFC-113	3.4163
Complete patient monitoring systems; subassemblies thereof	9018.19.80.60	CFC-113	1.9320
Physical or chemical analysis instruments	9027	CFC-12	0.0003
		CFC-113	0.0271
Oscilloscopes	9030	CFC-11	0.49
		CFC-12	0.5943
		CFC-113	0.2613
Foam chairs	9401	CFC-11	0.30
Foam sofas	9401	CFC-11	0.75
Foam mattresses	9404.21	CFC-11	1.60
Electronic games	9504	CFC-113	
Electronic items not otherwise listed in the Table	chapters 84, 85, 90	CFC-113	0.0004 pound/ $1.00 of entry value

PART III

Product Name	*Harmonized Tariff Schedule Heading*
Room air conditioners	8415.10.00.60
Dishwashers	8422.11
Clothes washers	8450.11
Clothes dryers	8451.21
Floppy disk drive units	8471.93
Transformers and inductors	8504
Toasters	8516.72
Unrecorded media	8523
Recorded media	8524
Capacitors	8532
Resistors	8533
Switching apparatus	8536
Cathode tubes	8540

* See paragraph (e)(3)(ii)(C) of this section. Denotes an ODC used in the manufacture of rigid foam insulation.
** See paragraph (f)(2)(ii) of this section. Denotes products for which the effective date is October 1, 1990.

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(7) *Subsequent Tables.* If the Commissioner determines that the Imported Products Table then in effect should be modified, a superseding Table shall be issued. Such revised Tables shall be published in revenue procedures and shall be effective prospectively for the periods prescribed by such revenue procedures.

(g) *Requests for modification of Table*—(1) *In general.* Any manufacturer or importer of a product may request that the Commissioner modify the Table in any of the following respects:

(i) Adding a product to the Table and specifying its Table ODC weight.

(ii) Removing a product from the Table.

(iii) Changing or specifying the Table ODC weight of a product.

(2) *Form of request.* The Commissioner will consider a request for modification that includes the following:

(i) The name, address, taxpayer identifying number, and principal place of business of the requester.

(ii) For each product with respect to which a modification is requested:

(A) The name of the product;

(B) The HTS heading or subheading;

(C) The type of modification requested;

(D) The Table ODC weight that should be specified for the product if the request relates to adding a product or changing or specifying its Table ODC weight; and

(E) The data supporting the request.

(3) *Public notice and comments*—(i) *In general.* Before considering requests for modification received during a calendar quarter, the Commissioner will—

(A) Publish a notice in the Federal Register summarizing such requests; and

(B) Solicit written comments on the proposed modifications.

(ii) *Form of comments.* The Commissioner will consider written comments on a proposed modification if the comments include—

(A) The name, address, taxpayer identifying number, and principal place of business of the commenter;

(B) An identification of the proposed modification to which the comments relate.

(C) An identification of incorrect statements and supporting data in the request for modification; and

(D) The data supporting each of the commenter's claims that the request contains incorrect information.

(4) *Address.* The address for submission of requests and comments under this paragraph (g) is: Internal Revenue Service, Attn: CC:CORP:T:R (Imported Products Table), Room 4429, Washington, D.C. 20224.

(5) *Public inspection and copying.* Requests and comments submitted under this paragraph (g) will be available in the Internal Revenue Service Freedom of Information Reading Room for public inspection and copying.

§52.4682-4T Floor stocks tax (temporary).

(a) *Overview.* This section provides rules for identifying ozone-depleting chemicals (ODCs) that are subject to the floor stocks tax imposed by section 4682(h)(1), determining the person that is liable for the tax, and computing the amount of the tax. See §52.4681-1T(a)(3) and (c) for general rules and definitions relating to the floor stocks tax.

(b) *ODCs subject to floor stocks tax*—(1) *ODCs that are held for sale or for use in further manufacture*—(i) *In general.* The floor stocks tax is imposed only on an ODC that is held for sale or for use in further manufacture on the date the tax is imposed. This paragraph (b)(1) provides rules for identifying ODCs held for sale or for use in further manufacture.

(ii) *Held for sale.* For purposes of determining whether an ODC is held for sale, the term "sale" shall have the meaning set forth in §52.4681-1T(c)(6). ODCs held for sale include ODCs that will be sold in connection with the provision of services or in connection with the sale of a manufactured article and, in such cases, include ODCs that will be sold without the statement of a separate charge for those ODCs.

(iii) *Held for use in further manufacture.* An ODC is held for use in further manufacture if—

(A) The ODC will be used as a material (within the meaning of paragraph (b)(1)(iv) of this section) in the manufacture of an article; and

(B) Such article will be held for sale.

(iv) *Use as material*—(A) *In general.* Except as provided in paragraph (b)(1)(iv)(B) of this section, an ODC will be used as a material in the manufacture of an article if the ODC will be—

(*1*) Incorporated into the article; or

(*2*) Released into the atmosphere in the process of manufacturing the article.

(B) *ODCs used in equipment.* An ODC is not used as a material in the manufacture of an article if the ODC is (or will be) contained in equipment used in such manufacture and the ODC will be used for its intended purpose without being released from such equipment. Thus, ODCs that are (or will be) used as coolants in a factory's air-conditioning system are not used as materials in the manufacture of articles produced in the factory.

(v) *Storage containers.* The floor stocks tax is imposed on an ODC without regard to the type or size of the storage container in which the ODC is held. Thus, the tax may apply to an ODC whether it is in a 14-ounce can or a 30-pound tank.

(vi) *Examples.* The provisions of this paragraph (b)(1) may be illustrated by the following examples:

Example 1. A, a manufacturer of air conditioners, holds an ODC for use in air conditioners that it will manufacture and sell. A holds the ODC for use in further manufacture.

Example 2. B, a manufacturer of electronic components, holds an ODC for use as a solvent to clean printed circuits that it will sell to computer manufacturers. B holds the ODC for use in further manufacture.

Example 3. C, an automobile dealer, holds an ODC for use in charging air conditioners installed in automobiles that it sells to retail customers. C does not hold the ODC for use in further manufacture. C does, however, hold the ODC for sale, even if the customers are not separately charged for ODCs used in the automobile air conditioners.

Example 4. D operates an air-conditioning repair service and holds an ODC for use in repairing air conditioners for its customers. D holds the ODC for sale even if the customers are not separately charged for ODCs used in the repairs.

Example 5. E, a grocery-store chain, holds an ODC for use in its refrigeration units. E does not hold the ODC for sale or for use in further manufacture.

Example 6. F, a bank, holds an ODC for use in its fire extinguishers to protect the computer system. F does not hold the ODC for sale or for use in further manufacture.

(2) *Nontaxable ODCs*—(i) *Mixtures*—(A) *Tax imposed on January 1, 1990.* In the case of the floor stocks tax imposed on January 1, 1990, the tax is not imposed on an ODC that has been mixed with any other ingredients. For example, the tax is not imposed on the ODCs contained in the refrigerants commonly known in the industry as R-500 and R-502. As another example, the tax is not imposed on the ODCs contained in automotive products used for checking for leaks because such products are a mixture of ODCs and small amounts of dyes and oils.

(B) *Taxes imposed after 1990.* In the case of the floor stocks tax im-

posed on January 1 of 1991, 1992, 1993, or 1994, the tax is not imposed on an ODC that has been mixed with any other ingredients, but only if it is established that such ingredients contribute to the accomplishment of the purpose for which the mixture will be used. Thus, the tax is not imposed on the mixtures described in the examples in paragraph (b)(2)(i)(A) of this section because the ingredients mixed with the ODCs contribute to the accomplishment of the purpose for which the mixture will be used. On the other hand, a mixture is not exempt from tax under this paragraph (b)(2)(i)(B) if it contains only an ODC and an inert ingredient that does not contribute to the accomplishment of the purpose for which the mixture will be used.

(ii) *Manufactured articles.* The floor stocks tax is not imposed on an ODC that is contained in a manufactured article in which the ODC will be used for its intended purpose without being released from such article. For example, the tax is not imposed on the ODCs contained in the cooling coils of a refrigerator even if the refrigerator is held for sale. However, the tax is imposed on a can of ODC used to recharge an air conditioning unit because the ODC must be expelled from the can in order to be used. Similarly, beginning in 1991, the tax is imposed on the Halon-1211, Halon-1301, or Halon-2402 contained in a fire extinguisher held for sale because such ODCs must be expelled from the fire extinguisher in order to be used.

(iii) *Recycled ODCs.* The floor stocks tax is not imposed on ODCs that have been reclaimed or recycled. For example, the tax is not imposed on an ODC that is held for use in further manufacture after being used as a solvent and recycled.

(iv) *ODCs held by the manufacturer or importer.* The floor stocks tax is not imposed on ODCs held by their manufacturer or importer.

(c) *Person liable for tax*—(1) *In general.* The person liable for the floor stocks tax on an ODC is the person that holds the ODC on a date on which the tax is imposed. The person who holds the ODC is the person who has title to the ODC (whether or not delivery to such person has been made) as of the first moment of such date. The person who has title at such time is determined under applicable local law.

(2) *Special rule.* Each business unit that has, or is required to have, its own employer identification number is treated as a separate person for purposes of the floor stocks tax. For example, a chain of automotive parts stores that has one employer identification number is one person for purposes of the floor stocks tax, and a parent corporation and subsidiary corporation that each have a different employer identification number are two persons for purposes of the floor stocks tax.

(d) *Computation of tax*—(1) *In general*—(i) *Tentative tax amount.* Section 52.4681-1T(a)(3) provides that the amount of the floor stocks tax on an ODC is determined by reference to a tentative tax amount. The tentative tax amount is the amount of tax that would be imposed on the ODC under section 4681(a)(1) if a sale of the ODC by the manufacturer or importer had occurred on the date the floor stocks tax is imposed. This paragraph (d) provides rules for determining the tentative tax amount and the amount of the floor stocks tax.

(ii) *Floor stocks tax imposed on January 1, 1990.* The floor stocks tax imposed on January 1, 1990, is equal to the tentative tax amount. Thus, except as provided in paragraph (d)(2) or (3) of this section, the amount of the floor stocks tax imposed on January 1, 1990, is as follows:

ODC	*Tax per pound*
CFC-11	$1.37
CFC-12	$1.37
CFC-113	$1.096
CFC-114	$1.37
CFC-115	$0.822

(iii) *Subsequent floor stocks taxes.* The following rules apply for floor stocks taxes imposed after January 1, 1990.

(A) The tentative tax amount is determined, except as provided in paragraph (d)(2) or (3) of this section, by reference to the rate of tax prescribed in section 4681(b)(1)(B) and the ozone-depletion factors prescribed in section 4682(b).

(B) The amount of the floor stocks tax on an ODC is equal to the amount by which the tentative tax amount exceeds the amount of taxes previously imposed on the ODC.

(2) *Qualifying sales*—(i) *ODCs used as a feedstock.* In the case of an ODC that was sold in a qualifying sale for purposes of §52.4682-1T(c) (relating to use as a feedstock), the tentative tax amount is zero.

(ii) *ODCs used in the manufacture of rigid foam insulation.* In the case of an ODC that was sold in a qualifying sale for purposes of §52.4682-1T(d) (relating to use in the manufacture of rigid foam insulation) the tentative tax amount is determined under section 4682(g) for purposes of computing the floor stocks tax imposed on the ODC on January 1 of 1990, 1991, 1992 or 1993. For purposes of computing the floor stocks tax imposed on the ODC on January 1, 1990, the tentative tax amount is zero.

(iii) *ODCs sold before January 1, 1990.* An ODC that was sold by its manufacturer or importer before January 1, 1990, shall be treated, for purposes of this paragraph (d)(2), as—

(A) An ODC that was sold in a qualifying sale for purposes of §52.4682-1T(c) if the ODC will be used as a feedstock (within the meaning of §52.4682-1T(c)(3); and

(B) An ODC that was sold in a qualifying sale for purposes of §52.4682-1T(d) if the ODC will be used in the manufacture of rigid foam insulation (within the meaning of §52.4682-1T(d)(3) and (4)).

(3) *Halons.* In the case of Halon-1211, Halon-1301, or Halon-2402 (Halon), the tentative tax amount is determined under section 4682(g) for purposes of computing the floor stocks tax imposed on the Halon on January 1 of 1990, 1991, 1992, or 1993. For purposes of computing the floor stocks tax imposed on the Halon on January 1, 1990, the tentative tax amount is zero.

(e) *De minimis exception*—(1) *1990, 1992, and 1993.* In the case of the floor stocks tax imposed on January 1 of 1990, 1992, or 1993, a person is liable for the tax only if, on the date the tax is imposed, the person holds at least 400 pounds of ODCs that are not described in paragraph (d)(2) or (3) of this section and are otherwise subject to the tax.

(2) *1991.* In the case of the floor stocks tax imposed on January 1,

1991, a person is liable for the tax only if, on such date, the person holds at least 400 pounds of ODCs that are described in paragraph (d)(2)(ii) or (3) of this section and are otherwise subject to the tax.

(3) *1994.* In the case of the floor stocks tax imposed on January 1, 1994, a person is liable for the tax only if, on such date, the person holds—

(i) At least 200 pounds of ODCs that are described in paragraph (d)(2)(ii) of this section and are otherwise subject to the tax; or

(ii) At least 20 pounds of ODCs that are described in paragraph (d)(3) of this section and are otherwise subject to the tax.

(4) *Examples.* The following examples illustrate the rules of this paragraph (e):

Example 1. On January 1, 1990, A holds 300 pounds of ODCs for sale. A is not liable for the floor stocks tax imposed on January 1, 1990.

Example 2. On January 1, 1990, B holds for sale 250 pounds of CFC-12 and 250 pounds of CFC-113. None of the ODCs are described in paragraph (d)(2) or (3) of this section. Thus, B holds at least 400 pounds of ODCs that are taken into account under paragraph (e)(1) of this section and is liable for the floor stocks tax imposed on January 1, 1990, on the ODCs held for sale.

Example 3. On January 1, 1990, C holds 700 pounds of ODCs. C will use 500 pounds of these ODCs in the manufacture of rigid foam insulation (as defined in §52.4682-1T(d)(3) and (4)). The remainder of the ODCs are not described in paragraph (d)(2) or (3) of this section. Under paragraph (e)(1) of this section, ODCs that will be used in the manufacture of rigid foam insulation are disregarded in determining whether the *de minimis* exemption is applicable in 1990. Thus, C holds only 200 pounds of ODCs that are taken into account under paragraph (e)(1) of this section and is not liable for the floor stocks tax imposed on January 1, 1990.

Example 4. The facts are the same as in Example 3, except that the ODCs are held on January 1, 1991. Under paragraph (e)(2) of this section, the 500 pounds of ODCs that will be used in the manufacture of rigid foam insulation are taken into account in determining whether the *de minimis* exemption is applicable in 1991. The remaining 200 pounds of ODCs are not taken into account because the base tax amount does not increase in 1991. Nevertheless, C holds at least 400 pounds of ODCs that are taken into account under paragraph (e)(2) of this section and is liable for the floor stocks tax imposed on January 1, 1991.

(f) *Inventory.* If, on the date on which the floor stocks tax is imposed, a person holds ODCs that are held for sale or for use in further manufacture and that were not manufactured or imported by such person, the following rules apply:

(1) The person shall prepare an inventory of all such ODCs that the person holds on the date on which the tax is imposed.

(2) The inventory shall be taken as of the first moment of the date on which the tax is imposed, but work-back or work-forward inventories will be acceptable if supported by adequate commercial records of receipt, use, and disposition of ODCs held for sale or for use in further manufacture.

(3) The person must maintain records of the inventory and make such records available for inspection and copying by internal revenue agents and officers. Records of the inventory are not to be filed with the Internal Revenue Service.

(g) *Time for paying tax.* The floor stocks tax imposed under section 4682(h) shall be paid without assessment or notice on or before April 1 of the year in which the tax is imposed. See §52.6151(a)-1T(b) for the rules relating to paying the floor stocks tax.

Par. 4. Sections 52.6011(a)-1 and 52.6011(a)-2 are removed and new §§52.6011(a)-1T and 52.6011(a)-2T are added to read as follows.

§52.6011(a)-1T Returns (temporary).

(a) *In general.* Liability for tax imposed under chapter 38 shall be reported on Form 720, *Quarterly Federal Excise Tax Return,* (or any other form designated by the Commissioner subsequent to publication of these regulations for reporting such liability). Except as provided in paragraph (b) of this section, a return shall be made for a period of one calendar quarter. A return shall be filed for the first calendar quarter in which the person incurs liability for tax imposed under chapter 38 (but not before the calendar quarter ending June 30, 1981), and for each subsequent calendar quarter, whether or not liability was incurred under chapter 38 during such quarter, until the person has filed a final return in accordance with §52.6011(a)-2T.

(b) *Monthly and semimonthly returns*—(1) *Requirement.* If the district director determines that any person that is required under the provisions of §§52.6302(c)-1 and 52.6302(c)-2T to make deposits of taxes has failed to make those deposits, that person shall be required, if so notified in writing by the district director, to make a return on Form 720 (or other form furnished by the district director for use in lieu of Form 720) for a monthly or semimonthly period. Every person so notified by the district director shall make a return for the calendar month or semimonthly period (as defined in §52.6302(c)-1(b)) in which the notice is received and for each calendar month or semimonthly period thereafter until the person has filed a final return (as defined in §52.6011(a)-2T) or until the person is notified (as provided in paragraph (b)(2) of this section) to make returns on the basis of a different return period.

(2) *Change of requirement.* The district director may, at his or her discretion, notify any person in writing to make returns on the basis of any return period that the person may be required to use under paragraphs (a) or (b)(1) of this section.

(c) *Cross reference.* For provisions relating to the time to file returns, see §§52.6071(a)-1, 52.6071(a)-2T, and 52.6071(a)-3T. For provisions relating to the place for filing returns, see §52.6091-1T. For provisions relating to use of Government depositaries, see §§52.6302(c)-1 and 52.6302(c)-2T.

§52.6011(a)-2T Final returns (temporary).

(a) *In general.* Any person that is required by §52.6011(a)-1T to make a return and that permanently ceases the operations with respect to which the person incurred liability for tax shall make a final return in accordance with the instructions applicable to the return. A person that only temporarily has ceased to incur liability for tax shall not make a final return but shall continue to file returns in accordance with §52.6011(a)-1T.

(b) *Statement to accompany final return.* A statement must be attached to each final return. This statement must include—

(1) The address at which the business records relating to returns required under this part will be maintained.

(2) The name of the person maintaining such records.

(3) The name and address of any person to whom the business has been transferred and the date of transfer, if the reason for filing a final return is the transfer of the business.

Par. 5. Section 52.6071(a)-1 is amending by inserting "or §52.6011(a)-1T" after "§52.6011-(a)-1" wherever it appears.

Par. 6. New §§52.6071(a)-2T and 52.6071(a)-3T are added to read as follows.

§52.6071(a)-2T Time for filing returns under section 4681 (temporary).

(a) *Quarterly returns*—(1) *In general.* Except as provided in paragraph (a)(2), (3), and (4) of this section, each quarterly return required by §52.6011(a)-1T(a) relating to tax imposed under section 4681 shall be filed on or before the last day of the second calendar month following the quarter for which such return is made.

(2) *Special rule.* Except as otherwise provided in paragraph (a)(3)(ii) and (a)(4)(ii) of this section, only one quarterly Form 720 shall be filed for a calendar quarter. If a person is also required to report liability for other excise taxes for the quarter on a Form 720 and such Form 720 would otherwise be due on or before a date earlier than the date provided in paragraph (a)(1) of this section, the person shall file only one Form 720 on or before the filing date provided by paragraph (a)(1) of this section. This rule does not extend the time for making deposits or paying any other excise tax.

(3) *Returns for the first calendar quarter of 1990*—(i) *In general.* The Form 720 reporting liability for tax imposed under section 4681 for the first calendar quarter of 1990 shall be filed on or before April 30, 1990. However, the date for filing is extended (without application) until October 9, 1990. Extension of the filing date does not extend the date on which the payment of tax is due. The payment of tax for the first calendar quarter of 1990 is due on April 30, 1990.

(ii) *Special rule for persons required to file a return reporting liability for taxes other than taxes imposed under section 4681*—(A) *In general.* If a person was required to file Form 720 for the first calendar quarter of 1990 to report liability for tax imposed under section 4681 and filed Form 720 for the first calendar quarter of 1990 without reporting section 4681 liability, the person must file a supplemental Form 720 for that quarter on or before October 9, 1990. In addition, a person may file a supplemental Form 720 to make or change an election under §§52.4682-1T(b)(2)-(iii) or 52.4682-3T(c)(2) or to reflect consistent treatment for purposes of §52.4682-3T(c)(3).

(B) *Filing instructions.* The supplemental Form 720 shall be marked "SUPPLEMENTAL—1st QUARTER 1990" at the top. Except as otherwise provided in paragraph (a)(3)(ii)(C) of this section, only the liability for tax under section 4681 (IRS No. 19) for the first calendar quarter of 1990 shall be reported on this form. Part II of the supplemental Form 720 shall be completed as follows. Enter the amount from IRS No. 19 on Line 1 and again on Line 3. Do not make any adjustments on Line 2. Enter the amount from Line 3 on Line 4(a)F and again on Line 4(b). Enter any amount already paid relating to section 4681 liability for the first quarter of 1990 on Line 4(c). If the amount on Line 3 exceeds the amount on Line 4(c), pay the balance with the return.

(C) *Exception.* Any person that is required by §52.6071(a)-3T(a)(2) to file a supplemental Form 720 to report liability for floor stocks tax shall file one combined supplemental Form 720 for the first calendar quarter of 1990 to report the taxes imposed by both sections 4681 and 4682. In the case of a combined supplemental Form 720, Part II shall be completed as follows. Enter the total of IRS No. 19 and IRS No. 20 on Line 1 and again on Line 3. Do not make any adjustments on Line 2. Enter the amount from IRS No. 20 on Line 4(a)A and the amount from IRS No. 19 on Line 4(a)F. Enter the amount from Line 3 on Line 4(b). Enter any amount already paid relating to sections 4681 and 4682 liability for the first quarter of 1990 on Line 4(c). If the amount on Line 3 exceeds the amount on Line 4(c), pay the balance with the return.

(4) *Returns for the second calendar quarter of 1990*—(i) *In general.* The Form 720 reporting liability for tax imposed under section 4681 for the second calendar quarter of 1990 shall be filed on or before September 7, 1990. However, the date for filing is extended (without application) until October 9, 1990. Extension of the filing date does not extend the date on which payment of tax is due. The payment of tax for the second calendar quarter of 1990 is due on September 7, 1990.

(ii) *Special rule for persons required to file a return reporting liability for taxes other than taxes imposed under section 4681*—(A) *In general.* If a person was required to file Form 720 for the second calendar quarter of 1990 to report liability for tax imposed under section 4681 and filed Form 720 for the second calendar quarter of 1990 without reporting section 4681 liability, the person must file a supplemental Form 720 for that quarter on or before October 9, 1990. In addition, a person may file a supplemental Form 720 to make or change an election under §52.4682-3T(c)(2) or to reflect consistent treatment for purposes of §52.4682-3T(c)(3).

(B) *Filing instructions.* The supplemental Form 720 shall be marked "SUPPLEMENTAL—2nd QUARTER 1990" at the top. Only the liability for tax under section 4681 (IRS No. 19) for the second calendar quarter of 1990 shall be reported on this form. Part II of the supplemental Form 720 shall be completed as follows. Enter the amount from IRS No. 19 on Line 1 and again on Line 3. Do not make any adjustments on Line 2. Enter the amount from Line 3 on Line 4(a)F and again on Line 4(b). Enter any amount already paid relating to section 4681 liability for the second quarter of 1990 on Line 4(c). If the amount on Line 3 exceeds the amount on Line 4(c), pay the balance with the return.

(b) *Monthly and semimonthly returns*—(1) *Monthly returns.* Each monthly return required by §52.6011(a)-1T(b) relating to tax imposed under section 4681 shall be filed not later than the last day of the month following the month for which it is made.

(2) *Semimonthly returns.* Each semimonthly return required by §52.6011(a)-1T(b) relating to tax imposed under section 4681 shall be filed not later than the last day of the

semimonthly period following the semimonthly period for which it is made.

(c) *Cross references.* For provisions relating to timely mailing treated as timely filing and paying, see section 7502. For provisions relating to time for performance of acts where last day for performance falls on Saturday, Sunday, or legal holiday, see section 7503. For provisions relating to time and place for paying tax shown on the return, see §52.6151(a)-1T.

§52.6071(a)-3T Time for filing returns under section 4682(h) (temporary).

(a) *Return reporting liability for floor stocks tax imposed on January 1, 1990*—(1) *In general.* The Form 720 reporting liability for floor stocks tax imposed on January 1, 1990, under section 4682(h) shall be filed on or before April 30, 1990. However, the date for filing is extended (without application) until October 9, 1990. This Form 720 is for the first calendar quarter of 1990. In the case of a person not otherwise required to file Form 720 for such calendar quarter, the return shall be marked "FINAL—FLOOR STOCKS" at the top. Extension of the filing date does not extend the date on which the payment of tax is due. The payment of tax for 1990 is due on April 1, 1990.

(2) *Special rule for persons required to file a return reporting liability for taxes other than taxes imposed under section 4682*—(i) *In general.* If a person was required to file Form 720 for the first calendar quarter of 1990 to report liability for floor stocks tax imposed under section 4682(h) and filed Form 720 for the first calendar quarter of 1990 without reporting section 4682 liability, the person must file a supplemental Form 720 for that quarter on or before October 9, 1990.

(ii) *Filing instructions.* The supplemental Form 720 shall be marked "SUPPLEMENTAL—1st QUARTER 1990" at the top. Only the liability for tax under section 4682 (IRS No. 20) for the first calendar quarter of 1990 shall be reported on this form. Part II of the supplemental Form 720 shall be completed as follows. Enter the amount from IRS No. 20 on Line 1 and again on Line 3. Do not make any adjustments on Line 2. Enter the amount from Line 3 on Line 4(a)A and again on Line 4(b). Enter any amount already paid relating to section 4682 liability for 1990 on Line 4(c). If the amount on Line 3 exceeds the amount on Line 4(c), pay the balance with the return.

(b) *Returns for floor stocks tax imposed in 1991, 1992, 1993, and 1994*—(1) *In general.* Each return required by §52.6011(a)-1T reporting floor stocks tax imposed under section 4682(h) shall be filed on or before May 31 of the year the tax is imposed. Each of these returns will be a return for the first calendar quarter of the year in which the tax is imposed. In the case of a person not otherwise required to file Form 720 (or other return on which this floor stocks tax is reported), the return shall be marked "FINAL—FLOOR STOCKS" at the top.

(2) *Special rule.* Only one quarterly Form 720 shall be filed for a calendar quarter. If a person is also required to report liability for other excise taxes for the quarter on a Form 720 and such Form 720 would otherwise be due on or before a date earlier than the date provided in paragraph (b)(1) of this section, the person shall file only one Form 720 on or before the date provided in paragraph (b)(1) of this section. This rule does not extend the time for making deposits or paying any other excise tax.

(c) *Cross reference.* For provisions relating to timely mailing treated as timely filing and paying, see section 7502. For provisions relating to time for performance of acts where last day for performance falls on Saturday, Sunday, or legal holiday, see section 7503. For provisions relating to time and place for paying floor stocks tax shown on the return, see §52.6151(a)-1T(b).

Par. 7. Section 52.6091-1 is removed and new §52.6091-1T is added to read as follows.

§52.6091-1T Place for filing returns (temporary).

(a) *Quarterly returns.* Quarterly returns shall be filed in accordance with the instructions applicable to the return.

(b) *Monthly and semimonthly returns.* Monthly and semimonthly returns required by §52.6011(a)-1T(b) shall be filed in accordance with the instructions of the district director requiring such filing.

Par. 8. New §§52.6101-1T and 52.6109(a)-1T are added to read as follows.

§52.6101-1T Period covered by returns (temporary).

See §52.6011(a)-1T for the rules relating to the period covered by the return.

§52.6109(a)-1T Identifying numbers (temporary).

Every person required by §52.6011(a)-1T to make a return shall provide the identifying number required by the instructions applicable to the return.

Par. 9. Section 52.6151-1 is removed and new §52.6151(a)-1T is added to read as follows.

§52.6151(a)-1T Time and place for paying tax shown on return (temporary).

(a) *In general.* Except as provided in paragraph (b) of this section, the tax shall be paid at the time prescribed in §§52.6071(a)-1 and 52.6071(a)-2T for filing the return, and at the place prescribed in §52.6091(a)-1T for filing the return.

(b) *Floor stocks tax imposed under section 4682(h).* For each year in which tax is imposed under section 4682(h), the tax shall be paid on or before April 1 of that year. The payment shall be accompanied by Form 8109, *Federal Tax Deposit Coupon* (or any other form designated by the Commissioner for making deposits) and deposited in accordance with the instructions applicable to that form. For years in which the tax is reported on Form 720 and deposits are accompanied by Form 8109, mark the boxes on Form 8109 for "720" and "1st Quarter."

(c) *Cross reference.* For provisions relating to use of Government depositaries, see §§52.6302(c)-1 and 52.6302(c)-2T.

Par. 10. New §52.6302(c)-2T is added to read as follows.

§52.6302(c)–2T Use of Government depositaries under section 4681 (temporary).

(a) *Overview.* This section provides rules relating to deposits of tax imposed under section 4681. The provisions of this section shall not apply to taxes for the month or the semimonthly period in which the taxpayer receives notice from the district director that returns are required under §52.6011(a)–1T(b), or for any subsequent month or semimonthly period for which such a return is required.

(b) *Semimonthly deposits*—(1) *In general.* Except as provided in paragraph (b)(3) of this section, each person required by §52.6011(a)–1T(a) to file a return shall make deposits of the tax imposed under section 4681 for a semimonthly period (as defined in paragraph (b)(2) of this section) on or before the last day of the second following semimonthly period.

(2) *Semimonthly period.* The term "semimonthly period" means the first 15 days of a calendar month or the portion of a calendar month following the 15th day of the month.

(3) *Special rule for deposits relating to the first three semimonthly periods of the third calendar quarter of 1990.* The deposit of tax imposed under section 4681 for the first three semimonthly periods of the third calendar quarter of 1990 is due on or before September 27, 1990.

(c) *Safe harbor rules*—(1) *Persons eligible.* The provisions of this paragraph (c) apply only to persons that reported liability for tax under section 4681 for the second preceding calendar quarter.

(2) *In general.* Except as otherwise provided in paragraph (c)(3) of this section, a person will be considered to have complied with the semimonthly deposit requirement if the deposit for the semimonthly period is not less than 1/6 (16.67 percent) of the total tax liability under section 4681 for the second preceding calendar quarter, and the person deposits any underpayment for the current calendar quarter on or before the last day of the second calendar month following the end of the quarter.

(3) *Special rule*—(i) *Applicability.* The safe harbor rule of paragraph (c)(2) is modified for semimonthly periods during the first and second quarters following the effective date of—

(A) An increase in the base tax amount under section 4681(b); or

(B) A change in the treatment of ODCs that are described in section 4682(g)(1).

(ii) *Rule.* With respect to semimonthly periods during such calendar quarters, a person will be considered to have complied with the semimonthly deposit requirement only if the deposit for the semimonthly period is not less than 1/6 (16.67 percent) of the tax liability the person would have had under section 4681 for the second preceding calendar quarter if the increased base tax amount or the change in treatment had been in effect for such preceding calendar quarter.

(d) *Remittance of deposits.* Each deposit shall be accompanied by Form 8109, *Federal Tax Deposit Coupon* (or any other form designated by the Commissioner for making deposits) and remitted in accordance with the instructions applicable to that form.

(e) *Effective date.* This section is effective as of July 1, 1990, for deposits relating to the tax imposed under section 4681 for quarters beginning after June 30, 1990.

Par. 11. The authority for Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805

Par. 12. Section 602.101(c) is revised by inserting in the appropriate places in the table "52.4682–1T(b)(2)-(iii) . . .1545–1153", "52.4682–2T(b) . . . 1545–1153", "52.4682–2T(d) . . . 1545–1153", "52.4682–3T(c)(2) . . . 1545–1153", "52.4682–3T(g) . . . 1545–1153", and "52.4682–4T(f) . . . 1545–1153".

Fred T. Goldberg, Jr.,
Commissioner of Internal Revenue.

Approved August 24, 1990.

Kenneth W. Gideon,
Assistant Secretary of the Treasury.

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26 CFR 52.4681–1T: Taxes imposed with respect to ozone-depleting chemicals.

Pursuant to the Convention on the Privileges and Immunities of the United Nations, the United Nations may make purchases for its official use free of certain federal excise taxes. See Rev. Rul. 90–83, page 219.

Chapter 44.—Qualified Investment Entities

Section 4982.—Excise Tax on Undistributed Income of Regulated Investment Companies

26 CFR 55.4982–1: Imposition of excise tax on undistributed income of regulated investment companies.
(Also Sections 852, 6011; 1.852–11T, 55.6011–1, 5h.5.)

Election under section 4982(e)(4). If the first calendar year for which a regulated investment company (RIC) has made an election under section 4982(e)(4) of the Code (the "election year") is not the first calendar year section 4982 applies to the RIC, then for purposes of determining the RIC's required distribution under section 4982(b), the RIC's capital gain net income for the election year is determined on the basis of the period that begins on November 1 of the preceding calendar year and that ends on the last day of the RIC's tax year ending in November (or December) of the election year. For purposes of section 852(b)(3)(C), the first tax year to which an election under section 4982(e)(4) applies is the first tax year ending in November (or December) of the election year.

Rev. Rul. 90–57

ISSUES

(1) If the first calendar year for which a regulated investment company's (RIC's) election is in effect under section 4982(e)(4) of the Internal Revenue Code (the election year) is not the first calendar year section 4982 applies to the RIC, what period is used under section 4982(e)(2) to determine the RIC's capital gain net income for the election year for purposes of determining the RIC's required distribution under section 4982(b)?

(2) What is the first tax year to which an election under section 4982(e)(4) of the Code "applies" for purposes of section 852(b)(3)(C)?

LAW AND ANALYSIS

Issue 1. Effective for calendar years beginning after December 31, 1986, section 4982(a) of the Code imposes an excise tax on every RIC for each calendar year. The tax is equal to 4 percent of the excess (if any) of the RIC's "required distribution" for the calendar year over the "distributed amount" for the calendar year.

Section 4982(b)(1) of the Code defines the required distribution for a calendar year in general as the sum of 98 percent of the RIC's ordinary income for the calendar year plus 98 percent of the RIC's capital gain net income for the 1-year period ending on October 31 of the calendar year.

Section 4982(c)(1) of the Code defines the distributed amount for a calendar year in general as the sum of the deduction for dividends paid (as defined in section 561) during the calendar year plus any amount on which tax is imposed under section 852(b)(1) or 852(b)(3)(A) for any tax year ending in that calendar year.

Section 4982(c)(2) of the Code provides that the distributed amount for a calendar year is increased by any overdistribution in the preceding year.

Section 4982(e)(2)(A) of the Code provides that, for purposes of section 4982, the term "capital gain net income" has the meaning given to that term by section 1222(9), but determined by treating the 1-year period ending on October 31 of any calendar year as the RIC's tax year. Under section 4982(e)(2)(B), this amount is reduced (but not below the amount of the RIC's net capital gain) by the RIC's net ordinary loss for the calendar year.

Section 4982(e)(2)(C)(i) of the Code provides that, for purposes of section 4982, the term "net capital gain" has the meaning given to that term by section 1222(11), but determined by treating the 1-year period ending on October 31 of any calendar year as the RIC's tax year.

Section 4982(e)(4) of the Code allows a RIC having a tax year ending with the month of November or December to elect to determine its capital gain net income for purposes of sections 4982(b)(1) and 4982(e)(2) by taking its tax year into account in lieu of the 1-year period ending on October 31 of the calendar year.

Section 5h.5(a)(2)(iv) of the Temporary Regulations—Elections Under Various Public Laws provides that the election under section 4982(e)(4) of the Code must be filed on or before the later of March 15 of the first calendar year after the end of the first excise tax period for which the election is to be effective or the due date (including any extensions granted) for filing the excise tax return for such period.

For purposes of determining a RIC's required distribution under section 4982(b) of the Code for the calendar year immediately preceding the election year (the preceding calendar year), a RIC's capital gain net income is determined without regard to capital gains and losses that are attributable to the period after October 31 of that year. The RIC's capital gain net income for the election year must therefore be determined by taking into account the RIC's capital gains and losses for the period after October 31 of the preceding calendar year in addition to the RIC's capital gains and losses from the beginning of the election year through the end of its tax year ending in November or December of the election year. If that were not the case, 1 or 2 months of capital gains and losses would never be taken into account for purposes of section 4982.

Issue 2. For purposes of determining the amount a RIC may designate as capital gain dividends for a tax year, section 852(b)(3)(C) of the Code provides a special rule that excludes from the determination of the RIC's net capital gain for the tax year certain capital losses attributable to transactions after October 31 of that tax year (post-October capital losses). This rule applies only to a tax year to which an election under section 4982(e)(4) "does not apply." However, because the excise tax is based on a calendar year, when an election is made, it is necessary to identify the first tax year to which the election "applies" within the meaning of section 852(b)(3)(C).

This special rule concerning post-October capital losses is necessary whenever a RIC's tax year ends after the 1-year period ending October 31 that is used to determine the RIC's capital gain net income for purposes of section 4982 of the Code. By excluding post-October capital losses from the determination of the RIC's net capital gain, the rule better matches the amount the RIC may designate as capital gain dividends for the tax year and the amount the RIC must distribute under section 4982 for the calendar year.

Without the election under section 4982(e)(4) of the Code, a RIC's tax year (other than some short years or a tax year ending October 31) always falls in more than one "1-year period" (that is, the period used under section 4982(b)(1)(B) and 4982(e)(2) to determine the required distribution for purposes of the excise tax). On the other hand, when a RIC makes an election under section 4982(e)(4) of the Code for a calendar year, the "1-year period" of sections 4982(b)(1)(B) and 4982(e)(2) (including, in the case of an election year, the 13- or 14-month period) ends on the last day of the RIC's tax year ending in November (or December) of that calendar year. Thus, the rule of section 852(b)(3)(C) is not necessary for a tax year ending in November (or December) of a calendar year for which the election is in effect.

HOLDINGS

(1) If the first calendar year for which a RIC's election is in effect under section 4982(e)(4) of the Code (the election year) is not the first calendar year section 4982 applies to the RIC, the RIC's capital gain net income for the election year under section 4982(e)(2) for purposes of determining the RIC's required distribution under section 4982(b) is determined on the basis of the period that begins on November 1 of the preceding calendar year and that ends on the last day of the RIC's tax year ending in November (or December) of the election year.

(2) For purposes of section 852(b)(3)(C) of the Code, the first tax year to which an election under section 4982(e)(4) applies is the first tax year ending in November (or December) of the election year.

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26 CFR 5h.5: Time and manner of making certain election under the Tax Reform Act of 1986.

(1) If the first calendar year for which a regulated investment company's (RIC's) election is in effect under section 4982(e)(4) of the Code is not the first calendar year section 4982 applies to the RIC, what period is used under

section 4982(e)(2) to determine the RIC's capital gain net income for the election year for purposes of determining the RIC's required distribution under section 4982(b)? (2) What is the first tax year to which an election under section 4982(e)(4) of the Code applies for purposes of section 852(b)(3)(C)? See Rev. Rul. 90-57, page 247.

Subtitle F.—Procedure and Administration
Chapter 61.—Information and Returns
Subchapter A.—Returns and Records
Part II.—Tax Returns or Statements
Subpart B.—Income Tax Returns

Section 6011.—General Requirement of Return, Statement or List

Printing of substitutes for Form W-2, Wage and Tax Statement, Form W-2P, Statement for Recipients of Annuities, Pensions, Retired Pay, or IRA Payments, and Form W-3, Transmittal of Income and Tax Statements. See Rev. Proc. 90-48, page 601.

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26 CFR 55.6011-1: General requirement of return, statement, or list.

If the first calendar year for which a regulated investment company's (RIC's) election is in effect under section 4982(e)(4) of the Code is not the first calendar year section 4982 applies to the RIC, what period is used under section 4982(e)(2) to determine the RIC's capital gain net income for the election year for purposes of determining the RIC's required distribution under section 4982(b). See Rev. Rul. 90-57, page 247.

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 1991 to reflect changes in the cost of living. See Rev. Proc. 90-64, page 674.

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26 CFR 1.6012-5: Composite return in lieu of specified form.

An electronically filed Form 1040, U.S. Individual Income Tax Return, which is a composite return, is described. See Rev. Proc. 90-62, page 659.

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 and trusts and estates for taxable years beginning in 1991 to reflect changes in the cost of living. See Rev. Proc. 90-64, page 674.

Part III.—Information Returns
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.

Specification for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 90-44, page 498.

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26 CFR 1.6041-1: Return of information as to payments of $600 or more.

Printing of substitutes for Form W-2, Wage and Tax Statement, Form W-2P, Statement for Recipients of Annuities, Pensions, Retired Pay, or IRA Payments, and Form W-3, Transmittal of Income and Tax Statements. See Rev. Proc. 90-48, page 601.

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26 CFR 1.6041-2: Return of information as to payments to employees.

Printing of substitutes for Form W-2, Wage and Tax Statement, Form W-2P, Statement for Recipients of Annuities, Pensions, Retired Pay, or IRA Payments, and Form W-3, Transmittal of Income and Tax Statements. See Rev. Proc. 90-48, page 601.

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26 CFR 7.6041-1: Return of information as to payments of winnings from bingo, keno, and slot machines (Temporary).

Specification for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 90-44, page 498.

Section 6041A.—Returns Regarding Payments of Remuneration for Services and Direct Sales

Specification for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 90-44, page 498.

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.

Specification for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 90-44, page 498.

Section 6043.—Liquidating, etc., Transactions

Specification for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 90-44, page 498.

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.

Specification for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 90-44, page 498.

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26 CFR 1.6044-5: Statements to recipients of patronage dividends

Specification for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 90-44, page 498.

Section 6045.—Returns of Brokers

26 CFR 1.6045-1: Returns of information of brokers and barter exchanges.

Specification for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 90-44, page 498.

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26 CFR 1.6045-1: Returns of information of brokers and barter exchanges (Temporary).

Specification for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 90-44, page 498.

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26 CFR 1.6045-2: Furnishing statement required with respect to certain substitute payments.

Specification for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 90-44, page 498.

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26 CFR 1.6045-3T: Information reporting on real estate transactions (Temporary).

Specification for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 90-44, page 498.

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.

Specification for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 90-44, page 498.

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26 CFR 1.6047-1: Information to be furnished with regard to employee retirement plan covering an owner-employee.

Printing of substitutes for Form W-2, Wage and Tax Statement, Form W-2P, Statement for Recipients of Annuities, Pensions, Retired Pay,

or IRA Payments, and Form W-3, Transmittal of Income and Tax Statement. See Rev. Proc. 90-48, page 601.

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.

Specification for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 90-44, page 498.

26 CFR 1.6049-4: Return of information as to interest paid and original issue discount includible in gross income after December 31, 1982.

Standard and alternative procedures are provided for information reporting on interest payments when one corporation acquires substantially all the assets and assumes substantially all the liabilities of another corporation. See Rev. Proc. 90-57, page 641.

26 CFR 1.6049-5T: Reporting by brokers of interest and original issue discount on and after January 1, 1986 (Temporary).

Specification for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 90-44, page 498.

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.

Specification for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 90-44, page 498.

26 CFR 1.6049-7T: Returns of information with respect to REMIC regular interests and collateralized debt obligations (Temporary).

Specification for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 90-44, page 498.

Section 6050A.—Reporting Requirements of Certain Fishing Boat Operators

26 CFR 1.6050A-1: Reporting requirements of certain fishing boat operators.

Specification for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 90-44, page 498.

Section 6050B.—Returns Relating to Unemployment Compensation

26 CFR 1.6050B-1: Information returns by person making unemployment compensation payments.

Specification for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 90-44, page 498.

Section 6050D.—Returns Relating to Energy Grants and Financing

26 CFR 1.6050D-1: Information returns relating to energy grants and financing.

Specification for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 90-44, page 498.

Section 6050E.—State and Local Income Tax Refunds

26 CFR 1.6050E-1: Reporting of State and local income tax refunds.

Specification for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 90-44, page 498.

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.

Specification for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 90-44, page 498.

26 CFR 1.6050H-2: Time, form, and manner of reporting interest received on qualified mortgage.

Specification for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 90-44, page 498.

Section 6050I.—Returns Relating to Cash Received in Trade or Business

26 CFR 1.6050I-1T: Returns relating to cash in excess of $10,000 received in a trade or business after December 31, 1989 (temporary).

T.D. 8304

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

Returns Relating to Cash in Excess of $10,000 Received in a Trade or Business

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations that require a person who currently must report the receipt of cash in excess of $10,000 with respect to a transaction to also make a report each time subsequent cash payments received within a one-year period with respect to the same transaction or a related transaction aggregate an amount in excess of $10,000. These regulations enable law enforcement authorities to ascertain the magnitude of large transfers of cash with respect to the same transaction. The regulations affect trades or businesses that are currently required to report large receipts of cash.

EFFECTIVE DATE: These regulations are effective for amounts received after December 31, 1989.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

This regulation is being issued without prior notice and public procedure pursuant to the Administrative Procedure Act (5 U.S.C. 553). For this reason, the collection of information contained in this regulation has been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget (OMB) under control number 1545-0892. The estimated annual burden per respondent varies from 11 minutes to 26 minutes, depending upon individual circumstances, with an average of 18 minutes.

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

For further information concerning this collection of information, and where to submit comments on this collection of information, the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble to the cross-reference notice of proposed rulemaking published in *** [IA-41-89, page 845, this Bulletin].

Background

This document contains temporary regulations amending the Income Tax Regulations under section 6050I of

the Internal Revenue Code of 1986 relating to returns required in the case of cash in excess of $10,000 received in a trade or business.

Explanation of Provisions

The temporary regulations require persons engaged in a trade or business who currently must report the receipt of cash in excess of $10,000 with respect to a transaction to also make a report each time that subsequent payments received within a one-year period with respect to the same transaction or a related transaction aggregate an amount in excess of $10,000. Under existing regulations, a report must be made only if a single subsequent payment exceeds $10,000. The temporary regulations will enable law enforcement authorities to ascertain the magnitude of large transfers of cash with respect to the same transaction.

Special Analyses

These rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis 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 final Regulatory Flexibility Act Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking for the regulations will be submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

Need for Temporary Regulations

There is need for immediate guidance with respect to the provisions contained in this Treasury decision. For this reason, it is found impracticable to issue this Treasury decision with prior notice as required by subsection (b) of section 553 of title 5 of the United States Code.

* * * * *

Proposed Amendments to the Regulations

Accordingly, Title 26, Chapter 1, Parts 1 and 602 of the Code of Federal Regulations is amended as follows: Part 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1986

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

Authority: 26 U.S.C. 7805 *** Section 1.6050I-1T also issued under 26 U.S.C. 6050I.

Par. 2. Section 1.6050I-1T is revised to read as follows:

§1.6050I-1T Returns relating to cash in excess of $10,000 received in a trade or business after December 31, 1989 (temporary).

(a) [Reserved]

(b) *Multiple payments.* The receipt of cash deposits or cash installment payments (or other similar payments or prepayments) relating to a single transaction (or two or more related transactions) are reported under this section in different manners depending upon the dollar amounts of the initial and subsequent payments. Reporting of multiple payments is effected as follows:

(1) *Initial payment in excess of $10,000.* If the initial payment exceeds $10,000, the recipient must report the initial payment within 15 days of its receipt.

(2) *Initial payment of $10,000 or less.* If the initial payment does not exceed $10,000, the recipient must aggregate the initial payment and subsequent payments made within one year of the initial payment until such aggregate amount exceeds $10,000, and report with respect to the aggregate amount within 15 days after receipt of that payment which causes the aggregate amount to exceed $10,000.

(3) *Payments received subsequent to payments previously reportable.* In addition to any report required under paragraph (b)(1) or (b)(2) of this section, a report must be made each time that payments (not previously required to be reported under paragraph (b)(1) or (b)(2) of this section or this paragraph (b)(3)) made within a one-year period with respect to a single transaction (or two or more related transactions), individually or in the aggregate, exceed $10,000. Such report must be made within 15 days after receipt of that payment which causes the aggregate amount received in the one-year period to exceed $10,000. (If payments are made within a 15-day period which, under paragraph (b)(1) or (b)(2) or this paragraph (b)(3), would require more than one report to be made, the recipient may elect to make a single report with respect to such payments. Such single report must be made no later than the date by which the first of the separate reports must be made.)

(4) *Example.* On January 10, 1990, M receives an initial cash payment of $11,000 with respect to a transaction. M receives subsequent cash payments with respect to the same transaction of $4,000 on February 15, 1990, $6,000 on March 20, 1990, and $12,000 on May 15, 1990. M must make a report with respect to the payment received on January 10, 1990, by January 25, 1990. M must also make a report with respect to the payments totalling $22,000 received from February 15, 1990, through May 15, 1990. This report must be made by May 30, 1990, that is, within 15 days of the date that the subsequent payments, all of which were received within a one-year period, exceeded $10,000.

(c) [Reserved]

(d) [Reserved]

(e) *Time, manner, and form of reporting*—(1) *Time of reporting.* (i) Except as otherwise provided in paragraph (e)(1)(ii), the reports required by this section must be filed with the Internal Revenue Service by the 15th day after the date the cash is received. In the case of multiple payments relating to a single transaction (or two or more related transactions), see paragraph (b) of this section.

(ii) If a report is required by paragraph (b)(3) of this section with respect to payments received after December 31, 1989, and such report would not have been required pursuant to §1.6050I-1(b), then such report must be filed no later than the later of (A) 15 days after the receipt of the payment which causes a report to be required by paragraph (b)(3) of this section or (B) 15 days after July 9, 1990.

(2) [Reserved]

(3) [Reserved]

(f) [Reserved]

(g) [Reserved]

(h) *Effective date.* This section is effective for amounts received after December 31, 1989. The rules contained in §1.6050I-1 remain effective with respect to amounts received after December 31, 1989, to the extent they are not inconsistent with the rules contained in this section.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

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

Authority: 26 U.S.C. 7805.

Par. 4. In the table in §602.101(c), the control number for §1.6050I-1T continues to read: "1.6050I-1T. . . 1545-0892."

Fred T. Goldberg, Jr.,
Commissioner of Internal Revenue.
Approved

Kenneth W. Gideon,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on July 6, 1990, 8:45 a.m., and published in the issue of the Federal Register for July 9, 1990, 55 F.R. 28021)

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).

Specification for paper substitutes for Forms 1098, 1098, 1099, 5498, and W-2G. See Rev. Proc. 90-44, page 498.

Section 6050N.—Returns Regarding the Payment of Royalties

Specification for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 90-44, page 498.

Subpart C.—Information Regarding Wages Paid Employees

Section 6051.—Receipts for Employees

26 CFR 31.6051-1: Statement for employees.

Printing of substitutes for Form W-2, Wage and Tax Statement, Form W-2P, Statement for Recipients of Annuities, Pensions, Retired Pay, or IRA Payments, and Form W-3, Transmittal of Income and Tax Statements. See Rev. Proc. 90-48, page 601.

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26 CFR 31.6051-2: Information returns on Form W-3 and Internal Revenue Service copies of Form W-2.

Printing of substitutes for Form W-2, Wage and Tax Statement, Form W-2P, Statement for Recipients of Annuities, Pensions, Retired Pay, or IRA Payments, and Form W-3, Transmittal of Income and Tax Statements. See Rev. Proc. 90-48, page 601.

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.

Procedures for signing an electronic return are described. See Rev. Proc. 90-62, page 659.

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.

Printing of substitutes for Form W-2, Wage and Tax Statement, Form W-2P, Statement for Recipients of Annuities, Pensions, Retired Pay, or IRA Payments, and Form W-3, Transmittal of Income and Tax Statements. See Rev. Proc. 90-48, page 601.

Part VI.—Extension of Time for Filing Returns

Section 6081.—Extension of Time for Filing Returns

26 CFR 1.6081-5: Extensions of time in the case of certain partnerships, corporations and U.S. citizens and residents.

T.D. 8312

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Extension of Time to File for Taxpayers Outside the United States and Puerto Rico

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document provides final Income Tax Regulations relating to the extension of time to file federal income tax returns and to pay any taxes owing by United States citizens and United States residents who are outside of the United States and Puerto Rico. Section 6081 of the Internal Revenue Code Act of 1986 provides that the Secretary may grant a reasonable extension of time to file federal income tax returns. These regulations provide the public with guidance needed to comply with that section and affect United States citizens and residents outside of the United States and Puerto Rico.

DATES: Effective Date: September 10, 1990. These final regulations apply to federal income tax returns due on or after April 15, 1988.

SUPPLEMENTARY INFORMATION:

Background

On February 23, 1989, the FEDERAL REGISTER published proposed amendments (54 FR 7783) [INTL-461-87, 1989-1 C.B. 1025] to the Income Tax Regulations (26 CFR Part 1) and temporary Income Tax Regulations (54 FR 7762) [T.D. 8241, 1989-1 C.B. 297] under section 6081(a) of the Internal Revenue Code of 1986. One written comment responding to the notice was received. No public hearing was requested and, therefore, a hearing was not held. After consideration, the proposed regulations are adopted with only minor changes by this Treasury Decision.

Explanation of Provisions

A commenter suggested that §1.6081-4T(a)(5) be amended to include non-military United States citizens and residents on temporary business assignment outside the United States and Puerto Rico but whose tax home remains in the United States. Section 1.6081-4T(a)(5) currently provides an automatic extension of time to file an income tax return for United States citizens or residents whose tax homes are outside the United States and Puerto Rico. That section recognizes that an individual who maintains his tax home abroad may have difficulty filing a return by the due date. Section 1.6081-4T(a)(6) provides an automatic extension of time to file an income tax return for United States citizens or residents in military or naval service on duty, including non-permanent or short term duty, outside the United States and Puerto Rico. That section recognizes that, due to the nature of military service, an individual may be unable to file a return on the due date. The Service does not believe that a non-military individual on short term assignment outside the United States and Puerto Rico would encounter hardships as significant as those faced by individuals to

whom the above provisions apply in filing a return by the due date or requesting an extension of time to file. Therefore, the regulations have not been amended to reflect this comment.

Special Analyses

It has been determined that these rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. 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 final Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking for the regulations was submitted to the Administrator 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 TAX REGULATIONS

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

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

Par. 2. Section 1.6081-4T is removed.

Par. 3. New §1.6081-5 is added to read as follows:

§1.6081-5 Extensions of time in the case of certain partnerships, corporations and U.S. citizens and residents.

(a) The rules in paragraphs (a) through (e) of this section apply to returns of income due after April 15, 1988. An extension of time for filing returns of income and for paying any tax shown on the return is hereby granted to and including the fifteenth day of the sixth month following the close of the taxable year in the case of:

(1) Partnerships which are required under §1.6031-1(e)(2) to file returns on the fifteenth day of the fourth month following the close of the taxable year of the partnership, and which keep their records and books of account outside the United States and Puerto Rico;

(2) Domestic corporations which transact their business and keep their records and books of account outside the United States and Puerto Rico;

(3) Foreign corporations which maintain an office or place of business within the United States;

(4) Domestic corporations whose principal income is from sources within the possessions of the United States;

(5) United States citizens or residents whose tax homes and abodes, in a real and substantial sense, are outside the United States and Puerto Rico; and

(6) United States citizens and residents in military or naval service on duty, including non-permanent or short term duty, outside the United States and Puerto Rico.

(b) In order to qualify for the extension under this section, a statement must be attached to the return showing that the person for whom the return is made is a person described in paragraph (a) of this section.

(c) For purposes of paragraph (a)(5) of this section, whether a person is a United States resident will be determined in accordance with section 7701(b) of the Code. The term "tax home," as used in paragraph (a)(5), will have the same meaning which it has for purposes of section 162(a)(2) (relating to travel expenses away from home). If a person does not have a regular or principal place of business, that person's tax home will be considered to be his regular place of abode in a real and substantial sense.

(d) In order to qualify for the extension under paragraph (a)(6), the assigned tour of duty outside the United States and Puerto Rico must be for a period that includes the entire due date of the return.

(e) A person otherwise qualifying for the extension under paragraph (a)(5) or paragraph (a)(6) shall not be disqualified because he is physically present in the United States or Puerto Rico at any time, including the due date of the return.

(f) With respect to income tax returns due on April 15, 1988, an extension of time for filing a return of income and for paying any tax shown on that return is hereby granted to and including the fifteenth day of the sixth month following the close of the taxable year in the case of citizens or residents of the United States who are traveling outside the United States and Puerto Rico. A taxpayer will be considered to be traveling outside the United States and Puerto Rico only if the period of travel outside the United States and Puerto Rico is a period of at least fourteen days continuous travel that includes all of April 15, 1988. For returns due after April 15, 1988, no extension will be granted to taxpayers traveling outside the United States and Puerto Rico.

Fred T. Goldberg, Jr.,
Commissioner of Internal Revenue.

Approved July 27, 1990.

Kenneth W. Gideon,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on September 7, 1990, 8:45 a.m., and published in the issue of the Federal Register for September 10, 1990, 55 F.R. 37226)

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26 CFR 31.6081(a)-1: Extension of time for filing returns.

Printing of substitutes for Form W-2, Wage and Tax Statement, Form W-2P, Statement for Recipients of Annuities, Pensions, Retired Pay, or IRA Payments, and Form W-3, Transmittal of Income and Tax Statements. See Rev. Proc. 90-48, page 601.

Part VII.—Place for Filing Returns or Other Documents

Section 6091.—Place for Filing Returns of Other Documents

Printing of substitutes for Form W-2, Wage and Tax Statement, Form W-2P, Statement for Recipients of Annuities, Pensions, Retired Pay, or IRA Payments, and Form W-3, Transmittal of Income and Tax Statements. See Rev. Proc. 90-48, page 601.

Subchapter B.—Miscellaneous Provisions

Section 6111.—Registration of Tax Shelters

26 CFR 301.6111-1T: Questions and answers relating to tax shelter registration (temporary).

Tax shelter organizer receipt or subscription for a limited partnership.

When a tax shelter organizer, in connection with a tax shelter offering, accepts fully paid subscriptions for a proposed limited partnership that will be capitalized only upon receipt of a minimum number of subscriptions, the organizer is not required to furnish investors with the tax shelter registration number upon mere receipt of subscriptions to the tax shelter offering.

Rev. Rul. 90-84

ISSUE

When a tax shelter organizer, in connection with a tax shelter offering, accepts fully paid subscriptions for a proposed limited partnership that will be capitalized only upon receipt of a minimum number of subscriptions, and the subscription funds are temporarily placed in an interest bearing account for the sole benefit of the subscribers, does section 6111(b)(1) of the Internal Revenue Code require the organizer to provide investors with the tax shelter registration number at the time the organizer receives the subscriptions to the tax shelter offering?

FACTS

In 1988, *X* organizes and promotes *Z*, a limited partnership. *X*'s offering prospectus and other promotional materials represented that investors would realize tax benefits with respect to an investment in *Z* such that *Z* constituted a tax shelter as defined in section 6111(c) of the Code. Accordingly, *X* timely complied with the tax shelter registration requirements of section 6111(a)(1) and began soliciting subscriptions to *Z*.

X's plan for marketing interests in *Z* called for investors to subscribe in the amount of $10*x* per unit. Subscriptions were payable in full upon execution of the subscription agreement furnished with the prospectus. The offering prospectus and subscription agreement, however, provided that *Z* would not be capitalized unless subscriptions for at least 1,300 units were received. *X* specifically reserved the right not to fund *Z* and to withdraw the offering at any time prior to actual capitalization of *Z* with investor funds.

Pursuant to the terms of the subscription agreement, *X* placed the funds of the subscribers in an interest-bearing escrow account at a local financial institution. Under the terms of the escrow, *X* could not use these funds to satisfy its debts or obligations, and the financial institution could release the funds to *X* only upon capitalization of *Z*. In the event that *Z* was not capitalized, the escrow agent was to return all funds, together with interest, to the subscribers.

LAW AND ANALYSIS

Section 6111(a)(1) of the Code provides, in general, that a tax shelter organizer shall register the tax shelter with the Secretary not later than the day on which the first offering for sale of interests in such tax shelter occurs. Section 6111(d)(1) provides that the term "tax shelter organizer" includes the person principally responsible for organizing the tax shelter. Section 6111(b)(1) provides that any person who sells (or otherwise transfers) an interest in a tax shelter shall (at such times and in such manner as the Secretary shall prescribe) furnish to each investor who purchases (or otherwise acquires) an interest in such tax shelter from such person the identification number assigned by the Secretary to such tax shelter.

Q&A 40 of section 301.6111-1T of the temporary Regulations on Procedure and Administration provides that a tax shelter must be registered no later than the day of the first "offering for sale" of an interest in a tax shelter. Q&A 43 defines an "offering for sale" as any representation, oral or written, relating to participation as an investor in a tax shelter despite any explicit statement that such representation is not an offer for sale. The term includes any advertisement relating to the tax shelter or other contact with prospective investors; federal and state security laws do not control for purposes of determining when such an offering occurs.

Q&A 42 of section 301.6111-1T of the temporary regulations states that the phrase "sale of an interest in a tax shelter" includes the sale of property, or any interest in property; the entry into a leasing arrangement; a consulting, management or other agreement for the performance of services; or the sale or entry into any other plan, investment, or arrangement.

Q&A 52 of section 301.6111-1T of the temporary regulations provides that the person who sells (or otherwise transfers) an interest in a tax shelter must furnish the registration number to the purchaser (or transferee) at the time of the sale (or transfer) of the interest (or, if later, within 20 days after the seller or transferor receives the registration number).

In the present situation, *X* made an offering for sale in the offering prospectus and other promotional materials for *Z* that is described in section 6111(a)(1) of the Code. Therefore, *X* was required to register *Z* as a tax shelter. However, investors executing subscription agreements did not acquire an interest in a tax shelter upon *X*'s receipt of their funds, but rather agreed to become participants in the tax shelter should *X* fund *Z* pursuant to the terms of the subscription agreement. Because *X* was not obligated to transfer an interest in an investment constituting a tax shelter to a subscriber prior to capitalization of *Z*, and because the transfer of funds at the time that the subscription agreement was executed was conditional, for purposes of section 6111, the subscription process did not itself result in the sale or transfer of interests in the shelter. A sale or transfer was not completed until all conditions were satisfied and *X* was obligated to transfer interests in the tax shelter to the subscribers.

Q&A 42 of section 301.6111-1T of the temporary regulations defines the phrase "sale of an interest in a tax shelter" very broadly to ensure that investors in tax shelters will be furnished with tax shelter registration numbers irrespective of the form of the investment. Q&A 42, however, does not require that the mere acceptance of subscriptions under the circumstances described above be treated as the sale or transfer of interests in the tax shelter.

HOLDING

If a tax shelter organizer, in connection with a tax shelter offering, accepts fully paid subscriptions for a proposed limited partnership that will be capitalized only upon receipt of a minimum number of subscriptions, and the subscription funds are temporarily placed in an interest bearing

account for the sole benefit of the subscribers, the tax shelter organizer is not required to furnish investors with the tax shelter registration number upon mere receipt of subscriptions to the tax shelter offering. That notice is required only when the tax shelter organizer is first unconditionally obligated to transfer a partnership interest to a subscriber.

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26 CFR 301.6111-1T: Questions and answers relating to tax shelter registration (temporary). (Also Section 469.)

Passive losses and tax shelter registration. Representations by a tax shelter organizer to prospective investors in a passive activity that certain losses of the activity may be disallowed to the extent that aggregate deductions from the activity exceed aggregate income from the activity have no effect on the computation of an investor's tax shelter ratio for purposes of section 6111 of the Code.

Rev. Rul. 90-85

ISSUE

If a partnership is a passive activity as defined in section 469(c) of the Internal Revenue Code and the organizer of the partnership represents to prospective investors that certain losses of the partnership may be disallowed to the extent that aggregate deductions exceed aggregate income from the partnership, what effect, if any, do such representations have on the computation of an investor's "tax shelter ratio" for purposes of determining whether the partnership is a tax shelter as defined in section 6111?

FACTS

In 1988, *B* organized a limited partnership, *PRS*, to engage in a trade or business. *B* intends to offer limited partnership units for sale pursuant to an exemption from registration of the type described in section 6111(c)(1)(B)(ii) of the Code. The private placement memorandum ("PPM") provides information from which any person could reasonably infer that for 1988, the aggregate amount of the deductions and 350 percent of the credits allocable to each investor will be more than twice the amount of money the investor contributes to the partnership before the end of 1988.

The PPM also indicates that the deductions allocable to each investor will exceed the income allocable to the investor from the investment in 1988, and that section 469 of the Code limits the deductions that may be taken by an investor with respect to *PRS* to the amount of the investor's passive income. If the deductions that may be disallowed as a result of section 469 are not taken into account, the aggregate amount of the deductions and 350 percent of the credits allocable to each investor for any of the first five years of the investment will not exceed twice the amount of money contributed by the investor before the end of each such year.

LAW AND ANALYSIS

Section 6111(a)(1) of the Code requires a tax shelter organizer to register the tax shelter not later than the day on which the first offering for sale of interest in such tax shelter occurs.

Section 6111(c)(1) of the Code provides that the term "tax shelter" means any investment (A) with respect to which any person could reasonably infer from the representations made, or to be made, in connection with the offering for sale of interests in the investment that the tax shelter ratio for any investor as of the close of any of the first five years ending after the date on which such investment is offered for sale may be greater than 2 to 1, and (B) which is (i) required to be registered under a federal or state law regulating securities, (ii) sold pursuant to an exemption from registration requiring the filing of a notice with a federal or state agency regulating the offering or sale of securities, or (iii) a substantial investment.

"Tax shelter ratio" is defined in section 6111(c)(2) of the Code as meaning, with respect to any year, the ratio that the aggregate amount of deductions and 350 percent of the credits that are represented to be potentially allowable to any investor for all periods up to (and including) the close of such year bears to the investment base for such investor as of the close of the tax year.

"Investment base" is defined generally in section 6111(c)(3)(A) of the Code to mean, with respect to any year, the amount of money and the adjusted basis of other property (reduced by any liability to which such other property is subject) contributed by the investor as of the close of the year. Certain borrowed and other amounts are excluded from the amount contributed for purposes of determining the investment base. *See* section 301.6111-1T of the temporary Regulations on Procedure and Administration, Q&A's 13 and 14.

Section 301.6111-1T of the temporary Regulations on Procedure and Administration, Q&A 6, provides that the term "amount of deductions" in section 6111(c)(2) means the amount of gross deductions and other similar tax benefits potentially allowable with respect to the investment. The temporary regulations provide in Q&A 8 that a deduction is considered to be represented as being potentially allowable to an investor if any statement is made (or will be made) in connection with the offering for sale of an interest in an investment indicating that a tax deduction or credit is available or may be used to reduce federal income tax or federal taxable income. The temporary regulations also provide in Q&A 10 that deductions and credits represented as being potentially allowable are taken into account in computing the tax shelter ratio regardless of whether any qualifying statements are made.

Section 469(a) of the Code, in part, disallows passive activity losses or credits claimed by individuals for the taxable year. Section 469(d)(1) defines passive activity loss as the amount by which the aggregate losses from all passive activities for the tax year exceed the aggregate income from all passive activities during the tax year.

In the determination of whether an investment must be registered as a tax shelter pursuant to section 6111 of the Code, all deductions and credits potentially allowable as a result of the investment must be included when calculating an investor's tax shelter ratio. A deduction is potentially allowable even if it may be (or is) disallowed under section 469. Such deductions must be included as potentially allowable because an investor may have net aggregate passive activity income from other activities so that the limitation of section 469 does not apply. In addition, some investors, such as certain corporations, are

not subject to section 469. *See* section 469(a)(2).

Notwithstanding the potential application of section 469 of the Code, a person could reasonably infer that the potentially allowable deductions to be allocated to investors in *PRS* will result in a tax shelter ratio in excess of 2 to 1. Accordingly, *PRS* is a tax shelter as defined in section 6111 and *B* must file Form 8264 to register *PRS* as a tax shelter not later than the day on which the first offering for sale of interests in *PRS* occurs.

HOLDING

Even if a tax shelter organizer represents to prospective investors in a passive activity, as defined in section 469(c) of the Code, that certain losses of the activity may be disallowed to the extent that aggregate deductions from the activity exceed aggregate income from the activity, such representations have no effect on the computation of an investor's tax shelter ratio for purposes of section 6111. Deductions that may be (or are) disallowed under section 469 are treated as potentially allowable for purposes of section 6111.

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26 CFR 301.6111-1T: Questions and answers relating to tax shelter registration (temporary).

Partnership registering as a tax shelter. In determining whether a partnership must be registered as a tax shelter under section 6111 of the Code, the numerator of the tax shelter ratio calculated for each partner under section 6111(c)(2) includes each partner's share of the gross deductions of the partnership. If the partnership invests in a second partnership, the numerator of the tax shelter ratio for each partner in the first partnership includes that partner's share of the gross deductions of both partnerships.

Rev. Rul. 90-86

ISSUES

(1) In a determination of whether a partnership must be registered as a tax shelter under section 6111 of the Internal Revenue Code, does the numerator of the tax shelter ratio calculated under section 6111(c)(2) include only the net deductions allocable to a partner or the gross deductions allocable to that partner?

(2) If a partnership invests in a second partnership, does the numerator of the tax shelter ratio for a partner in the first partnership include the net or the gross deductions of the second partnership?

FACTS

PRS 1 is a limited partnership that was organized by *C* in 1988. *C* filed Form 8264, Application for Registration as a Tax Shelter, to register *PRS 1* as a tax shelter. *PRS 1* owns and operates a variety of commercial real estate properties. *B* owns a 5 percent limited partnership interest in *PRS 1*.

PRS 2 is a limited partnership organized by general partner *A* in 1990. Neither *B* nor *C* participated in the organization of *PRS 2*. *PRS 2* was organized for the purpose of investing in commercial real estate. The offering material indicated that *PRS 2* would purchase *B*'s interest in *PRS 1* for $200,000. In addition, the offering material represented that *PRS 2* would purchase a building for $1,000,000 by paying $100,000 and incurring a mortgage liability of $900,000. *PRS 2* is not a projected income investment as defined in Q&A 57A of section 301.6111-1T of the temporary Regulations on Procedure and Administration. *A* and nine limited partners will each own a 10 percent partnership interest in *PRS 2*. Each partner will contribute $30,000 upon joining *PRS 2*, for a total capital contribution to *PRS 2* of $300,000.

In making an investment in *PRS 2*, an investor could have reasonably inferred from the offering material that each partner would receive net deductions of $20,000 in 1990. *A* based the offering material projections for 1990, in part, on the assumptions (1) that the investment in the building would generate gross income of $200,000 and gross deductions of $300,000, and (2) that the investment in *PRS 1* would generate net deductions of $100,000 based on gross income of $500,000 and gross deductions of $600,000.

The sale of *B's* interest in *PRS 1* to *PRS 2* in 1990 was not anticipated at the time of *C's* original offering of interests in *PRS 1*. In addition, the sale of *B's* interest is not required to be registered under a federal or state law regulating securities, nor is the sale pursuant to an exemption from registration requiring the filing of a notice with a federal or state agency.

LAW AND ANALYSIS

Section 6111(a)(1) of the Code requires a tax shelter organizer to register a tax shelter not later than the day on which the first offering for sale of interests in the tax shelter occurs. Section 6111(c)(1) defines "tax shelter" as including any investment (A) with respect to which any person could reasonably infer from the representations made, or to be made, in connection with the offering for sale of interests in the investment that the tax shelter ratio for any investor as of the close of any of the first five years ending after the date on which the investment is offered for sale may be greater than 2 to 1, and (B) which (i) is required to be registered under a federal or state law regulating securities, (ii) is sold pursuant to an exemption from registration requiring the filing of a notice with a federal or state agency regulating the offering or sale of securities, or (iii) constitutes a substantial investment. Section 6111(c)(4) states that an investment is a "substantial investment" if the aggregate amount which may be offered for sale exceeds $250,000 and there are expected to be 5 or more investors.

"Tax shelter ratio" is defined in section 6111(c)(2) of the Code as, with respect to any year, the ratio that the aggregate amount of deductions and 350 percent of the credits that are represented as potentially allowable to an investor (the numerator) bears to the investment base (the denominator) for such investor as of the close of the tax year.

Q&A 6 of section 301.6111-1T of the temporary regulations provides that, in determining the tax shelter ratio for an investment, gross deductions are not to be offset by any gross income potentially to be derived from the investment. Thus, the term "amount of deductions" is not equivalent to the net loss, if any, attributable to the investment.

Q&A 9 of section 301.6111-1T of the temporary regulations provides that once an explicit representation is made (or will be made) regarding any tax benefit, all deductions or credits

typically associated with the investment will be inferred to have been represented as potentially allowable. Thus, the tax shelter ratio will be determined with reference to those tax benefits that are explicitly represented as being potentially allowable and to all other tax benefits that are typically associated with the investment.

Q&A 46 of section 301.6111-1T of the temporary regulations provides that if assets constituting a tax shelter are sold, and subsequently either the assets or interests in the assets are offered for sale by the purchaser, the purchaser must file a new application for registration if the resale constitutes a tax shelter, unless the tax shelter organizer with respect to the original sale is also the tax shelter organizer with respect to the resale and the facts pertaining to the resale were reflected in the application for registration filed with respect to the original sale.

Q&A 51 of section 301.6111-1T of the temporary regulations provides that if the resale of an interest does not constitute a tax shelter, the transferor must furnish the transferee of the interest with the original tax shelter registration number for the investment.

B's sale of its interest in *PRS 1* is not required to be registered under a federal or state law regulating securities and is not sold pursuant to an exemption from registration requiring the filing of a notice with a federal or state agency, and the amount *B* offered for sale did not exceed $250,000. Thus, *B* is not required to register the sale of its interest as a tax shelter because *B's* sale of its interest in *PRS 1* does not constitute a tax shelter. However, *B* is required to provide *PRS 1's* tax shelter registration number to *PRS 2*.

The offering by *A* of interests in *PRS 2* constitutes a substantial investment because the aggregate amount offered for sale exceeded $250,000 and *A* expected that there would be more than 5 investors. Accordingly, the question of whether the offering must be registered as a tax shelter depends on whether any person could reasonably infer from the representations made in connection with the offering that the tax shelter ratio for any investor in *PRS 2* as of the close of any of *PRS 2's* first 5 years would exceed 2 to 1.

The numerator of the tax shelter ratio equals the aggregate amount of deductions and 350 percent of the credits that are represented to be potentially allowable to any investor. *See* section 6111(c)(2)(A). Q&A 6 of section 301.6111-1T of the temporary regulations specifically provides that the term "amount of deductions" is not equivalent to the net loss, if any, attributable to the investment. Thus, the tax shelter ratio is calculated using the gross deductions rather than the "bottom line" or net loss deductions that may be allocated by a partnership to the investor. Similarly, if the offering materials for a partnership provide information concerning deductions that are to be derived from an activity conducted by a second partnership in which the first partnership is to be a partner, the tax shelter ratio for investors in the first partnership is calculated using the gross deductions rather than the bottom line or net loss deductions from the second partnership.

Thus, the numerator of the tax shelter ratio for an investor in *PRS 2* includes the investor's share of the gross deductions to be derived from *PRS 1* as well as the investor's share of the gross deductions to be derived from *PRS 2*. By excluding income and including the *PRS 2* partners' allocable shares of gross deductions derived from *PRS 1* and *PRS 2* in the tax shelter ratio, each partner in *PRS 2* is expected to be allocated $90,000 in deductions ($60,000 for the investment by *PRS 2* in *PRS 1*, and $30,000 for the investment in the building) for 1990. Because each partner has an investment base of $30,000 for 1990, the tax shelter ratio is 3 to 1.

This tax shelter ratio of 3 to 1 for 1990 could have been inferred from representations made in connection with the first offering for sale of an interest in *PRS 2*. Therefore, under section 6111(c)(1) of the Code, *A*, as the tax shelter organizer, is required to register *PRS 2* as a tax shelter at that time by filing Form 8264, Application for Registration as a Tax Shelter. *A* would be required to register *PRS 2* as a tax shelter even if the investment in *PRS 1* had not been identified at the time interests in *PRS 2* were sold, if an investor could have reasonably inferred from representations made in the offering material that the type of investment *PRS 2* was expected to make would result in a tax shelter ratio for any investor that may be greater than 2 to 1 as of the close of any of *PRS 2's* first 5 years.

HOLDINGS

1. In a determination of whether a partnership must be registered as a tax shelter under section 6111 of the Code, the numerator of the tax shelter ratio calculated for each partner under section 6111(c)(2) includes each partner's share of the gross deductions of the partnership.

2. If a partnership invests in a second partnership, the numerator of the tax shelter ratio for each partner in the first partnership includes that partner's share of the gross deductions of both partnerships.

Section 6114.—Treaty-Based Return Positions

26 CFR 301.6114-1: Treaty-based return positions.

T.D. 8305

DEPARTMENT OF THE TREASURY Internal Revenue Service

26 CFR Part 301

Treaty-Based Return Positions

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final Income Tax Regulations that amend final regulations previously issued on March 14, 1990, that relate to the requirement that any taxpayer who takes a position that a treaty of the United States overrules, or otherwise modifies, an internal revenue law of the United States shall disclose such position. These final regulations are necessary to provide additional guidance needed to implement section 6114 of the Internal Revenue Code.

DATES: These regulations are effective for taxable years of the taxpayer for which the due date for filing returns (without extensions) occurs after December 31, 1988.

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 Paperwork Reduction Act (44 U.S.C. 3507) under the control number 1545-1126. The estimated annual burden per respondent to comply with section 301.6114-1 varies from 1/2 hour to 3 hours depending on individual circumstances, with an average estimate of one hour.

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

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be directed to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224, and to the Office of Management and Budget, Attention: Desk Officer for the Department of Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Background

This document contains amendments to the Income Tax Regulations (26 CFR Part 301) under section 6114 of the Internal Revenue Code that were published in the FEDERAL REGISTER (55 FR 9438) on March 14, 1990 [T.D. 8292, 1990-1 C.B. 180]. These amendments respond to comments received after the final regulations under section 6114 were published and provide further guidance with respect to section 6114. These amendments are discussed below.

Explanation of provisions

Several commentators stated that the language of §301.6114-1(b)(4)(ii) was unclear. In response to these comments §301.6114-1(b)(4)(ii) has been revised to narrow specifically required reporting under section 6114 to certain payments received from related persons. In addition, paragraph (b)(4)(ii)(B)(*4*) includes, as a foreign person who must report under section 6114, a foreign related party as defined in section 6038A(c)(2).

In response to a comment, §301.6114-1(b)(5) and (c)(1) has been revised to clarify that income derived from certain independent personal services is subject to reporting under section 6114.

In response to comments, §301.6114-1(c)(7) has been revised to limit to foreign insurers and reinsurers only the class of persons required to report with respect to payments of insurance premiums described in section 4371. Thus, insureds and insurance brokers are not required to so report. Under the final regulations previously issued, insureds, insurance brokers, and foreign insurers or reinsurers were required to report, unless an exception to reporting applied. Information provided by commentators indicated that this information could be provided most efficiently by foreign insurers or reinsurers. Language has been added to §301.6114-1(d) to indicate that reporting with respect to payments of premiums must be made for each of three specified categories, as described in section 4371(a), and that aggregation of payments within each category is permitted. Also, for reports first due before May 1, 1991, the report may disclose, for the previous calendar year, for each of the three categories either the total amount of premiums derived in U.S. dollars (even if a portion of the premiums relate to risks that are not U.S. situs) or the total amount of premiums derived with respect to U.S. situs risks. For reports first due after April 30, 1991, the report must disclose, for the previous calendar year, for each of the three categories the total amount of premiums that is derived with respect to U.S. situs risks. In each case, as is the general rule, reasonable estimates of the amounts required to be disclosed will satisfy these reporting requirements. Foreign insurers and reinsurers must report for calendar years 1988 and 1989 no later than August 15, 1990.

Language has been added to §301.6114-1(c) to provide a rule, applicable only to individuals, that reporting of a treaty-based return position is not required for any payments received by the individual during the course of his taxable year if such payments, in total, do not exceed $10,000.

Special Analyses

It has been determined that these rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. 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 final Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking for the previous regulations under section 6114 was submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

* * * * *

Adoption of amendments to the regulations

Accordingly, 26 CFR Part 301 is amended as follows:

PART 301—REGULATIONS ON PROCEDURE AND ADMINISTRATION

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

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

Par. 2. Section 301.6114-1(b)(4)(ii), that portion of paragraph (b)(5) that precedes paragraph (b)(5)(i), and paragraph (c)(1) and (c)(7)(i) and (ii) are revised. In addition, one sentence is added at the beginning of that portion of paragraph (c) that follows paragraph (c)(7)(iii), four sentences are added at the end of that portion of paragraph (d) that follows paragraph (d)(4)(v), and one sentence is added at the end of paragraph (e), all to read as follows:

§301.6114-1 Treaty-based return positions.

* * * * *

(b) *Reporting specifically required.*

* * * * *

(4) ***

(ii) A treaty exempts from tax, or reduces the rate of tax on, fixed or determinable annual or periodical in-

come subject to withholding under sections 1441 or 1442 that a foreign person receives from a U.S. person, but only if—

(A) The payment is not properly reported to the Service on a Form 1042S; and

(B) The foreign person is any of the following:

(*1*) A controlled foreign corporation (as defined in section 957) in which the U.S. person is a U.S. shareholder within the meaning of section 951(b);

(*2*) A foreign corporation that is controlled within the meaning of section 6038 by the U.S. person;

(*3*) A foreign shareholder of the U.S. person that, in the case of tax years beginning on or before July 10, 1989, is controlled within the meaning of section 6038A by the foreign shareholder, or, in the case of tax years beginning after July 10, 1989, is 25-percent owned within the meaning of section 6038A by the foreign shareholder; or

(*4*) With respect to payments made after October 10, 1990, a foreign related party, as defined in section 6038A(c)(2)(B), to the U.S. person; or

(5) That, notwithstanding paragraph (c)(1) of this section, under a treaty—

* * * * *

(c) *Reporting requirement waived.*

* * * * *

(1) Except as provided in paragraph (b)(4) or (5) of this section, that a treaty has reduced the rate of withholding tax otherwise applicable to a particular type of fixed or determinable annual or periodical income subject to withholding under section 1441 or 1442, such as dividends, interest, rents, or royalties;

* * * * *

(7) ***

(i) The person claiming such treaty-based return position is an insured, as defined in section 4372(d) (without the limitation therein referring to section 4371(1)), or a U.S. or foreign broker of insurance risks,

(ii) Reporting under this section that would otherwise be required to be made by foreign insurers or reinsurers on a Form 720 on a quarterly basis is made on an annual basis on a Form 720 by a date no later than the date on which the return is due for the first quarter after the end of the calendar year, or

* * * * *

*** Reporting is waived for an individual where payments or income items otherwise reportable under this section received by the individual during the course of the taxable year do not exceed $10,000 in the aggregate.

* * * * *

(d) *Information to be reported.*

* * * * *

(4) ***

(v) ***

*** For purposes of reporting by foreign insurers or reinsurers, as described in paragraph (c)(7)(ii) of this section, such reporting must separately set forth premiums paid with respect to: casualty insurance and indemnity bonds (subject to section 4371(1)); life insurance, sickness and accident policies, and annuity contracts (subject to section 4371(2)); and reinsurance (subject to section 4371(3)).

All premiums paid with respect to each of these three categories may be treated as a single payment or income item within that category. For reports first due before May 1, 1991, the report may disclose, for each of the three categories, the total amount of premiums derived by the foreign insurer or reinsurer in U.S. dollars (even if a portion of these premiums relate to risks that are not U.S. situs). Reasonable estimates of the amounts required to be disclosed will satisfy these reporting requirements.

(e) *Effective date.*

* * * * *

*** Foreign insurers and reinsurers subject to reporting described in paragraph (c)(7)(ii) of this section must so report for calendar years 1988 and 1989 no later than August 15, 1990.

Fred T. Goldberg, Jr.,
Commissioner of Internal Revenue.
Approved

Kenneth W. Gideon,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on July 11, 1990, 8:45 a.m., and published in the issue of the Federal Register for July 12, 1990, 55 F.R. 28608)

Section 6302.—Mode or Time of Collection

26 CFR 1.6302-2: Use of Government depositaries for payment of tax withheld on nonresident aliens and foreign corporations.

The Service announces a change in the method of applying federal tax deposits for purposes of determining the applicability of the failure-to-deposit penalty. See Rev. Proc. 90-58, page 642.

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26 CFR 31.6302(c)-1: Use of Government depositaries in connection with taxes under Federal Insurance Contributions Act and income tax withheld.

The Service announces a change in the method of applying federal tax deposits for purposes of determining the applicability of the failure-to-deposit penalty. See Rev. Proc. 90-58, page 642.

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26 CFR 31.6302(c)-2: Use of Government depositaries in connection with employee and employer taxes under Railroad Retirement Tax Act.

The Service announces a change in the method of applying federal tax deposits for purposes of determining the applicability of the failure-to-deposit penalty. See Rev. Proc. 90-58, page 642.

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26 CFR 31.6302(c)-3: Use of Government depositaries in connection with taxes under the Federal Unemployment Tax Act.

The Service announces a change in the method of applying federal tax deposits for purposes of determining the applicability of the failure-to-deposit penalty. See Rev. Proc. 90-58, page 642.

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26 CFR 46.6302(c)-1: Use of Government depositaries.

The Service announces a change in the method of applying federal tax deposits for purposes of determining the applicability of the failure-to-deposit penalty. See Rev. Proc. 90-58, page 642.

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26 CFR 48.6302(c)-1: Use of Government depositaries.

The Service announces a change in the method of applying federal tax deposits for purposes of determining the applicability of the failure-to-deposit penalty. See Rev. Proc. 90-58, page 642.

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26 CFR 49.6302(c)-1: Use of Government depositaries.

The Service announces a change in the method of applying federal tax deposits for purposes of determining the applicability of the failure-to-deposit penalty. See Rev. Proc. 90-58, page 642.

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26 CFR 52.6302(c)-1: Use of Government depositaries.

The Service announces a change in the method of applying federal tax deposits for purposes of determining the applicability of the failure-to-deposit penalty. See Rev. Proc. 90-58, page 642.

Chapter 67.—Interest

Subchapter C.—Determination of Interest Rate; Compounding of Interest

Section 6621.—Determination of Rate of Interest

26 CFR 301.6621-1: Interest rate.

Interest rates; underpayments and overpayments. The rate of interest determined under section 6621 of the Code for the calendar quarter beginning October 1, 1990, will remain at 10 percent for overpayments and 11 percent for underpayments.

Rev. Rul. 90-71

Section 6621 of the Internal Revenue Code establishes differential rates for allowance of interest on tax overpayments and assessment of interest on tax underpayments. Under section 6621(a)(1), the overpayment rate is the sum of the federal short-term rate plus 2 percentage points. Under section 6621(a)(2), the underpayment rate is the sum of the federal short-term rate plus 3 percentage points.

Section 6621(b)(1) of the Code provides that the Secretary shall determine the federal short-term rate for the first month in each calendar quarter.

Section 6621(b)(2)(A) of the Code provides that the federal short-term rate determined under section 6621(b)(1) for any month shall apply during the first calendar quarter beginning after such month.

Section 6621(b)(3) of the Code provides that the federal short-term rate for any month shall be the federal short-term rate determined during such month by the Secretary in accordance with section 1274(d), rounded to the nearest full percent (or, if a multiple of ½ of 1 percent, the rate shall be increased to the next highest full percent).

Notice 88-59, 1988-1 C.B. 546, announced that in determining the quarterly interest rates to be used for overpayments and underpayments of tax under section 6621 of the Code, the Internal Revenue Service will use the federal short-term rate based on daily compounding because that rate is most consistent with section 6621 which, pursuant to section 6622, is subject to daily compounding.

Rounded to the nearest full percent, the federal short-term rate based on daily compounding determined during the month of July 1990 is 8 percent. Accordingly, an overpayment rate of 10 percent and an underpayment rate of 11 percent are established for the calendar quarter beginning October 1, 1990.

Interest factors for daily compound interest for annual rates of 10 percent and 11 percent were published in Tables 16 and 17 of Rev. Proc. 83-7, 1983-1 C.B. 583, 599, 600.

Annual interest rates to be compounded daily pursuant to section 6622 of the Code that apply for prior periods are set forth in the accompanying tables.

TABLE OF INTEREST RATES
PERIODS BEFORE JUL. 1, 1975—DEC. 31, 1986
OVERPAYMENTS AND UNDERPAYMENTS

PERIOD	RATE	DAILY RATE TABLE IN 1983-1 C.B.
Before Jul. 1, 1975	6%	Table 2, pg. 586
Jul. 1, 1975—Jan. 31, 1976	9%	Table 4, pg. 588
Feb. 1, 1976—Jan. 31, 1978	7%	Table 3, pg. 587
Feb. 1, 1978—Jan. 31, 1980	6%	Table 2, pg. 586
Feb. 1, 1980—Jan. 31, 1982	12%	Table 5, pg. 588
Feb. 1, 1982—Dec. 31, 1982	20%	Table 6, pg. 588
Jan. 1, 1983—Jun. 30, 1983	16%	Table 22, pg. 605
Jul. 1, 1983—Dec. 31, 1983	11%	Table 17, pg. 600
Jan. 1, 1984—Jun. 30, 1984	11%	Table 41, pg. 625
Jul. 1, 1984—Dec. 31, 1984	11%	Table 41, pg. 625
Jan. 1, 1985—Jun. 30, 1985	13%	Table 19, pg. 602
Jul. 1, 1985—Dec. 31, 1985	11%	Table 17, pg. 600
Jan. 1, 1986—Jun. 30, 1986	10%	Table 16, pg. 599
Jul. 1, 1986—Dec. 31, 1986	9%	Table 15, pg. 598

TABLE OF INTEREST RATES
FROM JAN. 1, 1987—PRESENT

	OVERPAYMENTS			UNDERPAYMENTS		
	RATE	TABLE	PG.	RATE	TABLE	PG.
Jan. 1, 1987—Mar. 31, 1987	8%	14	597	9%	15	598
Apr. 1, 1987—Jun. 30, 1987	8%	14	597	9%	15	598
Jul. 1, 1987—Sep. 30, 1987	8%	14	597	9%	15	598
Oct. 1, 1987—Dec. 31, 1987	9%	15	598	10%	16	599
Jan. 1, 1988—Mar. 31, 1988	10%	40	624	11%	41	625
Apr. 1, 1988—Jun. 30, 1988	9%	39	623	10%	40	624
Jul. 1, 1988—Sep. 30, 1988	9%	39	623	10%	40	624
Oct. 1, 1988—Dec. 31, 1988	10%	40	624	11%	41	625
Jan. 1, 1989—Mar. 31, 1989	10%	16	599	11%	17	600
Apr. 1, 1989—Jun. 30, 1989	11%	17	600	12%	18	601
Jul. 1, 1989—Sep. 30, 1989	11%	17	600	12%	18	601
Oct. 1, 1989—Dec. 31, 1989	10%	16	599	11%	17	600
Jan. 1, 1990—Mar. 31, 1990	10%	16	599	11%	17	600
Apr. 1, 1990—Jun. 30, 1990	10%	16	599	11%	17	600
Jul. 1, 1990—Sep. 30, 1990	10%	16	599	11%	17	600
Oct. 1, 1990—Dec. 31, 1990	10%	16	599	11%	17	600

26 CFR 301.6621-1: Interest rate.

Interest rates; underpayments and overpayments. The rate of interest determined under section 6621 of the code for the calendar quarter beginning January 1, 1991, will remain at 10 percent for overpayments and 11 percent for underpayments.

Rev. Rul. 90-94

Section 6621 of the Internal Revenue Code establishes differential rates for allowance of interest on tax overpayments and assessment of interest on tax underpayments. Under section 6621(a)(1), the overpayment rate is the sum of the short-term federal rate plus 2 percentage points. Under section 6621(a)(2), the underpayment rate is the sum of the short-term federal rate plus 3 percentage points.

Section 6621(b)(1) of the Code provides that the Secretary shall determine the federal short-term rate for the first month in each calendar quarter.

Section 6621(b)(2)(A) of the Code provides that the federal short-term rate determined under section 6621(b)(1) for any month shall apply during the first calendar quarter beginning after such month.

Section 6621(b)(2)(B) of the Code provides that in determining the addition to tax under section 6654 for failure to pay estimated tax for any taxable year, the federal short-term rate which applies during the 3rd month following such taxable year shall also apply during the first 15 days of the 4th month following such taxable year.

Section 6621(b)(3) of the Code provides that the federal short-term rate for any month shall be the federal short-term rate determined during such month by the Secretary in accordance with section 1274(d), rounded to the nearest full percent (or, if a multiple of ½ of 1 percent, the rate shall be increased to the next highest full percent).

Notice 88-59, 1988-1 C.B. 546, announced that in determining the quarterly interest rates to be used for overpayments and underpayments of tax under section 6621 of the Code, the Internal Revenue Service will use the federal short-term rate based on daily compounding because that rate is most consistent with section 6621 which, pursuant to section 6622, is subject to daily compounding.

Rounded to the nearest full percent, the federal short-term rate based on daily compounding determined during the month of October 1990 is 8 percent. Accordingly, an overpayment rate of 10 percent and an underpayment rate of 11 percent is established for the calendar quarter beginning January 1, 1991. The rates apply to amounts bearing interest during that calendar quarter.

The 11 percent rate also applies to estimated tax underpayments for the quarter and for the first 15 days in April.

Interest factors for daily compound interest for annual rates of 10 percent and 11 percent were published in Tables 16 and 17 of Rev. Proc. 83-7, 1983-1 C.B. 583, 599, 600.

Annual interest rates to be compounded daily pursuant to section 6622 of the Code that apply for prior periods are set forth in the accompanying tables.

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TABLE OF INTEREST RATES

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Oct. 1, 1987—Dec. 31, 1987	9%	15	598	10%	16	599
Jan. 1, 1988—Mar. 31, 1988	10%	40	624	11%	41	625
Apr. 1, 1988—Jun. 30, 1988	9%	39	623	10%	40	624
Jul. 1, 1988—Sep. 30, 1988	9%	39	623	10%	40	624
Oct. 1, 1988—Dec. 31, 1988	10%	40	624	11%	41	625
Jan. 1, 1989—Mar. 31, 1989	10%	16	599	11%	17	600
Apr. 1, 1989—Jun. 30, 1989	11%	17	600	12%	18	601
Jul. 1, 1989—Sep. 30, 1989	11%	17	600	12%	18	601
Oct. 1, 1989—Dec. 31, 1989	10%	16	599	11%	17	600
Jan. 1, 1990—Mar. 31, 1990	10%	16	599	11%	17	600
Apr. 1, 1990—Jun. 30, 1990	10%	16	599	11%	17	600
Jul. 1, 1990—Sep. 30, 1990	10%	16	599	11%	17	600
Oct. 1, 1990—Dec. 31, 1990	10%	16	599	11%	17	600
Jan. 1, 1991—Mar. 31, 1991	10%	16	599	11%	17	600

Chapter 68.—Additions to the Tax, Additional Amounts, and Assessable Penalties

Subchapter A.—Additions to the Tax and Additional Amounts

Part I.—General Rule

Section 6656.—Failure To Make Deposit of Taxes

26 CFR 301.6656-1: Penalty for underpayment of deposits.

The Service announces a change in the method of applying federal tax deposits for purposes of determining the applicability of the failure-to-deposit penalty. See Rev. Proc. 90-58, page 642.

Part II.—Accuracy—Related and Fraud Penalties

Section 6662.—Imposition of Accuracy-Related Penalty

Notices and Announcements; substantial authority. All Notices and Announcements are considered authorities for purposes of determining substantial authority under section 6662(d)(2)(B)(i) of the Code. Rev. Rul. 87-138 modified and, as modified, superseded.

Rev. Rul. 90-91

This revenue ruling reconsiders Rev. Rul. 87-138, 1987-2 C.B. 287, in light of the repeal of section 6661 of the Internal Revenue Code by the Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, 103 Stat. 2106.

Rev. Rul. 87-138 holds that, for purposes of applying the penalty imposed under section 6661 of the

Code, notices and announcements released by the Internal Revenue Service are to be considered authority and the Service will be bound by substantive or procedural guidance provided in a notice or announcement to the same extent as a revenue ruling or revenue procedure. Rev. Rul. 87-138 also holds that notices and announcements issued on or after December 28, 1987, will include specific reliance language designating them as "administrative pronouncements," as that term is used in section 1.6661-3(b)(2) of the Income Tax Regulations, if they contain substantive or procedural guidance intended by the Service to be relied upon by taxpayers as authority.

The Revenue Reconciliation Act of 1989 (the "Act") repealed section 6661 of the Code effective for returns the due date for which (determined without regard to extensions) is after December 31, 1989, and revised and consolidated the penalties relating to accuracy of tax returns under section 6662 of the Code. The portion of the new accuracy-related penalty imposed by section 6662(b)(2) and (d) that is attributable to a substantial understatement of income tax is generally the same as the substantial understatement penalty provided in former section 6661. However, according to the committee reports accompanying the Act, Congress intended that the list of authorities upon which taxpayers may rely, contained in section 1.6661-3(b)(2) of the regulations, be expanded to include, among other items, notices published by the Internal Revenue Service. *See, e.g.*, H.R. Rep. No. 101-247, 101st Cong., 1st Sess., 1389 (1989).

The Service announced, in Notice 90-20, 1990-1 C.B. 328, dated March 5, 1990, that for purposes of applying the substantial understatement portion of the accuracy-related penalty imposed under new section 6662(b)(2) and (d) of the Code, all notices and announcements issued by the Service and published in the Internal Revenue Bulletin are considered authority and may be relied upon to the same extent as a revenue ruling or revenue procedure. Notice 90-20 also announced that the definition of "authority" for purposes of section 6662(d)(2)(B)(i) applies retroactively to former section 6661(b)(2)(B)(i). As a result, it is no longer necessary that notices and announcements include specific reliance language designating them as "administrative pronouncements" upon which taxpayers may rely. Rev. Rul. 87-138, therefore, is no longer controlling.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 87-138 is hereby modified and, as modified, is superseded.

Chapter 77.—Miscellaneous Provisions

Section 7501.—Liability for Taxes Withheld or Collected

Ct. D. 2048

SUPREME COURT OF THE UNITED STATES

No. 89-255

United States, Petitioner v. Energy Resources Co., Inc., et al

[—U.S.—]

On Writ of Certiorari to The United States Court of Appeals for The First Circuit

May 29, 1990

Syllabus

The Internal Revenue Code requires employers to withhold from their employees' paychecks money representing the employees' personal income and social security taxes. 26 U.S.C. §§3102(a), 3402(a). Because employers must hold these funds in "trust for the United States," §7501(a), the taxes are commonly called "trust fund" taxes. Should an employer fail to pay such taxes, §6672 authorizes the Government to collect an equivalent sum directly from the employer's officers or employees who are responsible for collecting the tax and are thus commonly referred to as "responsible" individuals. Newport Offshore, Ltd., and Energy Resources Co., Inc., filed separate petitions for reorganization under Chapter 11 of the Bankruptcy Code. In conjunction with reorganization plans which they had approved, both Bankruptcy Courts authorized payments on the federal tax liabilities of the reorganized corporations to be applied to extinguish their trust fund debts before paying off the nontrust fund portions of the liabilities. The Internal Revenue Service (IRS) appealed both cases to the appropriate Federal District Courts, which, respectively, reversed as to Newport Offshore and affirmed as to Energy Resources. Consolidating the two cases, the Court of Appeals in turn reversed the former but affirmed the latter.

Held: A bankruptcy court has the authority to order the IRS to treat tax payments made by Chapter 11 debtor corporations as trust fund payments where the court determines that this designation is necessary for the success of a reorganization plan. Although the Bankruptcy Code does not explicitly authorize such a court to approve reorganization plans designating tax payments as either trust fund or nontrust fund, the orders at issue are wholly consistent with the court's broad authority under the Code to approve plans including "any appropriate provision not inconsistent with. . .this title," 11 U.S.C. §1123(b)(5), and to "issue an order . . .necessary or appropriate to carry out the [Code's] provisions," §105. Other Bankruptcy Code provisions protecting the Government's ability to collect delinquent taxes do not preclude the court from issuing such orders, since those restrictions do not address the court's ability to designate whether tax payments are to be applied to trust fund or nontrust fund liabilities or assure the Government that its taxes will be paid even if the court is incorrect in its judgment that the reorganization plan will succeed. Nor do the orders at issue contravene §6672 of the Internal Revenue Code—the "responsible" individuals provision—which remains both during and after the corporate Chapter 11 filing as an alternative source for collecting trust fund taxes. By its terms, that section does not protect against the eventuality that, if the IRS cannot designate a debtor corporation's tax payments as nontrust fund, the debtor might be able to pay only the trust fund debt, leaving the Government at risk for nontrust fund taxes. 871 F. 2d 223, affirmed.

WHITE, J., delivered the opinion of the Court, in which REHNQUIST, C. J., and BRENNAN, MARSHALL, STEVENS, O'CONNOR, SCALIA, and KENNEDY, JJ., joined. BLACKMUN, J., dissented.

JUSTICE WHITE delivered the opinion of the Court.

In this case, we decide that a bankruptcy court has the authority to order the Internal Revenue Service (IRS) to treat tax payments made by Chapter 11 debtor corporations as trust fund payments where the bankruptcy court determines that this designation is necessary for the success of a reorganization plan.

I

The Internal Revenue Code requires employers to withhold from their employees' paychecks money representing employees' personal income taxes, and social security taxes. 26 U.S.C. §§3102(a), 3402(a). Because federal law requires employers to hold these funds in "trust for the United States," 26 U.S.C. §7501(a), these taxes are commonly referred to as "trust fund" taxes. *Slodov v. United States*, 436 U.S. 238, 242-243 (1978). Should employers fail to pay trust fund taxes, the Government may collect an equivalent sum directly from the officers or employees of the employer who are responsible for col-

lecting the tax. 26 U.S.C. §6672. These individuals are commonly referred to as "responsible" individuals. *Slodov, supra*, at 244-245.

This case involves corporations that have filed petitions for reorganization under Chapter 11 of the Bankruptcy Code, 11 U.S.C. §§1101-1174. Newport Offshore, Ltd., filed a petition for reorganization on November 13, 1985; the Bankruptcy Court approved a reorganization plan in June 1986, creating Newport Oil Offshore, Inc. Over the IRS's objection, that plan included a provision stating that the reorganized Newport Offshore would pay its tax debts (totaling about $300,000) over a period of about six years and that the payments would be applied to extinguish all trust fund tax debts " 'prior to the commencement of payment of the nontrust fund portion' " of the tax debts owed. *In re Energy Resources Co., Inc.*, 871 F. 2d 223, 226 (CA1 1989). The IRS appealed to the United States District Court for the District of Rhode Island, which reversed in an unpublished opinion. The debtor then sought review in the Court of Appeals for the First Circuit.

Energy Resources Co., Inc., petitioned for reorganization under Chapter 11 in January 1983. In September 1984, the Bankruptcy Court confirmed a reorganization plan that created a special trust which, among other things, was to pay Energy Resources' federal tax debt of approximately $1,000,000 over roughly five years. In November 1985, the trustee of the special trust sent approximately $358,000 in payment to the IRS. The trustee asked the IRS to apply the money to Energy Resources' trust fund tax debt. After the IRS refused to do so, the trustee successfully petitioned the Bankruptcy Court to order the IRS to apply the money to the trust fund tax liabilities. *Id.*, at 226-227. The IRS appealed this order to the United States District Court for the District of Massachusetts which affirmed the Bankruptcy Court in an oral opinion. The Government then appealed to the First Circuit.

Consolidating the two cases, the First Circuit reversed in *In re Newport Offshore Ltd.* and affirmed in *In re Energy Resources Co. Id.*, at 234. The court first considered whether a tax payment made pursuant to a Chapter 11 reorganization plan is "voluntary" or "involuntary" as those terms are used in the IRS's own rules. IRS policy permits taxpayers who "voluntarily" submit payments to the IRS to designate the tax liability to which the payment will apply. See *id.*, at 227, citing Rev. Rul. 79-284, 1979-2 Cum. Bull. 83, modifying Rev. Rul. 73-305, 1973-2 Cum. Bull. 43, superseding Rev. Rul. 58-239, 1958-1 Cum. Bull. 94. The taxpayer corporations argued that tax payments within a Chapter 11 reorganization are best characterized as "voluntary" and therefore that the IRS's own rules bind the agency to respect the debtors' designation of the tax payments. Granting deference to the agency's interpretation of its own rules, the First Circuit accepted the IRS's view that payments made pursuant to the Chapter 11 plan are involuntary for purposes of the IRS's rules. 871 F. 2d, at 230. The First Circuit concluded, however, that even if the payments were properly characterized as involuntary under the IRS's regulations, the Bankruptcy Court nevertheless had the authority to order the IRS to apply an "involuntary" payment made by a Chapter 11 debtor to trust fund tax liabilities if the Bankruptcy Court concluded that this designation was necessary to ensure the success of the reorganization. *Id.*, at 230-234.

We granted certiorari because the First Circuit's conclusion on this issue conflicts with decisions in other circuits. 493 U.S. ____ ; see e.g., *In re Ribs-R-Us, Inc.*, 828 F. 2d 199 (CA3 1987). We affirm the judgment below, for whether or not the payments at issue are rightfully considered to be involuntary, the bankruptcy court has the authority to order the IRS to apply the payments to trust fund liabilities if the bankruptcy court determines that this designation is necessary to the success of a reorganization plan.

II

The Bankruptcy Code does not explicitly authorize the bankruptcy courts to approve reorganization plans designating tax payments as either trust fund or nontrust fund. The Code, however, grants the bankruptcy courts residual authority to approve reorganization plans including "any. . .appropriate provision not inconsistent with the applicable provisions of this title." 11 U.S.C. §1123(b)(5); see also §1129. The Code also states that bankruptcy courts may "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions" of the Act. §105. These statutory directives are consistent with the traditional understanding that bankruptcy courts, as courts of equity, have broad authority to modify creditor-debtor relationships. See *Pepper v. Litton*, 308 U.S. 295, 303-304 (1939); *United States National Bank v. Chase National Bank*, 331 U.S. 28, 36 (1947); *Katchen v. Landy*, 382 U.S. 323, 327 (1966).

The Government suggests that, in this case, the Bankruptcy Court has transgressed one of the limitations on its equitable power. Specifically, the Government contends that the orders conflict with the Code's provisions protecting the Government's ability to collect delinquent taxes. As the Government points out, the Code provides a priority for specified tax claims, including those at issue in this case, and makes those tax debts nondischargeable. See 11 U.S.C. §§507(a)(7), 523(a)(1)(A). The Code, moreover, requires the bankruptcy court to assure itself that reorganization will succeed, §1129(a)(11), and therefore that the IRS, in all likelihood, will collect the tax debt owed. The tax debt must be paid off within six years. §1129(a)(9)(C).

It is evident that these restrictions on the bankruptcy court's authority do not preclude the court from issuing orders of the type at issue here, for those restrictions do not address the bankruptcy court's ability to designate whether tax payments are to be applied to trust fund or nontrust fund tax liabilities. The Government is correct that, if it can apply a debtor corporation's tax payments to nontrust fund liability before trust fund liability, it stands a better chance of debt discharge because the debt that is not guaranteed will be paid off before the guaranteed debt. While this result might be desirable from the Government's standpoint, it is an added protection not specified in the Code itself: whereas the Code gives it the right to be assured that its taxes will be paid in six years, the Government wants an assurance that its taxes

will be paid even if the reorganization fails—*i.e.*, even if the bankruptcy court is incorrect in its judgment that the reorganization plan will succeed.

Even if consistent with the Code, however, a bankruptcy court order might be inappropriate if it conflicted with another law that should have been taken into consideration in the exercise of the court's discretion. The Government maintains that the orders at issue here contravene §6672 of the Internal Revenue Code, the provision permitting the IRS to collect unpaid trust fund taxes directly from the personal assets of "responsible" individuals. The Government contends that §6672 reflects a congressional decision to protect the Government's tax revenues by ensuring an additional source from which trust fund taxes might be collected. It is true that §6672 provides that, if the Government is unable to collect trust fund taxes from a corporate taxpayer, the Government has an alternative source for this revenue. Here, however, the Bankruptcy Courts' orders do not prevent the Government from collecting trust fund revenue; to the contrary, the orders require the Government to collect trust fund payments before collecting nontrust fund payments. As the Government concedes, §6672 remains both during and after the corporate Chapter 11 filing as an alternative collection source for trust fund taxes.

The Government nevertheless contends that the Bankruptcy Court's orders contravene §6672 because, if the IRS cannot designate a debtor corporation's tax payments as nontrust fund, the debtor might be able to pay only the guaranteed debt, leaving the Government at risk for nontrust fund taxes. This may be the case, but §6672, by its terms, does not protect against this eventuality. That section plainly does not require us to hold that the orders at issue here, otherwise wholly consistent with the bankruptcy court's authority under the Bankruptcy Code, were nonetheless improvident.

III

In this case, the Bankruptcy Court has not transgressed any limitation on its broad power. We therefore hold that it may order the IRS to apply tax payments to offset trust fund obligations where it concludes that this action is necessary for a reorganization's success. The judgment of the Court of Appeals is therefore

Affirmed.

JUSTICE BLACKMUN dissents.

Ct. D. 2050

SUPREME COURT OF THE UNITED STATES

No. 89-393

Harry P. Begier, Jr., etc., Petitioner
v. Internal Revenue Service

—U.S.—

On Writ of Certiorari to The United States Court of Appeals for The Third Circuit

June 4, 1990

Syllabus

The Internal Revenue Code directs "every person receiving any payment for facilities or services" subject to excise taxes to "collect the amount of the tax from the person making such payment." 26 U.S.C. §4291. It also requires an employer to "collect" Federal Insurance Contributions Act taxes from its employees "by deducting the amount of the tax from the wages *as and when paid*," §3102(a), and to "deduct and withhold *upon such wages* [the employee's federal income tax]," §3402(a)(1). The amount of taxes "collected or withheld" is "held to be in a special fund in trust for the United States." §7501. Thus, these taxes are often called "trust-fund taxes." After American International Airlines, Inc., fell behind in its trust-fund tax payments, the Internal Revenue Service, pursuant to §7512, ordered it to deposit all future taxes collected into a separate bank account. AIA established the account, but did not deposit funds sufficient to cover the entire amount of its obligations. Nonetheless, it remained current on the obligations, paying part of them from the separate bank account and part from its general operating funds. In a subsequent liquidation proceeding under the Bankruptcy Code, petitioner Begier was appointed AIA's trustee. Seeking to exercise his power under §547(b) of the Bankruptcy Code—which permits a trustee to avoid certain preferential payments made before the debtor files for bankruptcy—Begier filed an adversary action against the Government to recover the entire amount that AIA had paid the IRS for trust-fund taxes during the 90 days before the bankruptcy filing. The Bankruptcy Court refused to permit Begier to recover any of the money AIA had paid out of the separate account on the ground that AIA had held that money in trust for the IRS. However, it allowed him to avoid most of the payments made out of AIA's general accounts, holding that such funds were property of the debtor. The District Court affirmed, but the Court of Appeals reversed, holding that *any* prepetition payment of trust-fund taxes is a payment of funds that are not the debtor's property, and that such a payment is therefore not an avoidable preference.

Held: AIA's trust-fund tax payments from its general accounts were transfers of property held in trust and therefore cannot be avoided as preferences.

(a) Equality of distribution among creditors is a central policy of the Bankruptcy Code that is furthered by §547(b) to the extent that it permits a trustee to avoid prepetition preferential transfers of "property of the debtor." Although not defined by the Code, "property of the debtor" is best understood to mean property that would have been part of the estate had it not been transferred. Its meaning is coextensive with its postpetition analog "property of the estate," which includes all of the debtor's legal or equitable interests in property as of the commencement of the case. §541(a)(1). Since a debtor does not own an equitable interest in property he holds in trust for another, that interest is not "property of the estate" and, likewise, not "property of the debtor."

(b) AIA created a trust within the meaning of 26 U.S.C. §7501 at the moment the money was withheld or collected. The statutory trust extends to the amount of tax "collected or withheld," and the language of §§4291, 3102(a), and 3402(a)(1) makes clear that the acts of collecting and withholding occur at the time of payment—the recipient's payment for the service in the case of excise taxes and the employer's payment of wages in the case of FICA and income taxes. The fact that AIA neither put the taxes in a segregated fund nor paid them to the IRS does not somehow mean that AIA never collected or withheld them in the first place. Mandating segregation as a prerequisite to the creation of a trust under §7501 would make §7512's requirement that funds may be segregated in special and limited circumstances superfluous and would mean that an employer could avoid the creation of a trust simply by refusing to segregate.

(c) The funds transferred from AIA's general accounts were trust assets. Neither §7501 nor common-law rules for tracing trust res offer guidance on how to determine whether the assets were trust property. And the strict rule of *United States* v. *Randall*, 401 U.S. 513—which prohibited the IRS from recovering withheld taxes ahead of the bankruptcy proceeding's administrative expenses—did not survive the 1978 restructuring of the Bankruptcy Code. The 1978 Code's legislative history shows that Congress intended that the courts permit the use of "reasonable assumptions" under which the IRS could demonstrate that amounts of withheld taxes were still in the debtor's possession at the time the petition was filed. Thus, Congress expected that the IRS would have to show *some* connection between the trust and the assets sought to be applied to a debtor's trust-fund obligations. While the Bankruptcy Code does not demonstrate how extensive this nexus must be, the legislative history identifies one reasonable assumption: that *any* voluntary prepetition payment of trust-fund taxes out of the debtor's assets is not a transfer of the debtor's property. Other rules might be reasonable, but the only evidence presented suggests that Congress preferred this one.

878 F.2d 762, affirmed.

MARSHALL, J., delivered the opinion of the Court, in which REHNQU-

IST, C.J., and BRENNAN, WHITE, BLACKMUN, STEVENS, O'CONNOR, and KENNEDY, JJ., joined. SCALIA, J., filed an opinion concurring in the judgment.

JUSTICE MARSHALL delivered the opinion of the Court.

This case presents the question whether a trustee in bankruptcy may "avoid" (*i.e.*, recover) from the Internal Revenue Service payments of certain withholding and excise taxes that the debtor made before it filed for bankruptcy. We hold that the funds paid here were not the property of the debtor prior to payment; instead, they were held in trust by the debtor for the IRS. We accordingly conclude that the trustee may not recover the funds.

I

American International Airways, Inc., was a commercial airline. As an employer, AIA was required to withhold federal income taxes and to collect Federal Insurance Contributions Act taxes from its employees' wages. 26 U.S.C. §3402(a) (income taxes); §3102(a) (FICA taxes). As an airline, it was required to collect excise taxes from its customers for payment to the IRS. §4291. Because the amount of these taxes is "held to be a special fund in trust for the United States," §7501, they are often called "trust-fund taxes." See, *e.g.*, *Slodov* v. *United States*, 436 U.S. 238, 241 (1978). By early 1984, AIA had fallen behind in its payments of its trust-fund taxes to the Government. In February of that year, the IRS ordered AIA to deposit all trust-fund taxes it collected thereafter into a separate bank account. AIA established the account, but did not deposit funds sufficient to cover the entire amount of its trust-fund tax obligations. It nonetheless remained current on these obligations through June 1984, paying the IRS $695,000 from the separate bank account and $946,434 from its general operating funds. AIA and the IRS agreed that all of these payments would be allocated to specific trust-fund tax obligations.

On July 19, 1984, AIA petitioned for relief from its creditors under Chapter 11 of the Bankruptcy Code, 11 U.S.C. §1101 *et seq.* (1982 ed.). AIA unsuccessfully operated as a debtor in possession for three months. Accordingly, on September 19, the Bankruptcy Court appointed petitioner Harry P. Begier trustee and converted the case to a Chapter 7 liquidation. 11 U.S.C. §701 *et seq.* (1982 ed.). Among the powers of a Chapter 7 trustee is the power under §547(b)[1] to avoid certain payments made by the debtor that would "enabl[e] a creditor to receive payment of a greater percentage of his claim against the debtor than he would have received if the transfer had not been made and he had participated in the distribution of the assets of the bankrupt estate." H.R. Rep. No. 95-595, p. 177 (1977). Seeking to exercise his avoidance power, Begier filed an adversary action against the Government to recover the entire amount that AIA had paid the IRS for trust-fund taxes during the 90 days before the bankruptcy filing.

The Bankruptcy Court found for the Government in part and for the trustee in part. *In re American International Airways, Inc.*, 83 B.R. 324 (ED Pa. 1988). It refused to permit the trustee to recover any of the money AIA had paid out of the separate account on the theory that AIA had held that money in trust for the IRS. *Id.*, at 327. It allowed the trustee to avoid most of the payments that AIA had made out of its general accounts, however, holding that "only where a tax trust fund is actually established by the debtor and the taxing authority is able to trace funds segregated by the debtor in a trust account established for the purpose of paying the taxes in question would we conclude that such funds are not property of the debtor's estate." *Id.*, at 329. The District Court affirmed. App. to Pet. for Cert. A-22-A-26. On appeal by the Government, the Third Circuit reversed, holding that *any* prepetition payment of trust-fund taxes is a payment of funds that are not the debtor's property and that such a payment is therefore not an avoidable preference. 878 F.2d 762 (1989).[2] We affirm.

II

A

Equality of distribution among creditors is a central policy of the Bankruptcy Code. According to that policy, creditors of equal priority should receive pro rata shares of the debtor's property. See, *e.g.*, 11 U.S.C. §726(b) (1982 ed.); H.R. Rep. No. 95-595, *supra*, at 177-178. Section 547(b) furthers this policy by permitting a trustee in bankruptcy to avoid certain preferential payments made before the debtor files for bankruptcy. This mechanism prevents the debtor from favoring one creditor over others by transferring property shortly before filing for bankruptcy. Of course, if the debtor transfers property that would not have been available for distribution to his creditors in a bankruptcy proceeding, the

[1]This case is governed by 11 U.S.C. §547(b) (1982 ed.), which reads: "Except as provided in subsection (c) of this section, the trustee may avoid any transfer of property of the debtor—

"(1) to or for the benefit of a creditor;

"(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

"(3) made while the debtor was insolvent;

"(4) made—

"(A) on or within 90 days before the date of the filing of the petition; or

"(B) between 90 days and one year before the date of the filing of the petition, if such creditor, at the time of such transfer—

"(i) was an insider; and

"(ii) had reasonable cause to believe the debtor was insolvent at the time of such transfer, and

"(5) that enables such creditor to receive more than such creditor would receive if—

"(A) the case were a case under chapter 7 of this title;

"(B) the transfer had not been made; and

"(C) such creditor received payment of such debt to the extent provided by the provisions of this title."

The statute has been amended to replace "property of the debtor" with "an interest of the debtor in property." See n. 3, *infra*. The old version of §547(b) applies to this case, however, because AIA filed its bankruptcy petition before the effective date of the amendment.

[2]No other Court of Appeals has decided a case that presents the precise issue we decide here. The Ninth and District of Columbia Circuits have, however, resolved against the taxing authorities cases presenting related issues. See *In re R & T Roofing Structures & Commercial Framing, Inc.*, 887 F.2d 981, 987 (CA9 1989) (rejecting the Government's argument that assets the IRS seized from a debtor to satisfy a trust-fund tax obligation before the debtor filed its bankruptcy petition were assets held in trust for the Government under 26 U.S.C. §7501, and therefore deciding that the transfer effected by the seizure involved "property of the debtor" and was not exempt from avoidance); *Drabkin* v. *District of Columbia*, 263 U.S. App. D.C. 122, 125, 824 F.2d 1102, 1105 (1987) (reaching a similar conclusion with respect to a voluntary payment of withheld District of Columbia employee income taxes in a case governed by a provision of local law that "essentially mirror[ed]" §7501).

policy behind the avoidance power is not implicated. The reach of §547(b)'s avoidance power is therefore limited to transfers of "property of the debtor."

The Bankruptcy Code does not define "property of the debtor." Because the purpose of the avoidance provision is to preserve the property includable within the bankruptcy estate—the property available for distribution to creditors—"property of the debtor" subject to the preferential transfer provision is best understood as that property that would have been part of the estate had it not been transferred before the commencement of bankruptcy proceedings. For guidance, then, we must turn to §541, which delineates the scope of "property of the estate" and serves as the postpetition analog to §547(b)'s "property of the debtor."[3]

Section 541(a)(1) provides that the "property of the estate" includes "all legal or equitable interests of the debtor in property as of the commencement of the case." Section 541(d) provides:

> "Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest. . .becomes property of the estate under subsection (a) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold."

Because the debtor does not own an equitable interest in property he holds in trust for another, that interest is not "property of the estate." Nor is such an equitable interest "property of the debtor" for purposes of §547(b). As the parties agree, then, the issue in this case is whether the money AIA transferred from its general operating accounts to the IRS was property that AIA had held in trust for IRS.

B

We begin with the language of 26 U.S.C. §7501, the Internal Revenue Code's trust-fund tax provision: "Whenever any person is required to collect or withhold any internal revenue tax from any other person and to pay over such tax to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States." The statutory trust extends, then, only to "the amount of tax so collected or withheld." Begier argues that a trust-fund tax is not "collected or withheld" until specific funds are either sent to the IRS with the relevant return or placed in a segregated fund. AIA neither put the funds paid from its general operating accounts in a separate account nor paid them to the IRS before the beginning of the preference period. Begier therefore contends that no trust was ever created with respect to those funds and that the funds paid to the IRS were therefore property of the debtor.

We disagree. The Internal Revenue Code directs "every person receiving any payment for facilities or services" subject to excise taxes to "collect the amount of the tax from the person making such payment." §4291. It also requires that an employer "collec[t]" FICA taxes from its employees "by deducting the amount of the tax from the wages *as and when paid.*" §3102(a) (emphasis added). Both provisions make clear that the act of "collecting" occurs at the time of payment—the recipient's payment for the service in the case of excise taxes and the employer's payment of wages in the case of FICA taxes. The mere fact that AIA neither placed the taxes it collected in a segregated fund nor paid them to the IRS does not somehow mean that AIA never collected the taxes in the first place.

The same analysis applies to taxes the Internal Revenue Code requires that employers "withhold." Section 3402(a)(1) requires that "every employer making payment of wages shall deduct and withhold *upon such wages* [the employee's federal income tax]." (Emphasis added.) Withholding thus occurs at the time of payment to the employee of his net wages. S. Rep. No. 95-1106, p. 33 (1978) ("[A]ssume that a debtor owes an employee $100 for salary on which there is required withholding of $20. If the debtor paid the employee $80, there has been $20 withheld. If, instead, the debtor paid the employee $85, there has been withholding of $15 (which is not property of the debtor's estate in bankruptcy)"). See *Slodov*, 436 U.S., at 243 (stating that "[t]here is no general requirement that the withheld sums be segregated from the employer's general funds," and thereby necessarily implying that the sums are "withheld" whether or not segregated). The common meaning of "withholding" supports our interpretation. See Webster's Third New International Dictionary 2627 (1981) (defining "withholding" to mean "the act or procedure of deducting a tax payment from income *at the source*") (emphasis added).

Our reading of §7501 is reinforced by §7512, which permits the IRS, upon proper notice, to require a taxpayer who has failed timely "to collect, truthfully account for, or pay over [trust-fund taxes]", or who has failed timely "to make deposits, payments, or returns of such tax," §7512(a)(1), to "deposit such amount in a separate account in a bank . . .and. . .keep the amount of such taxes in such account until payment over to the United States," §7512(b). If we were to read §7501 to mandate segregation as a prerequisite to the creation of the trust, §7512's requirement that funds be segregated in special and limited circumstances would become superfluous. Moreover, petitioner's suggestion that we read a segregation requirement into §7501 would mean that an employer could avoid the creation of a trust simply by refusing to segregate. Nothing in §7501 indicates, however, that Congress wanted the IRS to be protected only insofar as dictated by the debtor's whim. We conclude, therefore, that AIA created a trust within the meaning of §7501 at the moment the relevant payments (from customers to AIA for excise taxes and from AIA to its employees for FICA and income taxes) were made.

[3]To the extent the 1984 amendments to §547(b) are relevant, they confirm our view that §541 guides our analysis of what property is "property of the debtor" for purposes of §547(b). Among the changes was the substitution of "an interest of the debtor in property" for "property of the debtor." 11 U.S.C. §547(b). Section 547(b) thus now mirrors §541's definition of "property of the estate" as certain "interests of the debtor in property." §541(a)(1). The Senate Report introducing a predecessor to the bill that amended §547(b) described the new language as a "clarifying change." S. Rep. No. 98-65, p. 81 (1983). We therefore read both the older language ("property of the debtor") and the current language ("an interest of the debtor in property") as coextensive with "interests of the debtor in property" as that term is used in §541(a)(1).

C

Our holding that a trust for the benefit of the IRS existed is not alone sufficient to answer the question presented by this case: whether the *particular dollars* that AIA paid to the IRS from its general operating accounts were "property of the debtor." Only if those particular funds were held in trust for the IRS do they escape characterization as "property of the debtor." All §7501 reveals is that AIA at one point created a trust for the IRS; that section provides no rule by which we can decide whether the assets AIA used to pay the IRS were assets belonging to the trust.

In the absence of specific statutory guidance on how we are to determine whether the assets transferred to the IRS were trust property, we might naturally begin with the common-law rules that have been created to answer such questions about other varieties of trusts. Unfortunately, such rules are of limited utility in the context of the trust created by §7501. Under common-law principles, a trust is created *in property*; a trust therefore does not come into existence until the settlor identifies an ascertainable interest in property to be the trust res. G. Bogert, Law of Trusts and Trustees §111 (rev. 2d ed. 1984); 1A W. Fratcher, Scott on Trusts §76 (4th ed. 1987). A §7501 trust is radically different from the common-law paradigm, however. That provision states that "the *amount* of [trust-fund] tax. . .collected or withheld shall be held to be special fund in trust for the United States." (Emphasis added.) Unlike a common-law trust, in which the settlor sets aside a particular *property* as the trust res, §7501 creates a trust in an abstract "amount"—a dollar *figure* not tied to any particular assets—rather than in the actual dollars withheld.[4] Common-law tracing rules, designed for a system in which particular property is identified as the trust res, are thus unhelpful in this special context.

Federal law delineating the nature of the relationship between the §7501 trust and preferential transfer rules is limited. The only case in which we have explored that topic at any length is *United States* v. *Randall*, 401 U.S. 513 (1971), a case dealing with a postpetition transfer of property to discharge trust-fund tax obligations that the debtor had accrued prepetition. There, a court had ordered a debtor in possession to maintain a separate account for its withheld federal income and FICA taxes, but the debtor did not comply. When the debtor was subsequently adjudicated a bankrupt, the United States sought to recover from the debtor's general assets the amount of withheld taxes ahead of the expenses of the bankruptcy proceeding. The Government argued that the debtor held the amount of taxes due in trust for the IRS and that this amount could be traced to the funds the debtor had in its accounts when the bankruptcy petition was filed. The trustee maintained that no trust had been created because the debtor had not segregated the funds. The Court declined directly to address either of these contentions. *Id.*, at 515. Rather, the Court simply refused to permit the IRS to recover the taxes ahead of administrative expenses, stating that "the statutory policy of subordinating taxes to costs and expenses of administration would not be served by creating or enforcing trusts which eat up an estate leaving little or nothing for creditors and court officers whose goods and services created the assets." *Id.*, at 517.

In 1978, Congress fundamentally restructured bankruptcy law by passing the new Bankruptcy Code. Among the changes Congress decided to make was a modification of the rule this Court had enunciated in *Randall* under the old Bankruptcy Act. The Senate bill attacked *Randall* directly, providing in §541 that trust-fund taxes withheld or collected prior to the filing of the bankruptcy petition were not "property of the estate." See S. Rep. No. 95-1106, p. 33 (1978). See also *ibid.* ("These amounts will not be property of the estate regardless of whether such amounts have been segregated from other assets of the debtor by way of a special account, fund, or otherwise, or are deemed to be a special fund in trust pursuant to provisions of applicable tax law") (footnote omitted). The House bill did not deal explicitly with the problem of trust-fund taxes, but the House Report stated that "property of the estate" would not include property held in trust for another. See H.R. Rep. No. 95-595, p. 368 (1977). Congress was unable to hold a conference, so the Senate and House floor managers met to reach compromises on the differences between the two bills. See 124 Cong. Rec. 32392 (1978) (remarks of Rep. Edwards); Klee, Legislative History of the New Bankruptcy Law, 28 DePaul L. Rev. 941, 953-954 (1979). The compromise reached with respect to the relevant portion of §541, which applies to postpetition transfers, was embodied in the eventually-enacted House amendment and explicitly provided that "in the case of property held in trust, the property of the estate includes the legal title, but not the beneficial interest in the property." 124 Cong. Rec., at 32417 (remarks of Rep. Edwards). Compare *id.*, at 32363 (text of House amendment). Accordingly, the Senate language specifying that withheld or collected trust-fund taxes are not part of the bankruptcy estate was deleted as "unnecessary since property of the estate does not include the beneficial interest in property held by the debtor as a trustee. Under [§7051], the amounts of withheld taxes are held to be a special fund in trust for the United States." *Id.*, at 32417 (remarks of Rep. Edwards).[5]

Representative Edwards discussed the effects of the House language on the rule established by *Randall*, indicating that the House amendment would supplant that rule:

> "[A] serious problem exists where 'trust fund taxes' withheld from others are held to be property of the estate where the withheld amounts are commingled with other assets of the debtor. The courts should permit the use of reasonable assumptions under which the Internal Revenue Service, and other tax authorities, can demonstrate that amounts of withheld taxes are still

[4]The general common-law rule that a trust is not created absent a designation of particular property obviously does not invalidate §7501's creation of a trust in the "amount" of withheld taxes. The common law of trusts is not binding on Congress.

[5]Because of the absence of a conference and the key roles played by Representative Edwards and his counterpart floor manager Senator DeConcini, we have treated their floor statements on the Bankruptcy Reform Act of 1978 as persuasive evidence of congressional intent. See, *e.g.*, *CFTC* v. *Weintraub*, 471 U.S. 343, 351 (1985). Cf. 124 Cong. Rec. 32391 (1978) (remarks of Rep. Rousselot) (expressing view that remarks of floor manager of the Act have "the effect of being a conference report").

in the possession of the debtor at the commencement of the case." *Ibid.*

The context of Representative Edwards' comment makes plain that he was discussing whether a *post*petition payment of trust-fund taxes involved "property of the estate." This focus is not surprising given that *Randall*, the case Congress was addressing, involved a postpetition demand for payment by the IRS. But Representative Edwards' discussion also applies to the question whether a *pre*petition payment is made from "property of the debtor." We have explained that "property of the debtor" is that property that would have been part of the estate had it not been transferred before the commencement of bankruptcy proceedings. *Supra*, at 4-5. The same "reasonable assumptions" therefore apply in both contexts.

The strict rule of *Randall* thus did not survive the adoption of the new Bankruptcy Code. But by requiring the IRS to "demonstrate that amounts of withheld taxes are still in the possession of the debtor at the commencement of the case [*i.e.*, at the filing of the petition]," 124 Cong. Rec., at 32417 (remarks of Rep. Edwards), Congress expected that the IRS would have to show *some* connection between the §7501 trust and the assets sought to be applied to a debtor's trust-fund tax obligations. See *United States* v. *Whiting Pools, Inc.*, 462 U.S. 198, 205, n. 10 (1983) (IRS cannot exclude funds from the estate if it cannot trace them to §7501 trust property). The question in this case is how extensive the required nexus must be. The Bankruptcy Code provides no explicit answer, and Representative Edwards' admonition that courts should "permit the use of reasonable assumptions" does not add much. The House Report does, however, give sufficient guidance regarding those assumptions to permit us to conclude that the nexus requirement is satisfied here. That Report states:

"A payment of withholding taxes constitutes a payment of money held in trust under Internal Revenue Code §7501(a), and thus will not be a preference because the beneficiary of the trust, the taxing authority, is in a separate class with respect to those taxes, if they have been properly held for payment, as they will have been if the debtor is able to make the payments." H.R. Rep. No. 95-595, *supra*, at 373.[6]

Under a literal reading of the above passage, the bankruptcy trustee could not avoid *any* voluntary prepetition payment of trust-fund taxes, regardless of the source of the funds. As the House Report expressly states, the limitation that the funds must "have been properly held for payment" is satisfied "if the debtor is able to make the payments." The debtor's act of voluntarily paying its trust-fund tax obligation therefore is alone sufficient to establish the required nexus between the "amount" held in trust and the funds paid.

We adopt this literal reading. In the absence of any suggestion in the Bankruptcy Code about what tracing rules to apply, we are relegated to the legislative history. The courts are directed to apply "reasonable assumptions" to govern the tracing of funds, and the House Report identifies one such assumption to be that any voluntary prepetition payment of trust-fund taxes out of the debtor's assets is not a transfer of the debtor's property. Nothing in the Bankruptcy Code or its legislative history casts doubt on the reasonableness of that assumption. Other rules might be reasonable, too, but the only evidence we have suggests that Congress preferred this one. We see no reason to disregard that evidence.

III

We hold that AIA's payments of trust-fund taxes to the IRS from its general accounts were not transfers of "property of the debtor," but were instead transfers of property held in trust for the Government pursuant to §7501. Such payments therefore cannot be avoided as preferences. The judgment of the Court of Appeals is

Affirmed.

[6]Petitioner's claim that this legislative history is irrelevant because the House Bill was not enacted is in error. The exact language to which the quoted portion of the House Report refers was enacted into law. Compare §547(b) with H.R. 8200, 95th Cong., 1st Sess., §547(b) (1977). The version of §541 that was eventually enacted *is* different than the original House bill, but only in that it makes explicit rather than implicit that "property of the estate" does not include the beneficiary's equitable interest in property held in trust by the debtor. Compare §541(d) with H.R. 8200, *supra*, §541(a)(1).

Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1990. See Rev. Rul. 90-52, page 192.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1990. See Rev. Rul. 90-66, page 194.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1990. See Rev. Rul. 90-75, page 195.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1990. See Rev. Rul. 90-81, page 196.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1990. See Rev. Rul. 90-92, page 198.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1990. See Rev. Rul. 90-99, page 199.

Chapter 79.—Definitions

Section 7701.—Definitions

26 CFR 301.7701-1: Classification of organizations for tax purposes.

Is a full-time life insurance salesman who is an employee within the meaning of section 3121(d)(3) of the Code, an employee for purposes of sections 62 and 67? See Rev. Rul. 90-93, page 33.

26 CFR 301.7701-2: Associations.

Limited partnerships. The Tennessee Revised Uniform Limited Partnership Act corresponds to the Uniform Limited Partnership Act (ULPA) for purposes of section 301.7701-2 of the regulations. Rev. Rul. 89-123 amplified.

Rev. Rul. 90-59

In Rev. Rul. 89-123, 1989-2 C.B. 261, the Internal Revenue Service listed all the states whose revised limited

partnership acts correspond to the Uniform Limited Partnership Act (ULPA) for purposes of section 301.7701-2 of the Procedure and Administration Regulations.

The Service has determined that Tennessee has enacted legislation that, as of its effective date, corresponds to the ULPA for purposes of section 301.7701-2 of the regulations:

Tennessee: Tenn. Code Ann. sections 61-2-101 through 61-2-1208 (Supp. 1989) effective May 12, 1989.

EFFECT ON OTHER RULINGS

Rev. Rul. 89-123 is amplified.

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26 CFR 301.7701-2: Associations.

If a foreign person engages in U.S. barter transactions through a partnership or through a dependent agent, is gain or loss recognized on each separate barter transaction? See Rev. Rul. 90-80, page 170.

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26 CFR 301.7701-4: Trusts.

Investment trust; credit support. The power of a trustee to consent to changes in the credit support of debt obligations held in an investment trust, is not a "power to vary the investment" under section 301.7701-4(c) of the regulations where the power is exercisable only to the extent the trustee reasonably believes the change is advisable to maintain the value of trust assets by preserving the credit rating of the obligations.

Rev. Rul. 90-63

ISSUE

If the trustee of an investment trust has a power to consent to changes in the credit support of debt obligations that is exercisable only to the extent the trustee reasonably believes the change is advisable to maintain the value of trust property by preserving the credit rating of the obligations, is such power a "power to vary the investment" within the meaning of section 301.7701-4(c) of the Procedure and Administration Regulations?

FACTS

S, a financial services corporation, created an investment trust funded with a fixed portfolio that included a certain issue of tax-exempt debt obligations.

The tax-exempt debt obligations are exempt facility bonds issued by *C*, a municipal corporation, to provide a solid waste disposal facility described in section 142(a)(6) of the Internal Revenue Code. The bonds are payable only from the revenues derived from the facility and are nonrecourse as to *C*.

C and *D*, a corporation, entered into a loan agreement pursuant to which *C* loaned the proceeds from the issuance of the bonds to *D* for the development of the facility. Under the terms of the loan agreement, *D* is required to provide credit support in the form of a letter of credit from a financial institution specified in the agreement.

Under the terms of the trust agreement, the trustee, at *C*'s request, may consent to a change in the credit support if the trustee reasonably believes that the change is advisable to maintain the value of trust assets by preserving the credit rating of the bonds.

LAW AND ANALYSIS

Section 301.7701-4(c) of the regulations provides that an investment trust with a single class of ownership interests, representing undivided beneficial interests in the assets of the trust, is properly classified as a trust if there is no power under the trust agreement to vary the investment of the beneficiaries.

A power to vary the investment of the certificate holders is one that enables the trustee or another person to take advantage of market variations to improve the investment of all the beneficiaries. The existence of such a power is sufficient to turn the venture into a business, thereby precluding classification of the entity as a trust for federal tax purposes. *See Commissioner v. North American Bond Trust*, 122 F.2d 545 (2d Cir. 1941), *cert. denied*, 314 U.S. 701 (1942).

In the present case, the power to consent to changes in the credit support provided under the loan agreement does not permit the trustee to alter any of the other terms of the bond issue held by the trust. Furthermore, the trustee is permitted to accept changes in the credit support only when the trustee reasonably believes the change is advisable to maintain the value of trust property by preserving the credit rating of the bonds. Although it is possible that a proposed change would result in an increase in the value of the bonds held by the trust, any such increase would be incidental to maintaining the value of trust property. Thus, the increase would not be the result of trading in securities and thereby profiting from market fluctuations. Accordingly, the power is not a power to vary the investment as that term is used in section 301.7701-4(c) of the regulations.

HOLDING

The power to consent to changes in the credit support for debt obligations held in an investment trust is not a "power to vary the investment" within the meaning of section 301.7701-4(c) of the Procedure and Administration Regulations if it is exercisable only to the extent the trustee reasonably believes the change is advisable to maintain the value of trust property by preserving the credit rating of the bonds.

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26 CFR 301.7701-13A: Post-1969 domestic building and loan association. (Also Section 593.)

Domestic building and loan association; charter. An institution that is chartered as a bank cannot qualify as a domestic building and loan association under section 7701(a)(19) of the Code.

Rev. Rul. 90-54

ISSUE

May a bank qualify as a domestic building and loan association under section 7701(a)(19) of the Internal Revenue Code?

FACTS

Domestic corporation *X* is chartered and supervised as a bank by the Comptroller of the Currency, and *X* is operated in accordance with its charter. Previously, *X* was chartered and supervised as a Federal savings and loan association. *X*'s business consists principally of acquiring the

savings of the public and investing in loans. More than 60 percent of *X*'s total assets are assets described in section 7701(a)(19)(C) of the Code.

LAW AND ANALYSIS

Section 7701(a)(19) of the Code provides that the term "domestic building and loan association" means "a domestic building and loan association, a domestic savings and loan association, [or] a Federal savings and loan association" that meets certain tests. These are the supervisory test of section 7701(a)(19)(A), the business operations test of section 7701(a)(19)(B), and the assets test of section 7701(a)(19)(C).

It is clear from the introductory language of section 7701(a)(19) that an institution must be a domestic building and loan association, a domestic savings and loan association, or a Federal savings and loan association, in order to come within the statutory definition of the term "domestic building and loan association." The tests of subparagraphs (A), (B), and (C) of section 7701(a)(19) are limiting tests, and qualification as one of the three types of institutions listed in the introductory language of that section is a basic requirement.

The introductory language of section 7701(a)(19) has been part of the federal income tax law since 1913 and has consistently served to distinguish domestic building and loan associations from banks. Prior to 1952, section 101(4) of the Internal Revenue Code of 1939 exempted from federal income taxation "domestic building and loan associations substantially all the business of which is confined to making loans to members." In contrast, most banks historically were subject to tax. The Revenue Act of 1951, section 313, Pub. L. No. 82-183, 65 Stat. 452, 490, eliminated the exemption for domestic building and loan associations and provided liberal rules for calculating their deductions for additions to bad debt reserves. Different, less liberal rules applied to the bad debt reserves of most banks. The 1951 Act also added the definition of the term "domestic building and loan association," using the language of former section 101(4) and including "domestic savings and loan associations and Federal savings and loan associations." The Revenue Act of 1962, section 6(c), 1962-3 C.B. 111, 131, revised the definition of the term "domestic building and loan association" to remove the "loans to members" requirement and to add new supervisory, business operations, and asset tests. However, the basic requirement of the definition—that the institution be a domestic building and loan association, a domestic savings and loan association, or a Federal savings and loan association—remained unchanged.

Traditionally, the introductory language of section 7701(a)(19) has been applied by reference to an institution's charter and its operation in accordance with that charter. Rev. Rul. 64-123, 1964-1 C.B. (Part I) 521, discussed the requirements of that language. The ruling held that a fundamental requirement of section 7701(a)(19) is that the institution be one of the three types listed:

> It is, of course, not enough that substantially all of the business of the association is confined to making loans to members. It must still be a domestic building and loan association, a domestic savings and loan association, or a Federal savings and loan association. . . .
>
> . . . .
>
> [F]or an association to qualify as a domestic building and loan association, . . . the association must be organized as a building and loan association or savings and loan association pursuant to, and operated in all material respects as such in accordance with, the law of the chartering authority.

1964-1 C.B. (Part I) at 523. Rev. Rul. 64-123 was obsoleted by Rev. Rul. 72-623, 1972-2 C.B. 654, due to the changes made by the Revenue Act of 1962. However, the ruling was correct in its application of the introductory language of section 7701(a)(19), and that language has not changed.

The traditional importance and meaning of the introductory language of section 7701(a)(19) remain valid. Different statutes and regulations govern the chartering and operation of building and loan associations and savings and loan associations than govern the chartering and operation of banks. In general, the charter is the source of an institution's existence and its right to conduct business. Whether an institution is chartered as a domestic building and loan association or savings and loan association, or as a bank, determines the scope of its authority to transact business and the framework under which it is supervised and examined.

Moreover, Congress still seeks to provide federal income tax treatment for domestic building and loan associations that differs from the treatment for most banks. Code section 585 provides bad debt reserve rules for most banks, while section 593 provides more liberal bad debt reserve rules for domestic building and loan associations as defined in section 7701(a)(19), mutual savings banks, and certain cooperative banks. *See also* section 595.

In sum, the statutory structure and history of section 7701(a)(19) make it clear that only those types of institutions described in the introductory language of that section may qualify as domestic building and loan associations. The history of section 7701(a)(19) also reveals a long-standing purpose to distinguish between domestic building and loan associations and banks. Traditionally, this distinction has been understood to depend on the manner in which an institution is chartered. The nature of a financial institution's charter still has significance, and Congress has chosen to continue treating domestic building and loan associations more favorably than most banks for purposes of bad debt reserve rules. For these reasons, an institution that is chartered as a bank cannot qualify as a domestic building and loan association under section 7701(a)(19).

In the present situation, *X* is chartered as a bank. *X* is not chartered as a building and loan association or a savings and loan association. Accordingly, *X* is not described in the introductory language of section 7701(a)(19) and therefore cannot qualify as a domestic building and loan association under that section.

HOLDING

An institution that is chartered as a bank cannot qualify as a domestic building and loan association under section 7701(a)(19) of the Code.

Subchapter 80.—General Rules

Subchapter A.—Application of Internal Revenue Laws

Section 7805.—Rules and Regulations

26 CFR 301.7805-1: Rules and regulations.

Do supplemental unemployment compensation benefits constitute wages for purposes of the Federal Insurance Contributions Act and the Federal Unemployment Tax Act, and compensation for purposes of the Railroad Retirement Tax Act? See Rev. Rul. 90-72, page 211.

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 1990. See Rev. Rul. 90-52, page 192.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1990. See Rev. Rul. 90-66, page 194.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1990. See Rev. Rul. 90-75, page 195.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1990. See Rev. Rul. 90-81, page 196.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1990. See Rev. Rul. 90-92, page 198.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1990. See Rev. Rul. 90-99, page 199.

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26 CFR 1.9100-1: Extensions of time for making certain elections.

The Service will give consideration to applying the Commissioner's discretionary authority under section 1.9100-1 of the regulations to extend the time for satisfying the notice requirement of section 508(a) of the Code. See Rev. Rul. 90-100, page 156.

PART II. Treaties and Tax Legislation

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Part II. Treaties and Tax Legislation

Subpart A.—Tax Conventions

UNITED STATES—NEW ZEALAND INCOME TAX CONVENTION[1]

Convention, with protocol, signed at Wellington July 23, 1982;
Transmitted by the President of the United States of America to the Senate August 13, 1982 (Treaty Doc. No. 97-27, 97th Cong., 2d Sess.);
Reported favorably by the Senate Committee on Foreign Relations July 11, 1983 (S. Ex. Rept. No. 98-15, 98th Cong., 1st Sess.);
Advice and consent to ratification by the Senate July 27, 1983;
Ratified by the President August 23, 1983;
Ratified by New Zealand October 18, 1983;
Ratifications exchanged at Washington November 2, 1983;
Proclaimed by the President December 5, 1983;
Entered into force November 2, 1983.

BY THE PRESIDENT OF THE UNITED STATES OFAMERICA

A PROCLAMATION

CONSIDERING THAT:

The Convention between the United States of America and New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, together with a related Protocol, was signed at Wellington on July 23, 1982, the text of which is hereto annexed;

The Senate of the United States of America by its resolution of July 27, 1983, two-thirds of the Senators present concurring therein, gave its advice and consent to ratification of the Convention, together with the related Protocol;

The Convention, together with the related Protocol, was ratified by the President of the United States of America on August 23, 1983, in pursuance of the advice and consent of the Senate, and was ratified on the part of New Zealand;

The instruments of ratification of the Convention and related Protocol were exchanged at Washington on November 2, 1983, and accordingly the Convention entered into force on November 2, 1983, its provisions to have effect as specified in Article 27;

NOW THEREFORE, I, Ronald Reagan, President of the United States of America, proclaim and make public the Convention and related Protocol to the end that they be observed and fulfilled with good faith on and after November 2, 1983, by the United States of America and by the citizens of the United States of America and all other persons subject to the jurisdiction thereof.

IN TESTIMONY WHEREOF, I have signed this proclamation and caused the Seal of the United States of America to be affixed.

DONE at the city of Washington this fifth day of December in the year of our Lord one thousand nine hundred eighty-three and of the Independence of the United States of America the two hundred eighth.

RONALD REAGAN
By the President:
GEORGE P. SHULTZ
Secretary of State

CONVENTION BETWEEN THE UNITED STATES OF AMERICA AND NEW ZEALAND FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME

The United States of America and New Zealand, desiring to conclude a convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, have agreed as follows:

Article 1

GENERAL SCOPE

1. This Convention shall apply to persons who are residents of one or both of the Contracting States, except as otherwise provided in the Convention.

2. The Convention shall not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance which may be accorded:

(a) by the law of either Contracting State; or

(b) by any other agreement between the Contracting States.

3. Notwithstanding any provision of the Convention except paragraph 4, a Contracting State may tax its residents (as determined under Article 4 (Residence)), and the United States may tax its citizens and United States companies, as if the Convention had not come into effect. For this purpose, the term "citizen" shall include a former citizen whose loss of citizenship had as one of its principal purposes the avoidance of tax, but only for a period of 10 years following such loss.

4. The provisions of paragraph 3 shall not affect:

(a) the benefits conferred in a Contracting State under the Convention in accordance with paragraph 2 of Article 9 (Associated Enterprises), paragraph 1(b) of Article 18 (Pensions and Annuities), and Articles 22 (Relief From Double Taxation), 23 (Non-Discrimination), and 24 (Mutual Agreement Procedure); and

(b) the benefits conferred in a Contracting State under the Convention in accordance with Articles 19 (Government Service), 20 (Students), and 26 (Diplomatic Agents and Consular Officers), upon individuals who are neither citizens of, nor have immigrant status in, that State.

Article 2

TAXES COVERED

1. The existing taxes to which this Convention shall apply are:

(a) in the United States: the Federal income taxes imposed by the Internal Revenue Code[1a] (but excluding the accumulated earnings tax, the personal holding company tax, and social security taxes), and the excise taxes imposed with respect to private

[1]The text of the convention is contained in the pamphlet of the Treaties and Other International Act Series (TIAS) and is designated TIAS 10772. Pertinent excerpts from Senate Report No. 98-15, page 285; Treasury Department Technical Explanation, page 303.

[1a]68A Stat. 3; 26 U.S.C. §§1-8023.

foundations (hereinafter referred to as United States tax);

(b) in New Zealand: the income tax (but excluding the excess retention tax and the bonus issue tax) (hereinafter referred to as New Zealand tax).

2. The Convention shall apply also to any identical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any significant changes which have been made in their respective taxation laws.

Article 3

GENERAL DEFINITIONS

1. For the purposes of this Convention, unless the context otherwise requires:

(a) the term "person" includes an individual, an estate, a trust, a company, and any other body of persons;

(b) the term "company" means any body corporate or any entity which is treated as a body corporate for tax purposes;

(c) the term "United States company" means a company which is created or organized under the laws of the United States or any State thereof or the District of Columbia;

(d) the terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State;

(e) the term "international traffic" means any transport by a ship or aircraft of an enterprise of a Contracting State, except when such transport is solely between places in the other Contracting State;

(f) the term "competent authority" means:

(i) in the United States: the Secretary of the Treasury or his delegate; and

(ii) in New Zealand: the Commissioner of Inland Revenue or his delegate;

(g) the term "United States" means the United States of America. When used in a geographical sense, it means the States thereof, the District of Columbia, the territorial waters of the United States, and any area beyond the territorial waters which, in accordance with international law and the laws of the United States is, or may hereafter be, an area within which the rights of the United States with respect to natural resources may be exercised;

(h) the term "New Zealand" means the territory of New Zealand but does not include Tokelau or the Associated Self Governing States of the Cook Islands and Niue; it also includes any area beyond the territorial sea which by New Zealand legislation and in accordance with international law has been, or may hereafter be, designated as an area in which the rights of New Zealand with respect to natural resources may be exercised;

(i) the terms "a Contracting State" and "the other Contracting State" mean the United States of America or New Zealand as the context requires;

(j) the term "tax" means United States tax or New Zealand tax as the context requires.

2. In the Convention, the terms "New Zealand tax" and "United States tax" do not include any amount which represents a penalty or interest imposed under the law of either Contracting State relating to the taxes to which the Convention applies.

3. As regards the application of the Convention by a Contracting State any term not defined therein shall, unless the context otherwise requires and subject to the provisions of Article 24 (Mutual Agreement Procedure), have the meaning which it has under the law of that State concerning the taxes to which the Convention applies.

Article 4

RESIDENCE

1. For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is subject to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature, provided, however, that:

(a) this term does not include any person who is subject to tax in that State in respect only of income from sources in that State, nor does it include a person who is subject to tax in that State by reason of citizenship but who is not resident in that State; and

(b) in the case of income derived or paid by a partnership, an estate, or trust, this term applies only to the extent that the income derived by such partnership, estate, or trust is subject to tax in that State as the income of a resident, either in its hands or in the hands of its partners or beneficiaries. The term "resident of a Contracting State" also includes a company or trust that would be subject to tax as a resident of a Contracting State but for a determination by the competent authority of that State that such company or trust is exempt from tax in that State because it is organized and operated exclusively for charitable or other purposes exempt under the law of that State.

2. Where by reason of the provisions of paragraph 1, an individual is a resident of both Contracting States, then his status shall be determined as follows:

(a) he shall be deemed to be a resident of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident of the State with which his personal and economic relations are closer (hereinafter referred to as his center of vital interests);

(b) if the State in which he has his center of vital interests cannot be determined, or if he does not have a permanent home available to him in either State, he shall be deemed to be a resident of the State in which he has an habitual abode;

(c) if he has an habitual abode in both States or in neither of

them, he shall be deemed to be a resident of the State of which he is a citizen;

(d) if he is a citizen of both States or of neither of them, the competent authorities of the Contracting States shall endeavor to settle the question by mutual agreement.

3. Where by reason of the provisions of paragraph 1 a person other than an individual or a company is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavor to settle the question by mutual agreement and determine the mode of application of the Convention to such person.

4. Where by reason of the provisions of paragraph 1 a company is a resident of both the Contracting States, the competent authorities of the Contracting States shall endeavor to settle the question by mutual agreement and determine whether the company is a resident solely of one Contracting State or a resident solely of the other Contracting State for any income year or taxable year as the case may be, but if the competent authorities are unable to make such determination the company shall be treated as a resident of neither Contracting State for the purposes of the Convention.

Article 5

PERMANENT ESTABLISHMENT

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term "permanent establishment" includes especially:

(a) a place of management;

(b) a branch;

(c) an office;

(d) a factory;

(e) a workshop; and

(f) a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources.

3. A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.

4. An enterprise shall be deemed to have a permanent establishment in a Contracting State and to carry on business through that permanent establishment if it carries on supervisory activities in that State for more than twelve months in connection with a building site, or construction or installation project which is being undertaken in that State.

5. (a) Notwithstanding the provisions of paragraphs 3 and 4 an enterprise shall be deemed to have a permanent establishment in a Contracting State and to carry on business through that permanent establishment if it carries on activities in that State in connection with the exploration or exploitation of natural resources situated in that State;

(b) The provisions of subparagraph (a) shall not apply if such activities are carried on for a period not exceeding six months in the aggregate in any consecutive twelve month period. However for the purposes of this subparagraph activities carried on in that State by an enterprise associated with another enterprise shall be regarded as carried on by the enterprise with which it is associated if those activities are connected with activities carried on in that State by the last-mentioned enterprise. An enterprise shall be deemed to be associated with another enterprise if one is controlled directly or indirectly by the other, or if both are controlled directly or indirectly by a third person or persons.

6. Notwithstanding the preceding provisions of this Article an enterprise of a Contracting State shall not be regarded as having a permanent establishment solely as a result of one or more of the following:

(a) the use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to the enterprise;

(b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display, or delivery;

(c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

(d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise;

(e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character.

7. Notwithstanding the provisions of paragraphs 1 and 2, where a person—other than an agent of an independent status to whom paragraph 8 applies—is acting on behalf of an enterprise and has and habitually exercises in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 6 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

8. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

9. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

Article 6

INCOME FROM REAL PROPERTY

1. Income derived by a resident of a Contracting State from real property (including income from agriculture or forestry) situated in

the other Contracting State may be taxed in that other State.

2. The term "real property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to real property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of real property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources. Ships, boats and aircraft shall not be regarded as real property.

3. The provisions of paragraph 1 shall apply to income derived from the direct use, letting, subletting or use in any other form of real property.

4. The provisions of paragraphs 1 and 3 shall also apply to the income from real property of an enterprise and to income from real property used for the performance of independent personal services.

Article 7[1b]

BUSINESS PROFITS

1. The business profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the business profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the business profits which it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment and with any other associated enterprise.

3. In determining the business profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses, research and development expenses and interest, whether incurred in the State in which the permanent establishment is situated or elsewhere.

4. No business profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

5. The business profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

6. Where business profits include items of income which are dealt with separately in other Articles of the Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

7. Nothing in this Article shall prevent either Contracting States from taxing according to its law the income or profits from the business of any form of insurance.

Article 8

SHIPPING AND AIR TRANSPORT

1. Profits of an enterprise of a Contracting State from the operation of ships or aircraft in international traffic shall be taxable only in that State.

2. Profits of an enterprise of a Contracting State referred to in paragraph 1 from the rental of ships or aircraft or from the use, maintenance, or rental of containers (including trailers, barges, and related equipment for the transport of containers) shall be taxable only in that State to the extent that those ships, aircraft or containers are used in international traffic and such profits are incidental to the profits of that enterprise described in paragraph 1.

3. The provisions of paragraphs 1 and 2 shall also apply to profits from participation in a pool, a joint business, or an international operating agency.

Article 9

ASSOCIATED ENTERPRISES

1. Where

(a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State; or

(b) the same persons participate directly or indirectly in the management, control, or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State.

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which, but for those conditions would have accrued to one of the enterprises, but by reason of those conditions have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State, and taxes accordingly, profits on which an enterprise of the other Contracting State has been charged to tax in that other State, and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be paid to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.

3. Nothing in this Article shall affect the application of any law of a Contracting State relating to the determination of the tax liability of a person, including determinations in cases where the information available to the competent authority of that State is inadequate to

[1b]See Protocol, p. 284.

determine the income to be attributed to an enterprise, provided that, on the basis of available information, the determination of that tax liability is consistent with the principles stated in this Article.

Article 10[1c]

DIVIDENDS

1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.

2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident, and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed 15 percent of the gross amount of the dividends. The competent authorities of the Contracting States shall endeavor to settle the mode of application of this limitation.

This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

3. The provisions of paragraph 2 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State, of which the company paying the dividends is a resident, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the dividends are attributable to such permanent establishment or fixed base. In such case the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, shall apply.

4. A Contracting State may not impose any tax on dividends paid by a company which is not a resident of that State, except insofar as:

(a) the dividends are paid to a resident of that State, or

(b) the dividends are attributable to a permanent establishment or a fixed base of the beneficial owner of the dividends situated in that State, or

(c) the dividends are paid out of profits attributable to one or more permanent establishments of such company in that State, provided that the gross income of the company attributable to such permanent establishment constituted at least 50 percent of the company's gross income from all sources, or

(d) the dividends are paid by a United States company which is resident in New Zealand for the purposes of New Zealand tax.

Where subparagraph (c) or (d) applies and subparagraphs (a) and (b) do not apply and the beneficial owner of the dividends is a resident of the other Contracting State, tax may be imposed by the first-mentioned State according to its law but the rate of tax shall not exceed 15 percent.

Article 11[1d]

INTEREST

1. Interest derived and beneficially owned by a resident of a Contracting State may be taxed in that State.

2. However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed 10 percent of the gross amount of the interest. The competent authorities of the Contracting States shall endeavor to settle the mode of application of this limitation.

3. Notwithstanding paragraph 2, interest shall be exempt from tax by the Contracting State where it arises if the interest is:

(a) derived and beneficially owned by the other Contracting State or an instrumentality of that Contracting State which is not subject to tax on its income by that State; or

(b) derived and beneficially owned by a resident of the other Contracting State with respect to debt obligations guaranteed or insured by that State or an instrumentality of that State which is not subject to tax on its income by that State.

4. The provisions of paragraph 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State, in which the interest arises, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the interest is attributable to such permanent establishment or fixed base. In such case the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, shall apply.

5. Interest shall be deemed to arise in a Contracting State when the payer is that State itself, a political subdivision, a local authority, or resident of that State, or is a United States company which is resident in New Zealand for the purposes of New Zealand tax but is treated as a resident of neither Contracting State by reason of paragraph 4 of Article 4 (Residence). Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.

6. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of the Convention.

[1c]See Protocol, p. 284.

[1c]See Protocol, p. 284.

7. Where a resident of a Contracting State pays interest to a person other than a resident of the other Contracting State, that other State may not impose any tax on such interest except insofar as it arises in that other State or insofar as the interest paid is attributable to a permanent establishment or a fixed base of the beneficial owner of the interest situated in that other State.

Article 12[1e]

ROYALTIES

1. Royalties derived and beneficially owned by a resident of a Contracting State may be taxed in that State.

2. However, such royalties may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the beneficial owner of the royalties is a resident of the other Contracting State, the tax so charged shall not exceed 10 percent of the gross amount of the royalties. The competent authorities of the Contracting States shall endeavor to settle the mode of application of this limitation.

3. The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematographic films, films or video tapes for use in connection with television or tapes for use in connection with radio broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience. The term "royalties" also includes:

(a) payments of any kind received as consideration for the use of, or the right to use, industrial, commercial, or scientific equipment other than payments under a hire-purchase agreement; and

(b) income or gains from the alienation of any property or rights described in this paragraph to the extent that such income or gains are contingent on productivity, use or disposition of such property or rights.

4. The provisions of paragraph 2 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State, in which the royalties arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the royalties are attributable to such permanent establishment or fixed base. In such case the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, shall apply.

5. (a) Royalties shall be deemed to arise in a Contracting State when the payer is that State itself, a political subdivision, a local authority or a resident of that State, or is a United States company which is resident in New Zealand for the purposes of New Zealand tax but is treated as a resident of neither Contracting State by reason of paragraph 4 of Article 4 (Residence). Where, however, the person paying the royalties, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the liability to pay the royalties was incurred, and such royalties are borne by such permanent establishment or fixed base, then such royalties shall be deemed to arise in the State in which the permanent establishment or fixed base is situated;

(b) Where subparagraph (a) does not operate to deem royalties as arising in either Contracting State and the royalties relate to the use of, or the right to use, in one of the Contracting States, any property or right described in paragraph 3, the royalties shall be deemed to arise in that State.

6. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right, or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of the Convention.

Article 13

ALIENATION OF PROPERTY

1. Income or gains derived by a resident of a Contracting State from the alienation or disposition of real property situated in the other Contracting State may be taxed in that other State.

2. For the purposes of this Article:

(a) the term "real property situated in the other Contracting State", where the United States is that other Contracting State, includes a United States real property interest, and real property referred to in Article 6 which is situated in the United States; and

(b) the term "real property", in the case of New Zealand, includes:

(i) real property referred to in Article 6;

(ii) shares or comparable interests in a company, the assets of which consist wholly or principally of real property situated in New Zealand; and

(iii) an interest in a partnership, trust, or estate of a deceased individual, the assets of which consist wholly or principally of real property situated in New Zealand.

3. Income or gains derived by an enterprise of a Contracting State from the alienation of ships, aircraft or containers operated or used in international traffic shall, except to the extent to which that enterprise has been allowed depreciation in the other Contracting State in respect of those ships, aircraft or containers, be taxable only in the first-mentioned State.

[1e]See Protocol, p. 284.

4. Income or gains described in paragraph 3(b) of Article 12 (Royalties) shall be taxable only in accordance with the provisions of Article 12.

5. For the purposes of this Article, real property consisting of shares in a company referred to in paragraph 2(b)(ii), and interests in a partnership, trust or estate referred to in paragraph 2(b)(iii), shall be deemed to be situated in New Zealand.

6. Income or gains from the alienation of personal property which are attributable to a permanent establishment which an enterprise of a Contracting State has or had in the other Contracting State, or which are attributable to a fixed base available or previously available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, and gains from the alienation of such permanent establishment (alone or with the whole enterprise) or such a fixed base, may be taxed in that other State.

7. Income or gains from the alienation of any property other than property referred to in the preceding paragraphs of this Article shall be taxable only in the Contracting State of which the alienator is a resident.

Article 14

INDEPENDENT PERSONAL SERVICES

Income derived by an individual who is a resident of a Contracting State from the performance of personal services in an independent capacity shall be taxable only in that State, unless such services are performed in the other Contracting State and:

(a) the individual is present in that other State for a period or periods aggregating more than 183 days in any consecutive twelve month period; or

(b) the individual has a fixed base regularly available to him in that other State for the purpose of performing his activities, in which case so much of the income as is attributable to that fixed base may be taxed in such other State.

Article 15

DEPENDENT PERSONAL SERVICES

1. Subject to the provisions of Articles 18 (Pensions and Annuities) and 19 (Government Service), salaries, wages, and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.

2. Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:

(a) the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any consecutive twelve month period; and

(b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State; and

(c) the remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other State.

3. Notwithstanding the preceding provisions of this Article, remuneration derived by a resident of a Contracting State in respect of an employment as a member of the regular complement of a ship or aircraft operated in international traffic may be taxed only in that State.

Article 16

LIMITATION ON BENEFITS

1. A person (other than an individual) which is a resident of a Contracting State shall not be entitled under this Convention to relief from taxation in the other Contracting State unless:

(a) more than 75 percent of the beneficial interest in such person (or in the case of a company, more than 75 percent of the number of shares of each class of the company's shares) is owned, directly or indirectly, by any combination of one or more of:

(i) individuals who are residents of the United States;

(ii) citizens of the United States;

(iii) individuals who are residents of New Zealand;

(iv) companies as described in subparagraph (b); and

(v) the Contracting States; or

(b) it is a company in whose principal class of shares there is substantial and regular trading on a recognized stock exchange; or

(c) the establishment, acquisition and maintenance of such person and the conduct of its operations did not have as a principal purpose the purpose of obtaining benefits under the Convention.

2. For the purposes of paragraph 1(b), the term "a recognized stock exchange" means:

(a) the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for the purposes of the Securities Exchange Act of 1934; and

(b) the New Zealand Stock Exchange; and

(c) any other stock exchange agreed upon by the competent authorities of the Contracting States.

3. Where

(a) income derived by a trustee is to be treated for the purposes of the Convention as income of a resident of a Contracting State; and

(b) the trustee derived the income in connection with a scheme a principal purpose of which was to obtain a benefit under the Convention;

then, notwithstanding any other provision of the Convention, the Convention does not apply in relation to that income.

4. Before a resident of a Contracting State is denied relief from taxation in the other Contracting State by reason of this Article the

competent authorities of the Contracting States shall consult each other.

Article 17

ARTISTES AND ATHLETES

1. Notwithstanding the provisions of Articles 14 (Independent Personal Services) and 15 (Dependent Personal Services), income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio, or television artiste, or a musician, or as an athlete, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State, except where the amount of the gross receipts derived by such entertainer or athlete, including expenses reimbursed to him or borne on his behalf, from such activities does not exceed ten thousand United States dollars ($10,000) or its equivalent in New Zealand dollars for the income year or taxable year concerned.

2. Where income in respect of activities exercised by an entertainer or an athlete in his capacity as such accrues not to the entertainer or athlete but to another person, that income of that other person may, notwithstanding the provisions of Articles 7 (Business Profits) and 14 (Independent Personal Services), be taxed in the Contracting State in which the activities of the entertainer or athlete are exercised, unless it is established that neither the entertainer or athlete nor persons related thereto participate directly or indirectly in any profits of that other person in any manner whatsoever including (without limitation) the receipt of deferred remuneration, bonuses, fees, dividends, partnership distributions, or other distributions.

Article 18

PENSIONS AND ANNUITIES

1. Subject to the provisions of Article 19 (Government Service)

(a) Pensions and other similar remuneration derived and beneficially owned by a resident of a Contracting State in consideration of past employment shall be taxable only in that State; and

(b) Pensions and other payments made under the social security legislation of a Contracting State to a resident of the other Contracting State or a citizen of the United States shall be taxable only in the first-mentioned State.

2. Annuities derived and beneficially owned by a resident of a Contracting State shall be taxable only in that State. The term "annuities" as used in this paragraph means stated sums (not being alimony) paid periodically at stated times during life or during a specified or ascertainable number of years, under an obligation to make the payments in return for adequate and full consideration (other than services rendered or to be rendered).

Article 19

GOVERNMENT SERVICE

1. (a) Remuneration, other than a pension, paid by a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services in the discharge of functions of a Governmental nature rendered to that State or subdivision or authority shall be taxable only in that State.

(b) However, such remuneration shall be taxable only in the other Contracting State if the services are rendered in that State and the individual is a resident of that State who:

(i) is a citizen of that State; or

(ii) did not become a resident of that State solely for the purpose of rendering the services.

2. (a) Any pension paid by, or out of funds created by, a Contracting State or a political subdivision or local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State.

(b) However, such pension shall be taxable only in the other Contracting State if the individual is a resident of, and a citizen of, that State.

3. The provisions of Articles 14 (Independent Personal Services), 15 (Dependent Personal Services), 17 (Artistes and Athletes) and 18 (Pensions and Annuities) shall apply to remuneration and pensions in respect of services rendered in connection with a business carried on by a Contracting State or a political subdivision or a local authority thereof.

Article 20

STUDENTS

Payments received for the purpose of maintenance or education by a student who is or was immediately before visiting a Contracting State is resident of the other Contracting State and who is present in the first-mentioned State for the purpose of his full-time education shall not be taxed in that State, provided that such payments arise outside that State.

Article 21[1f]

OTHER INCOME

Items of income of a resident of a Contracting State not dealt with in the foregoing Articles of this Convention shall be taxable only in that State except that, if such income is derived from sources within the other Contracting State, it may also be taxed in that other State.

Article 22

RELIEF FROM DOUBLE TAXATION

1. Subject to paragraph 4, and in accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), in the case of the United States double taxation shall be avoided as follows:

(a) the United States shall allow to a resident or citizen of the United States or a United States company as a credit against United States tax the income tax paid to New Zealand by or on behalf of such resident, citizen or company; and

(b) the United States shall also allow to a United States company owning at least 10 percent of the voting stock of a company

[1f]See Protocol, p. 284.

(other than a United States company) which is a resident of New Zealand and from which the United States company receives dividends, as a credit against United States tax, the income tax paid to New Zealand by or on behalf of the distributing company with respect to the profits out of which the dividends are paid. For the purpose of this paragraph, the taxes referred to in paragraphs 1(b) and 2 of Article 2 (Taxes Covered) shall be considered income taxes.

2. In the case of New Zealand, double taxation shall be avoided as follows:

In accordance with, and subject to any provisions of, the law of New Zealand which may from time to time be in force and which relate to the allowance of a credit against New Zealand tax for tax paid in a country outside New Zealand (which shall not affect the general principle hereof), United States tax paid under the law of the United States and consistently with this Convention, whether directly or by deduction, in respect of income derived by a resident of New Zealand arising in the United States (excluding in the case of a dividend, tax paid in respect of the profits out of which the dividend is paid) shall be allowed as a credit against New Zealand tax payable in respect of that income; except that such credit shall not exceed the amount of the tax that would be paid to the United States if the resident were not a United States citizen or a United States company. However, where a company which is a resident of New Zealand beneficially owns at least 10 percent of the paid-up share capital of a United States company any dividend derived by the first-mentioned company from the United States company (being dividends which, in accordance with the taxation law of New Zealand in existence at the date of signature of the Convention would be exempt from New Zealand tax) shall be exempt from New Zealand tax.

3. For the purposes of computing United States tax, where a citizen of the United States or a United States company is a resident of New Zealand, the United States shall allow as a credit against United States tax the income tax paid to New Zealand after the credit referred to in paragraph 2. The credit so allowed against United States tax shall not reduce that portion of the United States tax that is creditable against New Zealand tax in accordance with paragraph 2.

4. For the purpose of allowing relief from double taxation pursuant to this Article, income shall be deemed to arise as follows:

(a) income derived by a resident of the United States which may be taxed in New Zealand in accordance with this Convention shall be deemed to arise in New Zealand;

(b) income derived by a resident of New Zealand which may be taxed in the United States in accordance with the Convention (other than income taxed by the United States solely because the beneficial owner is a citizen of the United States or a United States company) shall be deemed to arise in the United States;

(c) For purposes of paragraph 3, income beneficially owned by a resident of New Zealand who is a citizen of the United States or a United States company shall be deemed to arise in New Zealand to the extent necessary to give effect to the provisions of this paragraph.

5. No provision of this Convention relating to source of income shall apply in determining credits against United States tax for foreign taxes other than those referred to in paragraphs 1(b) and 2 of Article 2 (Taxes Covered).

Article 23

NON-DISCRIMINATION

1. Citizens of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is more burdensome than the taxation and connected requirements to which citizens of that other State in the same circumstances are or may be subjected. This provision shall apply to persons who are not residents of one or both of the Contracting States. However, for the purposes of United States tax, a United States citizen who is not a resident of the United States and a New Zealand citizen who is not a resident of the United States are not in the same circumstances.

2. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as:

(a) obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, exemptions, rebates, reliefs and reductions which it grants to its own residents; or

(b) preventing a Contracting State from imposing on the profits attributable to a permanent establishment in that State of a company which is a resident of the other Contracting State a tax not exceeding 5 percent of those profits in addition to the tax which would be chargeable on those profits if they were the profits of a company which was a resident of the first-mentioned State; or

(c) requiring a Contracting State to grant to a company which is a resident of the other Contracting State the same tax relief that it provides to a company which is a resident of the first-mentioned State with respect to dividends received by it from a company.

3. Except where the provisions of paragraph 1 of Article 9 (Associated Enterprises), paragraph 6 of Article 11 (Interest), or paragraph 6 of Article 12 (Royalties) apply, interest, royalties and other disbursements paid by a resident of a Contracting State to a resident of the other Contracting State shall, for the purposes of determining the taxable profits of the first-mentioned resident, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State.

4. An enterprise of a Contracting State, the capital of which is

wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement directly connected therewith which is more burdensome than the taxation and directly connected requirements to which an enterprise of the first-mentioned State, carrying on the same activities the capital of which is owned or controlled by residents of that State, are or may be subjected.

5. This Article shall not apply to any provision of the taxation laws of a Contracting State which:

(a) is reasonably designed to prevent or defeat the avoidance or evasion of taxes; or

(b) is in force on the date of signature of this Convention, or is substantially similar in general purpose or intent to any such provision but is enacted after that date; provided that any such provision (except where that provision is in an international agreement) does not allow for different treatment of residents or citizens of the other Contracting State as compared with the treatment of residents or citizens of any third State.

6. Nothing in this Article shall be construed as preventing a Contracting State from distinguishing in its taxation laws between residents and non-residents solely on the basis of their residence.

7. If a Contracting State considers that future taxation measures of the other Contracting State infringe the principles set forth in this Article, the competent authorities of the Contracting States shall consult each other in an endeavor to resolve the matter.

Article 24

MUTUAL AGREEMENT PROCEDURE

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or citizen. This case must be presented within 3 years from the first notification of that action.

2. The competent authority shall endeavor, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.

3. The competent authorities of the Contracting States shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.

4. The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement in the sense of the preceding paragraphs.

Article 25

EXCHANGE OF INFORMATION AND ADMINISTRATIVE ASSISTANCE

1. The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention insofar as the taxation thereunder is not contrary to the Convention. The exchange of information is not restricted by Article 1 (General Scope). Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Convention. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

2. If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall endeavor to obtain the information to which the request relates in the same manner and to the same extent as if the tax of the first-mentioned State were the tax of that other State and were being imposed by that other State. If specifically requested by the competent authority of a Contracting State, the competent authority of the other Contracting State shall endeavor to provide information under this Article in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and writings), to the same extent such depositions and documents can be obtained under the laws and administrative practices of that other State with respect to its own taxes.

3. In no case shall the provisions of paragraphs 1 and 2 be construed so as to impose on a Contracting State the obligation:

(a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;

(b) to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;

(c) to supply information which would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy.

Article 26

DIPLOMATIC AGENTS AND CONSULAR OFFICERS

Nothing in this Convention shall affect the fiscal privileges of diplomatic agents or consular officers

under the general rules of international law or under the provisions of special agreements.

Article 27

ENTRY INTO FORCE

1. This Convention shall be subject to ratification in accordance with the applicable procedures of each Contracting State and instruments of ratification shall be exchanged at Washington as soon as possible.

2. The Convention shall enter into force upon the exchange of instruments of ratification[1g] and its provisions shall have effect:

(a) in the United States:

(i) in respect of taxes withheld at source, for amounts paid or credited on or after the first day of the second month next following the date on which the Convention enters into force;

(ii) in respect of other taxes, for taxable years beginning on or after the date on which the Convention enters into force.

(b) in New Zealand:

(i) in respect of withholding tax on income that is derived by a non-resident, for any income year beginning on or after the first day of April next following the date on which the Convention enters into force;

(ii) in respect of other New Zealand tax, for any income year beginning on or after the first day of April next following the date on which the Convention enters into force.

3. If the Convention enters into force before 1 April 1984 then, notwithstanding the provisions of paragraph 2(b)(i), New Zealand shall for the purposes of New Zealand tax apply the provisions of Article 10 (Dividends) to dividends derived on or after 1 April 1982 and beneficially owned by a resident of the United States.

4. The Agreement between the Government of New Zealand and the Government of the United States of America for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, signed at Washington on 16 March 1948[1h] (in this Article referred to as "the 1948 Agreement") shall cease to have effect in relation to any tax in respect of which this Convention comes into effect in accordance with paragraph 2 or 3.

5. The 1948 Agreement shall terminate on the last date on which it has effect in accordance with the foregoing provisions of this Article.

Article 28

TERMINATION

1. This Convention shall remain in force until terminated by a Contracting State. Either Contracting State may terminate the Convention at any time after 5 years from the date on which the Convention enters into force, provided that at least 6 months prior notice of termination has been given through diplomatic channels. In such event, the Convention shall cease to have effect:

(a) in the United States:

(i) in respect of taxes withheld at source, for amounts paid or credited on or after the first day of January next following the expiration of the 6 month period;

(ii) in respect of other taxes, for taxable periods beginning on or after the first day of January next following the expiration of the 6 month period.

(b) in New Zealand:

(i) in respect of withholding tax on income that is derived by a non-resident on or after the first day of April next following the expiration of the 6 month period;

(ii) in respect of other taxes, for any income year beginning on or after the first day of April next following the expiration of the 6 month period.

IN WITNESS WHEREOF the undersigned, duly authorized thereto, have signed the present Convention.

DONE at Wellington in duplicate, this 23rd day of July 1982.

PROTOCOL

to the Convention between the United States of America and New Zealand for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income.

At the signing of the Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, concluded today between the United States of America and New Zealand, the undersigned have agreed that the following provisions shall form an integral part of that Convention.

1. With reference to Articles 10, 11 and 12

If in any future double taxation convention with any other country, being a member of the Organization for Economic Cooperation and Development, New Zealand should limit its taxation at source on any dividends, interest or royalties to a rate lower than the one provided for in any of such articles, New Zealand shall without undue delay enter into negotiations with the United States to review the appropriate article with a view to providing the same treatment on a reciprocal basis.

2. With reference to Articles 7, 12 and 21

So long as New Zealand continues to tax the income of film renters according to section 224 of the Income Tax Act of 1976 (including any subsequent enactment which does not affect the general principle thereof) and to exempt from tax in accordance with that section certain payments received from such film renters by persons not resident in New Zealand for the purposes of New Zealand tax, the provisions of Articles 7, 12 and 21 of the Convention shall not affect the taxation by New Zealand of such income or the exemption by New Zealand of such payments.

DONE at Wellington in duplicate, this 23rd day of July 1982.

Charles B. Salmon, Jr.

FOR THE UNITED STATES OF AMERICA

Warren E. Cooper

FOR NEW ZEALAND

[1g]Nov. 2, 1983.

[1h]TIAS 2360; 2 UST 2378.

Senate Executive Report No. 98-15

[Bracketed numerals indicate official report page numbers]

TAX CONVENTION (AND PROPOSED PROTOCOL) WITH THE GOVERNMENT OF NEW ZEALAND

JULY 11, 1983.

Mr. PERCY, from the Committee on Foreign Relations, submitted the following report to accompany Treaty Doc. 97-27, 97th Cong. 2d sess.

The Committee on Foreign Relations, to which was referred the Tax Treaty (and Proposed Protocol) with the Government of New Zealand for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income (Treaty Doc. 97-27) (collectively referred to as the proposed treaty), having considered the same, reports favorably thereon, and recommends that the Senate give its advice and consent to ratification thereof.

I. PURPOSE

The principal purpose of the proposed income tax treaty between the United States and New Zealand is to reduce or eliminate potential double taxation of income earned by citizens and residents of either country from sources within the other country, and to prevent avoidance or evasion of the income taxes of the two countries. The proposed treaty is intended to promote closer economic cooperation between the two countries and to eliminate possible barriers to trade caused by overlapping taxing jurisdictions of the two countries. It is intended to enable the countries to cooperate in preventing avoidance and evasion of taxes.

II. BACKGROUND

The proposed treaty with New Zealand was signed on July 23, 1982. The proposed protocol was signed the same day. The proposed treaty would replace the 1948 income tax treaty between the United States and New Zealand. The treaty and the protocol were transmitted to the Senate for advice and consent to ratification on August 13, 1982.

III. SUMMARY

[2] The proposed treaty is similar to other recent U.S. income tax treaties and to the model income tax treaty of the Organization for Economic Cooperation and Development (OECD) in many respects, but in certain respects it accords greater jurisdiction to tax to the country of source, rather than to the country of residence.

As in other U.S. tax treaties, the objectives of the treaty are principally achieved by each country agreeing to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other. For example, the treaty contains the standard tax treaty provisions that neither country will tax business income derived from sources within that country by residents of the other unless the business activities in the taxing country are substantial enough to constitute a permanent establishment or fixed base (Articles 7 or 14). Similarly, the treaty contains the standard "commercial visitor" exemptions under which residents of one country performing personal services in the other will not be required to pay tax in the other unless their contact with the other exceeds specified minimums (Articles 14, 15, and 17). The proposed treaty provides that dividends, interest, royalties, certain capital gains and certain other income derived by a resident of either country from sources within the other country generally may be taxed by both countries (Articles 10, 11, 12, 13, and 21). Generally, however, dividends, interest, and royalties received by a resident of one country from sources within the other country are to be taxed by the source country on a restricted basis (Articles 10, 11, and 12).

In situations where the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the treaty generally provides for the relief of the potential double taxation by the country of residence allowing a foreign tax credit or, in certain cases, a partial exemption.

This treaty contains the standard provision (the "saving clause") contained in U.S. tax treaties that each country retains the right to tax its citizens and residents as if the treaty had not come into effect (Article 1). In addition, it contains the standard provision that the treaty will not be applied to deny any taxpayer any benefits he would be entitled to under the domestic law of the country or under any other agreement between the two countries (Article 1); that is, the treaty will be applied only to the benefit of taxpayers.

The proposed treaty differs in certain respects from other U.S. income tax treaties and the U.S. model. It also differs in significant respects from the present treaty with New Zealand. Some of these differences are as follows:

(1) U.S. citizens who are not also U.S. residents are not generally covered. The U.S. model does cover such U.S. citizens. However, the United States has rarely been able to negotiate coverage for nonresident citizens.

(2) The proposed treaty does not provide for determination of a single residence for all corporations that are residents of both the United States and New Zealand under local law. The U.S. and Organization for Economic Cooperation and Development (OECD) model treaties do each provide for such a determination. The effect [3] of the lack of such a provision in the proposed treaty is to deny treaty benefits to dual resident corporations.

(3) The definition of permanent establishment in the proposed treaty is somewhat broader than that in the U.S. model and in many existing U.S. treaties. The principal differences are that the proposed treaty provides that an enterprise has a permanent establishment in a country if it carries on activities in connection with the exploration for or exploitation of natural resources situated in that country or its continental shelf for at least 6 months in any 12 month period (rather than the model's 12 months) or if it carries on supervisory activities in connection with a building site for more than 12 months. The model does not treat such activities as a permanent establishment independently of other tests. The present treaty does not contain special rules for these activities.

(4) The proposed treaty does not contain a definition of the term "business profits", although certain categories of business profits are defined in various articles. This leaves to local law the definition of that

term in some cases, and accordingly the profits that must be attributed to a permanent establishment before those profits can be taxed by the country where the permanent establishment is located. Many U.S. treaties, and the U.S. model, define the term business profits to include income from rental of tangible personal property and from rental or licensing of films or tapes. Absence of this definition means that persons who earn such rental or licensing income could be subject to tax on a gross basis, not a net basis, in the source country unless they maintain a permanent establishment there.

(5) The proposed treaty does not allow investors in real property in the country not of their residence to elect to be taxed on such investments on a net basis. The U.S. model allows such an election. Although current New Zealand law and current U.S. law provide for net basis taxation, there is no guarantee that New Zealand will continue such treatment.

(6) The proposed treaty does not restrict source country taxation of profits from shipping and air transport so tightly as does the U.S. model treaty. Under the proposed treaty, the source country must exempt income that a lessor earns from bareboat leases of ships, aircraft, or containers only if both (1) those items are used in international traffic and (2) the income is incidental to other income that the lessor earns from the operation of ships or aircraft in international traffic. The model treaty mandates source country exemption if the lease meets either one of these two criteria.

(7) The limit on the gross dividend withholding tax that the country of source may impose is 15 percent (Article 10) in contrast to the 5 percent limit on direct dividends and 15 percent limit on portfolio dividends in the U.S. model. The present treaty does not limit New Zealand's dividend withholding tax, presently 30 percent. The analogous U.S. rate is also 30 percent.

(8) The tax at source on interest is limited to 10 percent of the gross interest (Article 11) rather than the zero rate in the U.S. model, except that interest derived by or insured or guaranteed by the other government is exempt at source. A zero rate is not generally achieved in many treaties, but is at times achieved for interest earned by banks on loans made into the source country. The [4] present treaty does not limit the rate of the withholding tax on interest. The current New Zealand statutory withholding rate is 15 percent, while the analogous U.S. rate is 30 percent.

(9) The tax at source on royalties is limited to 10 percent (Article 12) rather than the zero rate in the U.S. model. New Zealand's statutory rate on royalty payments (which would be reduced to 10 percent by the proposed treaty) is generally 15 percent. The present treaty does not generally limit source country taxation of royalties, but does specifically allow taxpayers earning certain royalty income to elect to be taxed on a net basis. The proposed treaty contains no net basis election, although certain rentals are taxed on a net basis by New Zealand. The present treaty provides separate rules for film royalties. They are exempt from the income tax in New Zealand, but are subject to a film-hire tax and film-hire duty. Under the proposed treaty film rentals may not be taxed in excess of 10 percent of the gross amount; however, so long as New Zealand law taxes such income at the corporate rate of 45 percent on a deemed profit of 10 percent of the gross amount, that lower statutory provision will prevail. As in the present treaty the customs duty (film-hire duty) is not a covered tax.

(10) The proposed treaty allows source country taxation of income from independent personal services on the basis of presence in that country for more than 183 days in any consecutive 12 month period. Under the model, independent personal services of a nonresident are taxable only if the nonresident has a fixed base available in the source country.

(11) The proposed treaty allows source country taxation of wages of an employee on the basis of presence in that country for more than 183 days in any consecutive 12 month period. The U.S. model treaty allows source country taxation in that case only if there is more than 183 days' presence in a taxable year.

(12) The proposed treaty prevents application of sanctions against treaty-shopping until the competent authorities of the two countries have consulted each other. The U.S. model requires no consultation. In addition, the proposed treaty does not require either country to endeavor to collect for the other amounts necessary to insure that the treaty is not benefiting unintended parties. The U.S. model requires collection endeavors in that case.

(13) The proposed treaty allows source country taxation of an entertainer or athlete who earns more than $10,000 there during a taxable year; the comparable amount in the U.S. model treaty is $20,000.

(14) The proposed treaty does not limit taxation of alimony or child support payments. The model treaty allows taxation of alimony payments only in the country of residence of the recipient, and taxation of child support payments only in the country of residence of the payor. Although New Zealand does not now allow a deduction to the payor or tax either kind of payment to the recipient, there is no guarantee that New Zealand will continue that treatment.

(15) The present treaty exempts from source country taxation the salaries of teachers from the other country who visit for two years or less. The proposed treaty, like the U.S. model, subjects those [5] amounts to its standard rules, which would ordinarily result in full source country taxation.

(16) The proposed treaty's nondiscrimination provision is more limited than the U.S. model and provisions found in many U.S. tax treaties because it does not apply to tax rules that were in effect in either country on the date of signature, July 23, 1982, and because it does not prevent discrimination by States and localities in their tax laws. The existing treaty, however, does not limit discrimination at all.

(17) The U.S. model treaty provides for the exchange of information about all taxes imposed by the parties to the treaty, and not just those that the treaty covers. The exchange of information provision in the proposed treaty covers only those taxes that the treaty otherwise covers.

IV. DATE OF ENTRY INTO FORCE AND TERMINATION

Entry into Force

The proposed treaty will enter into

force upon the exchange of instruments of ratification. With respect to U.S. taxes withheld at source, the treaty will be effective for amounts paid or credited on or after the first day of the second month next following the date on which the treaty enters into force. With respect to other U.S. taxes, the treaty is to be effective for taxable years beginning on or after the date on which the treaty enters into force. With respect to New Zealand taxes, the treaty will be effective for any income year beginning on or after the first day of April next following the date on which the treaty enters into force. If the Convention enters into force before April 1, 1984, its reduction of New Zealand withholding tax on dividends will apply to dividends derived on or after April 1, 1982, and beneficially owned by a resident of the United States. The existing treaty is to be phased out as the proposed treaty becomes effective. When the proposed treaty becomes fully effective the existing treaty will terminate.

Termination

The proposed treaty will continue in force indefinitely, but either country may terminate it at any time after five years from its entry into force by giving at least six months prior notice through diplomatic channels. If termination occurs, with respect to U.S. taxes withheld at source, the termination will be effective for amounts paid or credited on or after the first day of January next following the expiration of the six month period. With respect to other U.S. taxes, the termination will be effective for taxable periods beginning on or after the first day of January next following the expiration of the six month period. With respect to New Zealand taxes, the termination will be effective for any income year beginning on or after the first day of April next following the expiration of the six month period.

V. COMMITTEE ACTION

The Committee on Foreign Relations held public hearings on the proposed New Zealand tax treaty and protocol, and on other tax [6] treaties, on May 24, 1983. The Committee heard testimony in opposition to the treaty from Edward Woolley, Secretary and General Counsel of the Institute of International Container Lessors. The Committee considered the proposed treaty and protocol on June 28, 1983, and ordered them favorably reported by a voice vote, with the recommendation that the Senate give its advice and consent to ratification of both instruments.

VI. COMMITTEE COMMENTS

The Committee on Foreign Relations approved the treaty and the protocol to the treaty, but expressed its serious concern with the treatment of container leasing income and with the extension of permanent establishment treatment to drilling rigs present in the taxing country for a limited period of time.

This treaty contains two provisions that depart from the U.S. model treaty in a way that adversely affects two important U.S. industries—the container leasing industry and the contract drilling industry. In some cases, a particular taxpayer or industry may receive better treatment under an existing treaty than under a newly negotiated treaty or may receive better treatment under the U.S. model treaty than under a specific treaty. Since a treaty is essentially a compromise between two countries with competing interests, that result is not unexpected. The central issue is whether the final agreement represents a bargain which is sufficiently favorable overall to the United States that it should be ratified. The Committee recognizes that the negotiation of a tax treaty involves a wide range of issues and a significant amount of give and take on both sides. In this case, the Committee notes that the proposed treaty is the result of many years of negotiation and would benefit a number of U.S. industries with substantial investments in New Zealand. Therefore, the Committee believes that the appropriate course of action is to approve the treaties while indicating the disfavor with which it views the provisions allowing New Zealand taxation of U.S. container lessors and contract drillers.

The Committee is, however, concerned that an individual industry not repeatedly pay the price for treaty relationships. The Committee will monitor treaties that are negotiated in the future to make sure that individual industries are not bearing the brunt of the bargain in those treaties, and will have to seriously consider rejecting treaties that do not contain the proper balance between the interests of a particular industry and benefits to a broad range of U.S. taxpayers.

Container leasing income

The proposed treaty would permit New Zealand to tax container leasing rentals as royalties subject to a withholding tax of 10 percent of the gross rental in certain cases unless (1) the lease is merely incidental to the operation in international traffic of ships or aircraft by the lessor and (2) the leased item is used in international traffic (Articles 8 and 12). Under the U.S. model, income from leasing containers in international traffic is treated as transportation income and is exempt from tax at source even though the lessor is not engaged in international traffic of ships or aircraft.

[7] The Committee is concerned with this provision for several reasons. First, it represents a significant departure from U.S. policy as expressed in the U.S. model income tax treaty and from recent U.S. practice. All the treaties that the United States has negotiated since adoption of the 1977 U.S. model have treated container leasing income as either shipping income, exempt in the source country, or as business profits, taxable on a net basis. Second, inclusion of this provision seems to indicate that there is some justifiable distinction between container leasing income and other transportation income. The Committee does not believe that any such justifiable distinction exists. Third, it could allow New Zealand to impose a gross withholding tax that would exceed net income in certain cases. Fourth, it would place container leasing companies at a competitive disadvantage to shipping companies who lease containers in international traffic as an incidental part of their business, and who would be exempt from tax on those container leases under the proposed treaty (as under the U.S. model treaty). Fifth, the taxation of container leasing income on the basis of the residence of the payor is inappropriate because it could lead to multiple taxation. If one country (such as New Zealand) taxes container leasing income of a U.S. lessor on the basis of residence of the lessee, while a third country

(not a party to the treaty) taxes that income on the basis of location of the container, there may be double taxation. Although the United States, as residence country, would not claim primary taxing jurisdiction in this example, the overlapping claims of source country jurisdiction could result in extremely high tax rates.

The Committee has been advised that the Treasury does not view this provision as precedent. The Committee expresses its strong concern about this provision and advises the Treasury Department, in any future negotiations, to take all necessary steps to conform future treaties to the U.S. model treaty on this point.

Income from drilling activities

The proposed treaty contains a permanent establishment article that is broader than that contained in the U.S. or OECD models. This would permit the country in which the activities are carried on to tax activities sooner than it would be able to under the model. Under the proposed treaty, U.S. enterprises carrying on activities in connection with exploration for or exploitation of natural resources may be subject to New Zealand tax if they are present in New Zealand territory for as little as 6 months in any 12 month period. Under the U.S. model, they must be present there for at least one year. The practical effect of the provision could be to increase New Zealand taxation of mineral exploration activities. This expansion was made at the insistence of New Zealand.

The Committee wishes to express its strong concern with the treatment that contract drillers receive under this treaty. The contract drilling industry is important to the United States, and the Committee strongly supports the approach of the U.S. model income tax treaty for contract drillers for treaties to be negotiated in the future. The Committee wishes to stress that the acceptance of this provision in this particular treaty does not indicate that the Committee will accept similar treatment in treaties nego[8]tiated in the future; it does not view this provision as a precedent for treaties to be negotiated in the future.

VII. BUDGET IMPACT

The Committee estimates that the effect of the proposed treaty on budget receipts will be negligible.

In accordance with the objectives of section 403 of the Budget Act, the Committee advises that the Director of the Congressional Budget Office has examined the Committee's budget estimate and agrees that the effect on budget receipts will be negligible. In keeping with the spirit of section 308(a) of the Budget Act, and after consultation with the director of the Congressional Budget Office, the Committee states that the treaty does not provide any new budget authority or any new or increased tax expenditures.

[9] VIII. EXPLANATION OF TREATY PROVISIONS

Set forth below is an article-by-article explanation of the proposed income tax treaty between the United States and New Zealand, as modified by the proposed protocol.

Article 1. General Scope

The general scope article describes the persons who may claim the benefits of the treaty and contains other rules including the "saving clause."

The proposed treaty applies generally to residents of the United States and to residents of New Zealand, with specific exceptions designated in other articles. This follows other U.S. income tax treaties, the U.S. model income tax treaty, and the OECD model income tax treaty. Residence is defined in Article 4.

The proposed treaty provides that it does not restrict any benefits accorded by internal law or by any other agreement between the United States and New Zealand. Thus, the treaty will apply only where it benefits taxpayers.

The proposed treaty also contains the "saving clause" contained in all U.S. income tax treaties that provides, with specific exceptions described below, that the treaty is not to affect the taxation by either country of its residents. In addition, subject to those specific exceptions, the treaty is not to affect taxation by the United States of U.S. citizens and U.S. companies. Consequently, unless otherwise specifically provided in the proposed treaty, the United States will continue to tax its citizens and companies that are residents of New Zealand, as if the treaty were not in force. Residents for purposes of the treaty (and thus, for purposes of the saving clause) include corporations and other entities as well as individuals (Article 4 (Residence)).

Under Section 877 of the Internal Revenue Code of 1954 ("Code"), a former U.S. citizen whose loss of citizenship had as one of its principal purposes the avoidance of U.S. income, estate or gift taxes, will, in certain cases, be subject to tax for a period of 10 years following the loss of citizenship. The treaty contains the standard provision found in the U.S. model and most recent treaties specifically retaining the right to tax former citizens. Even absent a specific provision the Internal Revenue Service takes the position that the United States retains the right to tax former citizens resident in the treaty partner (Rev. Rul. 79-152, 1979-1 C.B. 237).

Exceptions to the saving clause are provided for certain benefits conferred by the articles dealing with Associated Enterprises (Article 9); Pensions and Annuities (Article 18); Relief from Double Taxation (Article 22); Non-Discrimination (Article 23); and Mutual Agreement Procedure (Article 24).

[10] In addition, the saving clause does not apply to the benefits conferred by one of the countries under the articles dealing with Government Service (Article 19), Students (Article 20), or Diplomatic Agents and Consular Officers (Article 26), upon individuals who are not citizens of that conferring country and who do not have immigrant status in that conferring country.

Article 2. Taxes Covered

The proposed treaty generally applies to the income taxes of the United States and New Zealand.

In the case of the United States, the proposed treaty applies to (1) the Federal income taxes imposed by the Internal Revenue Code, but excluding the accumulated earnings tax, the personal holding company tax, and social security taxes, and (2) the excise tax on private foundations. In the case of New Zealand, the proposed treaty applies to the New Zealand income tax, but excluding the excess retention tax and the bonus issue tax. The excess retention tax is similar in concept to the U.S. personal holding

company tax. The bonus issue tax applies to certain capitalizations of reserves. Although the U.S. model treaty applies to the excise tax on private foundations and (in certain cases) to the excise tax on insurance premiums paid to foreign insurers, the proposed treaty does not apply to those taxes. Thus, the United States could continue to impose them.

The proposed treaty also contains a provision generally found in U.S. income tax treaties to the effect that it will apply to substantially similar taxes that either country may subsequently impose. The proposed treaty, like the U.S. model, obligates the competent authority of each country to notify the competent authority of the other country of any substantial changes in the tax laws of his country.

Article 3. General Definitions

Certain of the standard definitions found in most U.S. income tax treaties are contained in the proposed treaty.

The term "person" is defined to include an individual, an estate or trust, a company and any other body of persons. A "company" is any body corporate or any entity which is treated as a company or body corporate for tax purposes. The term "United States company" is defined to mean a company that is created or organized under the laws of the United States or any State thereof or the District of Columbia.

An enterprise of a country is defined as an enterprise carried on by a resident of that country. Although the treaty does not defined the term "enterprise" it would have the same meaning that it has in other U.S. tax treaties—the trade or business activities undertaken by an individual, partnership, company, or other entity.

The proposed treaty defines international traffic as any transport by a ship or aircraft by an enterprise of one of the two countries, except where the transport is solely between places in the other country. Accordingly, with respect to a New Zealand enterprise, purely domestic transport in the United States is excluded.

The U.S. competent authority is the Secretary of Treasury or his delegate. In fact, the U.S. competent authority function has been [11] delegated to the Commissioner of the Internal Revenue Service, who has redelegated the authority to the Associate Commissioner (Operations). The Assistant Commissioner (Examination) has been delegated the authority to administer programs for simultaneous, spontaneous, and industry-wide exchanges of information. The Director, Foreign Operations District (formerly called the Director of the Office of International Operations), has been delegated the authority to administer programs for routine and specific exchanges of information and mutual assistance in collection. The New Zealand competent authority is the Commissioner of Inland Revenue or his delegate.

The "United States" means the United States of America, a term that does not include Puerto Rico, the Virgin Islands, Guam or any other United States possession or territory. The definition of the United States also includes, when the term is used in a geographical sense, the territorial waters of the United States and any area beyond the territorial waters that, in accordance with international law and the laws of the United States, is (or may at a later time be) an area within which the United States may exercise rights with respect to natural resources. The intent of this rule is to cover the U.S. continental shelf consistent with the definition of continental shelf contained in section 638 of the Code.

The term "New Zealand" means the territory of New Zealand but does not include Tokelau or the Associated Self Governing States of the Cook Islands and Niue; it also includes any area beyond the territorial sea which by New Zealand legislation and in accordance with international law has been, or may at a later time be, designated as an area in which the rights of New Zealand with respect to natural resources may be exercised. Therefore, income earned on the New Zealand continental shelf is covered.

The term "Contracting State" means the United States or New Zealand, as the context requires. The proposed treaty would define the term "tax" as meaning United States tax or New Zealand tax as the context requires. The terms "New Zealand tax" and "United States tax" do not include any amount that represents a penalty or interest imposed under the law of either country that relates to taxes covered by the treaty. Thus, the right of a country to impose penalties or interest is not limited by the proposed treaty.

The proposed treaty also contains the standard provision that, unless the context otherwise requires or the competent authorities of the two countries establish a common meaning, all terms are to have the meaning which they have under the applicable tax laws of the country applying the treaty.

Article 4. Residence

The assignment of a country of residence is important because the benefits of the proposed treaty generally are available only to a resident of one of the countries as that term is defined in the treaty. Furthermore, double taxation is often avoided by the treaty assigning one of the countries as the country of residence where under the laws of the countries the person is a resident of both.

Under U.S. law, residence of an individual is important because a resident alien is taxed on his worldwide income, while a nonresident alien is taxed only on U.S. source income and on his income [12] that is effectively connected with a U.S. trade or business. The Code, however, does not define the term "residence." Instead, IRS regulations state that an alien is a resident of the United States if he is actually present in the United States and is not a mere transient or sojourner. Whether he is a transient is determined by his intentions as to the length and nature of his stay. (See Treas. Reg. sec. 1.871-2(b).) A company is resident in the United States if it is organized in the United States.

The proposed treaty generally defines "resident of a Contracting State" to mean any person who, under the laws of that State, is subject to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature. However, the term "resident of a Contracting State" does not include any person who is subject to tax in that country in respect only of income from sources in that country, nor does it include a person who is subject to tax in that

country by reason of citizenship but who is not resident in that country.

This provision of the proposed treaty is generally based on the fiscal domicile article of the U.S. model and OECD model tax treaties and is similar to the provisions found in other U.S. tax treaties. Consistent with most U.S. income tax treaties, citizenship alone does not establish residence. As a result, U.S. citizens residing overseas (in countries other than New Zealand) are not entitled to the benefits of the treaty as U.S. residents. This result is contrary to U.S. treaty policy as expressed in the U.S. model. The U.S. position is achieved in very few treaties.

Moreover, in the case of income derived or paid by a partnership, an estate, or trust, the term "resident of a Contracting State" applies only to the extent that the income derived by the partnership, estate, or trust is subject to tax in that country as the income of a resident, either in its hands or in the hands of its partners or beneficiaries. For example, if the share of U.S. residents in the profits of a U.S. partnership is only one-half, New Zealand would have to reduce its withholding tax on only half of the New Zealand source income paid to the partnership.

The term "resident of a Contracting State" also includes a company or trust that would be subject to tax as a resident of a contracting country but for a determination by the competent authority of that country that the company or trust is exempt from tax in that country because it is organized and operated exclusively for charitable or other purposes that make it exempt from tax under the law of that country.

A set of "tie-breaking" rules is provided to determine residence in the case of an individual who, under the basic treaty definition, would be considered to be a resident of both countries. Such a dual resident individual will be deemed to be a resident of the country in which he has a permanent home available to him. If this permanent home test is inconclusive because the individual has a permanent home in both countries, the individual's residence is deemed to be the country with which his personal and economic relations are closer, i.e., his "center of vital interests". If the country in which he has his center of vital interests cannot be determined, or if he does not have a permanent home available to him in either country, he shall be deemed to be a resident of the country in [13] which he has an habitual abode. If the individual has an habitual abode in both countries or in neither of them, he shall be deemed to be a resident of the country of which he is a citizen. If he is a citizen of both States or of neither of them, the competent authorities of the Contracting States are to endeavor to settle the question of residence by mutual agreement.

In the case of a person other than an individual or a company who is resident of both countries under the basic treaty definition, the proposed treaty requires the competent authorities of the two countries to endeavor to settle the question by mutual agreement and to determine how the treaty applies to that person.

The interaction of United States and New Zealand law can result in a company being a resident of both countries under local law. For example, a company incorporated in the United States but carrying on business and being managed in New Zealand would be considered a domestic company by both countries under their local laws. The proposed treaty provides that, for treaty purposes, the competent authorities of the United States and New Zealand are to settle the question of residence by mutual agreement and to determine whether the company is a resident solely of one country. If the competent authorities are unable to make such a determination, the company is neither a U.S. nor a New Zealand company for treaty purposes generally and thus would not be entitled to the treaty benefits. In this definition of residence, the proposed treaty differs from the U.S. model treaty, which seeks to find a single residence for companies.

Article 5. Permanent Establishment

The proposed treaty contains a definition of the term "permanent establishment" which, with certain exceptions, follows the pattern of other recent U.S. income tax treaties, the U.S. model, and the OECD model.

The permanent establishment concept is one of the basic devices used in income tax treaties to limit the taxing jurisdiction of the host country and thus mitigate double taxation. Generally, an enterprise that is a resident of one country is not taxable by the other country on its business profits unless those profits are attributable to a permanent establishment of the resident in the other country. In addition, the reduced rates of, or certain exemptions from, tax provided for dividends, interest, and royalties will apply unless the asset generating the income is effectively connected with the permanent establishment, in which case such items of income are taxed as business profits. U.S. taxation of business profits is discussed under Article 7 (Business Profits).

In general, under the proposed treaty, a permanent establishment is a fixed place of business through which an enterprise engages in business in the other country. A permanent establishment includes a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry, or other place of extraction of natural resources. It also includes any building site or construction or installation project, if the site or project lasts for more than 12 months. This 12-month period corresponds to the rule of the U.S. model treaty.

[14] An enterprise of one country will also be deemed to have a permanent establishment in the other country if it engages in supervisory activities in that other country for more than 12 months in connection with a building site or construction or installation project in that other country. This 12-month rule for such supervisory activities corresponds to the rule, described above, for the maintenance of such a site or project. There is no special rule for such supervisory activities in the U.S. model treaty. Therefore, income from such activities would be taxable under the model, if the taxpayer maintained an office in the source country.

Carrying on activities in connection with exploration for or exploitation of natural resources situated in a country gives rise to a permanent establishment if an enterprise carries on those activities in that country for at least 6 months in any 12 month period. This 6-of-12 months rule differs from the 12-month rule of the U.S. model treaty. For the purposes of this rule, activities carried on in a

country by an enterprise associated with another enterprise are to be regarded as carried on by the enterprise with which it is associated if those activities are connected with activities carried on in that country by the last-mentioned enterprise. An enterprise is to be deemed to be associated with another enterprise if one is controlled directly or indirectly by the other, or if both are controlled directly or indirectly by a third person or persons.

The current treaty does not contain special rules for building sites, exploration and exploitation of natural resources, etc.

The general rule is modified to provide that a fixed place of business that is used solely for any or all of a number of specified activities will not constitute a permanent establishment. These activities include the use of facilities solely for storing, displaying, or delivering merchandise belonging to the enterprise or for the maintenance of a stock of goods belonging to the enterprise solely for storage, display, or delivery, or solely for processing by another enterprise. These activities also include the maintenance of a fixed place of business solely for the purchase of goods or merchandise or for the collection of information, or solely for the purpose of carrying on, for the enterprise, any other preparatory or auxiliary activity.

If a person has, and habitually exercises, the authority to conclude contracts in a country on behalf of an enterprise of the other country, then the enterprise will be deemed to have a permanent establishment in the first country. This rule does not apply where the contracting authority is limited to those activities (described above) such as storage, display, or delivery of merchandise which are excluded from the definition of permanent establishment. The proposed treaty contains the usual provision that the agency rule will not apply if the agent is a broker, general commission agent, or other agent of independent status acting in the ordinary course of its business.

The determination whether a company of one country has a permanent establishment in the other country is to be made without regard to the fact that the company may be related to a company that is a resident of the other country or a company that engages in business in that other country. The relationship is thus not relevant; only the activities of the company being tested are relevant.

[15] Article 6. Income from Real Property

This article covers income from owning real property. The rules governing income from the sale of real property are in Article 13.

Under the proposed treaty, income derived by a resident of one country from real property situated in the other country may be taxed in the country where the real property is located. Income from real property includes income from agriculture or forestry.

The term "real property" has the meaning which it has under the law of the country in which the property in question is situated. The term in any case includes property accessory to real property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of real property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources. Thus, income from real property will include royalties and other payments in respect of the exploitation of natural resources (e.g., oil). It does not include interest on loans secured by real property. Ships, boats and aircraft are not real property.

The source country may tax income derived from the direct use, letting, subletting or use in any other form of real property. These rules allowing source country taxation also apply to the income from real property of an enterprise and to income from real property used for the performance of independent personal services.

Certain U.S. treaties and the current U.S. model treaty permit residents of one country to elect to be taxed on income from real property in the other country on a net basis. The proposed treaty does not contain that election, but such an election is provided for United States real property income under the Code (secs. 871(d) and 882(d)), and New Zealand taxes income from real property on a net basis. Also, certain treaties limit the tax a country may impose on rental or royalty income from real property. There is no limit in the proposed treaty.

Under Article 13 (Alienation of Property), gains on the sale, exchange or other disposition of real property (and shares of certain corporations owning real property) may also be taxed by the country where the property is located.

Article 7. Business Profits

United States Code rules.—United States law distinguishes between the business income and the investment income of a nonresident alien or foreign corporation. A nonresident alien or foreign corporation is subject to a flat 30 percent rate (or lower treaty rate) of tax on certain U.S. source income if that income is not effectively connected with the conduct of a trade or business within the United States. The regular individual or corporate rates apply to income (from any source) which is effectively connected with the conduct of a trade or business within the United States.

The taxation of income as business or investment income varies depending upon whether the income is U.S. or foreign. In general, U.S. source periodic income (such as interest, dividends, rents, and wages) and U.S. source capital gains are effectively connected with the conduct of a trade or business within the United States only if [16] the asset generating the income is used in or held for use in the conduct of the trade or business, or if the activities of the trade or business were a material factor in the realization of the income. All other U.S. source income of a person engaged in a trade or business in the United States is treated as effectively connected income.

Foreign source income is effectively connected income only if the foreign person has an office or other fixed place of business in the United States and the income is attributable to that place of business. Only three types of foreign sources income can be effectively connected income: rents and royalties derived from the active conduct of a licensing business; dividends, interest, or gain from stock or debt derived in the active conduct of a banking, financing or similar business in the United States; and certain sales income attributable to a United States sales office.

Except in the case of a dealer, trading in stocks, securities or commodities in the United States for one's own account does not constitute a trade or business in the United States and accordingly income from those activities is not taxed by the United States as business income. This concept includes trading through a U.S. based employee, a resident broker, commission agent, custodian or other agent or trading by a foreign person physically present in the United States.

Proposed treaty rules.—Under the proposed treaty, business profits of an enterprise of one country are taxable in the other country only to the extent they are attributable to a permanent establishment in the other country through which the enterprise carries on business. This is one of the basic limitations on a country's right to tax income of a resident of the other country.

The taxation of business profits under the proposed treaty differs from United States rules for taxing business profits primarily by requiring more than merely being engaged in trade or business before a country can tax business profits and by substituting the "attributable to" standard for the Code's "effectively connected" standard. Under the Internal Revenue Code, all that is necessary for effectively connected business profits to be taxed is that a trade or business be carried on in the United States. Under the proposed treaty, on the other hand, some level of fixed place of business must be present and the business profits must be attributable to that fixed place of business.

The business profits of a permanent establishment are determined on an arm's-length basis. Thus, there is to be attributed to a permanent establishment the business profits which would reasonably be expected to have been derived by it if it were a distinct and independent entity engaged in the same or similar activities under the same or similar conditions and dealing at arm's-length with the enterprise of which it is a permanent establishment, or with any other associated enterprise. For example, this arm's-length rule applies to transactions between the permanent establishment and a branch of the resident enterprise located in a third country. Amounts may be attributed whether they are from sources within or without the country in which the permanent establishment is located.

[17] In computing taxable business profits, deductions are allowed for expenses, wherever incurred, which are incurred for the purposes of the permanent establishment. These deductions include executive and general administrative expenses, research and development expenses, interest, and other expenses. Thus, for example, a U.S. company which has a branch office in New Zealand but which has its head office in the United States will, in computing the New Zealand tax liability of the branch, be entitled to deduct the executive, general administrative and other expenses incurred in the United States by the head office that are reasonably connected with the profits of the New Zealand branch.

Unlike some U.S. treaties and the U.S. model, the proposed treaty does not define the term "business profits." Thus, to the extent not dealt with in other Articles, the term will be defined under the laws of the two countries. If the definitions cause double taxation, the competent authorities could agree on a common meaning of the term.

Business profits will not be attributed to a permanent establishment merely by reason of the purchase of merchandise by a permanent establishment for the account of the enterprise. Thus, where a permanent establishment purchases goods for its head office, the business profits attributed to the permanent establishment with respect to its other activities will not be increased by a profit element in its purchasing activities.

The amount of profits attributable to a permanent establishment must be determined by the same method each year unless there is good and sufficient reason to change the method.

Where business profits include items of income which are dealt with separately in other articles of the treaty, those other articles, and not this Business Profits Article, will govern the treatment of those items of income. Thus, for example, film rentals are taxed under the provisions of Article 12 (Royalties), and not as business profits.

The proposed treaty allows either country to continue to tax the income and profits of persons carrying on an insurance business under its internal law rather than under the treaty rules. New Zealand taxes foreign insurance companies on the basis of a formula. The United States taxes foreign insurance companies not subject to the U.S. income tax with an excise tax computed on the basis of a percentage of premiums they receive in respect of U.S. risks. Both countries could continue current tax treatment of foreign insurers, or could impose new regimens of taxation for foreign insurance companies.

The proposed protocol provides that so long as New Zealand continues to tax the income of film renters under section 224 of the Income Tax Act of 1976 and to exempt from tax the royalty remittance to persons not New Zealand residents, this article would not affect New Zealand's tax or its exemptions from that tax. That is, the proposed protocol confirms that defining film rentals as royalties under Article 12 (Royalties) will not deprive U.S. film renters of the treatment now authorized under New Zealand law or cause them to be subject to both the New Zealand tax on a deemed profit under section 224 and a tax on the royalty remittance under the [18] treaty. Under section 224, film renters are subject to a tax of 45 percent on a deemed profit of 10 percent of gross rental receipts.

Article 8. Shipping and Air Transport

As a general rule, the United States taxes the U.S. source income of a foreign person from the operation of ships or aircraft to or from the United States. An exemption from U.S. tax is provided if the ship or aircraft is documented under the laws of a foreign country that grants an equivalent exemption to U.S. citizens and corporations operating ships or aircraft documented under U.S. law. The United States has entered into agreements with a number of countries providing such reciprocal exemptions.

The proposed treaty provides that profits which are derived by a resident of one country from the operation of ships or aircraft in international traffic ("shipping profits") shall be exempt from tax by the other country. International traffic means any transportation by ship or aircraft, except where the transportation is

solely between places in one of the countries (Article 3(1)(e) (General Definitions)).

This exemption applies even if the ship or aircraft is not registered in either country. Thus, for example, income of a U.S. resident from the operation of a ship flying, for example, the Liberian flag would not be subject to New Zealand tax. The exemption also applies to income derived from the operation of ships and aircraft in international traffic through participation in a pool, a joint business, or an international operating agency.

Under the proposed treaty, certain profits from the rental of ships or aircraft would be exempt from tax in the source country as profits from the operation of ships and aircraft in international traffic. Profits of an enterprise of one of the countries referred to in the general rule from the rental of ships or aircraft or from the use, maintenance, or rental of containers (including trailers, barges, and related equipment for the transport of containers) shall be taxable only in that country to the extent that those ships, aircraft or containers are used in international traffic and such profits are incidental to profits that that enterprise makes from operating ships or aircraft in international traffic.

This rule governing leases of ships or aircraft and leases of containers and related equipment provides a narrower exemption for lessors than that provided in the U.S. model treaty, which provides the exemption if the rented property is used in international traffic or the profits are incidental to profits from the operation of ships or aircraft in international traffic. That is, the model provides exemption if the lessor operates ships in international traffic and enters into a casual lease of a ship for use within the source country. In addition, the model provides exemption in the source country for a lessor (such as a financial institution or a leasing company) that does not operate ships or aircraft in international traffic but that leases ships, aircraft, or containers for use in international traffic. The proposed treaty would allow the source country to tax the income under the provisions of Article 12 (Royalties).

[19] Article 9. Associated Enterprises

The proposed treaty, like most other U.S. tax treaties, contains an arm's-length pricing provision similar to section 482 of the Internal Revenue Code which recognizes the right of each country to make an allocation of income to that country in the case of transactions between related enterprises, if an allocation is necessary to reflect the conditions and arrangements which would have been made between independent enterprises.

For purposes of the proposed treaty an enterprise of one country is related to an enterprise of the other country if one of the enterprises participates directly or indirectly in the management, control or capital of the other enterprise. The enterprises are also related if the same persons participate directly or indirectly in the management, control, or capital of both enterprises.

When a redetermination of tax liability has been properly made by one country, the other country will make an appropriate adjustment to the amount of tax paid in that country on the redetermined income. In making that adjustment due regard is to be given to other provisions of the treaty and the competent authorities of the two countries will consult with each other if necessary. To avoid double taxation, the proposed treaty's saving clause retaining full taxing jurisdiction in the country of residence or citizenship will not apply in the case of such adjustments.

These provisions of the proposed treaty are not intended to affect the application of any law in either country that relates to the determination of the tax liability of a person. This provision makes it clear that the U.S. retains the right to apply its intercompany pricing rules (section 482) and its rules relating to the allocation of deductions (sections 861, 862, and 863, and Treas. Reg. Section 1.861-8). Moreover, these provisions are not to supersede U.S. or New Zealand law relating to determinations in cases where the information available to the competent authority is inadequate to determine the income to be attributed to an enterprise, so long as the competent authority proceeds on the basis of available information consistently with these rules. Thus, the treaty does not affect the U.S. rule that the burden of proof is on the taxpayer.

Article 10. Dividends

The United States imposes a 30-percent tax on the gross amount of U.S. source dividends paid to nonresident alien individuals and foreign corporations. The 30-percent tax does not apply if the foreign recipient is engaged in a trade or business in the United States and the dividends are effectively connected with that trade or business. In such a case, the foreign recipient is subject to U.S. tax like a U.S. person at the standard graduated rates on a net basis. U.S. source dividends are dividends paid by a U.S. corporation, and certain dividends paid by a foreign corporation if at least 50 percent of the gross income of the foreign corporation, in the prior three year period, was effectively connected with a U.S. trade or business of that foreign corporation.

Under the proposed treaty, dividends paid by a company that is a resident of one country to a resident of the other country may be taxed by both countries. However, the rate of tax that the country [20] of which the payor is a resident may impose on dividends paid to a beneficial owner in the other country cannot exceed 15 percent of the gross amount of the dividends. This limitation would not apply to taxation of the company in respect of the profits out of which the dividends are paid.

The existing treaty with New Zealand limits the U.S. tax on U.S. source dividends paid to New Zealand residents to 15 percent in the case of portfolio dividends and 5 percent in the case of direct dividends, but does not limit New Zealand's tax at the source on dividends. The existing treaty provides, however, that either country may terminate the dividend article without the standard six months' notice if New Zealand taxes New Zealand source dividends paid to U.S. residents at a rate exceeding the analogous (15 percent and 5 percent) limits on the United States in that existing treaty. Since April 1, 1982, the statutory rate in New Zealand has been 30 percent. Prior to that date, the rate was 15 percent. Accordingly, this abbreviated termination procedure is available to the United States.

The proposed treaty contains a provision that would apply its rate limitation retroactively. If the proposed treaty enters into force before April 1, 1984, the 15 percent limit will apply to dividends paid by New Zealand companies, beneficially owned by U.S. residents, and derived on or after April 1, 1982, the date of New Zealand's statutory rate increase (Article 27 (Entry into Force)).

The proposed treaty's 15 percent rate is greater than the five-percent rate that applies to direct dividends in many U.S. treaties and the U.S. model, but New Zealand has not to date agreed to any treaty providing a lower rate. The proposed protocol provides that if in any future tax treaty with a member of the Organization for Economic Cooperation and Development, New Zealand limits its tax at the source to a lower rate than that provided in the proposed treaty, New Zealand will without undue delay enter into negotiations with the United States to review this article with a view to providing that lower rate on a reciprocal basis.

The proposed treaty does not define dividends. The proposed treaty's general rule for undefined terms applies: unless there is a mutual agreement between the competent authorities, each country may apply its rules for determining when a payment by a resident company is on a debt obligation or an equity interest (see Article 3(3) (General Definitions)). Thus, for example, the United States could apply its section 385 rules for determining whether an interest is debt or equity.

The proposed treaty provides that the competent authorities are to endeavor to settle the mode of application of this limitation. That is, as under U.S. law, the competent authority is to provide for implementation of the rule (as by requiring forms for the identification of foreign recipients of income).

The reduced rates of tax on dividends will apply unless the recipient carries on business through a permanent establishment (or fixed base in the case of an individual performing independent personal services) in the source country and the dividends are attributable to the permanent establishment (or fixed base). Dividends effectively connected with a permanent establishment are to be taxed on a net basis as business profits (Article 7). Dividends effec[21]tively connected with a fixed base are to be taxed on a net basis as income from the performance of independent personal services (Article 14).

One country may not tax dividends paid by a company resident in the other country except in four cases: first, where a resident of the first country receives the dividends; second, where the dividends are attributable to a permanent establishment or a fixed base of the beneficial owner in the taxing country; third, where at least 50 percent of the paying company's gross income was attributable to one or more permanent establishments in the taxing country; and fourth, where the dividends are paid by a United States company which is resident in New Zealand for the purposes of New Zealand tax. In the third and fourth cases (in a situation where the payment is not taxable under the first or second case), and where the beneficial owner of the dividends is a resident of the other contracting State, the rate of tax may not exceed 15 percent. In the third case, however, the tax can be imposed only to the extent the dividends are paid out of the profits attributable to those permanent establishments. Under this provision, the rate of tax on the taxable portion is limited to the 15-percent withholding rate applicable to dividends. This third provision enables the United States to continue to tax dividends paid by foreign corporations doing substantial business in the United States. The provision is, however, different from the U.S. rules because the proposed treaty's permanent establishment concept is somewhat more limited than the U.S. trade or business concept. (See discussion in Article 7 (Business Profits).)

Article 11. Interest

The United States imposes a 30-percent tax on U.S. source interest paid to foreign persons under the same rules that are applicable to dividends. Under the Code, U.S. source interest generally is interest on debt obligations of U.S. persons, but not interest on deposits in banks. U.S. source interest also includes interest paid by a foreign corporation if at least 50 percent of the gross income of the foreign corporation, in the prior three year period, was effectively connected with a U.S. trade or business of that corporation.

Under the proposed treaty, interest may be taxed by a country if the beneficial owner of the interest is a resident of that country, the interest arose in that country, or the indebtedness to which the interest relates is effectively connected with a permanent establishment or fixed base in that country. The proposed treaty limits the withholding tax imposed at source to 10 percent generally. The present treaty does not limit the withholding tax on interest, although the current New Zealand statutory rate of withholding tax is 15 percent. The U.S. model treaty provides for elimination of the withholding tax on portfolio interest (a zero rate), although this result is rarely achieved. The proposed protocol provides that if in any future tax treaty with a member of the Organization for Economic Cooperation and Development, New Zealand limits its tax at the source to a lower rate than that provided in the proposed treaty, New Zealand will without undue delay enter into negotiations with the United States to review this article with a view to providing that lower rate on a reciprocal basis.

[22] The lower rate in the proposed treaty applies only if the interest is beneficially owned by a resident of the other country. Accordingly, it does not apply if the recipient is a nominee for a nonresident.

The reduced tax rate will not apply if the recipient carries on business through a permanent establishment or fixed base in the source country and the debt claim is effectively connected with that permanent establishment or fixed base. In that event, the interest will be taxed as business profits (Article 7) or income from the performance of independent personal services (Article 14).

The proposed treaty does not define interest. Therefore, the proposed treaty's general rule for undefined terms applies: unless there is mutual agreement between the competent authorities, each country may apply its rules for determining when a payment by a resident company is on a debt obligation or an equity interest. Thus, the United States could apply its section 385 rules for determining whether an interest is debt or equity.

The proposed treaty provides that the competent authorities are to endeavor to settle the mode of application of this limitation. That is, as under U.S. law, the competent authority is to provide for implementation of the rule (as by requiring forms for the identification of foreign recipients of income).

Interest would be exempt from tax by the source country under the proposed treaty if the interest is derived and beneficially owned by the other country or any instrumentality of that other country which is not subject to tax on its income by that other country or is derived and beneficially owned by a resident of the other country with respect to debt obligations guaranteed or insured by that country or an instrumentality of that country (such as the Export-Import Bank) which is not subject to tax on its income by that country.

The proposed treaty provides a source rule for interest (which is also used in Article 22 (Relief from Double Taxation) for foreign tax credit purposes). Interest will be sourced within a country if the payor is the government of that country, including political subdivisions and local authorities, or a resident of that country, or is a United States company which is resident in New Zealand for the purposes of New Zealand tax but is treated as a resident of neither country under the treaty (Article 4 (Residence)). However, if the interest is borne by a permanent establishment (or fixed base) that the payor has in a country other than his country of residence and the indebtedness was incurred with respect to that permanent establishment (or fixed base), interest will be sourced in that country, regardless of the residence of the payor. Generally, this is consistent with U.S. source rules (sections 861-862) which provide that interest income is sourced in the country in which the payor is resident. Thus, for example, if a New Zealand resident has a permanent establishment in France and that New Zealand resident incurs indebtedness to a U.S. person for that French permanent establishment and the permanent establishment bears the interest, then the interest will have its source in France and New Zealand will not tax the interest.

The proposed treaty addresses the issue of non-arm's-length interest charges between related parties (or parties having an otherwise special relationship) by providing that the amount of interest [23] for purposes of the treaty will be the amount of arm's-length interest. The amount of interest in excess of the arm's-length interest will be taxable according to the laws of each country, taking into account the other provisions of this treaty (e.g., excess interest paid to a parent corporation may be treated as a dividend under local law and thus entitled to the benefits of Article 10 of this treaty).

Article 12. Royalties

Under the same system that applies to dividends and interest, the United States imposes a 30-percent tax on U.S. source royalties paid to foreign persons. Royalties are from U.S. sources if they are for the use of property located in the United States. U.S. source royalties include royalties for the use of or the right to use intangibles in the United States. Such royalties include motion picture royalties.

The present treaty with New Zealand does not generally limit source country taxation of royalties. The present treaty generally allows residents of one country deriving certain royalties from sources within the other country to elect to be taxed on a net basis on the royalty income, however. The present treaty exempts from source country taxation rentals for motion picture films derived in one country by a resident of the other who has no permanent establishment in the source country, but this rule of the present treaty does not limit the New Zealand film-hire duty or the New Zealand film-hire tax on income from the business of renting motion picture films.

The proposed treaty provides for a limitation of the rate of source basis taxation of royalties. Royalties from sources (under the royalty source rule discussed below) in one country that are beneficially owned by a resident of the other country may be taxed by both countries. However, the withholding tax imposed in the source country may not exceed 10 percent of the gross royalty. The competent authorities of the two countries are to endeavor to settle the mode of application of this limitation. The 10-percent rate limitation in the proposed treaty applies only if the royalty is beneficially owned by a resident of the other country; it does not apply if the recipient is a nominee for a nonresident.

The U.S. model treaty exempts royalties from tax at source. The proposed protocol provides that if in any future tax treaty with a member of the Organization for Economic Cooperation and Development, New Zealand limits its tax at the source to a lower rate than that provided in the proposed treaty, New Zealand will without undue delay enter into negotiations with the United States to review this article with a view to providing that lower rate on a reciprocal basis.

The reduced withholding tax rate does not apply where the beneficial owner carries on business through a permanent establishment in the source country or performs personal services in an independent capacity from a fixed base in the source country, and the royalties are attributable to the permanent establishment or fixed base. In the event the royalties will be taxed as business profits (Article 7) or income from the performance of independent personal services (Article 14).

[24] Royalties are defined to mean payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematographic films, films or video tapes for use in connection with television or tapes for use in connection with radio broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience. The term royalties also includes payments of any kind received as consideration for the use of, or the right to use, industrial, commercial or scientific equipment other than payments under a hire-purchase agreement; and income or gains from the alienation of any property or rights that would yield royalty income to the extent that such income or gains are contingent on productivity, use or disposition of such property or rights.

In certain cases, income from leasing of ships, aircraft, and containers would be royalties subject to withholding tax at the source of up to 10

percent of gross receipts if the lessor had no permanent establishment in the source country (see Article 8 (Shipping and Air Transport)).

The proposed treaty provides that the competent authorities are to endeavor to settle the mode of application of this limitation. That is, as under U.S. law, the competent authority is to provide for implementation of the rule (as by requiring forms for the identification of foreign recipients of income).

The proposed treaty provides special source rules for royalties. Generally, under U.S. tax rules (section 861-862) royalty income is sourced where the property or right is being used. The proposed treaty alters this rule in certain cases. If a royalty is paid by the government of one of the countries, including political subdivisions and local authorities, by a resident of one of the countries, or by a U.S. company that is resident in New Zealand under New Zealand law but that does not have a single residence for treaty purposes, then the income will generally be sourced in the country of residence of the payor. However, if the payor has a permanent establishment or fixed base in a contracting state in connection with which the obligation to pay the royalty was incurred, and if the royalties are borne by the permanent establishment or fixed base, the royalties arise (for purposes of the proposed treaty) in the country in which the permanent establishment or fixed base is situated. Finally, if the above rules do not result in a U.S. or New Zealand source for the royalties, and if the royalties relate to the use of or the right to use rights or property in either the United States or New Zealand, then the source of the royalties will be that country.

The proposed treaty provides that in the case of royalty payments or credits between persons having a special relationship, only that portion of the payment or credit that represents an arm's-length royalty will be treated as a royalty under the treaty. Payments in excess of the arm's-length amount will be taxable according to the law of each country with due regard being given for the other provisions of the treaty. Thus, for example, any excess amount might be treated as a dividend subject to the taxing limitations of Article 10.

The proposed protocol provides that so long as New Zealand continues to tax the income of film renters under section 224 of the [25] Income Tax Act of 1976 and to exempt from that tax certain payments received from those film renters by persons not New Zealand residents, this article would not affect New Zealand's tax or its exemptions from that tax. U.S. film renters will be taxed by New Zealand under the present statutory regime (45 percent of a deemed profit of 10 percent of the gross receipts) as long as that lower statutory tax continues in force, rather than under the terms of this Article. The proposed protocol results in a tax of 4.5 percent of gross receipts rather than the 10 percent rate authorized by this Article.

Article 13. Alienation of Property

Generally, gain realized by a nonresident alien or a foreign corporation from the sale of a capital asset is not subject to U.S. tax unless the gain is effectively connected with the conduct of a U.S. trade or business or, in the case of a nonresident alien, he is physically present in the United States for at least 183 days in the taxable year. However, under the Foreign Investment in Real Property Tax Act of 1980, as amended, a nonresident alien or foreign corporation is taxed by the United States on gain from the sale of a U.S. real property interest as if the gain were effectively connected with a trade or business conducted in the United States. A U.S. real property interest includes certain corporations holding U.S. real property.

Under the proposed treaty gains from the disposition of real property may be taxed in the country where the real property is situated. The proposed treaty defines real property situated in the United States and real property situated in New Zealand separately. Real property situated in the United States includes real property located here for the purposes of Article 6. It also includes United States real property interests. This definition allows the United States to tax any transaction of a New Zealand resident taxable under the Foreign Investment in Real Property Tax Act of 1980.

Real property situated in New Zealand includes three categories of property: real property located there for the purposes of Article 6; shares (or comparable interests) in a company whose assets are wholly or principally New Zealand real property; and an interest in a partnership, trust, or estate whose assets are wholly or principally New Zealand real property. Such shares and interests are deemed to be situated in New Zealand, wherever the entity was created or is operated, and wherever any shares or other evidences of ownership may be found. The proposed treaty does not define the term "principally."

Gains from the sale or exchange of ships, aircraft or containers operated or used by an enterprise of one country in international traffic are taxable only by the country of residence. However, the other country (not the country of residence) may tax the gain to the extent that it allowed depreciation to that enterprise in respect of such items. Thus, that country may recapture that depreciation. Gains from dispositions of property or rights that are subject to tax under the royalty article (Article 12) as contingent on productivity, use, or further disposition are taxable only under that article; that [26] is, the source country tax is generally limited to 10 percent of the gross amount.

Income or gains from the alienation of personal property which are attributable to a permanent establishment which an enterprise of a country has or had in the other country, or which are attributable to a fixed base available or previously available to a resident of a country in the other country for the purpose of performing independent personal services, and gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or such a fixed base, may be taxed in that other country.

Income or gains from the alienation of any property other than property discussed above would be taxable under the proposed treaty only in the country where the alienator is a resident.

Article 14. Independent Personal Services

The United States taxes the income of a nonresident alien at the regular graduated rates if the income is effectively connected with the conduct of a trade or business in the United States by the individual. (See discussion of

U.S. taxation of business profits under Article 7 (Business Profits).) The performance of personal services within the United States can be a trade or business within the United States (sec. 864(b)).

The proposed treaty limits the right of a country to tax income from the performance of personal services by a resident of the other country. Under the proposed treaty, income from the performance of independent personal services is treated separately from income from the performance of personal services as an employee.

Income from the performance of independent personal services (i.e., services performed as an independent contractor, not as an employee) in one country by a resident of the other country is exempt from tax in the country where the services are performed unless (1) the person performing the personal services is present in the country where the services are performed for more than 183 days during any consecutive 12 month period, or (2) the individual has a fixed base regularly available to him in that country for the purpose of performing the services. In the second situation, the source country can tax only that portion of the individual's income which is attributable to the fixed base.

Independent personal services include all independent activities, not merely those of persons in professions such as physicians, lawyers, engineers, architects, dentists, and accountants.

The proposed treaty provides a broader exemption from tax than the present treaty. While the present treaty contains a 183-day rule, it does not exempt income under that rule unless the person performing the services does so for or on behalf of a resident of the country of which he is resident. However, the present treaty does not contain the fixed base rule of the proposed treaty; under the present treaty, a fixed base maintained in a country for the purpose of performing services does not necessarily cause taxation of those services in that country. The U.S. model treaty, by contrast, does not contain a 183-day rule, but rather allows taxation in the source country only on the basis of a fixed base regularly available to the individual performing the independent services.

[27] Article 15. Dependent Personal Services

Under the Code, the income of a nonresident alien from the performance of personal services in the United States is not taxed if the individual is not in the United States for at least 90 days during a taxable year, the compensation does not exceed $3,000, and the services are performed as an employee of a foreign person not engaged in a trade or business in the United States or they are performed for a foreign permanent establishment of a U.S. person.

Under the proposed treaty, income from services performed as an employee in one country (the source country) by a resident of the other country will be taxable only in the country of residence if three requirements are met: (1) the individual is present in the source country for fewer than 184 days during any consecutive 12-month period; (2) his employer is not a resident of the source country; and (3) the compensation is not borne by a permanent establishment or fixed base of the employer in the source country. In the U.S. model, the fewer than 184 day test is computed on the basis of a tax year, not on the basis of 12 consecutive months.

Compensation derived by an employee as a member of the regular complement of a ship or aircraft operated in international traffic may be taxed only by the country where the employee resides.

This article is modified in some respects for pensions (Article 18) and for compensation as a government employee (Article 19).

The present treaty does not distinguish between dependent and independent personal services. Those present treaty rules are discussed in the discussion of Article 14, above. In addition, the present treaty contains a special rule for teachers that allows visits of up to two years duration without subjecting the visiting teacher to taxation in the country he visits. Under the proposed treaty, as in the U.S. model, teachers who perform dependent personal services will be subject to the general rules for employees.

Article 16. Limitation On Benefits

The proposed treaty contains a provision which is intended to limit the benefits of the treaty to persons who are entitled to those benefits by reason of their residence in the United States or New Zealand.

The proposed treaty is intended to limit double taxation caused by the interaction of the tax systems of the United States and New Zealand as they apply to residents of the two countries. At times, however, residents of third countries attempt to use a treaty. Such use is known as "treaty shopping", and refers to the situation where a person who is not a resident of either country seeks certain benefits under the income tax treaty between the two countries. Under certain circumstances, and without appropriate safeguards, the nonresident is able to secure these benefits by establishing a corporation (or other entity) in one of the countries which, as a resident of that country, is entitled to the benefits of the treaty. Additionally, it may be possible for the third country resident to repatriate funds to that third country from the entity under favorable conditions (i.e., it may be possible to reduce or eliminate taxes on the repatriation) either through relaxed tax provisions in the distributing country or by passing the funds through [28] other treaty countries (essentially, continuing to treaty shop), until the funds can be repatriated under favorable terms.

The proposed treaty contains provisions intended to limit the use of the treaty to bona fide residents of the two countries. This is accomplished by providing that a person other than an individual (such as a corporation, partnership, trust, or other business organization) is not entitled to the benefits of the convention unless it satisfies any one of an ownership test, a public company test, or a good business purpose test. Under the ownership test, more than 75 percent of the beneficial interest (in the case of a company, more than 75 percent of the number of shares of each class of shares) in that entity must be owned directly or indirectly by any combination of one or more individual residents of New Zealand or the United States, citizens of the United States, publicly traded companies (discussed below), or the countries (the United States and New Zealand) themselves. This provision would, for example,

deny the benefits of the reduced U.S. withholding tax rates on dividends, interest or royalties to a New Zealand company that is owned by individual residents of a third country.

Under the public company test, a company that is a resident of one of the countries and that has substantial and regular trading in its principal class of stock on a recognized stock exchange in the United States or New Zealand is entitled to the benefits of the treaty regardless of where its actual owners reside. In addition, any interest that such a company holds is a qualifying interest under the 75-percent test, above. The term "recognized stock exchange" includes the NASDAQ System owned by the National Association of Securities Dealers, Inc. in the United States; any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for the purposes of the Securities Exchange Act of 1934; the New Zealand Stock Exchange; and any other stock exchange agreed upon by the competent authorities of the two countries.

Under the good business purpose test, denial of treaty benefits does not occur if it is determined that the acquisition, ownership and maintenance of an entity that is a resident of the United States or New Zealand and the conduct of its operations did not have as a principal purpose the purpose of obtaining benefits under the proposed treaty. Accordingly, the provision will not apply if there was no treaty shopping motive for forming the company and if its operation does not have as one of its principal purposes the purpose of obtaining the treaty benefits. Thus the burden of overcoming the treaty shopping rule, as under U.S. tax law generally, is on the taxpayer claiming treaty benefits.

The proposed treaty disallows any treaty benefits to any income derived by a trustee that is treated as income of a resident of the United States or New Zealand for purposes of the treaty if the trustee derived that income in connection with a scheme one of whose principal purposes was to obtain a benefit under the treaty.

The proposed treaty contains a rule not found in the U.S. model or in recent U.S. income tax treaties that requires consultation between the competent authorities upon invocation of this anti-treaty shopping article.

[29] Article 17. Artistes and Athletes

The proposed treaty contains an additional set of rules which apply to the taxation of income earned by entertainers (such as theater, motion picture, radio or television "artistes" or entertainers, musicians, and athletes). The proposed article supplements the other provisions dealing with the taxation of income from personal services (Articles 14 and 15), and is intended, in part, to prevent entertainers and athletes from using the treaty to avoid paying any tax on their income earned in one of the countries.

Under the Article, one country may tax an entertainer who is a resident of the other country on the income from his personal services as an entertainer in that country during any year in which the gross receipts derived by him from such activities, including his reimbursed expenses, exceed $10,000 or its equivalent in New Zealand dollars. (The comparable amount in the U.S. model treaty is $20,000.) Thus, if a New Zealand entertainer maintained no fixed base in the United States and performed (as an independent contractor) for two days in one taxable year in the United States for total compensation of $9,000, the United States could not tax that income. If, however, that entertainer's total compensation were $11,000, the full $11,000 (less appropriate deductions) would be subject to U.S. tax. As in the case of the other provisions dealing with personal services income, this provision does not bar the country of residence or, in the case of the United States, the country of citizenship, from also taxing that income (subject to a foreign tax credit).

In addition, the proposed treaty provides that where income in respect of personal services performed by an entertainer or athlete accrues not to the entertainer or athlete but rather to another person or entity, that income will be taxable by the country in which the services are performed in any situation where the entertainer or athlete shares directly or indirectly in the profits of the person or entity receiving the income. (This provision applies notwithstanding Articles 7 and 14.) For this purpose, participation in the profits of the recipient of the income includes (without limitation) the receipt of deferred compensation, bonuses, fees, dividends, partnership distributions, or other distributions. The provision does not apply if it is established that neither the entertainer or athlete, nor related persons, participate directly or indirectly in the profits of the person or entity receiving the income in any manner. This provision is intended to prevent highly paid performers and athletes from avoiding tax in the country in which they perform by routing the compensation for their services through a third person such as a personal holding company or trust located in a country that would not tax the income.

Article 18. Pensions and Annuities

Under the proposed treaty, pensions and other similar remuneration derived and beneficially owned by a resident of either country in consideration of past employment are subject to tax only in the recipient's country of residence. (This rule does not apply in the case of pensions which are paid to citizens of one country attributa[30]ble to services performed by the individual for government entities of the other (Article 19 (Governmental Service)).

Pension payments and other payments made under the Social Security legislation of one country to a resident of the other country or to a U.S. citizen will be taxable only by the paying country. This rule, which is not subject to the saving clause, exempts U.S. citizens and residents from U.S. tax on New Zealand social security payments.

The proposed treaty also provides that annuities may be taxed by only the country of residence of the person who derives and beneficially owns them. Annuities are defined as stated sums paid periodically at stated times during life or during a specified or ascertainable number of years, under an obligation to make the payments in return for adequate and full consideration (other than services).

The U.S. model treaty contains rules for alimony payments and child support payments that the proposed treaty does not contain. Under the model treaty, alimony payments (and other maintenance payments other than child support payments) are taxable only by the country of residence

of the recipient, while child support payments are taxable only by the country of the payor. The child support rule in the U.S. model is not subject to the saving clause. Under the proposed treaty, alimony payments and child support payments are covered under Article 21 (Other Income) and could be taxable in the country of residence of the recipient and in the country of the source of the income. At present New Zealand rules provide that such payments are neither deductible to the payor nor taxable to the recipient.

Article 19. Government Service

The proposed treaty contains the standard provision that as a general rule exempts the wages of employees of one of the countries from tax by the other country.

Under the proposed treaty, remuneration, other than a pension, paid by a country or one of its political subdivisions or local authorities to an individual for services in the discharge of functions of a governmental nature rendered to that country (or subdivision or authority) would generally be taxable only in that country. However, such remuneration would be taxable only in the other country (the country not the payor) if the services are rendered in that other country and the individual is a resident of that other country who either (1) is a citizen of that country or (2) did not become a resident of that country solely for the purpose of rendering the services. Thus, for example, New Zealand would not tax the compensation of a U.S. citizen and resident who is in New Zealand to perform services for the U.S. government in the discharge of governmental functions, and the United States would not tax the compensation of a New Zealand citizen and resident who performs those services for the U.S. Government in New Zealand.

Any pension paid by, or out of funds created by, a country or one of its political subdivisions or local authorities to an individual for services rendered to that country (or subdivision or authority) would generally be taxable only in that country. However, such [31] pensions would be taxable only in the other country if the individual is both a resident and a citizen of that other country.

In the situations described above, the U.S. model treaty allows exclusive taxing jurisdiction to the paying country, but only in the case of payments to one of its citizens.

If a country or one of its political subdivisions or local authorities is carrying on a business (as opposed to functions of a governmental nature) the provisions of Articles 14 (Independent Personal Services), 15 (Dependent Personal Services), 17 (Artistes and Athletes) and 18 (Pensions and Annuities) would apply to remuneration and pensions for services rendered in connection with the business.

This provision is generally excluded from the saving clause.

Article 20. Students

Under the proposed treaty, an individual who is a resident of one country and who is present for the purposes of his full-time education in the other country will generally be exempt from tax in the host country on payments from abroad used for maintenance or education. This rule also applies to a student who was a resident of one country immediately before visiting the other country. There is no precise limitation on the amount of income to which the exemption applies. The saving clause does not apply to this article.

Article 21. Other Income

This article is a catch-all article intended to cover items of income not specifically covered in other articles, and to assign the right to tax third country income to only one of the countries. It applies to income from third countries as well as income from the United States and New Zealand.

As a general rule, items of income not otherwise dealt with in the proposed treaty which are derived by residents of either country shall be taxable only by the country of residence. However, if the income is sourced in the other country, it may also be taxed by that country. The source of an item of income is determined under the domestic laws of the two countries unless the treaty contains a special rule. This provision, for example, gives the United States the sole right to tax income sourced in a third country and paid to a resident of the United States. This provision is subject to the saving clause, so U.S. citizens who are New Zealand residents would continue to be subject to U.S. taxation on their worldwide income.

The proposed protocol provides that so long as New Zealand continues to tax the income of film renters under section 224 of the Income Tax Act of 1976 and to exempt from that tax certain payments received from those film renters by persons not New Zealand residents, this article would not affect New Zealand's tax or its exemptions from that tax.

Article 22. Relief from Double Taxation

Background

One of the two principal purposes for entering into an income tax treaty is to limit double taxation of income earned by a resi[32]dent of one of the countries that may be taxed by the other country. The United States seeks unilaterally to mitigate double taxation by generally allowing U.S. taxpayers to credit the foreign income taxes that they pay against the U.S. tax imposed on their foreign source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax on U.S. source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets U.S. tax on only foreign source income. This limitation is computed on a worldwide consolidated basis. Hence, all income taxes paid to all foreign countries are combined to offset U.S. taxes on all foreign income. Separate limitations on the foreign tax credit are provided for certain interest and for DISC dividends.

A U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation may credit foreign taxes paid or deemed paid by that foreign corporation on earnings that are received as dividends (deemed paid credit). These deemed paid taxes are included in the U.S. shareholder's total foreign taxes paid for the year the dividend is received and go into the general pool of taxes to be credited.

Unilateral efforts to limit double taxation are imperfect. Because of differences in rules as to when a

person may be taxed on business income, a business may be taxed by two countries as if it were engaged in business in both countries. Also, a corporation or individual may be treated as a resident of more than one country and be taxed on a worldwide basis by both.

Part of the double tax problem is dealt with in other articles that limit the right of a source country to tax income. This article provides further relief where both New Zealand and the United States will still tax the same item of income. This article is not subject to the saving clause, so that the country of citizenship or residence waives its overriding taxing jurisdiction to the extent that this article applies.

The present treaty generally provides for relief from double taxation by each country permitting a credit against its tax for the appropriate amount of taxes paid to the other country on income from sources within that other country. The credit is provided, however, only to the extent permitted under certain domestic laws.

The proposed treaty provides separate rules for relief from double taxation for the United States and New Zealand. In addition, it provides special rules covering U.S. citizens and companies resident in New Zealand.

United States

The proposed treaty contains the provision that the United States will allow a citizen or resident a foreign tax credit for income taxes paid or accrued to New Zealand. This kind of provision is found in many U.S. income tax treaties. The credit is to be computed in accordance with the provisions of and subject to the limitations of U.S. law (as those provisions and limitations may change from time to time without changing the general principles of the credit).

The proposed treaty also allows the U.S. deemed paid credit (section 902) to U.S. corporate shareholders of New Zealand corpo[33]rations receiving dividends from those corporations if the U.S. company owns 10 percent or more of the voting stock of the New Zealand corporation. The credit is allowed for New Zealand income taxes paid by or on behalf of the New Zealand corporation on the profits out of which the dividends are paid. This deemed paid credit is not available in the case of a U.S. company that is a resident of New Zealand.

This article provides that New Zealand income taxes covered by the treaty (Article 2 (Taxes Covered)) are to be considered income taxes for purposes of the U.S. foreign tax credit. Accordingly, all such New Zealand taxes will be eligible for the U.S. foreign tax credit. These taxes would probably be creditable for U.S. tax purposes in the absence of the proposed treaty.

New Zealand

The proposed treaty generally provides that New Zealand is to credit U.S. taxes paid by New Zealand residents on U.S. source income. This credit is not to exceed the amount of the tax that would be paid to the United States if the resident were not a United States citizen or a United States company. That is, in the case of a New Zealand resident who is subject to U.S. tax on worldwide income as a U.S. citizen or company, New Zealand will credit only the U.S. tax to which the New Zealand resident would have been subject absent U.S. citizenship or incorporation. In addition, the credit is to be computed in accordance with, and subject to any provisions of, the law of New Zealand which may from time to time be in force and which relate to the allowance of a credit against New Zealand tax for tax paid in a country outside New Zealand (which do not affect the general principle of allowing a credit). Thus, New Zealand could limit its foreign tax credit on a country by country and class-of-income by class-of-income basis.

To be creditable, the United States tax must be paid under the law of the United States and consistently with the proposed treaty. U.S. taxes are generally creditable whether imposed directly or by deduction.

The credit does not apply, in the case of a dividend, to tax paid in respect of the profits out of which the dividend is paid. The proposed treaty provides an exemption-like system for dividends received by certain New Zealand corporations from U. S. corporations in which they own at least ten percent of the paid-up share capital. Where a company which is a resident of New Zealand beneficially owns at least 10 percent of the paid-up share capital of a United States company, any dividend derived by the New Zealand company from the United States company (that would, in accordance with the taxation law of New Zealand in existence at the date of signature of the proposed treaty (July 23, 1982), be exempt from New Zealand tax) would be exempt from New Zealand tax under the proposed treaty.

The proposed treaty provides a special rule for U.S. citizens and companies that are New Zealand residents. Such persons are generally entitled to a credit against U.S. tax liability in the amount of the New Zealand tax paid. Thus, New Zealand generally would have primary taxing jurisdiction over the income of such persons. [34] This U.S. tax credit is not to reduce U.S. taxation on a source basis of such a person's U.S. source income.

In this article, the proposed treaty also provides source rules for determining when an item of income arises in one of the countries. These source rules are used for the purpose of allowing relief from double taxation under this Article. These source rules do not supersede the U.S. source of income rules for the purpose of internal U.S. law.

The general source rule is that an item of income of a resident of one country that may be taxed in the other country under the treaty is considered to arise in that other country. Accordingly, income taxes paid to that other country on that income will be creditable (subject to any relevant limitations) in the country of residence.

The general source rule (described above) does not apply to income derived by a New Zealand resident that is taxable in the United States solely by reason of U.S. citizenship or solely by reason of U.S. incorporation. Such income will not be treated as U.S. source income. Income of a U.S. citizen or company resident in New Zealand is to be treated as New Zealand source income to the extent necessary to implement the special treaty rule, described above, that allows primary taxing jurisdiction to the United States on the U.S. source income of such a person while allowing primary taxing jurisdiction to New Zealand on the non-U.S. source income of such a person.

The treaty does not affect the U.S. treatment of taxes not covered by Article 2 (Taxes Covered), whatever the source of the affected income under the treaty. The treaty's source rules do not apply for purposes of computing the limitation for other foreign taxes.

Article 23. Nondiscrimination

The proposed treaty contains a non-discrimination provision relating to the taxes covered by the treaty similar to provisions embodied in other recent U.S. income tax treaties. This non-discrimination provision differs from other recent treaties and from the U.S. model in that it allows existing practices to continue, and in that it does not cover either U.S. or New Zealand taxes not generally covered by the proposed treaty or the taxes of States, localities, or other political subdivisions.

In general, under the proposed treaty, one country cannot discriminate by imposing more burdensome taxes (or requirements connected with taxes) on citizens of the other country than on its citizens in the same circumstances. This provision applies whether or not those citizens are residents of the United States or New Zealand. However, for the purposes of United States tax, a United States citizen who is not a resident of the United States and a New Zealand citizen who is not a resident of the United States are not in the same circumstances.

Similarly, in general, one country cannot impose less favorable taxes on permanent establishments of residents of the other country than it imposes on its comparable residents. However, a country need not grant to residents of the other country the personal allowances, exceptions, rebates, reliefs, or deductions for tax pur[35]-poses on account of personal status that it grants to its own residents.

The non-discrimination provision is subject to two exceptions regarding permanent establishments that are not found in the U.S. model treaty. First, it does not prevent a country from imposing on the profits attributable to a permanent establishment in that country of a company which is a resident of the other country a tax not exceeding 5 percent of those profits in addition to the tax that would be chargeable on those profits if they were the profits of a company which was a resident of the country where the permanent establishment had its location. The United States does not impose such a tax, known as a branch profits tax. New Zealand now imposes a branch profits tax at the rate of 5 percent. Such a tax is analogous to the U.S. tax on certain dividends of foreign corporations that are attributable to U.S. operations (see discussion of Article 10 above). The U.S. model clearly contemplates coexistence of that U.S. tax with a broad non-discrimination article.

The proposed treaty differs from the U.S. model non-discrimination provision for permanent establishments in a second way. The proposed treaty would not require a country to grant to a company which is a resident of the other country the same tax relief that it provides to a company which is its resident with respect to dividends received. The United States allows U.S. branches of foreign corporations a dividends received deduction of no more than 85 percent, whereas U.S. corporations sometimes may deduct dividends received in full. New Zealand allows resident—but not nonresident—companies a dividends received deduction. The specific coverage in this treaty is at the request of New Zealand.

Each country is required (subject to the arm's-length pricing rules of Articles 9(1) (Associated Enterprises), 11(6) (Interest), and 12(6) (Royalties)) to allow a resident to deduct interest, royalties, and other disbursements paid by the resident to a resident of the other country under the same conditions that it allows deductions for such amounts paid to residents of the same country as the payor.

The rule of non-discrimination also applies to corporations of one country which are owned in whole or in part by residents by the other country. An enterprise resident in one country, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other country, would not be subjected in the country of its residence to any taxation or any directly connected requirement which is more burdensome than the taxation and directly connected requirements that the country of its residence imposes or may impose on its enterprises carrying on the same activities but the capital of which is owned or controlled by its residents.

The proposed treaty would permit a country to continue any discriminatory tax laws in force on July 23, 1982 (the date of the signing of the treaty), and to adopt any later discriminatory laws that are substantially similar in general purpose or intent to tax laws in effect on July 23, 1982, but that are enacted after that date. In addition, either country could adopt discriminatory laws reasonably designed to prevent or defeat tax avoidance or evasion. Any such substantially similar law or anti-avoidance law generally [36] cannot favor citizens or residents of any third country over citizens or residents of the treaty partner (the United States or New Zealand) of the country adopting the modification. The proposed treaty does not prevent such discrimination in favor of a third country by treaty, however.

Although this provision does not comport with the U.S. model treaty, New Zealand has never agreed to a more comprehensive non-discrimination rule than that of the proposed treaty.

The non-discrimination provisions do not generally require either country to treat nonresidents as it treats residents.

If the United States of New Zealand considers that future tax measures of the other country violate this non-discrimination clause, the competent authorities of the countries are to consult together in an endeavor to resolve the matter.

The non-discrimination provision is not intended to override the right of the United States to tax foreign corporations on their dispositions of a U.S. real property interest because the effect of the provisions imposing the tax is not discriminatory.

The saving clause (which allows the country of residence or citizenship to tax notwithstanding certain treaty provisions) does not apply to this non-discrimination article.

Article 24. Mutual Agreement Procedure

The proposed treaty contains the standard mutual agreement provision which authorizes the competent authorities of the United States and New Zealand to consult together to

attempt to alleviate individual cases of double taxation not in accordance with the proposed treaty. The saving clause of the proposed treaty does not apply to this article, so that the application of this article may result in waiver (otherwise mandated by the proposed treaty) of taxing jurisdiction by the country of citizenship or residence.

Under the proposed article a resident of one country who considers that the action of the countries or either of them will cause him to pay a tax not in accordance with the treaty may present his case to the competent authority of the country of which he is a resident or citizen. The taxpayer must notify this competent authority of his case within three years from the time the taxpayer receives notice of the action he considers improper. The competent authority then makes a determination as to whether the objection appears justified. If the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, then that competent authority would endeavor to resolve the case by mutual agreement with the competent authority of the other country, with a view to the avoidance of taxation which is not in accordance with the Convention. The provision requires the waiver of the statute of limitations of either country so as to permit the issuance of a refund or credit notwithstanding the statute of limitations. The provision, however, does not authorize the imposition of additional taxes after the statute of limitations has run.

The competent authorities of the Contracting States are to endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation of application of the treaty. They may also consult together for the elimination of double taxation in cases not provided for in the treaty.

[37] Unlike the U.S. model, the proposed treaty does not list particular matters to which the competent authorities might agree. However, it is intended that, as under the U.S. model, the competent authorities would be authorized to agree to the allocation of income, deductions, credits, or allowances, to the determination of the source of income, and to the common meaning of terms.

The treaty authorizes the competent authorities to communicate with each other directly for purposes of reaching an agreement in the sense of the mutual agreement provision. These provisions make clear that it is not necessary to go through standard diplomatic channels in order to discuss problems arising in the application of the treaty and also removes any doubt as to restrictions that might otherwise arise by reason of the confidentiality rules of the United States or New Zealand.

Article 25. Exchange of Information

This article forms the basis for cooperation between the two countries in their attempts to deal with avoidance or evasion of their respective taxes and to enable them to obtain information so that they can properly administer the treaty. The proposed treaty provides for the exchange of information which is necessary to carry out the provisions of the proposed treaty or of the domestic laws of the two countries concerning taxes covered by the treaty insofar as the taxation under those domestic laws thereunder is not contrary to the treaty. The exchange of information is not restricted by Article 1 (General Scope). Therefore, third country residents would be covered. The U.S. model treaty provides for the exchange of information about all taxes imposed by either country (whether or not otherwise covered by the treaty). The proposed treaty is more limited, applying only for enforcement of the taxes listed in Article 2 as generally covered by the treaty (generally income taxes).

Any information exchanged is to be treated as secret in the same manner as information obtained under the domestic laws of the country receiving the information. Exchanged information is to be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the treaty. Such persons or authorities could use the information for such purposes only. Persons involved in the administration of taxes include legislative bodies involved in the administration of taxes, including their agents such as, for example, the U.S. General Accounting Office, with respect to such information as they consider to be necessary to carry out their oversight responsibilities.

Upon an appropriate request for information, the requested country is to endeavor to obtain the information to which the request relates in the same manner and to the same extent as if its tax were at issue. A requested country is to use its subpoena or summons powers or any other powers that it has under its own laws to collect information requested by the other country. It is intended that the requested country may use those powers even if the requesting country could not under its own laws. Thus, it is not intended that the provision be strictly reciprocal. For example, [38] once the U.S. Internal Revenue Service has referred a case to the Justice Department for possible criminal prosecution, the United States investigators can no longer use an administrative summons to obtain information. If however, New Zealand could still use administrative process to obtain requested information, it would be expected to do so even though the United States cannot. The United States could not, however, tell New Zealand which of its procedures to use.

Where specifically requested, the requested competent authority would attempt to provide the information in the form requested. Specifically, the competent authority would attempt to provide depositions of witnesses and copies of unedited original documents (including books, papers, statements, records, accounts and writings) to the extent that they can be obtained under the laws and practices of the requested country in the enforcement of its own tax laws.

A country is not required to carry out administrative measures at variance with the laws and administrative practice of either country, to supply information which is not obtainable under the laws or in the normal course of the administration of either country, to supply information which would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy.

The U.S. model treaty provides that each country will collect taxes

for the other country to the extent necessary to insure that benefits of the treaty are not going to persons not entitled to those benefits. The proposed treaty does not contain such a collection provision.

Article 26. Diplomatic Agents and Consular Officers

The proposed treaty contains the rule found in other U.S. tax treaties that its provisions are not to affect the privileges of diplomatic agents or consular officials under the general rules of international law or the provisions of special agreements. Accordingly, the convention will not defeat the exemption from tax which a host country may grant to the salary of diplomatic officials of the other country. The saving clause does not apply to this article, so that, for example, U.S. diplomats who are considered New Zealand residents would not be subject to New Zealand tax.

Article 27. Entry Into Force

The proposed treaty is subject to ratification in accordance with the applicable procedures of each country and the instruments of ratification are to be exchanged as soon a possible in Washington. In general, the proposed treaty will enter into force when the instruments of ratification are exchanged.

With respect to U.S. taxes withheld at source, the treaty will be effective for amounts or credited on or after the first day of the second month next following the date on which the treaty enters into force. With respect to other U.S. taxes, the treaty is to be effective for taxable years beginning on or after the date on which the treaty enters into force.

[39] With respect to New Zealand withholding taxes on income derived by nonresidents of New Zealand, and with respect to other New Zealand taxes, the treaty will be effective for any income year beginning on or after the first day of April next following the date on which the treaty enters into force.

If the Convention enters into force before April 1, 1984, New Zealand is to apply the provisions of Article 10 (Dividends) for the purposes of New Zealand tax to dividends derived on or after April 1, 1982 and beneficially owned by a resident of the United States. That is, the reduced rate of New Zealand withholding taxes on dividends would apply retroactively.

The existing treaty is to be phased out as the proposed treaty becomes effective. When the proposed treaty becomes fully effective, the existing treaty will terminate.

Article 28. Termination

The proposed treaty will continue in force indefinitely, but either country may terminate it at any time after five years from its entry into force by giving at least six months prior notice through diplomatic channels.

If termination occurs, with respect to U.S. taxes withheld at source, the termination will be effective for amounts paid or credited on or after the first day of January next following the expiration of the six month period. With respect to other U.S. taxes, the termination will be effective for taxable periods beginning on or after the first day of January next following the expiration of the six month period.

With respect to New Zealand withholding taxes on income derived by nonresidents of New Zealand, the termination will be effective for income derived on or after the first day of April next following the expiration of the six month period. With respect to other New Zealand taxes, the termination will be effective for any income year beginning on or after the first day of April next following the expiration of the six month period.

Proposed Protocol

A proposed protocol to the treaty was signed at the time the proposed treaty was signed. The proposed protocol clarifies certain points raised in the treaty. The clarifications relate to the Articles dealing with dividends (Article 10), interest (Article 11), royalties (Article 12), and the Articles dealing with business profits (Article 7), royalties (Article 12), and other income (Article 21). The clarifications are described in the Articles affected.

[40] IX. TEXT OF THE RESOLUTION OF RATIFICATION

Resolved (two-thirds of the Senators present concurring therein), that the Senate advise and consent to the ratification of the Convention between the United States of America and New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (the Convention), Together with a Related Protocol, signed at Wellington on July 23, 1982.

UNITED STATES TREASURY DEPARTMENT TECHNICAL EXPLANATION OF THE CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF NEW ZEALAND FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME

This Convention, signed at Wellington, New Zealand on July 23, 1982, was negotiated on the basis of the U.S. Model Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, published in May 1977, the revised U.S. model published in draft form in June 1981 (also referred to as the "U.S. model"), and the New Zealand model draft income tax convention. The U.S. and New Zealand models are similar in most respects to the Model Double Taxation Convention on Income and Capital published by the Organization for Economic Cooperation and Development (OECD) in January 1977.

The technical explanation is an official guide to the Convention. It reflects policies behind particular Convention provisions, as well as understandings reached with respect to the interpretation and application of the Convention.

Article 1. GENERAL SCOPE

This Article identifies the persons who come within the scope of the Convention (also referred to as "the Treaty") and establishes the relationship between it and domestic law.

Paragraph 1 states that, except where the Convention specifically provides otherwise, the Convention applies to residents of the United States and/or New Zealand. Certain provisions of the Convention may apply to residents of third countries, for example, paragraph 4 of Article

10 (Dividends), paragraph 7 of Article 11 (Interest), and Article 25 (Exchange of Information). The term "resident" is defined in Article 4 (Residence).

Paragraph 2 provides that the Convention may not increase tax above the liability that would result under domestic law or under other agreements between the Contracting States. If domestic law provides a more favorable treatment than the Convention, the taxpayer may apply the provisions of domestic law. For example, if certain interest income derived by nonresidents is exempt from tax by statute, but the treaty authorizes a tax at source of not more than 10 percent, the statutory exemption will apply. A taxpayer, however, may not make inconsistent choices between the rules of the Internal Revenue Code and the Convention rules.

Paragraph 3 contains the tranditional "saving clause" under which each Contracting State reserves the right to tax its residents, as defined in Article 4 (Residence) as if the Convention had not come into effect. The United States also reserves its right so to tax U.S. citizens, U.S. companies, and former U.S. citizens whose loss of citizenship had as one of its principal purposes the avoidance of tax. Such former citizens are taxable in accordance with section 877 of the Internal Revenue Code for 10 years following the loss of citizenship. A U.S. corporation remains subject to U.S. income tax even if it is also a resident of New Zealand under New Zealand law.

Paragraph 4 sets forth certain exceptions to the application of the saving clause where other provisions of the Convention present overriding policies. The saving clause does not override the benefits provided under paragraph 2 of Article 9 (Associated Enterprises), relating to correlative adjustments of tax liability, or the benefit of paragraph 1(b) of Article 18 (Pensions and Annuities), relating to social security payments. Social security payments made by New Zealand are taxable only by New Zealand even though the recipient may be a citizen or resident of the United States; and, conversely, social security payments made by the United States to a resident of New Zealand are taxable only in the United States. The benefits provided in Articles 22 (Relief from Double Taxation), 23 (Non-Discrimination), and 24 (Mutual Agreement Procedure) are also available to residents and citizens of the Contracting States, notwithstanding the saving clause.

In some cases, the saving clause overrides benefits otherwise conferred by the Convention on citizens or persons having immigrant status in a Contracting State, but does not override those benefits otherwise conferred on residents who are not citizens and do not have immigrant status in that State. This second category of exceptions to the saving clause concerns the benefits provided under Articles 19 (Government Service), 20 (Students) and 26 (Diplomatic Agents and Consular Officers). The term "immigrant status" for U.S. purposes means a person admitted to the United States as a permanent resident under U.S. immigration laws (i.e., holding a "green card").

Article 2. TAXES COVERED

Paragraph 1 enumerates the existing taxes to which the Convention applies in each Contracting State.

In the United States these are the Federal income taxes imposed by the Internal Revenue Code, but excluding the accumulated earnings tax, the personal holding company tax and social security taxes. The excise taxes on private foundations are also covered by the Convention. The excise taxes on foreign insurers are not covered by the Convention.

In New Zealand the Convention covers the income tax, but excluding the excess retention tax and the bonus issue tax. The excess retention tax is imposed (currently at a rate of 35 percent) on privately held companies which retain an excessive portion of their earnings in any given income year, with the possibility of a refund in the following year if they make certain distributions. The bonus issue tax is imposed on a corporation that issues certain stock dividends.

Paragraph 2 provides that taxes enacted after the date of signature of the Treaty (July 23, 1982) are also covered if they are subtantially similar to the taxes referred to in paragraph 1. The competent authorities agree to notify each other of significant changes in their tax laws.

Article 3. GENERAL DEFINITIONS

Paragraph 1 defines some of the principal terms used throughout the Convention. Unless the context otherwise requires, the terms defined in this paragraph have a uniform meaning throughout the Convention. A number of other important terms are defined in other Treaty articles. For example, the term "resident" is defined in Article 4 (Residence), the term "permanent establishment" is defined in Article 5 (Permanent Establishment), and the term "royalties" is defined in Article 12 (Royalties).

The definitions of the terms "person", "company" and "enterprise of a Contracting State" are similar to the definitions in the U.S. Model; however, the word "partnership" has been deleted from the definition of the term "person" which appears in the U.S. model. Both New Zealand and the United States impose tax at the level of the partners, rather than at the level of the partnership, and New Zealand did not wish to suggest that a partnership is a taxable entity. A partnership is in any event included within the reference to "any other body of persons". A separate definition of a "United States company" was added, which includes companies created or organized in the United States but managed in New Zealand; see, for example, paragraph 3 of Article 1 (General Scope) and paragraph 1 of Article 23 (Relief from Double Taxation).

The definition of "international traffic" differs slightly from that of the U.S. model but has the same meaning. (See, however, Article 8 (Shipping and Air Transport)).

The "competent authority" for the United States is the Secretary of the Treasury or his delegate, and for New Zealand is the Commissioner of Inland Revenue or his delegate.

The terms "United States" and "New Zealand" are defined to include the continental shelf areas of the two countries with respect to exploration and exploitation of their natural resources. For the United States, the definition of the continental shelf is interpreted in accordance with section 638 of the Internal Revenue Code and the regulations thereunder. The term "United States" does not include Puerto Rico, the

Virgin Islands, Guam, or any other United States possession. The term "New Zealand" does not include the Cook Islands, Niue, or Tokelau.

Definitions are also provided for the terms "Contracting State," the "other Contracting State" and "tax".

Paragraph 2 states that the covered taxes do not include penalty or interest charges. For example, the ceiling rate of tax at source of 15 percent on dividends under Article 10 (Dividends) does not include any penalty or interest charge for late payment of tax.

Paragraph 3 provides that terms not defined in the Convention shall have the meaning which they have under the laws of the Contracting State concerning the taxes to which the Convention applies, unless the context of the Convention requires a different interpretation, or unless the competent authorities agree on a common definition under the terms of Article 24 (Mutual Agreement Procedure). The term "context" includes the purpose and background of the provision in which the term appears. An agreement by the competent authorities with respect to the meaning of a term used in the Convention would supersede conflicting meanings in the domestic laws of the Contracting States.

Article 4. RESIDENCE

This Article sets forth rules for determining the residence of individuals, corporations, and other persons for purposes of the Convention. A definition of residence is important because, for the most part, only residents of the Contracting States may claim benefits under the Convention. The Convention definition is, of course, exclusively for purposes of the Convention.

Paragraph 1 of this Article is based on the corresponding provision of the U.S. Model, with one change and one clarification. The change is that citizenship alone is not determinative of residence. Thus, U.S. citizens resident outside the United States are not residents of the United States for purposes of the Convention. In some other U.S. income tax conventions, this result has been achieved by simply deleting the reference to citizenship. In this Convention the exception for nonresident citizens is stated explicitly. The clarification is the explanation that the "subject to tax" requirement does not prevent a tax-exempt organization from being considered a resident of a Contracting State. The inclusion of this clarification is not intended to imply that tax-exempt organizations are not entitled to treaty benefits under conventions which do not include this language.

Paragraph 2 provides a series of tie-breakers for assigning a single residence to an individual who, by the criteria of paragraph 1, would be a resident of both countries. The tie-breakers are taken from the OECD Model.

The first test is where the individual has a permanent home. If that test is inconclusive because the individual has a permanent home in both countries, the second test is where his personal and economic relations are closest. If that test does not provide a satisfactory answer, or if the individual does not have a permanent home in either country, the next test is where he has his habitual abode. If that test also fails to establish a single country of residence, because the individual has an habitual abode in both countries or in neither of them, he is deemed to be a resident of his country of citizenship. And, if he is a citizen of both countries or of neither of them, the question is left to the competent authorities, who will attempt to settle it by mutual agreement.

Paragraph 3 provides that, in the event that a person other than an individual or a company is a resident of both Contracting States under the provisions of paragraph 1, the competent authorities of the two countries shall endeavor to resolve the question and determine how the Convention applies to such a person.

Paragraph 4 provides that, where a company is a resident of both countries (e.g., created or organized under the laws of a state of the United States and managed in New Zealand), the competent authorities will try to assign it a residence for the taxable year solely in the United States or New Zealand. Such cases are expected to be very unusual. However, if the situation arises and the competent authorities cannot agree on a single residence, the company in question will not be a resident of either country for purposes of the Convention. (Note, however, that in such a case residents of a Contracting State who derive dividends, interest or royalties from such a dual resident company are entitled to the reduced rates of tax provided in Article 10, 11 and 12.)

Article 5. PERMANENT ESTABLISHMENT

The rules for taxation by a Contracting State of business income derived by a resident of the other State utilize the concept of a "permanent establishment." Paragraph 1 of this Article defines in general terms the "permanent establishment" concept, and the following paragraphs give some specific illustrations of the meaning of the term.

Paragraph 2 provides an illustrative list of fixed places of business which constitute a permanent establishment. A place of management, branch, office, factory, workshop and a place of extraction of natural resources, such as a well or quarry, are examples of a permanent establishment. Since a place of management would in most cases require an office, which is specifically listed in paragraph 2, the addition of the term will not generally cause a permanent establishment to exist if there would not otherwise be one.

A building site or construction or installation project will only be considered a permanent establishment if it lasts longer than twelve months. In such a case, the site or project constitutes a permanent establishment from the first day when work physically begins within the territory of the Contracting State. A series of contracts or projects which are interdependent both commercially and geographically are to be treated as a single project for the purpose of applying the twelve month test.

Paragraphs 4 and 5 state two additional types of activities which constitute a permanent establishment. Supervisory activities in connection with a construction or installation project constitute a permanent establishment if carried on for longer than twelve months. Activities connected with the exploration for or exploitation of natural resources constitute a permanent establishment if carried on for longer than six months in any consecutive twelve months. In both cases, if the

activities are carried on for longer than the stated period, a permanent establishment exists from the first day. In applying the six-month and twelve-month tests to activities connected with the exploration for or exploitation of natural resources, connected activities of associated enterprises are considered to have been carried on by a single enterprise. Thus, for example, if one U.S. corporation spends four months drilling a gas well on the New Zealand continental shelf and an associated U.S. corporation spends the following three months laying pipeline to the well, the activities of the associated corporations over the seven-month period will be aggregated for purposes of the six-month and twelve-month tests. Accordingly, each of the two associated corporations will be considered to have carried on activities for seven months; thus each will have a permanent establishment in New Zealand.

Paragraph 6 enumerates certain activities which may be undertaken singly or in combination without creating a permanent establishment. Subparagraphs (a) through (e) are the same as the corresponding provisions in the U.S. model. Subparagraph (f) of the U.S. model was deleted, but the same effect is obtained by the insertion of the reference to "one or more" in the introductory language of paragraph 6.

Paragraphs 7 and 8 consider the use of agents. A dependent agent who habitually exercises an authority to conclude contracts in the name of an enterprise is deemed to be a permanent establishment of that enterprise except to the extent that his activities are limited to those mentioned in paragraph 6 which would not constitute a permanent establishment under that paragraph. An enterprise of a Contracting State will not be considered to have a permanent establishment in the other State merely because it uses the services of an independent agent acting in the ordinary course of business in that other State.

Paragraph 9 provides that control of one company by another does not of itself constitute either company a permanent establishment of the other. The determination as to whether a subsidiary is a permanent establishment of its parent corporation, or conversely, or whether two or more subsidiaries of the same corporation are permanent establishments of the parent or of each other is made by reference to the tests set out in paragraphs 1 through 8.

Article 6. INCOME FROM REAL PROPERTY

This Article provides that income from real property, including income from agriculture and forestry, may be taxed by the Contracting State where the property is located. This rule does not confer an exclusive right of taxation on the State where the property is located. It simply provides that the situs State has the primary right to tax such income, regardless of whether the income is derived through a permanent establishment in that State or not. This Article is substantially the same as Article 6 of the OECD Model. The provision in the U.S. Model for a binding election to be taxed on a net basis was deleted. Such an election is available under U.S. law, and New Zealand taxes income from real estate on a net basis.

Article 7. BUSINESS PROFITS

This Article provides rules for the taxation by a Contracting State of income from business activity carried on by a resident of the other State.

Paragraph 1 provides that business profits of an enterprise of one Contracting State (i.e., excluding a dual resident corporation treated by reason of paragraph 4 of Article 4 (Residence) as a resident of neither Contracting State) shall be taxable only in that State except to the extent that such profits are attributable to a permanent establishment through which the enterprise carries on business activities in the other Contracting State.

Paragraph 2 provides that the profits to be attributed to a permanent establishment are those which it might be expected to make if it were an independent enterprise engaged in similar activities under similar conditions. The profits must reflect arm's-length prices. The profits so attributed may be from sources within or without the Contracting State. Thus, items of income described in section 864(c)(4)(B) of the Internal Revenue Code which are attributable to a permanent establishment in the United States may be subject to tax by the United States. In addition, the limited "force of attraction" rule in I.R.C. 864(c)(3) does not apply for U.S. tax purposes under the Convention.

Paragraph 3 provides that deductions shall be allowed for expenses incurred for the purposes of the permanent establishment, as determined under the laws of each country, including, *inter alia*, such expenses, wherever incurred, for administration, research and development, and interest.

Paragraph 4 states that no profits shall be attributed to a permanent establishment by reason of the mere purchase by it of goods or merchandise for the enterprise.

Paragraph 5 provides that, unless there is good and sufficient reason to the contrary, the same method of determining profits attributable to the permanent establishment shall be used each year.

Paragraph 6 provides that, where business profits include items of income dealt with in other articles of the Convention, the provisions of those other articles override the provisions of this Article. For example, the taxation of income of international shipping and aircraft operations is governed by Article 8 (Shipping and Air Transport) and not by this Article. Similarly, the taxation of dividends, interest, and royalties is controlled by Articles 10, 11, and 12, respectively; however, the terms of those Articles provide that where dividends, interest, or royalties derived by a resident of a Contracting State are attributable to a permanent establishment in the other Contracting State, the provisions of this Article do apply and the item of income is taxed as business profits.

Paragraph 7 allows each State to apply its domestic law in taxing income from the insurance business, notwithstanding the other provisions of this Article. New Zealand imposes its ordinary income tax in such cases but applies special rules for determining taxable income. For example, a nonresident insurance company deriving premiums from New Zealand is taxed on a presumed profit equal to 10 percent of such premiums.

Unlike the U.S. model, the Convention treats income from the rental of industrial, commercial or scientific equipment and from the rental of

films as royalties covered by Article 12 (Royalties) rather than as profits covered by this Article.

Article 8. SHIPPING AND AIR TRANSPORT

Paragraph 1 provides that each of the Contracting States shall exempt from tax profits derived by an enterprise of the other Contracting State from the operation of ships or aircraft in international traffic, including profits from the rental on a full basis of ships and aircraft operated in international traffic.

Under paragraph 2, profits derived by an enterprise of one Contracting State from the rental of ships and aircraft on a bareboat basis or from the use, maintenance or rental of containers and related equipment are exempt from tax in the other State to the extent that the ships, aircraft or containers are used in international traffic and the profits are incidental to operating profits from international traffic.

For example, if a U.S. airline which operates internationally leases a plane on a bareboat basis to a New Zealand airline for use on its international routes, the rental income derived by the U.S. company is exempt from New Zealand tax under this Article. However, if the U.S. airline operates only within the United States, or if the leased plane is used only within New Zealand, the rental income is not exempt under this Article. Moreover, if a U.S. bank leases the plane on a bareboat basis to the New Zealand airline for use internationally or within New Zealand, that rental income is not exempt under this Article.

Income from the rental of ships, aircraft or containers which is not exempt from tax under this Article is taxable in accordance with Article 12 (Royalties). Under that Article, if the payer of the rental is a U.S. resident (e.g., if a U.S. bank leases a plane to a U.S. airline for use between the United States and New Zealand), New Zealand will not consider that income to have a New Zealand source and will not tax it to a U.S. resident. If the income does have a source in New Zealand (e.g., if a U.S. bank leases a plane to a New Zealand airline on a bare-boat basis), New Zealand law imposes tax on the net income after deducting expenses, subject to a maximum tax under Article 12 of 10 percent of the gross rental.

Paragraph 3 states that the provisions of this Article apply to the share of an enterprise of a Contracting State in the profits of a pool or joint venture, even though the other participants may be enterprises of third States not covered by this Convention. Third country participants are not affected by this Convention but are taxable in accordance with internal law or another international agreement if applicable.

Article 9. ASSOCIATED ENTERPRISES

This Article provides that, where related persons engage in transactions which are not at arm's-length, the Contracting States may make appropriate adjustments to their taxable income and tax liability.

Paragraph 1 states the general rule that where an enterprise of one Contracting State and an enterprise of the other Contracting State are related through management, control, or capital and their commercial or financial relations differ from those which would prevail between independent enterprises, the profits of the enterprises may be adjusted to reflect the profits which would have accrued if the two enterprises had been independent.

Paragraph 2 provides that, where one of the Contracting States has increased the profits of an enterprise of that State to the amount that would have accrued to the enterprise had it been independent of an enterprise in the other Contracting State, the second State shall make an appropriate adjustment, decreasing the amount of tax which it has already imposed on those profits. In determining such adjustments, due regard is to be had to the other provisions of the Convention. The competent authorities of the two States shall consult each other if necessary in implementing this provision.

Paragraph 3 clarifies that each Contracting State may apply its internal law in determining liability for its tax. For example, although paragraphs 1 and 2 refer to allocations of "profits" and "taxes," it is understood that such terms also include the components of the tax base and of the tax liability, such as income, deductions, credits, and allowances. The United States will apply its rules and procedures under section 482 of the Internal Revenue Code. New Zealand will apply the provisions of its Income Tax Act, particularly with respect to the determination of taxable income in cases where the information available is inadequate to measure net income under the ordinary rules. Such determinations must be consistent in each case with the standards of arm's length transactions.

Article 10. DIVIDENDS

This Article limits the rate of tax which may be imposed by either Contracting State on dividends paid by a company which is a resident of that State to a resident of the other Contracting State.

Paragraph 1 states that such dividends may be taxed in the State of residence of the recipient. This provision, which comes from the OECD model, confirms the provision of paragraph 3 of Article 1 (General Scope) that each Contracting State reserves the right to tax its residents.

Paragraph 2 provides that such dividends may also be taxed in the State of which the paying company is a resident, but such tax may not exceed 15 percent of the gross amount of the dividends when the beneficial owner is a resident of the other Contracting State.

In the absence of a treaty, New Zealand, like the United States, imposes a tax of 30 percent on gross dividends paid to nonresidents. By treaty, New Zealand is willing to reduce that tax to, but not below, 15 percent. In a Protocol accompanying this Convention, New Zealand agrees that, if in a future treaty with another member country of the Organization for Economic Cooperation and Development it reduces the New Zealand tax below 15 percent on dividends paid to residents of that country, New Zealand will reopen negotiations with the United States with a view to extending the same treatment to U.S. shareholders of New Zealand companies on a reciprocal basis.

As of April 1, 1982 the New Zealand statutory tax increased from 15 percent to 30 percent on dividends paid to nonresidents. The 1948 income tax treaty between the United States and New Zealand (also referred to as the "1948 Convention"), which is presently in effect, does not limit

New Zealand's tax at source on dividends. Thus, their statutory tax applies prior to entry into force of this Convention. However, if this Convention enters into force before April 1, 1984, New Zealand will apply the 15 percent rate provided by this Article retroactively to April 1, 1982 and refund the excess of the 30 percent statutory rate over the 15 percent treaty rate. The condition that the Convention must enter into force before April 1, 1984 for the reduced rate to apply retroactively is intended to prevent New Zealand from having to make refunds of tax collected more than two years earlier.

Under the 1948 Convention, the United States tax at source is limited to 15 percent on portfolio dividends and 5 percent on direct investment dividends. Under this Convention the U.S. rate will be uniformly 15 percent, effective the first day of the second month after entry into force.

Paragraph 3 provides that where the dividends are attributable to a permanent establishment or a fixed base which the beneficial owner of the dividends maintains in the country of which the company paying the dividend is a resident, such dividends are not taxable in accordance with this Article, but in accordance with the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services). This rule changes New Zealand's statutory provision, which taxes such dividends at a flat 30 percent rate, by allowing for taxation on a net basis.

Paragraph 4 provides that a Contracting State may not impose tax on dividends paid by a company which is not a resident of that State with four exceptions: (a) if the dividends are paid to a resident of the first Contracting State; (b) if the dividends are attributable to a permanent establishment or fixed base of the beneficial owner in the first State; (c) if at least 50 percent of the gross income of the company paying the dividends is attributable to one or more permanent establishments of that company in the first State and the dividends are paid out of profits attributable to such permanent establishment; or (d) if the dividends are paid by a U.S. company which is resident in New Zealand for purposes of New Zealand tax. The fourth situation allows each State to tax dividends paid by a corporation which under internal law is a resident of that State but which under the Convention (paragraph 4 of Article 4 (Residence)) is a dual resident assigned to neither State. If only subparagraph (c) or (d) applies and the beneficial owner of the dividends is a resident of the other Contracting State, the tax at source is limited to 15 percent as in paragraph 2 of this Article. The United States may also tax dividends received by U.S. citizens, pursuant to paragraph 3 of Article 1 (General Scope).

Article 11. INTEREST

This Article limits the tax which may be imposed by either Contracting State on interest derived and beneficially owned by a resident of the other Contracting State.

Paragraph 1 states that such interest may be taxed in the State of residence of the beneficial owner. This provision, which comes from the OECD model, confirms the provision of paragraph 3 of Article 1 (General Scope) that each Contracting State reserves the right to tax its residents.

Paragraph 2 provides that such interest may also be taxed by the State in which it arises, but the tax is limited to 10 percent of the gross amount of the interest. New Zealand's statutory rate of tax on interest paid to nonresidents is 15 percent.

Paragraph 3 provides, as an exception to paragraph 2, that certain interest will be exempt from tax in the State where it arises. The exemption at source applies when the interest is derived and beneficially owned by the Government of the other State or by a government instrumentality not subject to income tax by that other State. Interest derived by a political subdivision or local authority of a Contracting State is not exempt from tax at source under this provision. The exemption also applies when interest is derived and beneficially owned by a resident of the other State with respect to debt obligations guaranteed or insured by the Government of that other State or by a government instrumentality not subject to income tax by that other State. For example, New Zealand will not tax interest derived by the U.S. Government or by an instrumentality such as the Export-Import Bank. Interest derived by and beneficially owned by other U.S. residents, such as lending institutions, will be exempt from tax by New Zealand if the loan is guaranteed or insured by the U.S. Government or an instrumentality such as the Export-Import Bank.

Paragraph 4 provides that, where the interest is attributable to a permanent establishment or fixed base which the beneficial owner of the interest maintains in the other Contracting State, that interest is not taxable in accordance with this Article but in accordance with the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services).

Paragraph 5 defines the source of interest. Interest arises in a Contracting State if paid by that State, a political subdivision or local authority thereof, a resident of that State or a dual resident corporation. (Thus interest paid by a dual resident corporation is eligible for the reduced rate provided in paragraph 2, although interest beneficially owned by such a company is not.) An exception to this general rule provides that when the indebtedness is connected with a permanent establishment or fixed base of the payor in a Contracting State and the interest expense is borne (deducted in computing taxable income) by that permanent establishment or fixed base, the interest arises in the State where that permanent establishment or fixed base is located.

Paragraph 6 states that the provisions of this Article shall not apply to interest payments between related persons in excess of the amount which would have been agreed upon at arm's-length. Such excess amount shall be taxed according to the laws of each Contracting State, with regard also to the other provisions of this Convention.

Paragraph 7 provides that a Contracting State may not tax interest paid by a resident of the other State unless one of three conditions is met: the owner of the interest is a resident of the first State, the interest arises in the first State, or the interest is attributable to a permanent establishment or fixed base of the beneficial owner in the first State. Under these rules the United States may tax interest paid by a New Zealand company (which under the treaty is a resident of New Zealand) only to the extent

that the interest is U.S.—source income under the Code and the indebtedness was incurred in connection with and the interest was deducted by a permanent establishment or fixed base of the New Zealand resident in the United States. However, where such interest is beneficially owned by a resident of New Zealand, the U.S. tax will be reduced to 10 percent, in accordance with paragraph 2.

Article 12. ROYALTIES

This Article limits the tax which may be imposed by either Contracting State on royalties derived and beneficially owned by a resident of the other Contracting State.

Paragraph 1 states that such royalties may be taxed in the State of residence of the beneficial owner. This provision, which comes from the OECD model, confirms the provision of paragraph 3 of Article 1 (General Scope) that each Contracting State reserves the right to tax its residents.

Paragraph 2 provides that such royalties may also be taxed by the State in which they arise but the tax is limited to 10 percent of the gross amount of the royalties. New Zealand's statutory tax rate on royalties paid to nonresidents is generally 15 percent of the gross amount. Rentals are taxed on a net basis at the ordinary rates.

Paragraph 3 contains a definition of the term "royalties." The definition is broader than the one in the U.S. Model. For purposes of this Convention, payments for the use of, or right to use, industrial, commercial or scientific equipment are also treated as royalties except when such equipment is leased under a "hire-purchase" agreement. Under New Zealand law the lessee under a "hire-purchase" agreement (a lease accompanied by certain lessee purchase options or rights) is treated for tax purposes as the owner of the leased property. The exception for hire-purchase agreements was inserted at the request of New Zealand to distinguish such agreements from leases respected as such for tax purposes. Such a distinction is also made in the Commentary to Article 12 of the OECD Model Convention. Similarly, under the Internal Revenue Code, the terms of a lease may be such that for U.S. income tax purposes the lessee is treated as the owner of the property. For purposes of United States tax the exception for "hire-purchase" agreements simply confirms such treatment, which would also apply in the absence of such an explicit exception. See paragraph 2 of Article 3 (General Definitions). Under New Zealand law, payments for the use of equipment are taxed on a net basis. The recipient must file a return reporting gross receipts and expenses and apply the ordinary New Zealand tax to the taxable amount. Under the Convention, the same procedure will apply, but the amount of tax liability may not exceed 10 percent of the gross amount received. Payments for the use of, or right to use, cinematographic films and certain tapes and other films are also taxed as royalties under the Convention, subject to the ceiling of 10 percent of the gross amount. However, as long as New Zealand provides for a lower tax under its internal law, that lower amount will apply (see paragraph 2 of the Protocol).

Paragraph 4 provides that, where royalties are attributable to a permanent establishment or fixed base maintained by the beneficial owner of the royalties in the other Contracting State, the royalties will not be taxed in accordance with the provisions of this Article but in accordance with the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services).

Paragraph 5 defines the source of royalties. In general, a royalty is considered to arise in a Contracting State if paid by the Government or a resident of that State or by a company which under their internal laws is a resident of both Contracting States but which under the Convention is a resident of neither State. (Thus, a royalty paid by such a dual resident company is eligible for the reduced rate provided in paragraph 2 although a royalty beneficially owned by such a company is not.) However, if a permanent establishment or fixed base of the payor in one of the Contracting States incurs the liability to pay the royalties and bears the payment (deducts it in arriving at taxable income), the royalty is considered to arise in the State where the permanent establishment or fixed base is located. Moreover, if under these rules a royalty is not considered to arise in either Contracting State, but it relates to the use of, or the right to use, property in a Contracting State, the royalty is considered to arise in the State where the property is used (or where there is a right to use it). Thus, for example, if a New Zealand resident were to license a patent to a third country company, which it in turn sublicenses for use in the United States, the United States would tax the license payment by the third country company to the New Zealand resident, subject to the limitation in paragraph 2. The sublicense payment by the U.S. user to the third country resident would not be covered by the Convention and would be subject to U.S. tax under U.S. law or the provisions of a U.S. tax treaty with that third country, if applicable.

Paragraph 6 provides that, where royalties paid between related persons exceed the amount which would have been determined at arm's-length, the provisions of this Article shall apply only to the arm's-length amount and the excess shall be taxable according to the law of each Contracting State, taking into account other provisions of the Convention.

Article 13. ALIENATION OF PROPERTY

This Article provides rules for the taxation of gains derived by a resident of a Contracting State. In general, it provides that: (1) gains from the alienation of real property or certain business property may be taxed where the real property or the business is located; (2) gains derived from the alienation of ships or aircraft or related property may be taxed only by the State of which the enterprise is a resident, except to the extent that the enterprise has been allowed depreciation of the property in computing taxable income in the other State; (3) gains from the alienation of property referred to in paragraph 3(b) of Article 12 (Royalties) are taxable under Article 12; and (4) gains with respect to any other property may be taxed only in the State of which the recipient is a resident.

Paragraph 1 states the rule that gains derived from the alienation of real property situated in a Contracting State may be taxed by that State.

Paragraph 2 defines real property in each of the Contracting States. In the case of the United States, real

property includes a United States real property interest as defined under the Foreign Investment in Real Property Tax Act, as amended. Thus, the United States retains its full taxing right under that law.

Paragraph 3 provides that, when an enterprise of a Contracting State derives gains with respect to the alienation of ships, aircraft, or containers operated in international traffic, the gain shall be taxable only in the State of residence of the enterprise, except to the extent that the enterprise has been allowed depreciation on that property in the other Contracting State. To the extent that depreciation deductions have reduced the tax on income from such ships, aircraft, or containers in the other State, that other State may recapture those depreciation deductions (but not in excess of the gain realized) when the property is disposed of.

Paragraph 4 provides a cross-reference to paragraph 3(b) of Article 12 (Royalties) and states that gain on royalties described in that paragraph (royalties which are contingent on the use or productivity of the right or property) are taxable in accordance with that Article.

Paragraph 5 clarifies that real property situated in New Zealand includes shares of a company and interests in a partnership, trust or estate the assets of which consist wholly or principally of real property situated in New Zealand.

Paragraph 6 provides that gains with respect to personal property forming part of a permanent establishment or a fixed base which a resident of one Contracting State has or had (e.g., in a prior year) in the other Contracting State may be taxed in the State where the permanent establishment or fixed base is located.

Paragraph 7 provides that gains from the alienation of any other property shall be taxable only in the State of residence of the alienator.

Article 14. INDEPENDENT PERSONAL SERVICES

This Article concerns the taxation of income derived by a resident of one of the Contracting States from independent personal services.

The rule established in this Article is that, if an individual who is a resident of one Contracting State performs independent personal services in the other Contracting State, the income from those services may be taxed by that other State if the individual either is present in that other State for an aggregate of more than 183 days in any consecutive 12 months or has a fixed base regularly available to him in that other State for the purpose of performing his activities. In the latter case, the other State may tax the income attributable to that fixed base with respect to the services performed in that State.

It is understood that the term "fixed base" is analogous to the term "permanent establishment." Independent personal services include all personal services performed by an individual for his own account, including services performed as a partner in a partnership and services performed as a director of a company by an individual who is not an employee of that company, where he receives the income and bears the losses arising from such services.

Article 15. DEPENDENT PERSONAL SERVICES

This Article concerns the taxation of remuneration derived by residents of one of the Contracting States as employees.

Pensions, annuities and remuneration of government employees are covered by Articles 18 and 19. Other remuneration for employee services may be taxed only in the State of residence unless the employment is exercised in the other Contracting State, in which case that other State may tax the remuneration for the services performed there, subject to the conditions set forth in paragraph 2.

Paragraph 2 provides that even where a resident of one Contracting State performs services in the other State, that other State may not tax the income for such services if three conditions are met: the recipient is present in that State for not more than 183 days in any consecutive 12 months, the remuneration is paid by or on behalf of an employer who is not a resident of that State, and the remuneration is not borne by (deducted by) a permanent establishment or a fixed base of the employer in that State. If any one of these conditions is not met, e.g., if the employer is a resident of the State where the services are performed, the income may be taxed by that State. It should be noted that the 183 day test applies in any twelve consecutive month period, not in each taxable year.

Paragraph 3 provides that remuneration derived by a resident of a Contracting State for services performed as a member of the regular complement of a ship or aircraft operated in international traffic may be taxed only by that Contracting State. This provision corresponds to the provision in the revised draft U.S. Model published in June 1981. Taxing jurisdiction is determined by the residence of the employee rather than by the residence of the operating enterprise as in earlier U.S. models to correspond more closely to the practice of the United States and other countries in taxing individuals. The term "regular complement" is understood to mean the crew and other full time employees on board the ship or aircraft. It does not include persons who perform occasional services, such as entertainers who perform on cruise ships while they are in port.

Article 16. LIMITATION ON BENEFITS

This Article limits the benefits of the Convention to bona fide residents of the Contracting States. It is intended to prevent residents of third countries from inappropriately using a company which is a resident of one of the Contracting States as a conduit or similar vehicle to obtain Treaty benefits. Specifically, a person (other than an individual) which is a resident of one of the Contracting States is entitled to relief from taxation from the other Contracting State only if any of three alternative tests is met.

The first two tests are objective tests relating to the entity in question. If more than 75 percent of the beneficial interest in the person receiving the income is owned, directly or indirectly, by any combination of individuals who are residents of the Contracting States, citizens of the United States, the Contracting States themselves, or publicly traded companies which are residents of the Contracting States, the first test is met.

Under the second test a publicly traded company that is a resident of New Zealand or the United States is considered to have a sufficient nexus with New Zealand or the United

States respectively, so as to entitle it to treaty benefits. Under this test, Treaty benefits are not denied if there is substantial and regular trading of the principal class of shares of such a company on a recognized stock exchange.

Paragraph 2 defines a "recognized stock exchange" for the purposes of paragraph 1(b). A recognized stock exchange includes U.S. stock exchanges, the New Zealand Stock Exchange, and the NASDAQ system in the United States. In addition, the competent authorities may agree that an exchange other than those specifically mentioned is also a recognized exchange. It is understood that, in view of the close economic ties between New Zealand and Australia, the competent authorities will agree that recognized stock exchanges in Australia are recognized exchanges for purposes of paragraph 2.

The third test recognizes that ownership of an entity that is a resident of the United States or New Zealand by persons resident in third countries is not uncommon. In view of the factors discussed below, granting Treaty benefits to such an entity often is consistent with the goals of the Treaty. Accordingly, under the third test, Treaty benefits are allowed if the establishment, acquisition and maintenance of the person and the conduct of its operations did not have as a principal purpose the purpose of obtaining Treaty benefits. This test would be met, for example, if a New Zealand company owned by third country residents conducts business operations in New Zealand and its U.S. investments are related or incidental to those business activities, or if the aggregate New Zealand tax burden equals or exceeds the tax reduction claimed under the Convention. It could also be met in other situations.

Paragraph 3, inserted at the request of New Zealand, provides a special rule concerning certain trust situations. The benefits of the Treaty do not apply to income derived by a trustee which under the Convention is treated as income of a resident of one of the Contracting States if a principal purpose of the use of the trust was to obtain a benefit under the Convention. For example, if a New Zealand resident establishes one or more U.S. accumulation trusts with New Zealand beneficiaries to receive dividends from New Zealand corporations in order to reduce the New Zealand tax on those dividends, the reduced rate provided in paragraph 2 of Article 10 (Dividends) will not apply.

Paragraph 4 provides that the competent authorities shall consult each other before Treaty benefits are denied under this Article. This consultation obligation is intended to benefit the governments of the two Contracting States; any failure of the competent authorities in a particular case so to consult does not result in the grant of benefits under the Convention where those benefits would otherwise be denied, e.g., by reason of this Article.

This Article is not meant to impose any added burden on withholding agents, and withholding agents will not be required to verify a person's ownership or purposes.

In applying this Article the normal burden of proof rules apply. For example, under present U.S. procedures, an entity that is a resident of New Zealand and that believes it is entitled, under one of the alternative tests of this Article, to the 10 percent U.S. tax rate on interest provided by Article 11 (Interest) would merely file a U.S. Form 1001 with the appropriate withholding agent to claim the benefit. Of course, the Internal Revenue Service could, on audit, examine the transaction.

In view of a combination of factors—the tax burden imposed by both the United States and New Zealand; the fact that, even under treaties, New Zealand imposes source taxation on income of nonresidents of New Zealand at a level that is not insignificant; the fact that the Treaty's rate reductions on source taxation of passive income are not as great as those accorded by the United States in many other treaties; and the concerns of both countries about tax avoidance and evasion—this Convention is not expected to be the subject of abuse. It is, therefore, anticipated that residents of the Contracting States will typically satisfy at least one of the three exceptions. Consequently, it should rarely be necessary to deny Treaty benefits under this Article.

Article 17. ARTISTES AND ATHLETES

This Article provides certain exceptions to the rules otherwise governing income from personal services in the case of income derived by entertainers and athletes.

Paragraph 1 provides that a Contracting State may tax income derived by a resident of the other Contracting State from the performance of personal services in the first State as an entertainer or athlete if the gross receipts derived from such services, including expenses reimbursed or paid on his behalf, exceeds $10,000 (or the equivalent in New Zealand dollars) for the income year or taxable year concerned. In that case, the full amount may be taxed by the first State, subject to any deductions allowable under its laws. This rule overrides the provisions of Articles 14 (Independent Personal Services) and 15 (Dependent Personal Services) by adding another basis for taxation at source. However, if this Article does not permit taxation at source, because the income does not exceed $10,000, whether the income may be taxed by the State where the services are performed is determined in accordance with Article 14 or 15, as the case may be.

Income derived from services rendered by producers, directors, technicians and others who are not artistes or athletes is taxable in accordance with Article 14 or 15, as appropriate.

Paragraph 2 of this Article is similar to the corresponding provision in the U.S. model and the meaning is intended to be the same, although the language in this paragraph has been made more explicit. Where income for services performed by an entertainer or athlete accrues not to the entertainer or athlete but to another person, it may be taxed in the State where the activities are performed, without regard to the provisions of the Convention concerning business profits or income from independent personal services, unless it is established that neither the entertainer or athlete nor any related person participates in those profits in any manner whatsoever.

Foreign entertainers commonly perform services in the United States as employees of, or contractors for, a

company or other person. That person may act as the nominal recipient of the income in respect of the entertainer's services and the entertainer may act as its "employee" or "contractor." In such cases, the company may escape taxation in respect to those services under the provisions of Article 7 (Business Profits) because it does not have a permanent establishment in the United States. The entertainer may also escape taxation by receiving a small salary in the year the services were performed in the United States and then either receiving payment in a later year when the income is subject to little or no U.S. tax, or liquidating the company after the services are performed. Under paragraph 2 such other person could not claim the permanent establishment protection otherwise provided by Articles 5 (Permanent Establishment) and 7 (Business Profits) or the benefits of Article 14 or 15.

For purposes of paragraph 2, income is considered to accrue to another person if that other person has control over, or the right to receive, gross income derived in respect of the services of an entertainer or athlete. This rule applies regardless of whether the other person is a "sham" or conduit. Income will not, however, be deemed to accrue to the benefit of another person where it is established to the satisfaction of the competent authority of the Contracting State in which the services are performed that neither the artiste or athlete, nor related persons, participate directly or indirectly in profits of such other person in any manner, including the receipt of deferred compensation, bonuses, fees, dividends, partnership distributions, or other distributions. Depending on the facts in a particular case, a person may be considered to be related to an artiste or athlete if he is an employee or agent of the artiste or athlete or if he is regularly employed by the artiste or athlete in an advisory capacity, such as his attorney, accountant, or investment advisor. Paragraph 2 does not affect the rule of paragraph 1, that applies to the artiste or athlete himself.

Article 18. PENSIONS AND ANNUITIES

This Article deals with the taxation of pensions, social security payments and annuities.

Paragraph 1 provides that pensions derived and beneficially owned by a resident of one of the Contracting States in consideration of past employment shall be taxable only in that State. Public pensions such as social security payments, and other social security benefits, paid by one Contracting State to a resident of the other State or to a citizen of the United States are taxable only in the paying State. The reference to U.S. citizens is to ensure that a social security payment by New Zealand to a U.S. citizen resident in New Zealand shall be taxable only in New Zealand and not in the United States. Pensions in consideration of government employment are covered under Article 19 (Government Service).

Paragraph 2 provides that annuities beneficially owned by a resident of a Contracting State shall be taxable only in that State, and provides a definition of the term "annuities." The term "annuities" does not include alimony. The taxation of alimony income is covered under Article 21 (Other Income). The taxation of child support is also covered by Article 21 (Other Income).

Article 19. GOVERNMENT SERVICE

This Article deals with the taxation of income derived by a resident of one Contracting State for the performance of governmental functions in the other Contracting State.

Paragraph 1 provides that, as the general rule, such income shall be taxable only in the paying State. However, if the services are rendered in the other State by an individual who is both a resident and a citizen of that State, or who is a resident of that State and did not become a resident solely for the purpose of rendering such services, then the income is taxable only in the State where the services are performed.

Paragraph 2 provides that a pension paid to any individual by a Contracting State (or a political subdivision or local authority) as consideration for services rendered is taxable only in that State unless the recipient is both a resident and a citizen of the other Contracting State. In that case, such a pension is taxable only in that other State.

Paragraph 3 states that the provisions of this Article apply only to remuneration and pensions in respect of governmental services. Remuneration and pensions paid to government employees in respect of services performed in connection with a business carried on by a Contracting State (or a political subdivision or local authority) are taxable under the provisions of Articles 14 (Independent Services), 15 (Dependent Personal Services), 17 (Artistes and Athletes) and 18 (Pensions and Annuities), as the case may be. Whether functions are of the governmental nature is determined by reference to the concept of a governmental function in the State in which the income arises.

Article 20. STUDENTS

This Article provides that, when a resident of one of the Contracting States goes to the other Contracting State for the purpose of full-time education, the other State may not tax payments received by the student which arise outside that State and which are for the purpose of his maintenance or education.

Article 21. OTHER INCOME

This Article provides that items of income not covered in the preceding articles may be taxed both in the country of source and in the country of residence of the recipient. Among the items covered by this Article are alimony, child support, prizes, and income from the insurance business, which is specifically excluded from the provisions of Article 7 (Business Profits) by paragraph 7 of that Article. Under current New Zealand law, alimony and child support payments are not deductible by the payer and are not taxable to the recipient. The source of items of income covered by this Article is determined under the respective domestic laws of the two countries. Any difficulties or doubts in applying this Article, as in other cases, may be addressed in accordance with the provisions of Article 24 (Mutual Agreement Procedure).

Article 22. RELIEF FROM DOUBLE TAXATION

Paragraph 1 provides that the United States shall give a foreign tax credit for income taxes paid to New Zealand, subject to the limitations provided in U.S. law. The credit is allowed for taxes paid directly by or

on behalf of the income recipient. In addition, in the case of a U.S. company owning at least 10 percent of the voting stock of a New Zealand company, credit is allowed for the underlying corporate tax on the profits of the New Zealand company out of which dividends are paid to the U.S. company. Under this paragraph, a U.S. company which is also a resident of New Zealand for purposes of New Zealand tax (i.e., a dual resident) is a U.S. corporation (not a foreign corporation) for purposes of the U.S. foreign tax credit. Thus, a direct, not an indirect, credit is allowed for tax paid by such a dual resident company.

The New Zealand taxes referred to in paragraphs 1(b) and 2 of Article 2 (Taxes Covered) are considered income taxes for purposes of the credit. This guarantee of a foreign tax credit is independent of the statutory grant of a credit under the Internal Revenue Code, but the amount of the credit to be allowed is determined in accordance with the limitations provided in the Internal Revenue Code. Since the treaty does not provide credit for a tax which it is believed might not be creditable under the Internal Revenue Code, no special per country limitation is contained in the Convention. (See, however, the discussion of paragraph 5 with respect to treaty source rules.)

In paragraph 2, New Zealand agrees to allow to New Zealand residents a credit against New Zealand income tax equal to the income tax paid in the United States other than solely because the resident is a U.S. citizen or company, subject to the limitation in New Zealand law which limits the credit to the New Zealand income tax attributable to the income which may be taxed in the United States. In the case of intercorporate dividends, New Zealand law provides an exemption. Paragraph 2 confirms that the exemption applies with respect to dividends derived by a New Zealand company from a U.S. company of which the New Zealand company owns at least 10 percent of the paid-up share capital.

Paragraph 3 provides a special rule for avoiding double taxation of a U.S. citizen or a U.S. company which is a resident of New Zealand. Both the United States and New Zealand tax the worldwide income of such a person. The special rule provides that, in such a case, New Zealand will credit the amount of tax which the United States is authorized under the Convention to impose at source on residents of New Zealand who are not U.S. citizens or U.S. companies. The United States will then credit against any additional U. S. tax the New Zealand tax net of New Zealand's foreign tax credit. Paragraph 4(c) provides that, for purposes of the foreign tax credit limitation, the United States will recharacterize as New Zealand source income enough U.S.-source income to allow the special credit to be utilized. In so doing, the United States will not reduce its tax below the tax it may impose under the Convention on residents of New Zealand who are not U.S. citizens or U.S. companies.

Paragraph 4 provides source rules to be used in allowing relief from double taxation under this Article. Alternatively, taxpayers may use the foreign tax credit rules (including the source rules) of the Internal Revenue Code. For purposes of this Article, income beneficially owned by residents of the United States which may be taxed by New Zealand under this Convention will be considered to have its source in New Zealand. Income beneficially owned by residents of New Zealand which may be taxed by the United States in accordance with this Convention (other than solely because the beneficial owner is a U.S. citizen or company) will be considered to have its source in the United States. And the United States will re-source enough income to give effect to the special provision of paragraph 3.

Paragraph 5 provides that U.S. taxpayers may use the special Treaty source rules only for purposes of determining U.S. foreign tax credits for the New Zealand taxes covered by the Convention. Accordingly, the U. S. tax on income which in the absence of this Convention would have a U.S. source, but which under the Article is characterized as being of New Zealand source, may not be offset by a U.S. foreign tax credit for taxes of third countries.

Article 23. NON-DISCRIMINATION

This Article provides certain criteria of nondiscriminatory application of the taxes covered by the Convention.

Paragraph 1 provides that citizens of a Contracting State shall not be taxed less favorably in the other Contracting State than citizens of that other State who are in the same circumstances. For U.S. tax purposes, United States citizens who are not residents of the United States are not in the same circumstances as New Zealand citizens who are not residents of the United States. Nonresident U.S. citizens are subject to U.S. tax on their worldwide income; with special relief for certain foreign earned income; New Zealand citizens who are not U.S. residents are generally subject to U.S. tax only on their U.S.-source income.

Paragraph 2 provides that a Contracting State may not impose more burdensome taxes on a permanent establishment of an enterprise of the other Contracting State than it imposes on its own enterprises carrying on the same activities. This rule does not require a Contracting State to extend to nonresidents personal tax relief granted to residents to reflect their civil status or family responsibilities. Nor does it prevent either State from imposing a branch profits tax of not more than 5 percent in addition to the ordinary corporate income tax. And it does not require that a nonresident company be allowed the same dividends-received deduction or exemption afforded resident companies. (The latter point is merely clarifying; neither the United States nor New Zealand would interpret this Article as requiring such relief in the absence of such a provision.)

Both New Zealand and the United States allow certain exemptions, deductions or rate reductions to residents taxed on their worldwide income which they do not extend to nonresidents not taxable on their worldwide income. New Zealand taxes branches of foreign companies at 50 percent instead of at the 45 percent rate imposed on New Zealand corporations. The additional 5 percent is, in effect, a surrogate for the withholding tax on dividends distributed by domestic corporations to nonresidents. Under this Article, those practices will not be in violation of the Convention.

Paragraph 3 prohibits discrimination in the matter of deductions.

Interest, royalties, and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State must be deductible for determining taxable profits under the same conditions as if they had been paid to a resident of the first-mentioned State. The term "other disbursements" is understood to include a reasonable allocation of executive and administrative expenses, research and development expenses, and other expenses incurred for a group of related enterprises.

Paragraph 4 is the same as the corresponding paragraph in the U.S. Model. It requires that a Contracting State not impose more burdensome taxation on a subsidiary corporation owned by residents of the other Contracting State than it imposes on similar corporations which are locally owned.

Paragraph 5 states that the taxes covered by the Convention as in force on the date of signature of the Convention are not discriminatory. Tax laws subsequently enacted will also satisfy the conditions of this Article if they are substantially similar to the existing taxes in purpose or are reasonably designed to prevent avoidance of tax. However, any subsequent tax measure must treat residents or citizens of the other Contracting State no less favorably than residents or citizens of a third State (except where the treatment of residents or citizens of third States is governed by an international agreement rather than by internal law).

Paragraph 6 states that differentiating in taxation laws between residents and nonresidents does not of itself constitute discrimination contrary to this Article. This is merely an elaboration of the principles contained in paragraphs 1 and 2, which require equal treatment of residents in the same circumstances but do not prohibit different tax treatment of residents and nonresidents. Typically, such differences consist in more generous deductions or other reliefs from tax for residents, reflecting the fact that in both countries residents are taxable on their worldwide income whereas nonresidents are generally taxable only on income from sources in that country.

Paragraph 7 provides that the competent authorities will attempt to resolve any instances of discriminatory taxation which might arise as a result of future tax measures introduced by either country. Taxpayers may also take advantage of the provisions of Article 24 (Mutual Agreement Procedure) in such cases.

Article 24. MUTUAL AGREEMENT PROCEDURE

This Article provides for cooperation between the competent authorities to resolve problems of double taxation.

Paragraph 1 provides that a taxpayer who considers that the actions of one or both of the Contracting States may result in taxation not in accordance with the Convention may present his case to the competent authority of the State of which he is a resident or citizen. However, he must present his case within three years from the first notification of the action giving rise to the potential double taxation.

Paragraph 2 provides that the competent authority, if it considers the objection to be justified and if it is not able to arrive at a solution itself, shall endeavor to resolve the case by mutual agreement with the competent authority of the other Contracting State. Any agreement reached shall be implemented without regard to any statutory time limits of the Contracting States. Thus, for example, if it is agreed that tax liability should be adjusted downward, a refund of the excess tax paid will be made even though the statute of limitations may have expired. However, no additional tax may be imposed if the statute of limitations has expired in the taxing State.

Paragraph 3 provides that the competent authorities shall endeavor by mutual agreement to resolve any difficulties or doubts which may arise in the interpretation or application of the Treaty. They may also consult together to eliminate double taxation in cases not foreseen in the Convention. This language is identical to that of paragraph 3 of the OECD Model. It is understood that the competent authorities may agree, for example, on the same allocation of income, deductions, credits or allowances; on the same characterization of items of income; on the same application of source rules with respect to particular items of income; and on a common meaning of a term. They may also discuss the application of the provisions of domestic law regarding penalties, fines and interest in a manner consistent with the purposes of the Convention. The authority to resolve cases not foreseen in the Convention is not a broad grant of authority to expand the scope of the Convention, but is meant to allow the competent authorities to apply the principles of the Convention to settle specific situations of double taxation which are not expressly addressed.

Paragraph 4 provides that the competent authorities may communicate with each other directly for the purpose of reaching agreements in accordance with this Article.

Article 25. EXCHANGE OF INFORMATION AND ADMINISTRATIVE ASSISTANCE

The three paragraphs of this Article are substantially the same as paragraphs 1 through 3 of Article 26 of the U.S. model. Paragraphs 4 and 5 of the U.S. model, which deal with assistance in collection where treaty benefits accrue to residents of third countries are not included in this Convention, nor is paragraph 6 of the U.S. model, which extends the scope of this Article to all taxes imposed by the Contracting State at the national level.

Paragraph 1 provides that the competent authorities shall exchange such information as is necessary for carrying out the provisions of the Convention or of their domestic laws concerning taxes covered by the Convention. It also provides assurances that information so exchanged will be protected in the same manner as information obtained under domestic laws with respect to secrecy and disclosure. Persons involved in the administration of taxes covered by the Convention include legislative bodies involved in the administration of taxes and their agents such as, for example, the United States General Accounting Office; therefore, information may be disclosed to them, subject to the limitations of this Article and the internal law of the respective Contracting State.

Paragraph 2 states that, when information is requested by a Contracting State in accordance with this Article, the other State shall obtain the information as if the tax in question

were a tax of that other State. Further, the paragraph specifies that the State to which a request has been made shall provide information in forms usable in the judicial practice of the requesting State, such as depositions of witnesses and copies of unedited original documents, to the extent that such forms of information can be obtained under the laws and practices of the State to which the request is made when enforcing its own tax laws.

Paragraph 3 explains that the obligations undertaken in paragraphs 1 and 2 do not require a Contracting State to carry out measures contrary to the laws and administrative practice of either State, to supply information not obtainable under its laws or in the normal course of the administration of either State, or to supply information which would disclose trade secrets or other information the disclosure of which is contrary to public policy.

New Zealand could not agree to collect and remit to the United States additional U.S. tax due on payments to New Zealand which enjoyed the reduced rates of U.S. tax provided for in the Convention, but which were beneficially owned by residents of a third country. Nor is the United States obliged to collect tax on behalf of New Zealand in comparable situations. Such cases can arise, for example, as a result of the practice of applying withholding taxes paid to nonresidents on the basis of the address listed by the recipient. Both countries presently use this method in certain cases. The policing of such reduced rates of tax at source under the Convention is left to each Contracting State.

Article 26. DIPLOMATIC AGENTS AND CONSULAR OFFICIALS

This Article corresponds to Article 27 of the U.S. Model. It provides that the Treaty shall not affect taxation privileges of diplomatic or consular officials under other special agreements or under international law.

Article 27. ENTRY INTO FORCE

The Convention is subject to ratification. Instruments of ratification will be exchanged at Washington.

The Convention enters into force on the date on which the instruments of ratification are exchanged. Its provisions with respect to U.S. withholding taxes will have effect for amounts paid or credited on or after the first day of the second month following the entry into force of the Convention, and with respect to New Zealand withholding taxes for any income year beginning on or after April 1 following the entry into force. For New Zealand the withholding provisions of the 1948 Convention are linked to the time of assessment. Having the withholding provisions of this Convention take effect at the beginning of a tax year avoids the need to change in mid-year. With respect to other taxes, the provisions will have effect for U.S. taxable years beginning on or after the entry into force and for New Zealand income years beginning on or after April 1 following the entry into force.

However, if the Convention enters into force before April 1, 1984, New Zealand will apply the reduced rate of tax on dividends provided in Article 10 (Dividends) to dividends derived on or after April 1, 1982.

The 1948 Convention will cease to have effect in relation to any tax in respect of which the Convention comes into effect. The 1948 Convention will terminate on the last date on which it has effect in accordance with the rule stated above. There may be some uncertainty as to whether the 1948 Treaty presently applies to the Cook Islands. In the event that it does, the 1948 Treaty ceases to have effect with respect to the Cook Islands on the first date when the Convention comes into effect with respect to U.S. taxes (i.e., the first day of the second month following entry into force).

Article 28. TERMINATION

The Convention shall remain in force indefinitely unless terminated by one of the Contracting States. Either Contracting State may terminate the Convention after five years from the date on which it enters into force by giving at least six months' prior notice through diplomatic channels. In that event, the Convention will cease to have effect with respect to U.S. taxes withheld at the source for amounts paid or credited on or after January 1 following the termination date and with respect to New Zealand withholding taxes on or after April 1 following the termination date. For other taxes the Convention, if terminated, will cease to apply in the United States for taxable periods beginning on or after January 1 following the termination date and in New Zealand for income years beginning on or after April 1 following the termination date.

PROTOCOL

A Protocol to the Convention signed on the same day, explains how certain provisions of the Convention will be applied by New Zealand.

If New Zealand should conclude in the future an income tax convention with another member country of the Organization for Economic Cooperation and Development which provides for a lower New Zealand tax on dividends, interest, or royalties than provided for in Articles 10, 11, and 12 of this Convention, New Zealand will reopen negotiations with the United States with a view to providing the same treatment on a reciprocal basis.

Notwithstanding the provisions of Articles 7, 12 and 21, the taxation of film rentals will be governed by section 224 of the New Zealand Income Tax Act of 1976 as long as the provisions of that section as in effect on the date of signature of the Convention continue in effect without substantial modification. Under that statutory provision, film rentals derived from New Zealand by nonresidents of New Zealand are taxable at 45 percent on a presumed profit equal to 10 percent of the gross rentals and no further tax applies on the remittance of the rentals to the nonresidents.

May 24, 1983

United States—Switzerland Estate and Inheritance Tax Convention, 1957-1 C.B. 657; United States Estate and Inheritance Tax Conventions with Australia, 1957-1 C.B. 633; Finland, 1957-1 C.B. 641; Greece, 1957-1 C.B. 645; Italy, 1956-2 C.B. 1089; Japan, 1955-1 C.B. 654; and Norway, 1957-1 C.B. 653
(Also Part I, Sections 2010, 2102.)

Estate tax: unified credit. Rev. Rul. 81-303, 1981-2 C.B. 255, which held that the term "specific exemption" referred to in the estate tax convention between the U.S. and Switzerland may not be construed to include the section 2010 unified credit, is revoked.

Rev. Rul. 90-101

Rev. Rul. 81-303, 1981-2 C.B. 255, held that the term "specific exemption" referred to in Article III of the United States-Switzerland Estate and Inheritance Tax Convention, 1957-1 C.B. 657, may not be construed to include the section 2010 unified credit added to the Code by the Tax Reform Act of 1976. Under the ruling, the U.S. estate of a Swiss resident (who is not a U.S. citizen) dying after December 31, 1976, would be entitled to only the smaller exemption allowed under section 2102(c)(1) of the Code.

Section 5032 of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), P.L. 100-647, 1988-3 C.B. 329, amended section 2102(c)(3) of the Code to include the following:

> (A) *Coordination with treaties.*— To the extent required under any treaty obligation of the United States, the credit allowed under this subsection shall be equal to the amount which bears the same ratio to $192,800 as the value of the part of the decedent's gross estate which at the time of his death is situated in the United States bears to the value of his entire gross estate wherever situated.

This amendment follows the decisions in *Mudry v. United States*, 11 Cl. Ct. 207 (1986) and *Estate of Burghardt v. Commissioner*, 80 T.C. 705 (1983), *aff'd.*, 734 F.2d 3 (3rd Cir. 1984). H.Rep. No. 100-795, 100th Cong., 2d Sess. 594 (July 26, 1988). The amendment applies to estates of decedents dying after November 10, 1988. TAMRA, section 5032(d). Accordingly, Rev. Rul. 81-303 does not apply to estates of decedents dying after November 10, 1988. Furthermore, the Internal Revenue Service will follow *Mudry* and *Burghardt* for decedents dying prior to the effective date of section 5032 of TAMRA.

The estate tax conventions between the United States and Australia, Finland, Greece, Italy, Japan, and Norway contain provisions substantially similar to Article III of the Swiss Convention. This revenue ruling is equally applicable to those conventions.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 81-303 is revoked.

INDIA

Embassy of the United States of America, New Delhi
April 12, 1989

I have the honour to propose that the Government of the United States of America and the Government of India 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(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 India (other than U.S. citizens) and corporations organized in India. This exemption is granted on the basis of equivalent exemptions granted by India to citizens of the United States (who are not residents of India) and to corporations organized in the United States (which are not subject to tax by India 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 India 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 India or is wholly owned by a corporation whose stock is so traded and which is also organized in India.

For purposes of subparagraph (1), the Government of India will be treated as an individual resident of India. 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, including income from the rental of ships or aircraft on a full (time or voyage) basis. It also includes income from the rental on a bareboat basis of ships and aircraft used in international transport, income from the rental of containers and related equipment used in international transport, and gain on the disposition of ships or aircraft, provided in each case that the income is incidental to the international operation of ships or aircraft. Gross income from the international operation of ships or aircraft also includes income derived from participation in a pool, a joint business, or an international operating agency and interest on funds connected with the international operation of ships or aircraft.

The Government of the United States of America considers that this Note, together with your reply Note confirming that the Government of India agrees to these terms, constitutes an agreement amending the agreement of November 26, 1976, and the exchange of letters of December 27 and 29, 1976. This agreement shall enter into force on the date of your reply Note and 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.

I avail myself of this opportunity to renew to Your Excellency the assurances of my highest consideration.

Government of India
Ministry of Finance
Department of Revenue
New Delhi
April 12, 1989

I have the honour to acknowledge receipt of your Note of today's date proposing the terms of a reciprocal exemption from income tax of income derived from the international operation of ships and aircraft.

The Government of India agrees to exempt from income tax gross income derived from the international operation of ships or aircraft by U.S. citizens (who are not residents of India) and corporations organized in the United States (other than corporations which are subject to tax by India 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 citizens of the United States or residents of another country which grants a reciprocal exemption to Indian residents and corporations; or

(2) the corporation's stock is primarily and regularly traded on an established securities market in the United States, or is wholly owned by a corporation whose stock is so traded and which is also organized in the United States.

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. It also includes income from the rental on a bareboat basis of ships and aircraft used in international transport, income from the rental of containers and related equipment used in international transport, and gain on the disposition of ships or aircraft, provided in each case that the income is incidental to the international operation of ships or aircraft. Gross income from the international operation of ships or aircraft also includes income derived from participation in a pool, a joint business, or an international operating agency and interest on funds connected with the international operation of ships or aircraft.

I am pleased to confirm that Your Excellency's Note and this reply Note constitute an agreement between the two governments amending the agreement of November 26, 1976, and the exchange of letters of December 27 and 29, 1976. This agreement shall enter into force on today's date and shall have effect with respect to previous years beginning on or after January 1, 1987.

Either government may terminate this agreement by giving written notice of termination through diplomatic channels.

I avail myself of this opportunity to renew to Your Excellency the assurances of my highest consideration.

ISLE OF MAN

DEPARTMENT OF STATE
WASHINGTON

August 1, 1990

I have the honor to propose that the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland (on behalf of the Isle of Man) conclude an agreement to exempt from income tax, on a reciprocal basis, income derived by residents of the Isle of Man and the United States from the international operation of ships. The terms of the agreement are as follows:

1. The Government of the United States of America, in accordance with sections 872(b)(1) and 883(a)(1) of the Internal Revenue Code, agrees to exempt from tax gross income derived from the international operation of ships by Isle of Man residents and corporations organized in the Isle of Man. This exemption is granted on the basis of equivalent exemptions granted by the Isle of Man to United States residents and to corporations organized in the United States.

2. In the case of a corporation, the exemption shall apply only if the corporation meets either of the following conditions:

a) the corporation's stock is primarily and regularly traded on a established securities market in the Isle of Man, another country which grants an equivalent exemption to U.S. corporations, or the United States; or

b) more than 50 percent of the value of the corporation's stock is owned, directly or indirectly, by individuals who are residents of the Isle of Man or of a 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 a established securities market in that country, another country which grants an equivalent exemption to U.S. corporations, or the United States.

3. For purposes of subparagraph (b) of paragraph 2, the Government of the Isle of Man shall be treated as an individual resident of the Isle of Man. For purposes of the exemption from the United States tax, subparagraph (b) of paragraph 2 shall be considered to be satisfied if the corporation is a "controlled foreign corporation" under the Internal Revenue Code.

4. Gross income includes all income derived from the international operation or chartering of ships, including income from the rental of ships 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. It also includes income from the rental on a bareboat basis of ships used for international transport and income from the disposition of ships which is incidental to income from the international operation of ships.

5. Either Government may terminate this Agreement by giving written notice of termination through Diplomatic channels.

6. If the proposals set out above are acceptable to the Government of the United Kingdom, I have the honor to propose that the present Note together with your reply shall constitute an agreement between our two Governments which shall enter into force on the date of your reply, and shall have effect with respect to taxable years beginning on or after January 1, 1987.

Accept, Excellency, the renewed assurances of my highest consideration.

BRITISH EMBASSY

WASHINGTON D.C.

15 August 1989

I have the honour to acknowledge your Note of 1 August 1989 which reads as follows:

"I have the honor to propose that the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland (on behalf of the Isle of Man) conclude an agreement to exempt from income tax, on

a reciprocal basis, income derived by residents of the Isle of Man and the United States from the international operation of ships. The terms of the agreement are as follows:

1. The Government of the United States of America, in accordance with Sections 872(b)(1) and 883(a)(1) of the Internal Revenue Code, agrees to exempt from tax gross income derived from the international operation of ships by Isle of Man residents and corporations organized in the Isle of Man. This exemption is granted on the basis of equivalent exemptions granted by the Isle of Man to United States residents and to corporations organized in the United States.

2. In the case of a corporation, the exemption shall apply only if the corporation meets either of the following conditions:

(a) the corporation's stock is primarily and regularly traded on a established securities market in the Isle of Man, another country which grants an equivalent exemption to U.S. corporations, or the United States; or

(b) more than 50 percent of the value of the corporation's stock is owned, directly or indirectly, by individuals who are residents of the Isle of Man or of a country which grants an equivalent exemption to U.S. corporations and whose stock is primarily and regularly traded on a established securities market in that country, another country which grants an equivalent exemption to U.S. corporations, or the United States.

3. For purposes of subparagraph (b) of paragraph 2, the Government of the Isle of Man shall be treated as an individual resident of the Isle of Man. For the purposes of the exemption from United States tax, subparagraph (b) of paragraph 2 shall be considered to be satisfied if the corporation is a "controlled foreign corporation" under the Internal Revenue Code.

4. Gross income includes all income derived from the international operation or chartering of ships, including income from the rental of ships on a full (time or voyage) basis and income from the rental of containers and related equipment which is incidental to income from the international operation of ships. It also includes income from the rental on a bareboat basis of ships used for international transport and income from the disposition of ships which is incidental to income from the international operation of ships.

5. Either Government may terminate this Agreement by giving written notice of termination through Diplomatic channels.

6. If the proposals set out above are acceptable to the Government of the United Kingdom, I have the honor to propose that the present Note together with your reply shall constitute an agreement between our two Governments which shall enter into force on the date of your reply, and shall have effect with respect to taxable years beginning on or after January 1, 1987."

I have the honour to inform you that the foregoing proposals are acceptable to the Government of the United Kingdom of Great Britain and Northern Ireland, who therefore agree that your Note, together with the present reply, shall constitute an agreement between our two Governments in this matter which shall enter into force on the date of this present reply.

I avail myself of this opportunity to renew to you the assurance of my highest consideration.

JAPAN

DEPARTMENT OF STATE
WASHINGTON

AUGUST 29, 1989

I have the honor to refer to the Exchange of Notes between the Government of the United States of America and the Government of Japan dated March 31 and June 8, 1926, concerning reciprocal exemption from taxation of income accruing from the business of shipping (hereinafter referred to as "the Exchange of Notes"), and to propose on behalf of the Government of the United States as follows:

1. The Government of the United States of America, in accordance with sections 872(b) and 883(a) of the Internal Revenue Code, shall exempt from tax gross income derived from the international operation of ships or aircraft by individuals who are residents of Japan (other than U.S. citizens) and corporations organized in Japan. This exemption is granted on the basis of equivalent exemptions granted by Japan to residents of the United States.

In the case of a 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 Japan, 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 Japan or of another 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 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 Government of Japan, in accordance with the Japanese law No. 144 of 1962, shall exempt, on the basis of reciprocity, from income tax and corporation tax chargeable in Japan, an enterprise carried on by a resident of the United States of America in respect of the international operation of ships or aircraft.

International operation of ships or aircraft includes rental of ships or aircraft on a full (time or voyage) basis and rental of containers and related equipment which is incidental to the international operation of ships or aircraft. It also includes rental on a bareboat basis of ships and aircraft used for international transport.

3. Paragraphs 1 and 2 shall be applicable with respect to taxable years beginning on or after January 1, 1987.

4. It is confirmed that the arrangements set forth in the Exchange of Notes shall be superseded by the present arrangements.

5. Either Government may terminate the present arrangements by giving written notice of termination through diplomatic channels.

I have further the honor to propose that this Note and Your Excellency's reply confirming the foregoing, on behalf of the Government of Japan, shall constitute an agreement between our two Governments, which shall enter into force on the date of Your Excellency's reply.

Accept, Your Excellency, the renewed assurance of my highest consideration.

EMBASSY OF JAPAN
WASHINGTON

August 29, 1989

I have the honor to acknowledge the receipt of Your Excellency's Note of today's date, which reads as follows:

"I have the honor to refer to the Exchange of Notes between the Government of the United States of America and the Government of Japan dated March 31 and June 8, 1926, concerning reciprocal exemption from taxation of income accruing from the business of shipping (hereinafter referred to as "the Exchange of Notes"), and to propose on behalf of the Government of the United States as follows:

1. The Government of the United States of America, in accordance with sections 872(b) and 883(a) of the Internal Revenue Code, shall exempt from tax gross income derived from the international operation of ships or aircraft by individuals who are residents of Japan (other than U.S. citizens) and corporations organized in Japan. This exemption is granted on the basis of equivalent exemptions granted by Japan to residents of the United States.

In the case of a 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 Japan, 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 Japan or of another 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 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 Government of Japan, in accordance with the Japanese law No. 144 of 1962, shall exempt, on the basis of reciprocity, from income tax and corporation tax chargeable in Japan, an enterprise carried on by a resident of the United States of America, in respect of the international operation of ships or aircraft.

International operation of ships or aircraft includes rental of ships or aircraft on a full (time or voyage) basis and rental of containers and related equipment which is incidental to the international operation of ships or aircraft. It also includes rental on a bareboat basis of ships and aircraft used for international transport.

3. Paragraphs 1 and 2 shall be applicable with respect to taxable years beginning on or after January 1, 1987.

4. It is confirmed that the arrangements set forth in the Exchange of Notes shall be superseded by the present arrangements.

5. Either Government may terminate the present arrangements by giving written notice of termination through diplomatic channels.

I have further the honor to propose that this Note and Your Excellency's reply confirming the foregoing, on behalf of the Government of Japan, shall constitute an agreement between our two Governments, which shall enter into force on the date of Your Excellency's reply."

I have further the honor to confirm on behalf of the Government of Japan that the foregoing is acceptable to the Government of Japan and to agree that Your Excellency's Note and this reply shall constitute an agreement between our two Governments which shall enter into force on the date of this reply.

Accept, Excellency, the renewed assurance of my highest consideration.

MALAYSIA

Embassy of the United States of America
Kuala Lumpur
April 18, 1989

AN AGREEMENT BETWEEN THE GOVERNMENT OF MALAYSIA AND THE GOVERNMENT OF THE UNITED STATES OF AMERICA FOR RECIPROCAL EXEMPTION WITH RESPECT TO TAXES ON INCOME OF SHIPPING AND AIR TRANSPORT ENTERPRISES OF THE TWO COUNTRIES

The Government of Malaysia and the Government of the United States of America desiring to conclude an Agreement for reciprocal exemption

with respect to taxes on income of shipping and air transport enterprises of the two countries,

Have agreed as follows:

Article 1
TAXES COVERED

1. This Agreement shall apply to taxes on income imposed on behalf of each Contracting State irrespective of the manner in which they are levied.

2. There shall be regarded as taxes on income all taxes imposed on total income, or on elements of income, including taxes on gains from the alienation of movable property.

3. The existing taxes to which the Agreement shall apply are in particular:

(a) in the case of Malaysia, the income tax, excess profits tax and development tax;

(b) in the case of the United States of America, the income tax imposed by the Internal Revenue Code of 1986.

4. This Agreement shall also apply to any identical or substantially similar taxes as are subsequently imposed in addition to, or in place of the existing taxes.

Article 2
DEFINITIONS

In this Agreement, unless the context otherwise requires:

(a) the terms "a Contracting State" and "the other Contracting State" mean Malaysia or the United States of America, as the context requires;

(b) the term "exercise of shipping or air transport" means the operational activity of transportation by ship or by air of persons, livestock, goods and mail conducted by a resident of a Contracting State including sale of tickets and similar documents used for the purposes of transportation;

(c) the term "international traffic" means any transport by a ship or an aircraft operated by a resident of a Contracting State, except when such transport is made solely between places in the other Contracting State;

(d) the term "competent authority" means:

(i) in the case of Malaysia, the Minister of Finance or his authorized representative; and

(ii) in the case of the United States of America, the Secretary of the Treasury or his delegate;

(e) the term "resident of a Contracting State" means any person, who under the law of that State, is liable to taxation therein by reason of his domicile, residence, place of control and management, place of incorporation, or any other criterion of a similar nature;

(f) the term "person" includes an individual, a corporation, a company or any other body of persons which is treated as a person for tax purposes.

Article 3
SHIPPING AND AIR TRANSPORT

1. Income and profits derived by a resident of a Contracting State from the exercise of shipping or air transport in international traffic shall be exempted from tax in the other Contracting State.

2. The provisions of paragraph 1 shall also apply to income and profits derived by a resident of a Contracting State from its participation in a pool or a joint business.

3. For the purposes of paragraph 1, income and profits derived by a resident of a Contracting State from the exercise of shipping or air transport in international traffic also include income derived from:

(a) the rental of ships or aircraft used in international transport on a full (time or voyage) or bareboat basis which is incidental to income from the exercise of shipping or air transport in international traffic;

(b) the rental of containers and related equipment used in international traffic which is incidental to income from the exercise of shipping or air transport in international traffic; and

(c) gains from the alienation of ships or aircraft by a person whose predominant activity is the exercise of shipping or air transport in international traffic.

4. For the purposes of this Article, a corporation is a resident of a Contracting State if its stocks or shares are:

(a) more than 50 percent owned, directly or indirectly, by individuals who are residents of that Contracting State or by residents of another State which grants reciprocal exemption to the other Contracting State; or

(b) primarily and regularly traded on an established securities market in that Contracting State or are wholly owned by a corporation of that Contracting State whose stocks or shares are so traded.

For purposes of subparagraph (a), the Government of a Contracting State shall be treated as an individual resident of that State.

Article 4
LIMITATION OF AGREEMENT

Notwithstanding any provision of this Agreement, the United States may tax U.S. residents and citizens, including corporations organized in the United States, and Malaysia may tax any person resident in Malaysia, including corporations whose place of control and management is in Malaysia, as if this Agreement had not come into effect.

Article 5
MUTUAL AGREEMENT PROCEDURE

Consultation may be requested at any time by either Contracting State for the purpose of amendment to the present Agreement or for its application or its interpretation. Such consultation shall begin within 60 days from the date of receipt of any such request and decisions shall be by mutual consent.

Article 6
ENTRY INTO FORCE

1. The Contracting States shall notify each other when their respective legal procedures have been met with respect to this Agreement.

2. The Agreement shall enter into force upon the exchange of any necessary instruments of ratification and its provisions shall have effect, in the case of Malaysia, with respect to basis periods beginning on or after January 1, 1987, and, in the case of the United States, with respect to taxable years beginning on or after January 1, 1987.

Article 7
TERMINATION

Either government may terminate this agreement by giving written notice of termination through diplomatic channels.

IN WITNESS WHEREOF the undersigned, being duly authorized thereto, have signed this Agreement in duplicate at Kuala Lumpur this

day of April 18, 1989, in English Language and Bahasa Malaysia, both texts being equally authentic. In the case of any divergence between the texts the English text shall prevail.

MARSHALL ISLANDS

Embassy of the United States of America
Majuro, Marshall Islands
December 5, 1989

The Representative of the United States of America presents his compliments to His Excellency the Minister of Foreign Affairs and has the honor to propose that the Government of the United States of America and the Government of the Republic of the Marshall Islands conclude an agreement confirming the exemption from income tax, on a reciprocal basis, of 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(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 the Republic of the Marshall Islands (other than U.S. citizens) and corporations which are incorporated in the Marshall Islands. This exemption is granted on the basis of equivalent exemptions granted by the Marshall Islands to individual residents of the United States and to corporations organized in the United States.

In the case of a Marshall Islands Corporation, the exemption shall apply only if the corporation meets the ownership or public trading requirements of U.S. law. For purposes of such ownership requirements, the Government of the Republic of the Marshall Islands shall be treated as an individual resident of the Marshall Islands.

—Gross income includes all income derived from the international operation of ships, including:

—(I) Income from the rental of 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 which is incidental to income from the international operation of ships or aircraft; and

—(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.

—The Government of the United States of America considers that this note, together with the reply note of the Government of the Republic of the Marshall Islands confirming that it agrees to these terms, constitutes an agreement between the two Governments. This agreement shall enter into force on the date of the reply note of the Government of the Marshall Islands and shall have effect with respect to taxable years beginning on or after 1 January 1987.

—Either Government may terminate this agreement by giving written note of termination through diplomatic channels.

Ministry of Foreign Affairs
Republic of the Marshall Islands
Majuro, Marshall Islands
December 5, 1989

The Minister of Foreign Affairs for the Republic of the Marshall Islands presents his compliments to the Representative of the United States of America. The Government of the Republic of the Marshall Islands acknowledges receipt and agrees to the terms of diplomatic notes exchanged with the Government of the United States of America concluding an agreement confirming the exemption from income tax, on a reciprocal basis, of 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(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 the Republic of the Marshall Islands (other than U.S. citizens) and corporations which are incorporated in the Marshall Islands. This exemption is granted on the basis of equivalent exemptions granted by the Marshall Islands to individual residents of the United States and to corporations organized in the United States.

—In the case of a Marshall Islands corporation, the exemption shall apply only if the corporation meets the ownership or public trading requirements of U.S. law. For purposes of such ownership requirements, the Government of the Marshall Islands shall be treated as an individual resident of the Marshall Islands.

—Gross income includes all income derived from the international operation of ships, 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 which is incidental to income from the international operation of ships or aircraft; and

—(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.

The Government of the United States of America considers that its note, together with this reply note of the Government of the Marshall Islands confirming that it agrees to these terms, constitutes an agreement between the two Governments. This agreement shall enter into force on the date of the reply note of the Government of the Marshall Islands and shall have effect with respect to taxable years beginning on or after 1 January 1987.

Either Government may terminate this agreement by giving written notice of termination through diplomatic channels.

MEXICO

Tlatelolco, D.F., August 7, 1989

I have the honor to refer to Your Excellency's note of today's date, establishing that the United States of America agrees to exempt, on a reciprocal basis, all income obtained by individuals who are residents of Mexico (other than U.S. citizens) and corporations organized in Mexico, in accordance with the terms set forth in the above-mentioned note.

Reciprocally, the United Mexican States agree as follows:

The Government of Mexico will exempt from the payment of taxes all income derived from the operation of [sic—in] international traffic of ships or aircraft by individuals who are residents of the United States and by corporations organized in the United States. This exemption shall only apply to individuals and corporations whose primary activity is transportation by ships and aircraft, and is granted on the basis of equivalent exemptions granted by the United States to individual residents of Mexico and to corporations organized in Mexico.

In the case of corporations organized in the United States, the exemption shall apply only if the corporations meet the ownership and trading requirements of Mexican law. For purposes of such ownership requirements, the Government of the United States shall be treated as an individual resident of the United States.

The term "international traffic" means any transport by a ship or aircraft, except when such transportation is solely between places in Mexico.

All income from the operation of [sic—in] international traffic of ships or aircraft includes all income derived from the international operation of ships and aircraft, including:

1. income from the rental on a full-ship basis (by time or voyage) of ships and aircraft used in international traffic;

2. income from the rental on a bareboat basis of ships and aircraft used in international traffic;

3. income from the rental of containers and supplemental equipment used in international traffic; and

4. gains from the sale, or any other alienation of ships or aircraft used in international traffic.

The Government of Mexico considers that Your Excellency's note and this note of reply, agreeing to the proposed terms, shall constitute an agreement between the two governments. This agreement, which supersedes the agreement of August 7, 1964, shall enter into force on the date of this note, and shall have effect with respect to taxable years beginning on or after 1 January 1987.

Either government may terminate this agreement by giving written notice of termination through diplomatic channels. If this agreement is terminated as a consequence of any legislative act, the government concerned will give as much notice of termination as feasible. In any other case, six months' prior notice of termination shall be given, and the agreement shall cease to have effect for taxable years beginning on or after the first day of January next following the expiration of the six-month period.

I avail myself of this opportunity to renew to Your Excellency the assurances of my highest consideration.

EMBASSY OF THE UNITED STATES OF AMERICA

Mexico City, D.F. August 7, 1989

I have the honor to refer to conversations between representatives of the Government of the United States of America and of the Government of Mexico relating to the possibility of modifying the agreement of August 7, 1964 with a view to exempting, on a reciprocal basis, gross income derived from the operation of ships and aircraft in international traffic.

The Government of the United States of America agrees 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 operation in international traffic of ships or aircraft by individuals who are residents of Mexico (other than U.S. citizens) and corporations organized in Mexico. This exemption shall only apply to income derived and beneficially owned by individuals and corporations that are primarily engaged in transportation by ships or aircraft, and is granted on the basis of equivalent exemptions granted by Mexico to individual residents of the United States and to corporations organized in the United States (other than corporations taxed by Mexico on the basis of residence).

In the case of a Mexican corporation, the exemption shall apply only if the corporation meets the ownership or public trading requirements of U.S. law. For purposes of such ownership requirements the Government of Mexico shall be treated as an individual resident of Mexico.

The term "international traffic" means any transport by a ship or aircraft except when such transport is solely between places in the United States.

Gross income from the operation in international traffic of ships or aircraft includes all income derived from the international operation of ships or aircraft, including:

1. income from the rental on a full (time or voyage) basis of ships or aircraft used in international traffic;

2. income from the rental on a bareboat basis of ships or aircraft used in international traffic;

3. income from the rental of containers and related equipment used in international traffic; and

4. gains from the sale, or other alienation of ships or aircraft used in international traffic.

The Government of the United States of America considers that this note, together with the Government of Mexico's reply note confirming that the Government of Mexico agrees to these terms, constitute an agreement between the two governments. This agreement, which supersedes the agreement of August 7, 1964, shall enter into force on the date of the Government of Mexico's reply note and shall have effect with respect to taxable years beginning on or after 1 January 1987.

Either Government may terminate this agreement by giving written notice of termination through diplomatic channels. If this agreement is terminated as a consequence of any legislative enactment, the Government concerned will give as much notice of

termination as feasible. In any case, six months' prior notice of termination shall be given, and the agreement shall cease to have effect for taxable years beginning on or after the first day of January next following the expiration of the six month period.

Accept, Excellency, the renewed assurance of my highest consideration.

SINGAPORE

Embassy of the United States of America
Singapore
July 28, 1988

The Embassy of the United States of America presents its compliments to the Ministry of Foreign Affairs of the Republic of Singapore and has the honor to acknowledge receipt of the Ministry's note no. 560/88 dated July 5, 1988, proposing the terms of an amended agreement to exempt from income tax, on a reciprocal basis, income derived by residents of the other country from the international operation of ships or 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 the Republic of Singapore (other than U.S. citizens) and corporations which are controlled and managed in the Republic of Singapore (other than corporations organized in the United States). This exemption is granted on the basis of equivalent exemptions granted by the Republic of Singapore to citizens of the United States (who are not residents of the Republic of Singapore) and to corporations organized in the United States (which are not subject to tax by the Republic of Singapore 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:

(I) More than 50 percent of the value of the corporation's stock is owned, directly or indirectly, by individuals who are residents of the Republic of Singapore or of another country which grants a reciprocal exemption to U.S. citizens and corporations; or

(II) The corporation's stock is primarily and regularly traded on an established securities market in the Republic of Singapore, or is wholly-owned by a corporation whose stock is so traded and which is also organized in the Republic of Singapore.

For the purpose of sub-paragraph (I), the Government of the Republic of Singapore will be treated as an individual resident of the Republic of Singapore. For purposes of the exemption from U.S. tax, sub-paragraph (I) 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 operation of ships or aircraft, including:

(I) Income from the rental of ships or aircraft used in international transport on a full (time or voyage) or bareboat basis;

(II) Income from the rental of containers and related equipment used in international transport which is incidental to income from the international operation of ships or aircraft;

(III) Income from the participation in shipping or air transport pools which engage in international operation of ships or aircraft; and

(IV) Gains from the alienation of ships or aircraft by a person whose predominant activity is the international operation of ships or aircraft.

The Embassy of the United States of America is pleased to confirm that the Ministry's note and this reply note constitute an agreement amending the agreement of March 24, 1988. This agreement shall enter into force on today's date and shall have effect with respect to taxable years beginning on or after 1 January 1987.

If any difficulty or doubt as to the interpretation or application of this agreement should arise, the competent authorities of the two countries shall seek to resolve such difficulty or doubt by mutual agreement. For this purpose, the competent authorities are:

(A) In the United States, the Secretary of the Treasury or his authorized representative; and

(B) In Singapore, the Minister for Finance or his authorized representative.

Either Government may terminate this agreement by giving written notice of termination through diplomatic channels.

The Embassy of the United States of America avails itself of this opportunity to renew to the Ministry of Foreign Affairs the assurances of its highest consideration.

Ministry of Foreign Affairs
Republic of Singapore
Singapore
July 5, 1988

The Ministry of Foreign Affairs of the Republic of Singapore presents its compliments to the Embassy of the United States of America 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 or aircraft. The terms of the agreement are as follows:

The Government of the Republic of Singapore agrees to exempt from tax gross income derived from the international operation of ships or aircraft by U.S. citizens (who are not residents of the Republic of Singapore) and corporations organized in the United States (other than corporations which are subject to tax by the Republic of Singapore on the basis of residence). This exemption is granted on the basis of equivalent exemptions granted by the United States to individuals who are residents of the Republic of Singapore (other than U.S. citizens) and corporations which are controlled and managed in the Republic of Singapore (other than corporations organized in the United States).

In the case of a corporation, the exemption shall apply only if the corporation meets either of the following conditions:

(I) More than 50 percent of the value of the corporation's stock is owned, directly or indirectly, by individuals who are citizens of the United States or of another country which grants a reciprocal exemption to residents (both individuals

and corporations) of the Republic of Singapore; or

(II) The corporation's stock is primarily and regularly traded on an established securities market in the United States, or is wholly-owned by a corporation whose stock is so traded and which is also organized in the United States. For the purposes of sub-paragraph (I), the Government of the United States of America will be treated as an individual resident of the United States of America.

Gross income includes all income derived from the operation of ships or aircraft, including:

(I) Income from the rental of ships or aircraft used in international transport on a full (time or voyage) or bareboat basis;

(II) Income from the rental of containers and related equipment used in international transport which is incidental to income from the international operation of ships or aircraft;

(III) Income from the participation in shipping or air transport pools which engage in international operation of ships or aircraft; and

(IV) Gains from the alienation of ships or aircraft by a person whose predominant activity is the international operation of ships or aircraft.

The Ministry of Foreign Affairs considers that this note, together with the Embassy's reply note confirming that the Government of the United States of America agrees to these terms, constitute an agreement amending the agreement of 24 March 1988. This agreement shall enter into force on the date of the Embassy's reply note and shall have effect with respect to taxable years beginning on or after 1 January 1987.

If any difficulty or doubt as to the interpretation or application of this agreement should arise, the competent authorities of the two countries shall seek to resolve such difficulty or doubt by mutual agreement. For this purpose, the competent authorities are:

(A) In the United States, the Secretary of the Treasury or his authorized representative; and

(B) In Singapore, the Minister for Finance or his authorized representative.

Either government may terminate this agreement by giving written notice of termination through diplomatic channels.

The Ministry of Foreign Affairs of the Republic of Singapore avails itself of this opportunity to renew to the Embassy of the United States of America the assurances of its highest consideration.

Part III. Administrative, Procedural and Miscellaneous

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Part III. Administrative, Procedural, and Miscellaneous

Delegation Order No. 42 (Rev. 23) Effective September 17, 1990

AGENCY: Internal Revenue Service, Treasury.

ACTION: Delegation of authority.

SUMMARY: This delegation order clarifies the authority to execute consent agreements for fixing the period of limitations involving partnerships and S corporations and eliminates the delegated authority for certain job positions phased out due to reorganization of the function. The text of the delegation order appears below.

EFFECTIVE DATE: September 17, 1990.

Authority to Execute Consents Fixing the Period of Limitations on assessment or Collection Under Provisions of the 1939, 1954, and 1986 Internal Revenue Codes

1. Pursuant to authority vested in the Commissioner of Internal Revenue by Treasury Order 150-10; 26 U.S.C. 6229(b); 26 CFR 301.6501(c)-1; 26 CFR 301.6502-1; 26 CFR 301.6901-1(d); and 26 CFR 301.7701-9; the authority to sign all consents fixing the period of limitations on assessment or collection is delegated to the following officials:

a. Associate Chief Counsels (Technical and International);

b. Assistant Commissioner (International);

c. Assistant Commissioner (Employee Plans and Exempt Organizations) but limited to Form 872-C, Consent Fixing Period of Limitation Upon the Assessment of Tax Under Section 4940 of the Internal Revenue Code;

d. Regional Counsel;

e. Regional Directors of Appeals;

f. Service Center Directors;

g. Director, Austin Compliance Center; and

h. District Directors

2. This authority may be redelegated but not below the following levels for each activity:

a. *Service centers*—Chief Accounting Branch; Chief, Quality Assurance; Chief, Correspondence and Processing; Revenue Officers and Collection Branch managers Grade GS-9 or higher; Chief, Classification function; and personnel assigned to the Examination Support Unit, Grade GS-11 or higher;

b. *Austin Compliance Center*—Underreporter Division—Branch Chiefs; Collection Division—all Branch Chiefs and Chief, Quality Assurance Staff; Examination Division—Chiefs, Examination Branches, Chief, Quality Assurance Staff, Chief, Classification Branch; and personnel assigned to the Windfall Profits Staff, GS-11;

c. *Collection*—Revenue Officers; Collection Support function managers Grade GS-9 or higher; Automated Collection Branch managers Grade GS-9 or higher;

d. *Examination*—Reviewers, Grade GS-11 or higher; Group managers (including large case managers); Chiefs, Planing and Special Programs and personnel assigned thereto Grade GS-11 or higher; Returns Classification Specialists and Returns Classification Officers, Grade GS-11;

e. *Criminal Investigation*—Chiefs, Criminal Investigation Divisions, except in those districts where the Criminal Investigation Group managers report directly to the District Directors, the authority is limited to the District Director.

f. *Appeals*—Appeals Officers;

g. *Assistant Commissioner (International)*—Representatives at foreign posts; Revenue Agents, Tax Auditors, and Special Agents on foreign assignments; and levels indicated in c, d, and e above.

h. *EP/EO*—For Form 872-C, Exempt Organizations Technical Division Group Managers and Conferee/Reviewers and

i. *District employee plans and exempt organizations*—Reviewers, Grade GS-11 or higher; and Group Managers.

3. No authority is delegated under this Order to the District Counsel.

4. Delegation Order No. 42 (Rev. 22) effective February 9, 1988, is superseded.

Dated: August 31, 1990.
Approved

Charles H. Brennan,
Deputy Commissioner (Operations).

(Filed by the Office of the Federal Register on October 5, 1990, 8:45 a.m., and published in the issue of the Federal Register for October 9, 1990, 55 F.R. 41153)

Delegation Order No. 114 (Rev. 9) Effective July 10, 1990

AGENCY: Internal Revenue Service, Treasury.

ACTION: Delegation of authority.

SUMMARY: This delegation Order designates officials of the Internal Revenue Service to act as "Competent Authority" under tax treaties and tax information exchange agreements.

Designation to Act as "Competent Authority" Under Tax Treaties and Tax Information Exchange Agreements

1. Pursuant to the authority delegated to the Commissioner by Treasury Order No. 150-17, there is hereby delegated to the Assistant Commissioner (International) the authority to act as "competent or taxation authority" under the tax treaties of the United States and under tax information exchange agreements.

2. The Assistant Commissioner (International) shall have the authority to administer all those functions derived from the operating provisions of the tax treaties and tax information exchange agreements. This authority may not be redelegated.

3. The Assistant Commissioner (International) is also delegated the authority to interpret and apply such tax treaties and tax information exchange agreements, but in such matters shall act only with the concurrence of the Associate Chief Counsel (International). This authority may not be redelegated.

4. Delegation Order No. 114 (Rev. 8), effective December 24, 1987, is hereby superseded.

Dated: June 19, 1990.

Charles H. Brennan,
Deputy Commissioner (Operations).

(Filed by the Office of the Federal Register on July 11, 1990, 8:45 a.m., and published in the issue of the Federal Register for July 12, 1990, 55 F.R. 28713)

Delegation Order No. 156 (Rev. 12) Effective June 26, 1990

Delegation of Authority; Chief Counsel Directives Manual (30) 330

AGENCY: Internal Revenue Service, Treasury.

ACTION: Delegation of Authority.

SUMMARY: This delegation order has been revised to authorize additional Internal Revenue Service officials to disclose tax identity information in accordance with the recently enacted provisions of IRC 6103(l)(12) and 6103(m)(6); to reference Delegation Order No. 143 concerning disclosures relative to title 31 CFR part 103; and to reflect organizational restructuring, new positions, delete references to outdated titles and positions, and incorporate the transitional delegation made by the Deputy Commissioner (Operations) in a June 5, 1989 memorandum. The text of the delegation order appears below.

Authority to Permit Disclosure of Tax Information and To Permit Testimony or the Production of Documents

Pursuant to the authority vested in the Commissioner of Internal Revenue by Treasury Order 150-10 and in the Chief Counsel by General Counsel Order No. 4 and by Treasury Order 101-05, authority to act in matters officially before their respective functions is hereby delegated.

The authority to disclose returns and/or return information under certain provisions of the IR Code, such as IRC 6103(h)(1), (h)(4) and (k)(6) is not delegated herein as the language of these provisions themselves permits officers and employees of the Internal Revenue Service and the Office of the Chief Counsel to disclose such information. The authority to disclose returns and return information under IRC 6103(k)(4) is also not delegated herein as Delegation Order 114 (as revised) governs these disclosures.

(1) Deputy Chief Inspector; Deputy Assistant Commissioner; Deputy Assistant Chief Information Officers; Division Directors (or equivalent level position); Assistant Chief Counsels; Regional Commissioners; Regional Counsels; Regional Inspectors; District Counsels; District and Service Center Directors; the Director, Austin Compliance Center; Director, Martinsburg Computing Center, and Director, Detroit Computing Center are authorized:

(a) To disclose or, in specific instances, authorize the disclosure of returns or return information to such persons as the taxpayer may designate in a written request, subject to the conditions prescribed in IRC 6103(c) and the Treasury Regulations thereunder. The authority to withhold return information upon a determination that such disclosure would seriously impair Federal tax administration is also delegated. These authorities are also delegated to the Taxpayer Ombudsman. The authority delegated in this paragraph to disclose returns or return information may be redelegated to Internal Revenue Service employees and employees of the Office of Chief Counsel to the extent necessary within the exercise of their official duties. The authority delegated in this paragraph to withhold return information may be redelegated not lower than Chiefs, Special Procedures function; Group Managers (or their equivalent); Chiefs, Appeals Offices; Chiefs, Criminal Investigation Branch; Problem Resolution Officers; and Disclosure Officers.

(b) To disclose or, in specific instances, authorize the disclosure of returns, upon the written requests of an individual taxpayer, partner, corporate officer, shareholder, administrator, executor, trustee, or other person having a material interest subject to the conditions prescribed in IRC 6103(e). The authority to disclose or, in specific instances, authorize the disclosure of return information to such persons, upon a determination that disclosure would not seriously impair Federal tax administration, as prescribed in IRC 6103(e)(7), is also delegated. The authority to withhold return information upon a determination that disclosure would seriously impair Federal tax administration is also delegated. These authorities are also delegated to the Taxpayer Ombudsman. The authority delegated in this paragraph to disclose or authorize the disclosure of returns or return information may be redelegated to Internal Revenue Service employees and employees of the Office of Chief Counsel to the extent necessary within the exercise of their official duties. In the event a disclosure of return information would seriously impair Federal tax administration, the decision to withhold such return information will be referred to officials not lower than Chiefs, Special Procedures function; Group Managers (or their equivalent); Chiefs, Appeals Offices; Chiefs, Criminal Investigation Branch; Problem Resolution Officers and Disclosure Officers.

(c) To disclose or, in specific instances, authorize the disclosure of returns or return information to officers and employees of the Department of Justice including United States attorneys, in a matter involving tax administration, subject to the conditions prescribed in IRC 6103(h)-(2), the Treasury Regulations thereunder, and (h)(3)(A). The authority delegated in this paragraph may be redelegated no lower than Chiefs, Special Procedures function; and Group Managers (or their equivalent including Disclosure Officers). The authority delegated in this paragraph to Chief Counsel employees may be redelegated not lower than Chiefs, Appeals Offices; and to attorneys of the Office of Chief Counsel directly involved in such matters. (See paragraph (17) below.)

(d) To disclose or, in specific instances, authorize the disclosure of returns or return information to officers and employees of the Department of Treasury, as specified in IRC 6103(l)(4)(B) or, upon written requests to employees and other persons specified in IRC 6103(l)(4)(A) for use in personnel or claimant representative matters, and to make relevancy and materiality determinations as provided in section 6103(l)-(4)(A), subject to the conditions prescribed in IRC 6103(l)(4). The authority delegated in this paragraph may be redelegated only to Assistant Division Directors (or equivalent level position); Assistant Regional Commissioners; Regional Directors of Appeals; Assistant Regional Inspectors; Regional Chiefs, Personnel Branch; Assistant District and Service Center Directors; the Assistant Director, Austin Compliance Center; Division Chiefs; National Office Branch Chiefs, Internal Security Division; Assistant Regional Counsels (GLS); and to attorneys of the Office of Chief Counsel and Inspectors directly involved in such matters. (See paragraph 13(e).)

(e) To disclose or, in specific instances, authorize the disclosure of returns or return information to the extent necessary in connection with contractual procurement by the Service or Office of the Chief Counsel of equipment or other property or services, subject to the conditions prescribed in IRC 6103(n) and the Treasury Regulations thereunder. The authority delegated in this paragraph may be redelegated only to Assistant Division Directors (or equivalent level position); Assistant Regional Commissioners; Regional Directors of Appeals; Assistant Regional Inspectors; Assistant District and Service Center Directors; Assistant Director, Austin Compliance Center; Division Chiefs; Deputy Assistant Chief Counsels; Assistant Regional Counsel; and Disclosure Officers.

(f) To disclose, or in specific instances, authorize the disclosure of return information (other than taxpayer return information) which may constitute evidence of a violation of any Federal criminal law (not involving tax administration) or to disclose return information under circumstances involving a threat or other imminent danger of death or other physical injury, which is directed against the President or other government official, to the U. S. Secret Service, subject to the conditions prescribed in IRC 6103(i)(3). The authority delegated to this paragraph is also delegated to Assistant District and Service Center Directors and the Assistant Director, Austin Compliance Center. This does not limit the authority granted in paragraph 6(d) of this order.

(g) To determine whether a disclosure or standards used or to be used for selection of returns for examination, or data used or to be used for determining such standards will seriously impair assessment, collection or enforcement under the internal revenue laws pursuant to IRC 6103(b)(2). The authority delegated in this paragraph may be redelegated to Disclosure Officers.

(2) Deputy Chief Inspector; Deputy Assistant Commissioners; Deputy Assistant Chief Information Officers; Division Directors (or equivalent level position); Regional Commissioners; Regional Inspectors; District and Service Center Directors; the Director, Austin Compliance Center; Director, Martinsburg Computing Center; and Director, Detroit Computing Center are authorized to determine whether a disclosure of returns or return information in a Federal or State judicial or administrative proceeding pertaining to tax administration would identify a confidential informant or seriously impair a civil or criminal tax investigation, subject to the conditions prescribed in IRC 6103(h)(4). The authority delegated in this paragraph may not be redelegated.

(3) Director, Office of Disclosure; Regional Commissioners; Assistant Commissioner (International); District and Service Center Directors; and the Director, Austin Compliance Center are authorized.

(a) To furnish an affirmative or negative response to a written inquiry from an attorney of the Department of Justice (including a United States Attorney) involved in a judicial proceeding pertaining to tax administration, or any person (or his/her legal representative) who is party to such proceeding, as to whether a prospective juror has or has not been the subject of any audit or other tax investigation by the Internal Revenue Service, subject to the conditions prescribed in IRC 6103(h)(5). The authority delegated in this paragraph may be redelegated only to Assistant District and Service Center Directors; Assistant Director, Austin Compliance Center; Division Chiefs; and Disclosure Officers.

(b) To disclose or, in specific instances, authorize the disclosure of:

(i) Accepted offers-in-compromise to members of the general public, subject to the conditions prescribed in IRC 6103(k)(1).

(ii) The amount of an outstanding obligation secured by a lien, notice of which has been filed pursuant to section 6323(f), to any person who furnishes satisfactory written evidence establishing a right in or intent to obtain a right in property subject to such lien, subject to the conditions prescribed in IRC 6103(k)(2). The authority to disclose or, in specific instances, authorize the disclosure of the amount of such outstanding obligations is also delegated to the Deputy Assistant Commissioner (Collection).

(iii) Taxpayer identity information with respect to any income tax return preparer and information as to whether any penalty has been assessed against such preparer to officers and employees of any agency charged under State or local law with the regulation of such preparers, upon written request and subject to the conditions prescribed in IRC 6103(k)(5).

(iv) Returns or return information with respect to taxes imposed by IRC chapters 2, 21, and 24 to the Social Security Administration, upon written request and subject to the conditions prescribed in IRC 6103(l)(1)(A).

(v) Returns or return information with respect to taxes imposed by IRC chapter 22 to the Railroad Retirement Board, upon written request and subject to the conditions prescribed in IRC 6103(l)(1)(C).

(vi) Returns or return information with respect to taxes imposed by IRC subtitle E (relating to taxes on alcohol, tobacco and firearms) to officers and employees of the Bureau of Alcohol, Tobacco and Firearms, upon written request and pursuant to IRC 6103(o)(1).

The authority delegated in subparagraphs (iv) and (v) is also delegated to the Associate Chief Counsel (Technical). The authority delegated in this paragraph may be redelegated only to Assistant District and Service Center Directors; Assistant Director, Austin Compliance Center; Division Chiefs; and Disclosure Officers. In addition, the authority delegated in subparagraph (i) may also be redelegated only to Chiefs, Special Procedures function; Special Procedures function Advisor Reviewers; and Group Managers (or their equivalent). The authority delegated in subparagraph (ii) may also be redelegated only to Chiefs, Special Procedures function; Special Procedures function Advisor Reviewers; Group Managers (or their equivalent); and Revenue Officers. The authority delegated in subparagraph (iv) may be redelegated not lower than Branch Chief.

(4) Regional Commissioners; Assistant Commissioner (International); Director, Office of Disclosure; District and Service Center Directors; and the Director, Austin Compliance Center are authorized to disclose or, in specific instances, authorize the disclosure of returns or return information to designated State tax offi-

cials, upon written request by the head of a State tax agency, for the purpose of and to the extent necessary in the administration of State tax laws, pursuant to the provisions of IRC 6103(d) and subject to the conditions prescribed in IRC 6103(h)(4) and (p)(8). The authority to withhold return information pursuant to IRC 6103(d) and (h)(4) upon a determination that such disclosures would identify a confidential informant or seriously impair any civil or criminal tax investigation is also delegated. The authority delegated in this paragraph does not extend to the entry into Federal/State Agreements on the Coordination of Tax Administration. The authority delegated in this paragraph may be redelegated to Disclosure Officers, Disclosure Specialists and to any supervisory level deemed appropriate, but such redelegation shall not extend to the authority to withhold return information.

(5) The Regional Commissioners; Assistant Commissioner (International); District and Service Center Directors; Director, Austin Compliance Center; and Director, Martinsburg Computing Center are authorized to disclose or, in specific instances, authorize the disclosure of returns or return information pursuant to Federal/State Agreements on the Coordination of Tax Administration entered into between the head of any State tax agency and the Commissioner of Internal Revenue, pursuant to the provisions of IRC 6103(d) and subject to the conditions prescribed in IRC 6103(h)(4) and(p)(8). The authority to withhold return information pursuant to IRC 6103(d) and (h)(4) upon a determination that such disclosure would identify a confidential informant or seriously impair any civil or criminal tax investigations is also delegated. The authority delegated in this paragraph may be redelegated to Disclosure Officers, Disclosure Specialists and to any supervisory level deemed appropriate, but such redelegation shall not extend to the authority to withhold return information.

(6) The Director, Office of Disclosure, is authorized:

(a) To disclose or, in specific instances, authorize the disclosure of returns and return information to Congressional committees and other persons, upon written request and subject to the conditions prescribed in IRC 6103(f). The authority delegated in this paragraph is also delegated to the Assistant to the Commissioner (Legislative Liaison), Taxpayer Ombudsman, and Assistant Commissioner (International). The authority delegated in this paragraph may not be redelegated.

(b) To disclose or, in specific instances, authorize the disclosure of returns or return information to officers and employees of a Federal agency pursuant to an *ex parte* order by a Federal District Court judge or magistrate when needed for use in the enforcement of a Federal criminal statute (not involving tax administration), or to locate a fugitive from justice subject to the conditions prescribed in IRC 6103(l)(1) or (i)(5) and the Treasury Regulations thereunder. The authority to withhold any return or return information, pursuant to IRC 6103(i)(6), upon a determination that such disclosure would identify a confidential informant or seriously impair any civil or criminal tax investigation is also delegated. The authority delegated in this paragraph is also delegated to Assistant Commissioner (International); Regional Commissioners; Assistant District and Service Center Directors; and the Assistant Director, Austin Compliance Center. This authority may not be redelegated.

(c) To disclose or, in specific instances, authorize the disclosure of return information (other than taxpayer return information) to officers and employees of a Federal agency upon written request by the head of such agency or the Inspector General thereof, or in the case of the Department of Justice, the Attorney General, the Deputy Attorney General, the Associate Attorney General, any Assistant Attorney General, the Director of the Federal Bureau of Investigation, the Administrator of the Drug Enforcement Administration, any United States attorney, any special prosecutor appointed under section 593 of title 28, United State Code, or any attorney in charge of a criminal division organized crime strike force established pursuant to section 510 of title 28, United States Code, when needed for use in the enforcement of a Federal criminal statute (not involving tax administration), subject to the conditions prescribed in IRC 6103(i)(2). The authority to withhold return information (other than taxpayer return information), pursuant to IRC 6103(i)(6), upon a determination that such disclosure would identify a confidential informant, or seriously impair any civil or criminal tax investigation is also delegated. The authority delegated in this paragraph is also delegated to Regional Commissioners; Assistant District and Service Center Directors; Assistant Director Austin Compliance Center; and Assistant Commissioner (International). This authority may not be redelegated.

(d) To disclose or, in specific instances, authorize the disclosure of:

(i) return information (other than taxpayer return information) which may constitute evidence of a violation of Federal criminal law (not involving tax administration) to the extent necessary to apprise the head of the appropriate Federal agency pursuant to IRC 6103(i)(3)(A).

(ii) return information to the extent necessary to apprise appropriate officers or employees of a Federal or State law enforcement agency of circumstances involving an imminent danger of death or physical injury to any individual pursuant to IRC 6103(i)(3)(B)(i);

(iii) return information to the extent necessary to apprise appropriate officers or employees of a Federal law enforcement agency of circumstances involving the imminent flight of an individual from Federal prosecution pursuant to IRC 6103(i)(3)-(B)(ii);

With respect to subparagraph (i), the authority to withhold any return information pursuant to IRC 6103(i)-(6) upon a determination that such disclosure would identify a confidential informant or seriously impair a civil or criminal tax investigation is also delegated.

With respect to subparagraph (i), the authority is also delegated to Special Agents and Internal Security Inspectors. The authority delegated in this paragraph is also delegated to Assistant Commissioner (International); Regional Commissioner; Assistant District and Service Center Directors; and the Assistant Director, Austin Compliance Center. This authority is in addition to the authority previously delegated in paragraph (1)(f).

(e) To notify the Attorney General or his delegate or the head of a Federal agency that certain returns or return information obtained pursuant to IRC 6103(i)(1), (2) or (3)(A) shall not be admitted into evidence under IRC 6103(i)(4)(A)(i) or (B) upon a determination, in accordance with IRC 6103(i)(4)(C), that such admission would identify a confidential informant or seriously impair a civil or criminal tax investigation. The authority delegated in this paragraph is also delegated to Regional Commissioners; Assistant Commissioner (International); Assistant District and Service Center Directors; and the Assistant Director, Austin Compliance Center. This authority may not be redelegated.

(f) To disclose or, in specific instances, authorize the disclosure of returns or return information to officers and employees of the General Accounting Office, upon written request by the Comptroller General of the United States and subject to the conditions prescribed in IRC 6103(i)-(7). The authority to withhold any return or return information, pursuant to IRC 6103(i)(6), upon a determination that such disclosure would impair any civil or criminal tax investigation or reveal the identity of a confidential informant is also delegated. The authority delegated in this paragraph may not be redelegated.

(g) To disclose or, in specific instances, authorize the disclosure of:

(i) the mailing address of taxpayer to officers and employees of an agency when needed in connection with a Federal claim against such taxpayer, upon written request and subject to the conditions prescribed in IRC 6103(m)(2). The authority delegated in this paragraph is also delegated to Regional Commissioners; Assistant Commissioner (International); Assistant District and Service Center Directors; and the Assistant Director, Austin Compliance Center. Upon approval of a contractual agreement for such disclosures, the authority delegated in this paragraph is also delegated to the Deputy Assistant Commissioner. (Returns Processing); Director, Returns Processing and Accounting Division; Deputy Assistant Chief Information Officer (Information System Management) and Director, Martinsburg Computing Center. The authority delegated in this paragraph may be redelegated only as set forth below. The authority delegated to the Regional Commissioners; Director, Martinsburg Computing Center, Assistant District and Service Center Directors; and the Assistant Director, Austin Compliance Center may be redelegated to the Disclosure Officer, Martinsburg Computing Center and Regional, District and Service Center and Austin Compliance Center Disclosure Officers. The authority delegated in this order does not include authority to enter into a contractual agreement, which is contained in Delegation Order No. 100, as revised.

(ii) whether or not an applicant for a loan under an included Federal loan program has a tax delinquent account to the head of the Federal agency administering such program, upon written request and subject to the conditions prescribed in IRC 6103(l)(3). The authority delegated in this paragraph is also delegated to Regional Commissioners; Assistant Commissioner (international); Assistant District and Service Center Director, and the Assistant Director, Austin Compliance Center. Upon approval of a contractual agreement for such disclosures, the authority delegated in this paragraph is also delegated to the Deputy Assistant Commissioner (Returns Processing); Director, Returns Processing and Accounting Division; Deputy Assistant Chief Information Officer (Information Systems Management) and Director, Martinsburg Computing Center. The authority delegated in this paragraph may be redelegated only as set forth below. The authority delegated to the Regional Commissioners; Director, Martinsburg Computing Center, Assistant District and Service Center Directors, and the Assistant Director, Austin Compliance Center may be redelegated only to the Disclosure Office Martinsburg Computing Center, Service Center Directors, and the Director, Austin Compliance Center may not be redelegated. The authority delegated in this paragraph does not include authority to enter into a contractual agreement, which is contained in Delegation Order No. 100, as revised.

(h) To disclose or, in specific instances, authorize the disclosure of the mailing address of taxpayers to officers and employees of the National Institute for Occupational Safety and Health, upon written request and subject to the conditions prescribed in IRC 6103(m)(3). Upon approval by the Director, Office of Disclosure, or his/her delegate of a contractual agreement for such disclosures, the authority delegated in this paragraph is also delegated to the Deputy Assistant Chief Information Officer (Information Systems Management); Director, Tax Systems Division; Director, Martinsburg Computing Center, Service Center Directors, and the Director, Austin Compliance Center. The authority delegated to the Deputy Assistant Chief Information Officer (Information Systems Management); Director, Tax Systems Division; Director, Martinsburg Computing Center, Service Center Director, and the Director Austin Compliance Center may not be redelegated. The authority delegated in this paragraph does not include authority to enter into a contractual agreement, which is contained in Delegation Order No. 100, as revised.

(i) To disclose, or in specific instances, authorize the disclosure of the mailing address of any taxpayer who has defaulted on a loan:

(i) made from the student loan fund established under part B or E of title IV of the Higher Education Act of 1965 or a loan made to a student at an institute of higher education pursuant to section 3(a)(1) of the Migration and Refugee Assistance Act of 1962, to the Secretary of Education upon written request and subject to the conditions prescribed in IRC 6103(m)(4).

(ii) made under part C of title VII of the Public Health Service Act or under subpart II of part B of title VIII of such Act to the Secretary of Health and Human Services upon written request and subject to the conditions prescribed in IRC 6103(m)(5).

Upon approval by the Director, Office of Disclosure, or his/her delegate of a contractual agreement for such disclosures, the authority delegated in subparagraphs (i) and (ii) is also delegated to the following officials: Deputy Chief Information Officer (Information Systems Management); Director, Tax Systems Division; Director, Martinsburg Com-

puting Center, and Service Center Director, and the Director, Austin Compliance Center. This authority may not be redelegated. The authority delegated in this paragraph does not include authority to enter into a contractual agreement, which is contained in Delegation Order No. 100, as revised.

(j) To disclose or, in specific instances, authorize the disclosure of the mailing address of taxpayers to officers and employees of the Department of Health and Human Services' Blood Donor Locator Service, upon written request and subject to the conditions prescribed in IRC 6103(m)(6). This authority may only be redelegated to the Chief, Disclosure Operations Section.

(k) To disclose or, in specific instances, authorize the disclosure, upon written request, of returns filed in accordance with IRC 6050I, to officers and employees of any Federal agency whose official duties require such disclosure to administer Federal criminal statutes not related to tax administration, pursuant to the provisions of IRC 6103(i)(8). The authority delegated in this paragraph also is delegated to the Assistant Commissioner (Criminal Investigation); District Directors and Assistants; Special Assistant for Financial Enforcement, Detroit Computing Center, and Chiefs, Criminal Investigation Division. This authority may not be redelegated, and shall expire November 17, 1990, the expiration of the disclosure authority under IRC 6103(i)(8).

(l) For disclosure relate to title 31 CFR part 103 see Delegation Order 143, as revised, paragraph 5.

(7) The Assistant Commissioner (Returns Processing) is authorized:

(a) To disclose or, in specific instances, authorize the disclosure of returns or return information for statistical use to officers and employees of the Department of Commerce, Bureau of Census, upon the written request of the Secretary of Commerce or to officers and employees of the Department of the Treasury, subject to the conditions prescribed in IRC 6103(i)(1)(A) and the Treasury regulations thereunder and (j)(3). The authority delegated in this paragraph may be redelegated only to the Director, Statistics of Income Division.

(b) To disclose or, in specific instances, authorize the disclosure of return information for statistical use to officers and employees of the Department of Commerce, Bureau of Economic Analysis, upon the written request of the Secretary of Commerce, or to officers and employees of the Federal Trade Commission, upon written request of the Chairman, subject to the conditions prescribed in IRC 6103(j)(1)(B) and (j)(2) and the Treasury regulations thereunder. The authority delegated in this paragraph may be redelegated only to the Director, Statistics of Income Division.

(8) The Director, Public Affairs Division; Regional Commissioners; Assistant Commissioner (International); and District Directors are authorized to disclose or, in specific instances, authorize the disclosure of taxpayers' names and the city, state and zip code of their mailing addresses to the press and other media for purposes of notifying persons entitled to undelivered tax refunds, subject to the conditions prescribed in IRC 6103(m)(1). The authority delegated in this paragraph may be redelegated to Assistant Directors and Public Affairs Officers.

(9) The Assistant Commissioner (Examination) is authorized:

(a) Upon written request of the President, to disclose, or in specific instances, authorize the disclosure of return information (other than return information that is adverse to the taxpayer) of an individual who is under consideration for appointments to a position in the executive or judicial branch of the Federal Government to the authorized representative of the Executive Office of the President or to the Federal Bureau of Investigation on behalf of the President, subject to the conditions prescribed in IRC 6103(g)(2) and (g)(4). Authority is also delegated to disclose or, in specific instances, authorize the disclosure of return information with respect to the categories of individuals discussed above to the heads of Federal agencies upon written request, or the Federal Bureau of Investigation on behalf of and upon the written request of such agency heads, subject to the conditions described in IRC 6103(g)(2) and (g)(4). Upon receipt of any request for return information under IRC 6103(g)(2), authority to notify the individuals with respect to whom the request has been made is also delegated. The authority delegated in this paragraph may be redelegated but not lower than:

(i) Deputy Assistant Commissioner (Examination), in the case of requests by or on behalf of the President where the return information to be disclosed is not adverse to the taxpayer;

(ii) Director, Office of Disclosure, in the case of requests by or on behalf of the heads of Federal agencies where the return information to be disclosed is adverse to the taxpayer;

(iii) Director, Office of Disclosure, in the case of requests by or on behalf of the heads of Federal agencies where the return information to be disclosed is not adverse to the taxpayer; and

(iv) Director, Office of Disclosure, concerning the notification of individuals with respect to whom a request has been made.

(b) To make the determination that an agency, body or commission or the General Accounting Office has failed to or does not meet the requirements of IRC 6103(p)(4). Subject to the administrative review applicable to State tax agencies described in IRC 6103(p)(7), authority to withhold returns and return information from any agency, body or commission or the General Accounting Office until a determination is made that the requirements of IRC 6103(p)(4) have been or will be met is also delegated. The authority delegated in this paragraph may not be redelegated.

(10) The Deputy Assistant Commissioner (Employee Plans and Exempt Organizations); Director, Office of Disclosure; Regional Commissioners; District Directors of Key Districts for Employee Plans and Exempt Organizations matters; Service Center Directors; Director, Austin Compliance Center; Director, Martinsburg Computing Center; and Director, Detroit Computing Center are authorized to disclose, or in specific instances, authorize the disclosure of:

(a) Statements, notifications, reports, or other return information described in IRC 6057(d) to officers and employees of the Social Security Administration for the administration of section 1131 of the Social Security

Act, upon written request and subject to the conditions prescribed in IRC 6103(l)(1)(B). The authority delegated in this paragraph to the Deputy Assistant Commissioner (Employee Plans and Exempt Organizations) may be redelegated, but not lower than Branch Chiefs, Employee Plans Technical and Actuarial Division. The authority delegated in this paragraph to Regional Commissioners may be redelegated not lower than Assistant Regional Commissioner. The authority delegated in this paragraph to the District Directors of Key Districts may be redelegated, but not below Chiefs, Technical Review Staffs, Employee Plans and Exempt Organizations Division. The authority delegated in this paragraph to Service Center Directors and the Director, Austin Compliance Center may be (redelegated, but not lower than Section Chiefs (or their equivalent). The authority delegated in this paragraph to the Director, Martinsburg Computing Center and Director, Detroit Computing Center may be redelegated, but not lower than Branch Chiefs (or their equivalent).

(b) Returns or return information, including compensation information, to officers and employees of the Department of Labor and Pension Benefit Guaranty Corporation for the administration of titles I and IV of the Employee Retirement Income Security Act of 1974, upon written request and subject to the conditions prescribed in IRC 6103(l)(2) and the Treasury regulations thereunder. The returns or return information which may be disclosed under this paragraph include:

(i) Upon specific written request, the information specified in 26 CFR 301.6103(i)(2)-1(a), 2(a), 3(b)(1), and 3(b)(2);

(ii) Upon receipt by the Commissioner of Internal Revenue of an annual written request, the information specified in 26 CFR 301.6103(i)(2)-3(a);

(iii) Upon receipt by the Commissioner of Internal Revenue of a general written request, information specified in 26 CFR 301.6103(i)(2)-3(d).

The authority delegated in this paragraph to the Deputy Assistant Commissioner (Employee Plans and Exempt Organizations) may be redelegated, but not lower than Branch Chiefs, Employee Plans Technical and Actuarial Division. The authority delegated in this paragraph to Regional Commissioners may be redelegated not lower than Assistant Regional Commissioner. The authority delegated in this paragraph to District Directors of the Key Districts may be redelegated, but not lower than Employee Plans Specialist. The authority delegated in this paragraph to Service Center Directors and the Director, Austin Compliance Center may be redelegated, but not lower than Section Chiefs (or their equivalent). The authority delegated in this paragraph to the Director, Martinsburg Computing Center and Director, Detroit Computing Center may be redelegated, but not lower than Branch Chiefs (or their equivalent). The authority delegated in this paragraph is also delegated to the National Director of Appeals; Regional Director of Appeals; Chief, Appeals Office; and Associate Chief, Appeals Office and may not be redelegated.

(11) The Deputy Assistant Commissioner (Employee Plans and Exempt Organizations) is authorized to disclose or, in specific instances, authorize the disclosure of drafts of proposed exemptions or of proposed denials of exemption requests, denial letters, and copies of information submitted by taxpayers requesting exemptions to the proper officers of the Department of Labor for consultation and coordination as required by IRC 4975(c)(2). The authority delegated in this paragraph may be redelegated not lower than Branch Chiefs, Employee Plans Technical and Actuarial Division.

(12) Disclosure of information to appropriate Federal, State or local law enforcement officials may be made by Internal Revenue Service employees, and employees of the Office of Chief Counsel, concerning nontax crimes which do not involve return information or the income or other financial information of an individual or entity, in accordance with the provisions of Chapter (35)00 of the Disclosure of Official Information Handbook, IRM 1272. In situations where there is a question as to whether the information to be disclosed is or is not return information, such as those described in IRM 1272, the Director, Office of Disclosure; Regional Commissioners; Assistant Commissioner (International); Assistant District and Service Center Directors; and the Assistant Director, Austin Compliance Center are authorized to approve or deny such requests for disclosure. The Director, Office of Disclosure, should act in all such matters only after coordination with the office of the Assistant Chief Counsel (Disclosure Litigation). Regional Commissioners; Assistant Commissioner (International); Assistant District and Service Center Directors; and the Assistant Director Austin Compliance Center should act in all such matters only after coordination with the Associate Chief Counsel (International), Office of Regional or District Counsel, as appropriate. The authority delegated in this paragraph may not be redelegated.

(13) The authority vested in the Commissioner of Internal Revenue by 26 CFR 301.9000-1 is delegated by this Order to the Senior Deputy Commissioner. It is also delegated to the following officials to the extent described below. (No authorization is needed in cases referred to the Department of Justice which are discussed in paragraph (1)(c) where the testimony or disclosure is made on behalf of the government.)

(a) Regional Commissioners are authorized to determine whether employees of the Internal Revenue Service assigned to their regions, including employees of the Office of the Regional Counsel, but not including employees of the Regional Inspector, will be permitted to testify or produce Service records because of a request or demand for the disclosure of such records or information. The Regional Commissioners should act in all such matters only after coordination with the Office of Regional Counsel. However, the personal testimony of a Regional Commissioner shall require authorization in accordance with (b) below. The authority delegated in this paragraph may not be redelegated. (See (d) and (e) below.) The authority delegated in this paragraph shall not extend to the disclosure of Internal Revenue Service records and information in response to a subpoena or request or other order of the Tax Court. (See General Counsel Order No. 4, which provides the authority for disclosure of Internal Revenue

Service records and information in tax court proceedings.)

(b) The Deputy Assistant Commissioner (Examination) is authorized to determine whether Regional Commissioners, employees of the Internal Revenue Service assigned to the National Office, including employees of the Office of Chief Counsel, and employees assigned to Regional Inspectors will be permitted to testify or produce Service records because of a request or demand for the disclosure of such records or information. The Deputy Assistant Commissioner (Examination) should act in all such matters only after coordination with the office of the Assistant Chief Counsel (Disclosure Litigation). The authority delegated in this paragraph may not be redelegated. (See (d) and (e) below). the authority delegated in this paragraph shall not extend to the disclosure of Internal Revenue Service records and information in response to a subpoena or request or other order of the Tax Court. (See General Counsel Order No. 4.)

(c) The Assistant Commissioner (International), District Directors, Service Center Directors and the Director, Austin Compliance Center are authorized to determine whether officers and employees of the Internal Revenue Service assigned to their office, district of service center or the Austin Compliance Center (including regional appeals employees located in the district) will be permitted to testify or produce Service records because of a request or demand for disclosure of such records or information. For purposes of this paragraph, employees of the Office of the District Counsel come under the authority of the District Director. Employees of the Regional Inspector are covered under paragraph (b), above. The District and Service Center Directors and the Director, Austin Compliance Center should act in all such matters only after coordination with the Office of the District Counsel. The Assistant Commissioner (International) should act in all such matters only after coordination with the Associate Chief Counsel (International). However, the personal testimony of a District Director or Service Center Director or Director, Austin Compliance Center shall require authorization in accordance with (a) above. The authority in this paragraph may not be redelegated. (See (d) and (e) below.) The authority delegated in this paragraph shall not extend to the disclosure of Internal Revenue Service records and information in response to a subpoena or request or other order of the Tax Court. (See General Counsel Order No. 4.)

(d) The authority delegated in paragraphs (a), (b) and (c) shall not extend to testimony or the production of Service records because of a request or demand for the disclosure of such records or information:

(i) By a Congressional Committee;

(ii) Involving a disclosure to correct a misstatement of fact pursuant to IRC 6103(k)(3).

(e) The Assistant Chief Counsel (General Legal Services), and Assistant Regional Counsel (GLS), with the concurrence of the Assistant Chief Counsel (General Legal Services), are authorized to determine whether officers and employees of the Internal Revenue Service, including employees of the Office of Chief Counsel, will be permitted to testify or produce Internal Revenue records or information because of a request or demand for the disclosure of such records or information, if the request or demand is made in connection with personnel or claimant representative matters under the jurisdiction of the office of the Assistant Chief Counsel (General Legal Services) for which they have been delegated authority to disclose returns or return information as described in paragraph 1(d). The authority delegated above in this paragraph to the Assistant Chief Counsel (General Legal Services), may be redelegated only to the Deputy Assistant Chief Counsel (General Legal Services), and to Branch Chiefs and attorneys of the Office of Chief Counsel directly involved in such matters. This paragraph does not limit the authority granted in (a), (b), or (c) above.

(f) The authority delegated to Regional Commissioners, District and Service Center Directors and the Director, Austin Compliance Center in paragraphs (a) and (c) shall not extend to testimony or the production of Service records because of a request or demand for the disclosure of such records or information which may require a disclosure to a competent authority under a tax convention, whether or not such records or information were previously disclosed pursuant to such convention. The Deputy Assistant Commissioner (Examination) should act in all such matters only after authorization by the appropriate United States competent authority. (See Delegation Order 114, as revised).

(g) In addition to paragraphs (a), (b), (c) and (e) above, authority is further delegated to Assistant Regional Commissioners (Resources Management); Regional Inspectors; Regional and District Counsel; District Service Center Directors; Director, Austin Compliance Center, and Director, Detroit Computing Center, to release or, in specific instances, authorize the release of information from the leave and payroll records of employees under their jurisdiction, and to the Director, National Office Resources Management Division, to release or, in specific instances, authorize the release of information from the leave and payroll records of all employees of the National Office, when such information is requested or subpoenaed in connection with private litigation, upon determination that release of the information would not be detrimental to the Internal Revenue Service. This delegation does not include authority to release or authorize the release of information contained in official personnel folders, which is covered by IRM 0293. When any uncertainty exists as to the availability of furnishing leave and pay information in a particular case, the matter should be referred to the National Office, Attention: HR:N:H, with a compete report of the circumstances. The authority delegated in this paragraph may not be redelegated.

The provisions of this paragraph (13(a)—(g)) are limited to the authorization of testimony or the production of documents pursuant to a request or demand as referred to in paragraphs (d)(1)(i) and (ii) of 26 CFR 301.9000-1 and do not extend to or affect other disclosure authority previously delegated in paragraphs (6) and (9) of this order. Furthermore, in instances where it is anticipated that the testimony or production of Service records by a Chief Counsel attorney will involve matters which may fall within the attorney-client privilege, the determination of whether to

waive the privilege, as well as the authority to authorize the testimony or production shall lie with the Deputy Assistant Commissioner (Examination) who will act in these matters only after coordination with the office of the Assistant Chief Counsel (Disclosure Litigation). In instances involving Regional or District Counsel attorneys and the attorney-client privilege, authority shall lie with the Regional Commissioner, who will act in these matters only after coordination with the Regional Counsel.

(14) The Deputy Assistant Chief Information Officer (Information Systems Management); Regional Commissioners; Assistant Commissioner (International); Director, Tax Systems Division; Director, Martinsburg Computing Center; Service Center Directors; and the Director, Austin Compliance Center are authorized to disclose or, in specific instances, authorize the disclosure of individual master file information to the head of a Federal, State or local child support enforcement agency or an authorized supervisory official under a contractual agreement entered into pursuant to Delegation Order 100, as revised, Revenue Procedure 78-10, and subject to the conditions prescribed in IRC 6103(l)(6)(A)(i). Such contractual agreement should be entered into only after coordination with the Director, Office of Disclosure. The authority delegated in this paragraph may be redelegated to any supervisory level deemed appropriate.

(15) The Deputy Assistant Commissioner (Examination); Regional Commissioners; Assistant Commissioner (International); Service Center Directors; the Director, Austin Compliance Center are authorized to disclose or, in specific instances, authorize the disclosure of return information to the head of a Federal, State or local child support enforcement agency or an authorized supervisory official under a contractual agreement entered into pursuant to Delegation Order 100, as revised, Revenue Procedure 78–10, and subject to the conditions prescribed in IRC 6103(l)(6)(A)(ii). Such contractual agreement should be entered into only after coordination with the Director, Office of Disclosure. The authority delegated in this paragraph may be redelegated to any supervisory level deemed appropriate.

(16) The Deputy Assistant Commissioner (Examination); Regional Commissioners; Service Center Directors; the Director, Austin Compliance Center; Director, Martinsburg Computing Center; and Director, Detroit Computing Center are authorized to disclose or, in specific instances, authorize the disclosure of information returns filed pursuant to part III of subchapter A of IRC chapter 61 to designated personnel of the Social Security Administration for the purpose of carrying out an effective return processing program in accordance with section 232 of the Social Security Act and pursuant to IRC 6103(l)(5). The authority delegated in this paragraph may not be redelegated.

(17) The Senior Deputy Commissioner, Associate Chief Counsel (International), and Associate Chief Counsel (Litigation) are authorized to disclose or, in specific instances, authorize the disclosure of returns and return information to the designated officers and employees of the Department of Justice pursuant to a written request from the Attorney General, the Deputy Attorney General, or an Assistant Attorney General in a matter involving tax administration, subject to the conditions prescribed in IRC 6103(h)(3)(B). The authority delegated in this paragraph may not be redelegated.

(18) The Assistant Chief Information Officer (Information Systems Management); Assistant Commissioners (Returns Processing); Director, Office of Disclosure; Service Center Directors; Director, Austin Compliance Center, and Director, Martinsburg Computing Center are authorized upon written request to disclose, or in specific instances, authorize the disclosure of return information pursuant to IRC 6103(h)(6) with respect to the address and status of an individual as a nonresident alien, citizen or resident of the United States to the Social Security Administration or the Railroad Retirement Board for purposes of carrying out responsibilities for withholding tax from social security benefits under IRC 1441.

(19) At the request of the Commissioner of Internal Revenue and with the approval of the Joint Committee on Taxation, the following officials may disclose information with respect to a specific taxpayer pursuant to IRC 6103(k)(3): Regional Commissioners; Assistant Commissioner (International); District and Service Center Directors; Director, Austin Compliance Center; Assistant Commissioner (Collection); Assistant Commissioner (Criminal Investigation); Assistant Commissioner (Employee Plans and Exempt Organizations); Director, Office of Disclosure; any individual who is specifically designated by the Commissioner of Internal Revenue. The authority delegated in this paragraph may not be redelegated.

(20) Director, Martinsburg Computing Center; and Director, Office of Disclosure, are authorized to disclose or, in specific instances, to authorize the disclosure of return information from the Information Returns Master File under a contractual agreement entered into pursuant to Delegation Order No. 100, as revised, and the applicable Revenue Procedure to Federal, State, and local agencies administering certain welfare programs, subject to the conditions of IRC 6103(l)(7). Such contractual agreements may be entered into only after coordination with the Office of Disclosure. The authority in this paragraph may be redelegated to any supervisory level deemed appropriate, but only by the officials named above.

(21) The Assistant Commissioner (Returns Processing) and the Director, Office of Disclosure, are authorized to disclose or, in specific instances, to authorize the disclosure of available filing status and taxpayer identity information from the Individual Master File to the Commissioner of Social Security under a contractual agreement entered into pursuant to Delegation Order No. 100, as revised, and subject to the conditions of IRC 6103(l)(12). Such contractual agreements may be entered into only after coordination with the Office of Disclosure. The authority in this paragraph may be redelegated only to the Director, Returns Processing and Accounting Division.

(22) Delegation Order No. 156 (Rev. 11) and Chief Counsel Directives Manual (30)330, effective September 27, 1989 are superseded.

Dated May 25, 1990.

Charles H. Brennan,
Deputy Commissioner (Operations).

Delegation Order No. 159 (Rev. 3) Effective September 17, 1990

Delegation of Authority; Director, Employee Plans Technical and Actuarial Division

AGENCY: Internal Revenue Service, Treasury.

ACTION: Delegation of authority.

SUMMARY: The authority to waive the minimum funding standards under section 412 of the Internal Revenue Code may be further redelegated by Branch Chiefs in the Employee Plans Technical and Actuarial Division to reviewers Grade GS–13 and higher for waivers not exceeding $100,000. The text of the delegation order appears below.

Requests for Variance From Minimum Funding Standards (IRC 412(d))

1. Pursuant to authority vested in the Commissioner of Internal Revenue by Treasury Order 150–10, there is hereby delegated to the Director, Employee Plans Technical and Actuarial Division, the authority to:

a. Waive the minimum funding standards under IRC 412 in accordance with subsection (d) thereof, and

b. perform the corresponding duties of the Secretary of the Treasury under section 303 of the Employee Retirement Income Security Act of 1974 (ERISA) with respect to the minimum funding standards under ERISA section 302.

2. For purposes of this Order, a substantial waiver is a waiver with respect to a plan's minimum funding requirements for a plan year which, based on information reported to the Internal Revenue Service, exceeds one million dollars on a noncumulative basis (that is, exclusive of any amount with respect to which a waiver was requested for a prior plan year of years).

3. The authority contained in paragraph 1 may be redelegated to Branch Chiefs, Employee Plans Technical and Actuarial Division, for such waivers which are not determined substantial as defined in paragraph 2, with authority to further redelegate to reviewers Grade GS–13 and higher for waivers not exceeding $100,000.

4. Delegation Order No. 159 (Rev. 2), effective October 31, 1987, is superseded.

Dated: August 30, 1990.

Approved:

Charles H. Brennan,
Deputy Commissioner (Operations).

(Filed by the Office of the Federal Register on September 19, 1990, 8:45 a.m., and published in the issue of the Federal Register for September 20, 1990, 1990, 55 F.R. 38779)

Delegation Order No. 209 (Rev. 4) Effective September 19, 1990

Delegation of Authority

AGENCY: Internal Revenue Service, Treasury.

SUMMARY: This delegation order extends the authority to execute settlement agreements involving partnership and S corporation affected items to appeals officers at service centers and the Austin Compliance Center. The previous delegation order limited such appeals officers authority to partnership and S corporation items only. In addition, authority to execute consents extending the period for filing a refund suit pursuant to request for administrative adjustment that has been denied by the Service is being redelegated. The text of the delegation order appears below.

EFFECTIVE DATES: September 17, 1990.

Delegation of Authority in Partnership and S Corporation Matters

Pursuant to the authority vested in the Commissioner of Internal Revenue by IRC 6223, 6224, 6228, 6229, 6231(a)(7), 6232, 6243, and 6244, and Treasury Order 150–10:

1. Authority to sign the notice to partners or shareholders at the beginning of an administrative proceeding at the partnership or S corporation level with respect to a partnership or subchapter S item is delegated to revenue agents (grade GS–11 and higher).

2. Authority to sign the notice of final partnership or S corporation administrative adjustment is delegated to:

a. Chiefs and associate chiefs of appeals offices;

b. Appeals team chiefs as to their respective cases;

c. Appeals officers in service centers and the Austin Compliance Center.

d. Revenue agents (reviewers), (grade GS–11 and higher), in Examination Division or in Office of Taxpayer Service and Compliance, Assistant Commissioner (International); and

e. Revenue agents (grade GS–11 and higher) in service center and the Austin Compliance Center.

3. Authority to enter into and approve a written settlement agreement with one or more partners or shareholders with respect to the determination of partnership or subchapter S items and any items affected by such items for such partnership or S corporation taxable year is delegated to:

a. Chiefs and associate chiefs of appeals offices;

b. Appeals team chiefs, as to their respective cases; and

c. Appeals officers in service centers and the Austin Compliance Center but not as to their respective cases;

d. Revenue agents (reviewers), (grade GS–11 and higher), in Examination Division or Office of Taxpayer Service and Compliance, Assistant Commissioner (International); and

e. Revenue agents (grade GS–11 and higher) in service center and the Austin Compliance Center.

4. Authority to designate a Tax Matters Partner with respect to a partnership or a Tax Matters Person for an S Corporation, is delegated to:

a. Chiefs and associated chiefs of appeals offices;

b. Appeals team chiefs as to their respective cases;

c. Group managers in Examination Division.

5. Authority to sign consents fixing the period of limitations on assessment and collection of any tax under subtitle A attributable to any partnership item, subchapter S item (or affected items), or to extend the period filing a civil action for adjustment of partnership items pursuant to IRC 6228, is delegated to:

a. Appeals officers;

b. Appeals team chiefs, as to their respective cases; and

c. The Examination Division as indicated in Delegation Order No. 42, as revised.

6. To the extent that authority previously exercised consistent with this Order may require ratification, it is hereby affirmed and ratified.

The authority delegated herein may not be redelegated.

Delegation Order No. 209 (Rev. 3) (Correction), effective October 31, 1987, is hereby superseded.

Dated: August 31, 1990.

Approved.

Charles H. Brennan,
Deputy Commissioner (Operations).

(Filed by the Office of the Federal Register on October 5, 1990, 8:45 a.m., and published in the issue of the Federal Register for October 9, 1990, 55 F.R. 41154)

Weighted Average Interest Rate Update

Notice 90-43

Notice 88-73 provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of section 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 (OBRA 1987).

The notice also provides that an announcement will be published monthly to provide the weighted average and the permissible range for the plan years beginning each month. The following rates were determined for the plan years beginning each month. The following rates were determined for the plan years beginning in the months shown below.

Month	Year	Weighted Average	Permissible Range
June	1990	8.58	7.72 to 9.43

Administrative Pronouncement

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Like-Kind Exchanges; Additional Rules for Exchanges of Personal Property and for Exchanges of Multiple Properties (Corrections)

Notice 90-44

AGENCY: Internal Revenue Service, Treasury.

ACTION: Correction to Notice of Proposed Rulemaking.

SUMMARY: This document contains corrections to the notice of proposed rulemaking relating to amendments and additions under section 1031 of the Internal Revenue Code of 1986, as amended.

SUPPLEMENTARY INFORMATION:

Background

The notice of proposed rulemaking provided rules for determining the applicability of section 1031 in an exchange of personal property, as well as rules for determining gain recognized and the basis of property received in an exchange of multiple properties under section 1031; and, the treatment of liabilities incurred by the taxpayer in anticipation of an exchange under section 1031 was clarified.

Need for Correction

As published, the notice of proposed rulemaking contains errors which may prove to be misleading and are in need of clarification.

Correction of Publication

Accordingly, the publication of the notice of proposed rulemaking which was the subject of FR Doc. 90-9619, published April 26, 1990, is corrected as follows:

Par. 1. On page 17635, column 3 [1990-21 I.R.B. 9, column 1], in the "DATES" portion of the preamble, the first sentence should read "These proposed regulations are proposed to be effective after publication of the final regulations in the Federal Register."

Par. 2. On page 17638, column 3, in line 6 of §1.1031(a)-2(b)(2) [1990-21 I.R.B. 9], the language "and 00.4 of Rev. Proc. 87-56, 1978-2 C.B." should read "and 00.4 of Rev. Proc. 87-56, 1987-2 C.B.".

Par. 3. On page 17639, column 3, in line 19 of §1.1031(a)-2(c)(1), the language "tangible personal property relates." should read "intangible personal property relates.".

Par. 4. On page 17641, column 1, in line 5 of §1.1031(f)-1(b)(2)(iv), the language "exchange group surplus is the excess of" should read "exchange group deficiency, if any, must be determined. An exchange group surplus is the excess of".

Par. 5. On page 17641, column 2, in line 24 of §1.1031(f)-1(c), the language "accordance with its fair value. The basis" should read "accordance with its fair market value. The basis".

Par. 6. On page 17641, column 3, in line 1 of §1.1031(f)-1(d) Example 2 (i), the language "F exchanges computer F" should read "F exchanges computer A".

Par. 7. On page 17641, column 3, in line 5 of §1.1031(f)-1(d) Example 2 (i), the language "printed B (asset class 00.12) and automobile B" should read "printer B (asset class 00.12) and automobile B".

Par. 8. On page 17643, column 2, in line 3 of §1.1031(f)-1(d) Example 4 (ii)(B), the language "are offset by all liabilities of which R is" should read "are offset by all liabilities of which B is".

Dale D. Goode,
Federal Register Liaison Officer,
Assistant Chief Counsel (Corporate).

(Filed by the Office of the Federal Register on May 30, 1990, 8:45 a.m., and published in the issue of the Federal Register for May 31, 1990, 55 F.R. 22036)

Failure to Comply With Certain Information Reporting Requirements

Notice 90-45

This notice is intended to advise persons required to file information returns of changes made by the Revenue Reconciliation Act of 1989 to the penalties for failure to file information returns on or before the required filing date, and for failure to report correct information on those returns. The notice also advises filers of administrative practices that the Internal Revenue Service will follow with regard to the correction of information returns due during 1990. The new

penalty provisions, which appear in newly revised sections 6721-6724 of the Internal Revenue Code, apply to the widely used forms in the W-2 and 1099 series (except for Forms W-2P and 1099-R), to Form 1098, and to numerous other information returns, as specified in newly revised section 6724(d)(1) of the Code. The new rules are effective for returns the due date for which (determined without regard to extensions) is after December 31, 1989.

In general, the new penalty for failure to file correct information returns is "time sensitive," in that prompt correction of failures to file, or prompt correction of errors on returns that were filed, can lead to reduced penalties. The penalty generally is $50 for each information return that is not filed, or is not filed correctly, by the prescribed filing date, with a maximum penalty of $250,000 per year ($100,000 for certain businesses with average annual gross receipts, over the most recent 3-year period, not in excess of $5,000,000). The penalty generally is reduced to:

—$15 for each failure to comply if the failure is corrected within 30 days after the date the return was due, with a maximum penalty of $75,000 per year ($25,000 for certain businesses with average annual gross receipts, over the most recent 3-year period, not in excess of $5,000,000).

—$30 for each failure to comply if the failure is corrected more than 30 days after the return was due, but on or before August 1 of the calendar year in which the return was due, with a maximum penalty of $150,000 per year ($50,000 for certain businesses with average annual gross receipts, over the most recent 3-year period, not in excess of $5,000,000).

Penalties can be waived if failures were due to reasonable cause and not to willful neglect. In addition, section 6721(c) provides that if (a) information returns have been filed but were filed with incomplete or incorrect information, and (b) the failures are corrected on or before August 1 of the calendar year in which the returns were due, then the penalty will not apply to the greater of 10 returns, or one-half of 1 percent of the total number of information returns required to be filed by the filer during the calendar year.

In the past, the Service has applied an administrative policy providing certain relief from penalties if errors on previously filed information returns were corrected by October 1 of the year in which the returns were due. The Service's instructions for information returns due during calendar year 1990 were printed prior to the amendments to sections 6721-4 and thus advise taxpayers to correct errors by October 1. In view of these instructions, the Service will, for information returns due during 1990, continue to apply this policy by waiving penalties for incorrect information on returns that were previously filed, provided the filer furnishes corrected information, to the office of the Service (or the Social Security Administration) with which the returns were originally filed, by October 1, 1990. However, for information returns due after 1990, this administrative policy will be discontinued.

The Service has not in the past provided, and is not currently providing, automatic waiver, on grounds of correction, of penalties for *failure to file* information returns by the required filing date. Instead, penalties for failure to file are waived only upon a showing that the failure was due to reasonable cause and not to willful neglect.

Estate Tax Marital Deduction—Qualified Terminable Interest Property

Notice 90-46

This Notice extends the procedural relief provided by Notice 89-4, 1989-1 C.B. 624.

The Internal Revenue Service issued Notice 89-4 in response to *Estate of Howard v. Commissioner*, 91 T.C. 329 (1988). In *Howard*, the Tax Court held that a trust does not satisfy the requirements of a qualified terminable interest property (QTIP) trust under section 2056(b)(7) of the Internal Revenue Code unless certain requirements are met. These requirements are satisfied if the trustee is required (1) to distribute the trust income at annual or more frequent intervals and (2) to pay the income accrued between the last distribution date and the surviving spouse's death to the surviving spouse's estate or pursuant to his or her exercise of a general power of appointment.

The Tax Court's opinion is in conflict with section 20.2056(b)-7(c)(1) of the proposed Estate Tax Regulations. Because taxpayers and their representatives were concerned that the Service might abandon the position reflected in the proposed regulations and deny the marital deduction with respect to property passing to a trust that did not meet the requirements set forth by the Tax Court, the Service in Notice 89-4 set forth an interim settlement procedure available with respect to any trust that presented the issue addressed in *Howard* but otherwise met the requirements of section 2056(b)(7) or 2523(f)(2) of the Code. Under the procedure, the Service and the persons having an interest in the trust could formally acknowledge that the marital deduction is allowable for the property passing to the trust and that the spouse's interest in the trust is a "qualifying income interest for life" for purposes of sections 2044 and 2519.

Under Notice 89-4 the settlement procedure was made available with respect to any transfer in trust for which the applicable period of limitations remained open, including a transfer reported on a return that is the subject of a closing letter issued by the District Director. It was made available with respect to any transfer until the later of December 31, 1989, or ninety days after the date the District Director gave the taxpayer written notice of the availability of the procedure. Under the present notice, the period for which the settlement procedure is available is extended and will remain available with respect to any such transfer for which a properly prepared closing agreement is submitted by the taxpayer on or before December 31, 1990.

In cases where the return has not yet been filed, the taxpayer may initiate the procedure by filing a proposed closing agreement with the estate tax or gift tax return. Provided that the trust otherwise meets the requirements of section 2056(b)(7) or 2523(f)(2) of the Code, the filing with the estate tax or gift tax return of the proposed closing agreement (if

signed by all persons having an interest in the trust) will ensure that the marital deduction will not be disallowed on the basis that the surviving spouse does not have a right to accrued but undistributed income at death.

In other cases, a closing agreement may be executed in connection with the examination of the return on which the transfer is reported. In the case of a return that was previously examined or was filed and has not yet been examined, either the Service or the taxpayer may initiate the settlement procedure.

The provisions of Notice 89-4 continue to apply with respect to the interim settlement procedure for the extended period provided in this Notice.

Tax on Certain Imported Substances; Notice of Determination

Notice 90-47

SUMMARY: This notice announces a determination, under Notice 89-61, 1989-1 C.B. 717, that the list of taxable substances in section 4672(a)(3) of the Internal Revenue Code will be modified to include *linear alpha olefins* and *polyalphaolefins*.

EFFECTIVE DATE: This modification is effective as of April 1, 1990.

SUPPLEMENTARY INFORMATION:

Background

Under section 4672(a) of the Internal Revenue Code, an importer or exporter of any substance may request that the secretary determine whether such substance should be listed as a taxable substance. The Secretary shall add such substance to the list of taxable substances in section 4672(a)(3) if the Secretary determines that taxable chemicals constitute more than 50 percent of the weight, or more than 50 percent of the value, of the materials used to produce such substance. This determination is to be made on the basis of the predominant method of production. Notice 89-61, 1989-1 C.B. 717, sets forth the rules relating to the determination process.

Determination

On December 26, 1989, the Secretary determined that linear alpha olefins and polyalphaolefins should be added to the list of taxable substances in section 4672(a)(3) of the Internal Revenue Code, effective as of April 1, 1990.

The petitions to add linear alpha olefins and polyalphaolefins were submitted by Ethyl Corporation, a manufacturer and exporter of these substances. No material comments were received on these petitions.

Linear Alpha Olefins

Linear alpha olefins have been determined to be a taxable substance because a review of the stoichiometric material consumption formula shows that, based on the predominant method of production, taxable chemicals constitute 100 percent by weight of the materials used in its production.

HTS number: 2901.29.10.10
Schedule B number: 2901.29.1010
CAS number: variable

Linear alpha olefins are clear liquids derived from the taxable chemical *ethylene*. The predominant method of producing linear alpha olefins is via the catalytic chain growth of ethylene.

The stoichiometric material consumption formula for this substance is:

$n/2\ C_2H_4 \dashrightarrow C_nH_{2n}$
ethylene linear alpha olefin

The rate of tax prescribed for this substance, under section 4671(b)(3), is $4.87 per ton. This is based upon a conversion factor for ethylene of 1.00.

Polyalphaolefins

Polyalphaolefins have been determined to be a taxable substance because a review of the stoichiometric material consumption formula shows that, based on the predominant method of production, taxable chemicals constitute 99.6 percent by weight of the materials used in its production.

HTS number: 3902.90.00.50
Schedule B number: 3902.90.0050
CAS number: variable

Polyalphaolefins are clear liquids derived from the taxable chemical *ethylene*. The predominant method of producing polyalphaolefins is by oligomerization of decene-1, a linear alpha olefin.

The stoichiometric material consumption formula for this substance is:

$n/2\ C_2H_4 + H_2 \longrightarrow C_nH_{2n+2}$
ethylene hydrogen polyalphaolefin

The rate of tax prescribed for this substance, under section 4671(b)(3), is $4.85 per ton. This is based upon a conversion factor for ethylene of 0.9961.

Dale D. Goode,
Federal Register Liaison Officer,
Assistant Chief Counsel (Corporate).

(Filed by the Office of the Federal Register on June 12, 1990, 8:45 a.m., and published in the issue of the Federal Register for June 13, 1990, 55 F.R. 24023)

Tax on Certain Imported Substances; Notice of Determination

Notice 90-48

SUMMARY: This notice announces a determination, under Notice 89-61, 1989-1 C.B. 717, that the list of taxable substances in section 4672(a)(3) of the Internal Revenue Code will be modified to include *polyethylene terephthalate pellets*.

EFFECTIVE DATE: This modification is effective as of April 1, 1990.

SUPPLEMENTARY INFORMATION:

Background

Under section 4672(a) of the Internal Revenue Code, an importer or exporter of any substance may request that the Secretary determine whether such substance should be listed as a taxable substance. The Secretary shall add such substance to the list of taxable substances in section 4672(a)(3) if the Secretary determines that taxable chemicals constitute more than 50 percent of the weight, or more than 50 percent of the value, of the materials used to produce such substance. This determination is to be made on the basis of the predominant method of production. Notice 89-61, 1989-1 C.B. 717, sets forth the rules relating to the determination process.

Determination

On December 26, 1989, the Secretary determined that polyethylene terephthalate pellets should be added to the list of taxable substances in section 4672(a)(3) of the Internal Revenue Code, effective as of April 1, 1990.

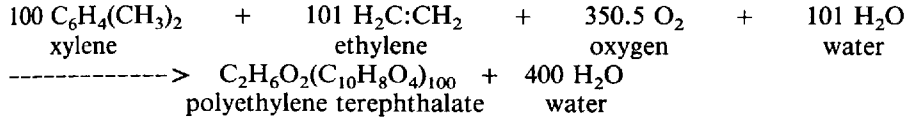
The petition to add polyethylene terephthalate was submitted by Eastman Chemicals Division, Eastman Kodak Company, a manufacturer and exporter of this substance. No material comments were received on this petition.

Polyethylene terephthalate has been determined to be a taxable substance because a review of its stoichiometric material consumption formula shows that, based on the predominant method of production, taxable chemicals constitute 50.8 percent by weight of the materials used in its production.

HTS number:	3907.60.00
Schedule B number:	3907.60.0000
CAS number:	25038-59-9

Polyethylene terephthalate, a semicrystalline solid, is derived from the taxable chemicals *xylene* and *ethylene*. The predominant method of producing polyethylene terephthalate involves reacting terephthalic acid with ethylene glycol. Terephthalic acid is produced by the air oxidation of p-xylene, and ethylene glycol is produced by reaction of ethylene with oxygen and water.

The stoichiometric material consumption formula for this substance is:



The rate of tax prescribed for this substance, under section 4671(b)(3), is $6.30 per ton. This is based upon a conversion factor for xylene of 0.5507 and a conversion factor for ethylene of 0.1470.

Dale D. Goode,
Federal Register Liaison Officer,
Assistant Chief Counsel (Corporate).

(Filed by the Office of the Federal Register on June 12, 1990, 8:45 a.m., and published in the issue of the Federal Register for June 13, 1990, 55 F.R. 24023)

Privacy Act; Computer Matching Programs

Notice 90-49

AGENCY: Internal Revenue Service; Treasury Department.

ACTION: Notice.

SUMMARY: Pursuant to the Computer Matching and Privacy Protection Act of 1988, Public Law 100-503, October 18, 1988, and the Office of Management and Budget (OMB) Guidelines on the Conduct of Matching Programs, notice is hereby given of the conduct of Internal Revenue Service's computer matching programs. In accordance with various provisions of section 6103 of the Internal Revenue Code of 1986, the computer matching programs provide Federal, State, and local agencies with tax information from IRS records to assist them in administering the programs and activities described hereafter. The matching programs substantially prevent or reduce fraud and abuse in certain government programs and facilitate the settlement of government claims while protecting the privacy interest of the subjects of the match.

EFFECTIVE DATE: July 27, 1990.

ADDRESSES: Inquiries may be mailed to Director, Office of Disclosure, Internal Revenue Service, P.O. Box 388, Washington, DC 20044.

SUPPLEMENTARY INFORMATION: The nature, purposes, and authorities for IRS computer matching programs are as follows:

Matches Conducted Pursuant to IRC 6103(l)(3)

Upon written request, the Service may disclose to the head of a Federal agency, which makes, guarantees, or insures certain Federal loans, whether an applicant for such a loan has a tax delinquent account.

The disclosure of a Tax Delinquent Account Status Indicator under IRC 6103(l)(3) is made only for the purpose of, and to the extent necessary in, determining the creditworthiness of the applicant for the loan in question. The information provided is extracted monthly from the Internal Revenue Service Individual Master File (Treas./IRS System 24.030 (IMF)) located at the Internal Revenue Service, Martinsburg Computing Center (MCC), in Martinsburg, West Virginia. The IMF contains tax accounts of individuals.

There are currently no (l)(3) matching agreements in effect.

Matches Conducted Pursuant to IRC 6103(l)(7)

The Service is required, upon written request, to disclose current information from returns with respect to unearned income to any Federal, State, or local agency administering certain federally approved programs to provide:

(a) Aid to Families with Dependent Children;

(b) Medical assistance;

(c) Supplemental Security Income benefits;

(d) Social security benefits;

(e) Unemployment compensation;

(f) Food Stamps; or

(g) State administered supplementary payments.

Information is disclosed by the Service only for the purpose of, and to the extent necessary in, determining eligibility for, or the correct amount of, benefits under the aforementioned programs.

The return information is extracted on a monthly basis from the Internal Revenue Service Wage and Information Returns Processing File (Treas./IRS System 22.061 (IRP)) for the latest processing year. This file contains information returns filed by payers of income such as interest and dividends reported on Forms 1099-INT and 1099-DIV.

Federal agencies participating in (l)(7) matches are the Social Security Administration and Health Care Financing Administration.

Matches Conducted Pursuant to IRC 6103(l)(12)

The Service shall, upon written request from the Commissioner of Social Security (SSA), disclose to SSA available filing status and taxpayer identity information from the IMF (Treas./IRS System 24.030) relating to whether any medicare beneficiary

identified by SSA was a married individual for any specified year after 1986, and, if so, the name of the spouse of such individual and such spouse's TIN, but only for purposes of, and to the extent necessary in, determining the extent to which any medicare beneficiary is covered under any group health plan. This section provides further for the redisclosure of certain taxpayer identity information by SSA to Health Care Financing Administration (HCFA) upon the written request of the Administrator of HCFA. With respect to the information redisclosed by the Commissioner of SSA, the Administrator of HCFA may further disclose said information to certain qualified employers and group health plans.

The information provided is extracted monthly from the IMF.

The Federal agencies participating in (l)(12) computer matches are SSA and HCFA.

Matches Conducted Pursuant to IRC 6103(m)(2)

The Service may, upon written request, disclose the mailing address of a taxpayer for use by officers, employees, or agents of a Federal agency for purposes of locating such taxpayer to collect or compromise a Federal claim against the taxpayer in accordance with sections 3711, 3717, and 3718 of title 31 of the United States Code. This section also provides for the redisclosure of a taxpayer's mailing address to a consumer reporting agency, but only to allow for the preparation of a commercial credit report on the taxpayer for use by the requesting Federal agency in accordance with the Federal Claims Collection Act of 1966, as amended by the Debt Collection Act of 1982.

The information provided is extracted monthly from the IMF (Treas./IRS System 24.030).

Federal agencies participating in (m)(2) matches are:

Army & Air Force Exchange Service (AAFES)
Army Finance & Accounting Center (AFAC)
Equal Employment Opportunity Commission (EEOC)
Health Resources & Services Administration (HRSA)
Health Care Financing Administration (HCFA)
Housing & Urban Development (HUD)
Marine Corps Finance Center (MCFC)
National Institutes of Health (NIH)
Navy Finance Center (NFC)
Navy Resale & Services Support Office (NRSSO)
Public Health Service (PHS)
Railroad Retirement Board (RRB)
Social Security Administration (SSA)
U.S. Army Community & Family Support Center (ACFSC)
U.S. Coast Guard (USCG)
Department of Education (ED)
Department of Health & Human Services (HHS)
Department of Justice—Civil Division (DOJ)
Department of State (DOS)
Department of Veterans Affairs (VA)

Matches Conducted Pursuant to IRC 6103(m)(4)

Upon written request from the Secretary of Education, the Service may disclose the mailing address of any taxpayer who has defaulted on certain loans extended under the Higher Education Act or Migration and Refugee Assistance Act for purposes of locating such taxpayer to collect the loan. This section further provides for the redisclosure by the Secretary of Education of a taxpayer's mailing address to any lender, or any State or nonprofit guarantee agency, participating under the Higher Education Act, or any educational institution with which the Secretary of Education has an agreement under that Act.

Redisclosure is made by the Secretary of Education for use only by officers, employees, or agents of such lender, guarantee agency, or institution whose duties relate to the collection of student loans for purposes of locating individuals who have defaulted on student loans made under such loan programs for purposes of collecting such loans.

The information provided is extracted monthly from the IMF (Treas./IRS System 24.030).

The U.S. Department of Education participates in (m)(4) computer matches.

Matches Conducted Under IRC 6103(m)(5)

Upon written request from the Secretary of Health and Human Services (HHS), the Service may disclose the mailing address of any taxpayer who has defaulted on certain loans extended under the Public Health Service Act for purposes of locating such taxpayer to collect the loan. This section also provides for the redisclosure by the Secretary of HHS of a taxpayer's mailing address to any school with which the Secretary has an agreement under the Public Health Service Act, or any eligible lender participating under such Act.

Redisclosure is made by the Secretary of HHS for use only by officers, employees, or agents of such school or eligible lender whose duties relate to the collection of student loans for purposes of locating individuals who have defaulted on student loans made under the Public Health Service Act for the purposes of collecting such loans.

The information provided is extracted monthly from the IMF (Treas./IRS System 24.030).

The Department of Health & Human Services participates in (m)(5) computer matches.

Approval of the IRS computer matching programs was granted by the Treasury Data Integrity Board on June 7, 1989.

Fred T. Goldberg, Jr.,
Commissioner of Internal Revenue.

Approved:

Linda M. Combs,
Assistant Secretary of the Treasury (Management).

(Filed by the Office of the Federal Register on June 26, 1990, 8:45 a.m., and published in the issue of the Federal Register for June 27, 1990, 55 F.R. 26327)

Tax on Certain Imported Substances; Notice of Determination

Notice 90-50

SUMMARY: This notice announces a determination, under Notice 89-61, 1989-1 C.B. 717, that the list of taxable substances in section 4672(a)-(3) of the Internal Revenue Code will be modified to include *butyl acrylate, methyl acrylate, ethyl acrylate,* and *2-ethylhexyl acrylate.*

EFFECTIVE DATE: This modification is effective as of July 1, 1990.

SUPPLEMENTARY INFORMATION:

Background

Under section 4672(a) of the Internal Revenue Code, an importer or exporter of any substance may request that the Secretary determine whether such substance should be listed as a taxable substance. The Secretary shall add such substance to the list of taxable substances in section 4672(a)(3) if the Secretary determines that taxable chemicals constitute more than 50 percent of the weight, or more than 50 percent of the value, of the materials used to produce such substance. This determination is to be made on the basis of the predominant method of production. Notice 89-61, 1989-1 C.B. 717, sets forth the rules relating to the determination process.

Determination

On March 5, 1990, the Secretary determined that butyl acrylate, methyl acrylate, ethyl acrylate, and 2-ethylhexyl acrylate should be added to the list of taxable substances in section 4672(a)(3) of the Internal Revenue Code, effective as of July 1, 1990.

The petitions to add butyl acrylate, methyl acrylate, ethyl acrylate, and 2-ethylhexyl acrylate were submitted by Hoechst Celanese, a manufacturer and exporter of these substances. No material comments were received on these petitions.

Butyl Acrylate

Butyl acrylate has been determined to be a taxable substance because a review of its stoichiometric material consumption formula shows that, based on the predominant method of production, taxable chemicals constitute 67.6 percent by weight of the materials used in its production.

HTS number:	2916.12.50.30
Schedule B number:	2916.12.5030
CAS number:	141-32-2

Butyl acrylate, a liquid, is derived from the taxable chemicals *propylene* and *methane*. The predominant method of producing butyl acrylate is by esterification of acrylic acid with butanol. Acrylic acid is produced by oxidation of propylene. Butanol is produced from propylene using the vapor phase technology.

The stoichiometric material consumption formula for this substance is:

$$2\ C_3H_6 + 1.5\ O_2 + CH_4 \text{ -----> } CH_2CHCOOC_4H_9 + H_2 + H_2O$$

propylene oxygen methane; butyl acrylate hydrogen water

The rate of tax prescribed for this substance, under section 4671(b)(3), is $4.38 per ton. This is based upon a conversion factor for propylene of 0.7841 and a conversion factor for methane of 0.162.

Methyl Acrylate

Methyl acrylate has been determined to be a taxable substance because a review of its stoichiometric material consumption formula shows that, based on the predominant method of production, taxable chemicals constitute 54.7 percent by weight of the materials used in its production.

HTS number:	2916.12.50.20
Schedule B number:	2916.12.5020
CAS number:	96-33-3

Methyl acrylate, a liquid, is derived from the taxable chemicals *propylene* and *methane*. The predominant method of producing methyl acrylate is by esterification of acrylic acid with methanol. Acrylic acid is produced by oxidation of propylene. Methanol is obtained by steam reforming natural gas.

The stoichiometric material consumption formula for this substance is:

$$C_3H_6 + 1.5\ O_2 + CH_4 \text{ -----> } CH_2CHCOOCH_3 + H_2 + H_2O$$

propylene oxygen methane; methyl acrylate hydrogen water

The rate of tax prescribed for this substance, under section 4671(b)(3), is $4.29 per ton. This is based upon a conversion factor for propylene of 0.5534 and a conversion factor for methane of 0.463.

Ethyl Acrylate

Ethyl acrylate has been determined to be a taxable substance because a review of its stoichiometric material consumption formula shows that, based on the predominant method of production, taxable chemicals constitute 59.3 percent by weight of the materials used in its production.

HTS number:	2916.12.50.10
Schedule B number:	2916.12.5010
CAS number:	140-88-5

Ethyl acrylate, a liquid, is derived from the taxable chemicals *propylene* and *ethylene*. The predominant method of producing ethyl acrylate is by esterification of acrylic acid with ethanol. Acrylic acid is produced by oxidation of propylene. Ethanol is produced from ethylene.

The stoichiometric material consumption formula for this substance is:

$$C_3H_6 + 1.5\ O_2 + C_2H_4 \text{ -----> } CH_2CHCOOCH_2CH_3 + H_2O$$

propylene oxygen ethylene; ethyl acrylate water

The rate of tax prescribed for this substance, under section 4671(b)(3), is $3.85 per ton. This is based upon a conversion factor for propylene of 0.4861 and a conversion factor for ethylene of 0.3039.

2-Ethylhexyl Acrylate

2-ethylhexyl acrylate has been determined to be a taxable substance because a review of its stoichiometric material consumption formula shows that, based on the predominant method of production, taxable chemicals constitute 76.7 percent by weight of the materials used in its production.

HTS number:	2916.12.50.40
Schedule B number:	2916.12.5040
CAS number:	103-11-7

2-ethylhexyl acrylate, a liquid, is derived from the taxable chemicals *propylene* and *methane*. The predominant method of producing 2-ethylhexyl acrylate is by direct esterification of acrylic acid with 2-ethylhexanol in the presence of sulfuric acid. Acrylic acid is obtained from propylene by two stage oxidation. 2-ethylhexanol is produced from propylene, using n-butyraldehyde as an intermediary.

The stoichiometric material consumption formula for this substance is:

$$3\ C_3H_6 + 1.5\ O_2 + 2\ CH_4 \text{ -----> } CH_2CHCOOCH_2CHC_2H_5C_4H_9 + H_2O + 2\ H_2$$

propylene oxygen methane; 2-ethylhexyl acrylate water hydrogen

The rate of tax prescribed for this substance, under section 4671(b)(3), is $5.08 per ton. This is based upon a conversion factor for propylene of 0.8741 and a conversion factor for methane of 0.2376.

Dale D. Goode,
Federal Register Liaison Officer,
Assistant Chief Counsel (Corporate).

(Filed by the Office of the Federal Register on June 21, 1990, 8:45 a.m., and published in the issue of the Federal Register for June 22, 1990, 55 F.R. 25768)

Tax on Certain Imported Substances; Notice of Determination

Notice 90-51

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice.

SUMMARY: This notice announces a determination, under Notice 89-61, 1989-1 C.B. 717, that the list of taxable substances in section 4672(a)-(3) of the Internal Revenue Code will be modified to include *vinyl acetate, normal propyl acetate, isopropyl acetate, normal butyl acetate,* and *isobutyl acetate.*

EFFECTIVE DATE: This modification is effective as of July 1, 1990.

SUPPLEMENTARY INFORMATION:

Background

Under section 4672(a) of the Internal Revenue Code, an importer or exporter of any substance may request that the Secretary determine whether such substance should be listed as a taxable substance. The Secretary shall add such substance to the list of taxable substances in section 4672(a)(3) if the Secretary determines that taxable chemicals constitute more than 50 percent of the weight, or more than 50 percent of the value, of the materials used to produce such substance. This determination is to be made on the basis of the predominant method of production. Notice 89-61, 1989-1 C.B. 717, sets forth the rules relating to the determination process.

Determination

On March 5, 1990, the Secretary determined that vinyl acetate, normal propyl acetate, isopropyl acetate, normal butyl acetate, and isobutyl acetate should be added to the list of taxable substances in section 4672(a)-(3) of the Internal Revenue Code, effective as of July 1, 1990.

The petitions to add vinyl acetate, normal propyl acetate, isopropyl acetate, normal butyl acetate, and isobutyl acetate were submitted by Hoechst Celanese, a manufacturer and exporter of these substances. No material comments were received on these petitions.

Vinyl acetate

Vinyl acetate has been determined to be a taxable substance because a review of its stoichiometric material consumption formula shows that, based on the predominant method of production, taxable chemicals constitute 63.8 percent by weight of the materials used in its production.

HTS number: 2915.32.00
Schedule B number: 2915.32.0000
CAS number: 108-05-4

Vinyl acetate, a liquid, is derived from the taxable chemicals *ethylene* and *methane.* The predominant method of producing vinyl acetate is by oxyacetylation of ethylene with oxygen and acetic acid. Acetic acid is made by carbonylation of methanol.

The stoichiometric material consumption formula for this substance is:

$$\underset{\text{ethylene}}{C_2H_4} + \underset{\text{methane}}{2\,CH_4} + \underset{\text{water}}{H_2O} + \underset{\text{oxygen}}{\tfrac{1}{2}\,O_2} \text{-----} > \underset{\text{vinyl acetate}}{CH_3COOHCH_2} + \underset{\text{hydrogen}}{4\,H_2}$$

The rate of tax prescribed for this substance, under section 4671(b)(3), is $2.72 per ton. This is based upon a conversion factor for ethylene of 0.3669 and a conversion factor for methane of 0.2695.

Normal Propyl Acetate

Normal propyl acetate has been determined to be a taxable substance because a review of its stoichiometric material consumption formula shows that, based on the predominant method of production, taxable chemicals constitute 67.9 percent by weight of the materials used in its production.

HTS number: 2915.39.45.10
Schedule B number: 2915.39.4510
CAS number: 109-60-4

Normal propyl acetate, a liquid, is derived from the taxable chemicals *ethylene* and *methane.* The predominant method of producing normal propyl acetate is by esterifying normal propyl alcohol with acetic acid. Normal propyl alcohol is produced by the hydrogenation of propionaldehyde. Propionaldehyde is produced by the oxo reaction of ethylene with synthesis gas. Acetic acid is made by carbonylation of methanol. Both carbon monoxide and methanol are produced from methane.

The stoichiometric material consumption formula for this substance is:

$$\underset{\text{ethylene}}{C_2H_4} + \underset{\text{methane}}{3\,CH_4} + \underset{\text{water}}{2\,H_2O} \text{-----} > \underset{\text{n-propyl acetate}}{CH_3COOC_3H_7} + \underset{\text{hydrogen}}{5\,H_2}$$

The rate of tax prescribed for this substance, under section 4671(b)(3), is $2.26 per ton. This is based upon a conversion factor for ethylene of 0.3148 and a conversion factor for methane of 0.2117.

Isopropyl Acetate

Isopropyl acetate has been determined to be a taxable substance because a review of its stoichiometric material consumption formula shows that, based on the predominant method of production, taxable chemicals constitute 67.9 percent by weight of the materials used in its production.

HTS number: 2915.39.50.00
Schedule B number: 2915.39.6000
CAS number: 108-21-4

Isopropyl acetate, a liquid, is derived from the taxable chemicals *ethylene* and *methane.* The predominant method of producing isopropyl acetate is by esterifying isopropyl alcohol with acetic acid. Isopropyl alcohol is produced by the hydrogenation of propionaldehyde. Propionaldehyde is produced by the oxo reaction of ethylene with synthesis gas. Acetic acid is made by carbonylation of methanol. Both carbon monoxide and methanol are produced from methane.

The stoichiometric material consumption formula for this substance is:

$$\underset{\text{ethylene}}{C_2H_4} + \underset{\text{methane}}{3\,CH_4} + \underset{\text{water}}{2\,H_2O} \text{-----} > \underset{\text{isopropyl acetate}}{CH_3COOC_3H_7} + \underset{\text{hydrogen}}{5\,H_2}$$

The rate of tax prescribed for this substance, under section 4671(b)(3), is $2.34 per ton. This is based upon a conversion factor for ethylene of 0.326 and a conversion factor for methane of 0.2173.

Normal Butyl Acetate

Normal butyl acetate has been determined to be a taxable substance because a review of its stoichiometric material consumption formula shows that, based on the predominant method of production, taxable chemicals constitute 71.4 percent by weight of the materials used in its production.

HTS number:	2915.33.00
Schedule B number:	2915.33.0000
CAS number:	123-86-4

Normal butyl acetate, a liquid, is derived from the taxable chemicals *propylene* and *methane*. The predominant method of producing normal butyl acetate is by esterifying normal butyl alcohol with acetic acid. Butyl alcohol is produced by the hydrogenation of butyraldehyde. Butyraldehyde is produced by the oxo reaction of propylene with synthesis gas. Acetic acid is made by carbonylation of methanol. Both carbon monoxide and methanol are produced from methane.

The stoichiometric material consumption formula for this substance is:

C_3H_6 + 3 CH_4 + 2 H_2O
propylene methane water

-----> $CH_3COOC_4H_9$ + 5 H_2
n-butyl acetate hydrogen

The rate of tax prescribed for this substance, under section 4671(b)(3), is $2.72 per ton. This is based upon a conversion factor for propylene of 0.4242 and a conversion factor for methane of 0.1881.

Isobutyl Acetate

Isobutyl acetate has been determined to be a taxable substance because a review of its stoichiometric material consumption formula shows that, based on the predominant method of production, taxable chemicals constitute 71.4 percent by weight of the materials used in its production.

HTS number:	2915.34.00
Schedule B number:	2915.34.0000
CAS number:	110-19-0

Isobutyl acetate, a liquid, is derived from the taxable chemicals *propylene* and *methane*. The predominant method of producing isobutyl acetate is by esterifying isobutyl alcohol with acetic acid. Butyl alcohol is produced by the hydrogenation of butyraldehyde. Butyraldehyde is produced by the oxo reaction of propylene with synthesis gas. Acetic acid is made by carbonylation of methanol. Both carbon monoxide and methanol are produced from methane.

The stoichiometric material consumption formula for this substance is:

C_3H_6 + 3 CH_4 + 2 H_2O
propylene methane water

-----> $CH_3COOC_4H_9$ + 5 H_2
isobutyl acetate hydrogen

The rate of tax prescribed for this substance, under section 4671(b)(3), is $2.86 per ton. This is based upon a conversion factor for propylene of 0.4524 and a conversion factor for methane of 0.1920.

Dale D. Goode,
Federal Register Liaison Officer,
Assistant Chief Counsel (Corporate).

(Filed by the office of the Federal Register on June 21, 1990, 8:45 a.m., and published in the issue of the Federal Register for June 22, 1990, 55 F.R. 25770)

Weighted Average Interest Rate Update

Notice 90-52

Notice 88-73 provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of section 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 (OBRA 1987).

The notice also provides that an announcement will be published monthly to provide the weighted average and the permissible range for the plan years beginning each month. The following rates were determined for the plan years beginning each month. The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	Permissible Range
July	1990	8.58	7.72 to 9.44

Administrative Pronouncement

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

List of Countries Requiring Cooperation with an International Boycott

Notice 90-53

In order to comply with the mandate of section 999(a)(3) of the Internal Revenue Code of 1986, the Department of the Treasury is publishing a current list of countries which may require participation in, or cooperation with, an international boycott (within the meaning of section 999(b)(3) of the Internal Revenue Code of 1986). The list differs from the prior quarterly list published in the Federal Register. The list reflects the recent union of the Arab Republic of Yemen and the Peoples Democratic Republic of Yemen, the new state being named the Republic of Yemen.

On the basis of the best information currently available to the Department of the Treasury, the following countries may require participation in, or cooperation with, an international boycott (within the meaning of section 999(b)(3) of the Internal Revenue Code of 1986).

Bahrain
Iraq
Jordan
Kuwait
Lebanon
Libya
Oman
Qatar
Saudi Arabia
Syria
United Arab Emirates
Yemen, Republic of

Dated: July 18, 1990.

Kenneth W. Gideon,
Assistant Secretary for Tax Policy.

(Filed by the Office of the Federal Register on July 24, 1990, 8:45 a.m., and published in the issue of the Federal Register for July 25, 1990, 55 F.R. 30363)

Income Limits Released by HUD

Notice 90-54

Rev. Rul. 89-24, 1989-1 C.B. 24, provides the manner in which to compute the income limits that are applicable both to exempt facility bonds issued to provide for qualified residential rental projects under section 142 of the Internal Revenue Code and to low-income housing credits under section 42. These income limits are computed by reference to income limits that are computed and listed, according to family size, by the Department of Housing and Urban Development (HUD). Rev. Rul. 89-24 provides that a list of income limits released by HUD may be relied upon until 30 days after the Internal Revenue Service publishes an announcement or notice in the Internal Revenue Bulletin indicating that HUD has released updated income limits.

On February 16, 1990, HUD released new income limits for every Metropolitan Statistical Unit, Primary Metropolitan Statistical Unit, and nonmetropolitan county of the United States, Puerto Rico, Guam, and the Virgin Islands. These new income limits must be used after September 26, 1990, for purposes of computing the income limits under sections 142(d) and 42 of the Code.

Designation of Foreign Countries Pursuant to Section 1.163-5(c)(2)(i)(D)(3)(*iii*)(*F*) of the Regulations

Notice 90-55

Section 163(f) of the Internal Revenue Code of 1986 provides that the issuer shall be denied a deduction for interest on any registration-required obligation that is not in registered form. Section 163(f)(2)(A)(iv) provides that the term "registration-required obligation" does not include an obligation described in section 163(f)(2)(B). Under section 163(f)(2)-B)(i), an obligation will not be considered to be described in section 163(f)(2)(B) unless "there are arrangements reasonably designed to insure that such obligation will be sold (or resold in connection with the original issue) only to a person who is not a United States person".

Section 1.163-5(c)(2)(i) of the regulations provides that an obligation will be considered to satisfy the requirement of "reasonable arrangements" if the provisions of paragraph (c)(2)(i)(D) of that section are met in connection with the original issuance of the obligation. In general, section 1.163-5(c)(2)(i)(D) applies to obligations issued after September 7, 1990. Under section 1.163-5(c)(2)(i)(D)(*3*), a certificate regarding the ownership of the obligation must generally be provided to the issuer. Certain obligations are exempted from the certification requirement. Those obligations must satisfy the conditions listed in section 1.163-5(c)(2)(i)(D)(*3*)(*iii*). Among these conditions is subdivision (F), which requires that the Commissioner designate the foreign country as a foreign country in which certification is not permissible.

The Federal Republic of Germany and the Swiss Confederation are hereby designated as foreign countries in which certification is not permissible for purposes of section 1.163-5(c)(2)-(i)(D)(*3*)(*iii*)(*F*) of the regulations.

This notice is effective in general for obligations originally issued after September 7, 1990, This notice also applies to an issuer making the election to apply the rules of section 1.163-5(c)(2)(i)(D) of the regulations to an obligation originally issued after May 10, 1990, pursuant to sections 1.163-5(c)(3)(ii) of the regulations.

Service May Require an Alternative Method of Basis Recovery with Respect to Installment Obligations Where Basis Is Inappropriately Deferred

Notice 90-56

The Internal Revenue Service understands that some taxpayers have entered into transactions with respect to which the installment sales rules under section 453(c) of the Internal Revenue Code are being interpreted to permit the creation of artificial gain and a corresponding artificial deferred loss. In this connection, the Service plans to amend the regulations under section 15A.453-1(c)(7) to clarify that the Service may require an alternative method of basis recovery with respect to installment obligations where basis is inappropriately deferred.

The Service will examine these transactions to determine whether they lack economic substance or are entered into for tax avoidance purposes. Depending on the facts and circumstances, it may be determined that (i) the deferred basis treatment of the regulations does not apply; (ii) an accounting method has been used that does not clearly reflect income; or (iii) other aspects of the transaction preclude the tax treatment intended by the parties. In cases in which the transaction occurs in the partnership context, the Service may determine, among other things, that a true partnership has not been formed, that one or more of the purported partners should not be treated as a partner for tax purposes, or that the partnership allocations do not meet the requirements of section 704(b) of the Code.

Separate Line of Business; Notification Requirement

Notice 90-57

The purpose of this notice is to inform plan sponsors that wish to apply the separate line of business rules under section 414(r) of the Code that notification of the Secretary, as provided by Code section 414(r)-(2)(B), is not required until further guidance is issued.

Section 414(r) of the Code provides rules for determining whether an employer operates separate lines of business for purposes of applying sections 129(d)(8) (relating to dependent care assistance programs), 401(a)(26) (relating to additional participation rules) and 410(b) (relating to minimum coverage). Section 414(r)(2) requires that (A) a line of business have at least 50 employees who are not excluded under section 414(q)(8) of the Code, (B) the employer notify the Secretary that the employer intends to treat the line of business as separate, and (C) the line of business satisfies either the safe harbor rule of section 414(r)(3) or the guidelines prescribed by the Secretary, or the employer receives a determination from the Secretary that, even though the line of business does not satisfy the safe harbor rule or the guidelines, the employer is nonetheless permitted to treat the line of business as separate under section 414(r).

Section 204 of the Public Debt Limit Increase (Public Law 101-140, enacted November 8, 1989) provides that for plan years beginning before the Secretary of the Treasury or his delegate issues guidelines and begins issuing determinations under section 414(r)(2)(C), an employer is treated as operating separate lines of business if the employer reasonably determines that it meets the applicable requirements of the Code (other than section 414(r)(2)(C)).

Pursuant to this notice, an employer will not currently be required to notify the Secretary that it intends to treat a line of business as separate under section 414(r) until further guidance is issued. Subsequent guidance, however, may require notification by the employer of its application of the separate line of business rules for periods prior to the issuance of such subsequent guidance.

EFFECTIVE DATE

This notice is effective for plan years beginning after December 31, 1988.

Continuation of Employer Health Coverage For Activated Reservists and Their Families

Notice 90-58

The calling up of military reservists to active duty during the current crisis in the Mideast has prompted a large number of inquiries about continuing health coverage for reservists and their families. This notice addresses the voluntary maintenance of group health plan coverage by employers and the COBRA continuation coverage requirements in section 4980B of the Internal Revenue Code. Group health plans that are subject to those requirements must give certain individuals an opportunity to continue coverage at their own expense.

May an employer voluntarily maintain coverage?

Yes. The Internal Revenue Service is aware that many employers will voluntarily maintain full coverage under their group health plans for reservists and their families, with no increase in employee contributions. These plans will not have to offer the reservists or their family members a COBRA election. In addition, employer contributions for the cost of that coverage will continue to be excludible from the gross income of the reservists under section 106 of the Code.

What if an employer does not voluntarily maintain coverage?

If an employer does not voluntarily maintain coverage for the period contemplated in section 4980B and the group health plan is otherwise subject to the requirements of that section, there is a "qualifying event" for COBRA purposes. In these situations, section 4980B requires that the group health plan offer the reservist and the reservist's spouse and dependent children (if they are covered under the plan) an election to continue coverage at their own expense. Section 4980B and title I of the Employee Retirement Income Security Act of 1974 (ERISA) require that those persons be furnished a notice of their COBRA rights.

Is an employer's COBRA obligation affected by military health coverage?

No. In some cases, section 4980B of the Code allows (but does not require) a cutoff of COBRA continuation coverage when a beneficiary is covered under another group health plan. Questions have thus arisen about whether COBRA continuation coverage can be cut off because a reservist receives health coverage as an active duty member of the uniformed services and a reservist's family member may receive health coverage under CHAMPUS.

"Group health plan" is defined in section 4980B by cross-reference to section 5000(b)(1) of the Code, which defines it in terms of an "employer" and the employer's employees. Section 5000(d), however, provides that for purposes of section 5000, "employer" does not include a Federal or other governmental entity. The military health plans, therefore, are not "group health plans" for purposes of the COBRA cutoff rule in section 4980B.

Accordingly, the Service considers that terminating the COBRA continuation coverage of a reservist or family member on the basis of coverage under the military health plans does not constitute good faith compliance with a reasonable interpretation of the statutory requirements.

Weighted Average Interest Rate Update

Notice 90-59

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 section 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 (OBRA 1987).

The notice also provides that an announcement will be published monthly to provide the weighted average and the permissible range for the plan years beginning each month. The following rates were determined for the plan years beginning each month. The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	Permissible Range
August	1990	8.59	7.73 to 9.45

Administrative Pronouncement

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Contributions in Aid of Construction

Notice 90-60

The purpose of this notice is to amplify and modify section 4, and to amend section 6, of Notice 88-129, 1988-2 C.B. 541. Notice 88-129 provides guidance with respect to certain payments or transfers of property to regulated public utilities ("utilities") by qualifying small power producers and qualifying cogenerators (collectively "Qualifying Facilities"), as defined in section 3 of the Federal Power Act, as amended by section

201 of the Public Utilities Regulatory Policies Act of 1978 ("PURPA").

1. Section 4(A) of Notice 88-129, 1988-2 C.B. 541, states that upon the occurrence of a "disqualification event", a portion of the fair market value of property transferred in a "QF transfer" shall be included in income by the utility as a contribution in aid of construction ("CIAC"). Notice 88-129 refers to Section III of Notice 87-82, 1987-2 C.B. 389, for guidance as to the fair market value of a CIAC. Notice 87-82 states that, absent unusual circumstances, the fair market value of a CIAC is determined under the replacement cost method. The implicit reference in Notice 88-129 to the replacement cost method is hereby amplified to clarify that the condition of property deemed transferred as a CIAC under section 4(A) of Notice 88-129 shall be taken into account in establishing its fair market value. Absent unusual circumstances, the fair market value of used CIAC property will be the depreciated replacement cost, that is, the percentage of the replacement cost which reflects the remaining economic useful life of the property. For example, a trunk line originally cost $100x to install. Ten years later the replacement cost of the line is $150x, and 60% of the useful life remains. The depreciated replacement cost is $90x (60% of $150x).

2. Section 4(B) of Notice 88-129 states that upon the termination of a power purchase contract between a Qualifying Facility and a utility, if the utility obtains or retains ownership (for tax purposes) of property transferred in a QF transfer, the Qualifying Facility will be deemed to have made a transfer to the utility which constitutes a CIAC under section 118(b) as of the first day of such termination. Section 4(B) of Notice 88-129 is hereby modified to read as follows:

(B) *Termination of Power Purchase Contract.* Upon the termination of the power purchase contract between a Qualifying Facility and a utility, if the utility obtains or retains ownership (for tax purposes) of property transferred in a QF transfer, the Qualified Facility will be deemed to have made a transfer to the utility as of the first day of such termination. Such a deemed transfer will not be treated as a CIAC, except where circumstances indicate an intention by the parties to characterize as a QF transfer a transaction that in substance constitutes a CIAC. The utility shall include in income the fair market value of the property deemed transferred less the amount, if any, paid by the utility to obtain or retain ownership of the property for tax purposes. Therefore, if the amount paid by the utility is fair market value, no amount will be includible in income by the utility. The amount paid by the utility shall include any "extension allowance" or similar payment by the utility to the Qualifying Facility during the term of the power purchase contract. For this purpose, an extension allowance is a payment to compensate the Qualifying Facility in consideration of the anticipated use of the property by the utility to deliver power to customers other than the Qualifying Facility.

The fair market value of the property deemed transferred upon termination (except for any deemed transfer treated as a CIAC) shall be determined by taking into account all facts and circumstances, including the age and condition of the property and whether the property is needed to serve the utility's customers. If a utility pays to a Qualifying Facility an amount which is determined upon termination of a power purchase contract to be the fair market value for such property under a procedure or method established or utilized by the relevant utility commission, such fair market value shall be presumed correct in the absence of substantial contrary evidence. For this purpose, a utility commission may take into account any relevant factors, including payments made in connection with the retention of property by a utility upon the termination of a PURPA contract and payments by the utility during the term of the contract (e.g., extension allowances).

These principles are illustrated by the following examples:

Example 1. The QF transfer property is a circuit breaker that was installed as part of the intertie to protect the utility against damage to its system in the event of a generator breakdown at the Qualifying Facility. At termination, the utility does not need the circuit breaker to serve its customers. The fair market value is the salvage value of the circuit breaker (less any cost of removal).

Example 2. Upon termination of a 20 year power purchase contract, a utility retains ownership of a 50 megawatt trunk line which was the subject of a QF transfer at the commencement of the contract. The utility will not use the trunk line other than to supply power to a 10 megawatt customer who has hooked into the trunk line. The fair market value is the economic value to the utility of a 20 year old 10 megawatt line, taking into account any other characteristics or factors which are relevant.

Example 3. Assume the same facts as Example 2, except that upon termination the local public utility commission requires the utility to pay $10x to the Qualifying Facility, which the commission has determined to be the fair market value of the property. In the absence of substantial contrary evidence, the commission's finding will be presumed correct, $10x will be treated as the fair market value for federal income tax purposes, and the utility will not be required to include any amount in income upon termination.

Example 4. A Qualifying Facility transfers a trunk line to a utility in a QF transfer. The trunk line cost the Qualifying Facility $10x to construct. Three years later, a customer of the utility hooks into the trunk line, and the local public utility commission requires the utility to pay to the Qualifying Facility an extension allowance of $5x. The following year, another customer of the utility hooks into the line, and the commission requires another extension allowance of $4x. The commission employs a procedure under which the utility will be required to compensate the Qualifying Facility for the fair market value of property deemed transferred upon termination. When the contract terminates, the commission determines that the utility has, by means of the extension allowances, paid to the Qualifying Facility the fair market value of the property. In the absence of substantial contrary evidence, the commission's finding will be respected and the utility will not be required to include any amount in income upon termination.

Example 5. A Qualifying Facility transfers a trunk line to a utility in a QF transfer. Twenty years later the

contract terminates. The utility commission determines the fair market value of the trunk line to be $10x, but does not require the utility to pay this amount to the Qualifying Facility. No presumption of correctness attaches to the utility commission's findings.

3. In Section 6 of Notice 88-129, the last sentence of the second paragraph is amended by deleting the words "as a CIAC". As amended, the sentence reads as follows: "However, if property which is the subject of a QF transfer is subsequently transferred or deemed transferred to the utility, the utility may be allowed to take depreciation deductions with respect to the property."

EFFECT ON OTHER DOCUMENTS

Notice 88-129, 1988-2 C.B. 541, is amplified and modified.

Reporting By Employee Plans and Exempt Organizations of Certain Amounts of Cash Received in a Trade or Business

Notice 90-61

This notice provides guidance to employee plans and exempt organizations as to their responsibilities under section 6050I of the Internal Revenue Code in reporting certain large amounts of cash received in the course of a trade or business.

Section 6050I of the Code provides generally that any person who is engaged in a trade or business and, that in the course of such trade or business, receives cash in excess of $10,000 in one transaction (or in any two or more related transactions) shall file a return with respect to such transaction as prescribed by the Secretary. Section 1.6050I-1 of the Income Tax Regulations provides implementing rules and requires that Form 8300, *Report of Cash Payments Over $10,000 Received in a Trade or Business*, be completed and returned to the Service for each transaction.

Section 7701(a)(1) of the Code defines "person" to include an individual, a trust, an estate, a partnership, an association, a company, or a corporation. Organizations exempt from federal income tax under section 501(a) of the Code, including employee plans, are persons as defined in section 7701(a) and are subject to the requirement to report cash transactions in the same manner and to the same extent as any other entity treated as a person under the Internal Revenue Code.

"Trade or business" under section 6050I of the Code has the same meaning as it does under section 162 and refers to any activity constituting the sale of goods or the performance of services to produce income. The determination that an activity is not subject to tax under the unrelated trade or business taxable income provisions of sections 511 through 514 of the Code does not control whether the activity constitutes a "trade or business" within the meaning of section 162. Thus, for example, an exempt organization that receives a cash payment in excess of $10,000 for the rental of part of its building must report the transaction on Form 8300 regardless of how the transaction might be viewed in the context of sections 511 through 514 of the Code. However, if, for example, the organization receives a charitable cash contribution in excess of $10,000, it would not be subject to the reporting requirement since the funds were not received in the course of a trade or business.

Weighted Average Interest Rate Update

Notice 90-62

Notice 88-73 provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of section 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 (OBRA 1987).

The notice also provides that an announcement will be published monthly to provide the weighted average and the permissible range for the plan years beginning each month. The following rates were determined for the plan years beginning each month. The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	Permissible Range
September	1990	8.60	7.74 to 9.46

Administrative Pronouncement

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Extension of Rev. Proc. 85-29

Notice 90-63

This notice extends the effective date of Rev. Proc. 85-29, 1985-1 C.B. 581, through plan years beginning on or before December 31, 1991.

Section 412(c)(5) of the Internal Revenue Code, as amended, and section 302(c)(5) of the Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. 93-406, 1974-3 C.B. 1, 40, states that a change in the funding method of a plan is effective only if the change is approved by the Secretary.

Rev. Proc. 85-29 gave approval, subject to certain restrictions and limitations, for changes to any acceptable funding method for plan years beginning on or after January 1, 1984, but not after December 31, 1989. This notice extends Rev. Proc. 85-29 to changes in funding method made with respect to plan years beginning on or after January 1, 1984, but not after December 31, 1991.

Economic Performance; Accrual of Property Taxes

Notice 90-64

This notice provides guidance regarding the economic performance requirement of section 461(h) of the Internal Revenue Code ("Code") and the accrual of property taxes.

Section 461(h) was added to the Code by the Tax Reform Act of 1984 and is effective with respect to amounts incurred (without regard to

section 461(h)) after July 18, 1984. Section 461(h) provides that the all events test with respect to a liability is not met before the economic performance requirement with respect to the liability occurs. On June 7, 1990, the Internal Revenue Service issued proposed regulations under section 461(h). The proposed section 461(h) regulations provide that for taxable years beginning after December 31, 1989, economic performance with respect to taxes occurs when the taxes are paid. The proposed regulations do not, however, provide rules for determining when economic performance occurs with respect to property taxes during the time between the effective date of section 461(h) and the effective date of the proposed regulations.

Before the enactment of section 461(h), the Service issued a number of revenue rulings addressing the accrual of property taxes. *See e.g.*, Rev. Rul. 73-64, 1973-1 C.B. 70; Rev. Rul. 72-409, 1972-2 C.B. 99; Rev. Rul. 71-204, 1971-1 C.B. 71; Rev. Rul. 70-653, 1970-2 C.B. 48. The Service has determined that, for taxable years beginning before January 1, 1990, it will not challenge positions previously taken by taxpayers that relied on earlier published rulings relating to the accrual of property taxes.

Table for Figuring Amount Exempt from Levy on Wages, Salary, and Other Income (Forms 668-W and 668-W(c)) 1991

Notice 90-65

Publication 1494, shown below, includes the amount of an individual's income that is exempt from a notice of levy used to collect delinquent tax in 1991.

(Amounts are for each pay period.)

Filing Status: Single							
Number of Exemptions Claimed on Statement							
Pay Period	1	2	3	4	5	6	More Than 6
Daily	21.35	29.62	37.88	46.15	54.42	62.69	13.08 Plus 8.27 for each exemption
Weekly	106.73	148.08	189.42	230.77	272.12	313.46	65.38 Plus 41.35 for each exemption
Bi-Weekly	213.46	296.15	378.85	461.54	544.23	626.92	130.77 Plus 82.69 for each exemption
Semi-Monthly	231.25	320.83	410.42	500.00	589.58	679.17	141.67 Plus 89.58 for each exemption
Monthly	462.50	641.67	820.83	1000.00	1179.17	1358.33	283.33 Plus 179.17 for each exemption

Filing Status: Married Filing Joint (and Qualifying Widow(er)s)							
Number of Exemptions Claimed on Statement							
Pay Period	1	2	3	4	5	6	More Than 6
Daily	30.19	38.46	46.73	55.00	63.27	71.54	21.92 Plus 8.27 for each exemption
Weekly	150.96	192.31	233.65	275.00	316.35	357.69	109.62 Plus 41.35 for each exemption
Bi-Weekly	301.92	384.62	467.31	550.00	632.69	715.38	219.23 Plus 82.69 for each exemption
Semi-Monthly	327.08	416.67	506.25	595.83	685.42	775.00	237.50 Plus 89.58 for each exemption
Monthly	654.17	833.33	1012.50	1191.67	1370.83	1550.00	475.00 Plus 179.17 for each exemption

Filing Status: Married Filing Separate							
Number of Exemptions Claimed on Statement							
Pay Period	1	2	3	4	5	6	More Than 6
Daily	19.23	27.50	35.77	44.04	52.31	60.58	10.96 Plus 8.27 for each exemption
Weekly	96.15	137.50	178.85	220.19	261.54	302.88	54.81 Plus 41.35 for each exemption
Bi-Weekly	192.31	275.00	357.69	440.38	523.08	605.77	109.62 Plus 82.69 for each exemption
Semi-Monthly	208.33	297.92	387.50	477.08	566.67	656.25	118.75 Plus 89.58 for each exemption
Monthly	416.67	595.83	775.00	954.17	1133.33	1312.50	237.50 Plus 179.17 for each exemption

Filing Status: Unmarried Head of Household							
Number of Exemptions Claimed on Statement							
Pay Period	1	2	3	4	5	6	More Than 6
Daily	27.50	35.77	44.04	52.31	60.58	68.85	19.23 Plus 8.27 for each exemption
Weekly	137.50	178.85	220.19	261.54	302.88	344.23	96.15 Plus 41.35 for each exemption
Bi-Weekly	275.00	357.69	440.38	523.08	605.77	688.46	192.31 Plus 82.69 for each exemption
Semi-Monthly	297.92	387.50	477.08	566.67	656.25	745.83	208.33 Plus 89.58 for each exemption
Monthly	595.83	775.00	954.17	1133.33	1312.50	1491.67	416.67 Plus 179.17 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	*	Wkly	Bi-Wkly	Semi-Mo	Monthly	Daily
Single or Head of Household	1	16.35	32.69	35.42	70.83	3.27
	2	32.69	65.38	70.83	141.67	6.54
Any Other Filing Status	1	12.50	25.00	27.08	54.17	2.50
	2	25.00	50.00	54.17	108.33	5.00
	3	37.50	75.00	81.25	162.50	7.50
	4	50.00	100.00	108.33	216.67	10.00

* ADDITIONAL STANDARD DEDUCTION claimed on Parts 3, 4, & 5 of levy

EXAMPLES

This table shows 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 $189.42 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, $205.77 is exempt from this levy ($189.42 plus $16.35).
3. A taxpayer who is married, files jointly, is paid bi-weekly, and claims two exemptions (including one for the taxpayer) has $384.62 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. Then, $434.62 is exempt from this levy ($384.62 plus $50.00).

Section 129 Notice on Fair Market Value

Notice 90-66

Notice 89-111, 1989-2 C.B. 449, provides guidance concerning the reporting requirements for dependent care assistance furnished by an employer to an employee under a qualified dependent care assistance program described in section 129 of the Internal Revenue Code of 1986. Notice 89-111 includes a safe harbor rule for computing the fair market value of in-kind dependent care assistance provided by an employer to an employee. The safe harbor was available only for calendar year 1989. This notice extends the safe harbor rule in Notice 89-111. Therefore, until further guidance is issued, an employer is permitted, but is not required, to use the safe harbor rule set forth in Notice 89-111 for years following 1989. In 1989, dependent care assistance was reported in Box 16 of Form W-2, Wage and Tax Statement. Beginning in 1990, dependant care assistance will be reported in Box 15 of Form W-2, Wage and Tax Statement. Other provisions of Notice 89-111 continue in effect without modification.

Domestic Asset/Liability Percentage and Domestic Investment Yield

Notice 90-67

I. INTRODUCTION.

This Notice provides the domestic asset/liability percentages and domestic investment yields needed by foreign life insurance companies and foreign property and liability insurance companies to compute their minimum effectively connected net investment income under section 842(b) of the Internal Revenue Code for taxable years beginning after December 31, 1989. Instructions are provided for computing foreign insurance companies' liabilities for the estimated tax and installment payments of estimated tax for taxable years beginning after December 31, 1989. For more specific guidance regarding the computation of the amount of net investment income to be included by a foreign insurance company on its U.S. income tax return, see Notice 89-96, 1989-2 C.B. 417.

II. DOMESTIC ASSET/LIABILITY PERCENTAGES FOR 1990.

The Secretary determines the domestic asset/liability percentage separately for life insurance companies and property and liability insurance companies. For the first taxable year beginning after December 31, 1989, the relevant domestic asset/liability percentages are:

116.5 percent for foreign life insurance companies, and 152.5 percent for foreign property and liability insurance companies.

III. DOMESTIC INVESTMENT YIELDS FOR 1990.

The Secretary is required to prescribe separate domestic investment yields for foreign life insurance companies and for foreign property and liability insurance companies. For the first taxable year beginning after December 31, 1989, the relevant domestic investment yields are:

8.8 percent for foreign life insurance companies, and 6.7 percent for foreign property and liability insurance companies.

IV. ESTIMATED TAXES.

To compute estimated tax and the installment payments of estimated tax due for taxable years beginning after December 31, 1989, a foreign insurance company must compute its estimated tax payments by adding to its income other than net investment income the greater of (i) its net investment income, as determined under section 842(b)(5), that is actually effectively connected with the conduct of a trade or business within the United States for the relevant period, or (ii) the minimum effectively connected net investment income under section 842(b) that would result from using the most recently available domestic asset/liability percentage and domestic investment yield. Thus, for installment payments due after the release of this Notice, the domestic asset/liability percentages and the domestic investment yields provided in this Notice must be used to compute the minimum effectively connected net investment income. However, if the due date of an installment is less than 20 days after the date this Notice is published in the Internal Revenue Bulletin, the asset/liability percentages and domestic investment yields provided in Notice 90-13 may be used to compute the minimum effectively connected net investment income for such installment. For further guidance in computing estimated tax, see Notice 89-96.

List of Countries Requiring Cooperation With an International Boycott

Notice 90-68

In order to comply with the mandate of section 999(a)(3) of the Internal Revenue Code of 1986, the Department of the Treasury is publishing a current list of countries which may require participation in, or cooperation with, international boycott (within the meaning of section 999(b)(3) of the Internal Revenue Code of 1986). The list reflects the recent union of the Arab Republic of Yemen and the Peoples Democratic Republic of Yemen, the new state being named the Republic of Yemen.

On the basis of the best information currently available to the Department of the Treasury, the following countries may require participation in, or cooperation with, an international boycott (within the meaning of section 999(b)(3) of the Internal Revenue Code of 1986).

Bahrain
Iraq
Jordan
Kuwait
Lebanon
Libya
Oman
Qatar
Saudi Arabia
Syria
United Arab Emirates
Yemen, Republic of

Dated: October 1, 1990.

Kenneth W. Gideon,
Assistant Secretary for Tax Policy.

(Filed by the Office of the Federal Register on October 11, 1990, 8:45 a.m., and published in the issue of the Federal Register for October 12, 1990, 55 F.R. 41635)

Applicable Rate of Interest on Nonqualified Withdrawals from a Capital Construction Fund

Notice 90-69

Under the authority in section 607(h)(4)(B) of the Merchant Marine Act, 1936, as amended (46 U.S.C. 1177(h)(4)(B)), we hereby determine and announce that the applicable rate of interest on the amount of additional tax attributable to any nonqualified withdrawals from a Capital Construction Fund established under section 607 of the Act shall be 9.28 percent, with respect to nonqualified withdrawals made in the taxable year beginning in 1990.

The determination of the applicable rate of interest with respect to nonqualified withdrawals was computed, according to the joint regulations issued under the Act (46 CFR 391.7(e)(2)(ii)), by multiplying eight percent by the ratio which (a) the average yield on 5-year Treasury securities for the calendar year immediately preceding the beginning of such taxable year bears to (b) the average yield on 5-year Treasury securities for the calendar year 1970. The applicable rate so determined was computed to the nearest one-hundredth of one percent.

Dated: September 27, 1990.

Warren G. Leback,
Maritime Administrator.

Jennifer Joy Wilson,
Acting Administrator, National Oceanic and Atmospheric Administration.

Kenneth W. Gideon,
Assistant Secretary for Tax Policy.

So ordered by Maritime Administrator, Maritime Administration.
Administrator, National Oceanic and Atmospheric Administration.
Assistant Secretary for Tax Policy, Department of the Treasury.

James E. Saari,
Secretary, Maritime Subsidy Board, Maritime Administration.

(Filed by the Office of the Federal Register on October 2, 1990, 8:45 a.m., and published in the issue of the Federal Register for October 3, 1990, 55 F.R. 40505)

Information Reporting on Home Mortgage Financing—Points and Federally-Subsidized Indebtedness

Notice 90-70

I. INTRODUCTION AND PURPOSE

This Notice informs persons who participate in home mortgage financing of two new information reporting requirements under the Internal Revenue Code that will become effective January 1, 1991.

First, under section 6050H(b)(2)(C) of the Internal Revenue Code, persons required to file a return of information (Form 1098, Mortgage Interest Statement) to report mortgage interest (mortgage interest recipients), must report certain points on financing provided after December 31, 1990, as set forth in this Notice.

Second, under the authority contained in section 143(m)(8)(D) of the Code issuers of qualified mortgage bonds (within the meaning of section 143(a) of the Code) will be required to report to the Internal Revenue Service the name, address and social security number of those persons who receive federally-subsidized financing (after December 31, 1990) through the issuance of the bond. This will facilitate the Service's enforcement of the recapture rules of section 143(m) of the Code (as amended by the Revenue Reconciliation Act of 1990 ("RRA 1990")).

The purpose of this Notice is to inform affected persons of the information they will be required to collect when these new reporting requirements become effective. Because this Notice is limited to guidance on the collection of prescribed information, the Service will issue additional comprehensive guidance (including forms and instructions) on these new reporting requirements. The additional guidance will be issued in time for affected persons to meet their reporting obligations.

II. POINTS REPORTING ON FORM 1098

Background

As the result of amendments contained in recent tax legislation, section 6050H(b)(2)(C) of the Code provides for the reporting of "points" on the return of information required under section 6050H, effective for returns of information the due date for which (without regard to extensions) is after December 31, 1991. Because the return of information under section 6050H of the Code generally includes information regarding the entire preceding calendar year, the first return of information required to be filed after December 31, 1991, will generally report points on financings provided after December 31, 1990.

These new rules are equally effective for the statement of information that must be furnished to the individual payer (hereinafter "mortgagor") of the points. Persons affected by this Notice should note that all rules referring to the return of information that is filed with the Service also apply to the statement of information furnished to the mortgagor. The return of information requirement is currently met by the timely, accurate filing of Form 1098, which will be modified for 1991 for this new reporting requirement. It is anticipated that the form will contain a new box for reporting points titled "Points paid directly by payer(s)/borrower(s) on purchase of principal residence." The Service expects the modified Form 1098 to be available in early January 1991.

Reporting requirements

Although other amounts may be charged, only the amounts that meet ALL the following criteria are to be reported by mortgage interest recipients as reportable points for purposes of section 6050H(b)(2)(C) of the Code:

A. The amounts are charged for the use or forbearance of money, and not for services;

B. The amounts conform to an established business practice of charging points in the area in which the loan is issued and do not exceed the amount generally charged in the area;

C. The amounts are for mortgage loan proceeds provided for and applied to closings occurring after December 31, 1990;

D. The amounts are paid directly by the mortgagor. An amount is so paid if the mortgagor provides funds (including down payments, escrow deposits, earnest money applied at the closing and funds actually paid over at closing) at least equal to the amount of points required for application at the closing. In view of standard commercial lending practices, for purposes of this reporting requirement an amount charged to the mortgagor as points with respect to the acquisition of a principal residence will be treated as paid directly by the mortgagor. (The determination of whether points are paid directly in transactions other than the acquisition of a principal residence (e.g., home improvements) must be based upon the actual facts of the transaction.)

E. The amounts are for the purchase of the mortgagor's principal residence and the mortgage loan is secured by such residence. The mortgage interest recipient may rely on a signed written statement of the mortgagor that states whether the proceeds of the loan are for the purchase of the mortgagor's principal residence

The reporting, for example, will not include the following amounts: (1) points paid for loans that will be used for the improvement of a principal residence; (2) points paid for loans to purchase or improve a second or vacation property, investment property, or trade or business property; (3) points paid on a refinancing, a home equity loan or for a line of credit secured by a principal residence; (4) points paid in excess of the amount generally charged in the area (e.g. the payment of excess points to "buy down" the cost of money); and (5) points paid on financing provided for closings occurring prior to January 1, 1991.

Income tax treatment of lender

The information required to be reported under this Notice is collected and reported for purposes of verifying deductions claimed by mortgagors. This information is not collected for purposes of determining the appropriate reporting of income by mortgage interest recipients. Thus, reporting is required with respect to the amounts that meet the criteria set forth above, irrespective of the mortgage interest recipient's method and timing of accounting for such points as income for federal income tax purposes.

III. REPORTING THE PRESENCE OF FEDERALLY-SUBSIDIZED INDEBTEDNESS

Background

If a taxpayer disposes of an interest in a residence, with respect to which there was federally-subsidized indebtedness (for which the taxpayer was liable in whole or in part) that was provided after December 31, 1990, section 143(m) of the Code provides (subject to specified exceptions) for the recapture of a portion of the subsidy. Rules for the determination of the recapture amount are found under section 143(m), as amended by RRA 1990. In addition, sections 6045(a) and 6045(e)(4) of the Code give the Service the authority to require reporting by those responsible for reporting real estate transactions to facilitate the Service's enforcement of the recapture rules of section 143(m) of the Code. Under section 143(m)(7) there is a separate reporting requirement.

The Service has determined that the recapture rules of section 143(m) of the Code can be most effectively enforced, with the minimum overall reporting, recordkeeping and processing burden, if the issuer of federally-subsidized indebtedness reports the information. In addition, because of exceptions contained in the regulations implementing section 6045(e) of the Code, certain transactions subject to recapture under section 143(m) are not currently subject to information reporting under section 6045(e). For those exempted transactions, it is necessary that the Service receive information on the presence of federally-subsidized indebtedness prior to the disposition of the taxpayer's residence.

However, in the case of a mortgage credit certificate, the mortgage lender is currently required to report (on Form 8329, Lender's Information Return for Mortgage Credit Certificates (MCCs)) sufficient information, for purposes of the Service's enforcement of the recapture rules of section 143(m) of the Code. Therefore, the requirements of this Notice are limited to issuers of qualified mortgage bonds.

Accordingly, the purpose of this portion of this Notice is to advise issuers of qualified mortgage bonds of the information they must collect to comply with this new reporting requirement. More comprehensive guidance (including guidance on the information that the issuer must furnish under section 143(m)(7) of the Code) will be issued by the Service on these new reporting requirements.

Authority

The reporting requirements contained in this portion of this Notice are imposed by the Service under the authority contained in section 143(m)(8)(D) of the Code.

Reporting requirements

Issuers of qualified mortgage bonds must, with respect to financing provided after December 31, 1990, directly or indirectly through the issuance of qualified mortgage bonds, report the name, address (of the residence purchased with the subsidized financing) and social security number (SSN) of taxpayers receiving such financing, in accordance with the form to be developed and its instructions. The SSN may be solicited and collected by the use of Form W-9 and must be solicited and collected by the issuer at or before the time the financing is provided. The issuer may rely on the mortgage lender's solicitation and collection of the mortgagor's SSN. However, the issuer is ultimately responsible for the timely, accurate filing of the information return.

Reserve reporting under section 6045(e)(4)

The Service will reserve, until otherwise provided in regulations or

forms and instructions, its authority under sections 6045(a) and 6045(e)(4) of the Code to require the real estate reporting person to report with respect to the presence of federally-subsidized indebtedness. Any such reporting requirements will not be effective for financing provided (or certificates issued) prior to the issuance of those requirements.

Weighted Average Interest Rate Updated

Notice 90-71

Notice 88-73 provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of section 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 (OBRA 1987).

The notice also provides that an announcement will be published monthly to provide the weighted average and the permissible range for the plan years beginning each month. The following rates were determined for the plan years beginning each month. The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	Permissible Range
October	1990	8.61	7.75 to 9.48

Certain Payments Received by Retired Insurance Agents

Notice 90-72

This notice is to advise current and former self-employed insurance salespersons and agents about the treatment under the Self-Employment Contributions Act (SECA) of certain payments received by those individuals from an insurance company after retirement from that company. The payments in question are (a) amounts paid to the individual after retirement, but calculated as a percentage of commissions received by the individual from the paying company prior to retirement, (b) renewal commissions, and (c) deferred commissions paid after the individual's retirement for sales made prior to the individual's retirement.

These payments are subject to tax under SECA. They are derived from the individuals' service as agents or salespersons. Under current law, no provision excludes these payments from taxation under SECA. The names or characterizations given these payments by a recipient or payor will not affect their taxation under SECA.

Because the payments are subject to SECA taxes in the year received, they may be used in computing benefits payable under Social Security. However, if the payments are attributable to sales activities that occurred prior to the initial month of entitlement to Social Security benefits, they generally will not cause a reduction in Social Security benefits under the Social Security earnings test. This is so, provided after the initial month of entitlement to Social Security benefits, the individual performs no services on the policies on which such payments are based.

Extension of Section 401(b) Remedial Amendment Period and Section 403(b) Safe Harbors

Notice 90-73

I. PURPOSE

This notice extends the period for amending plans qualified under section 401(a) or 403(a) of the Internal Revenue Code, extends certain safe harbors available to section 403(b) annuities, modifies the relief provided in Notice 88-131, 1988-2 C.B. 546, Notice 89-92, 1989-2 C.B. 410, and Rev. Proc. 89-65, 1989-2 C.B. 786, and addresses the application process for amended plans.

II. SUMMARY

This notice addresses the following areas related to the extension of the remedial amendment period and the dates for compliance with certain requirements.

1. Extension of Remedial Amendment Period

The expiration date of the remedial amendment period under section 401(b) of the Code for certain disqualifying provisions is extended until the end of the first plan year beginning after December 31, 1991. Although this extension enables the continued suspension of benefit accruals under Model Amendment 2 (Model 2) or Model Amendment 3 (Model 3) of Notice 88-131, if certain conditions are met, as noted below the relief provided under Alternative II D of Notice 88-131 for benefits accrued after the effective dates of certain qualification requirements will not continue into the 1992 plan year.

2. Section 403(b)(12) Compliance

The safe harbors under section 403(b)(12) of the Code provided in Notice 89-23, 1989-1 C.B. 654, which were scheduled to expire at the end of 1990, are extended until further guidance is issued under section 403(b)(12). Thus, employers may rely on a reasonable, good faith interpretation of section 403(b)(12) and/or the transitional safe harbors until further guidance is issued concerning these nondiscrimination rules.

3. Alternative II D

The availability of the relief provided by Alternative II D of Notice 88-131 is no longer connected to the remedial amendment period, but will end with the 1991 plan year. Thus, benefit accruals in the 1992 plan year must meet the requirements of section 401(a)(4) of the Code.

4. Notice to Participants

Plan sponsors are reminded that the suspension of benefit accruals for all participants under Model 3 beyond the last day of the 1990 plan year is conditioned upon providing the notice described in section 204(h) of the Employee Retirement Income Security Act of 1974 (ERISA) no later than the last day of the 1990 plan year. Suspension of benefit accruals for highly compensated employees beyond the last day of the 1991 plan year is also conditioned upon providing the notice described in section 204(h).

5. Applications for Approval of Plan Amendments

The deadline for submission of applications for sponsors of master and prototype plans that seek continued reliance on a prior opinion letter, and sponsors of master and prototype plans and regional prototype plans that seek extended reliance on a new letter, is extended to March 31, 1991. The Service anticipates that it will begin accepting applications for determination letters with respect to additional categories of plans, including defined benefit plans, early in 1991.

III. EXTENSION OF THE SECTION 401(b) REMEDIAL AMENDMENT PERIOD

A. BACKGROUND

Section 1.401(b)-1 of the Income Tax Regulations provides that a plan that fails to satisfy the requirements of section 401(a) solely as a result of a disqualifying provision defined under section 1.401(b)-1(b)(2)(ii) need not be amended to comply with those requirements until the later of the due date for filing the employer's tax return for the 1989 tax year (including extensions) or the last day of the 1989 plan year, or, in the case of a plan maintained by more than one employer, the last day of the tenth month following the end of the 1989 plan year. A disqualifying provision is defined in section 1.401(b)-1(b)(2)(ii) as a plan provision (or the absence of a plan provision) that causes a plan to fail to satisfy the qualification requirements of the Code because of changes made by the Tax Reform Act of 1986, Pub. L. No. 99-514, 1986-3 (Vol. 1) C.B. 1 (TRA '86), the Omnibus Budget Reconciliation Act of 1986, Pub. L. No. 99-509 (OBRA '86), and the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 1987-3 C.B. 1 (OBRA '87), that are effective before the first day of the first plan year beginning after December 31, 1989; a plan provision that is not required, but is integral to a qualification requirement changed by TRA '86, OBRA '86, OBRA '87; or a plan provision that fails to satisfy any requirement that is treated, directly or indirectly, by the Service as if section 1140 of TRA '86 applied to it (hereinafter collectively referred to as the "Tax Reform requirements").

Section 1.401(b)-1(b)(2)(iii) of the regulations also defines as a disqualifying provision any plan provision (or the absence of any plan provision) that results in the failure of the plan to satisfy the qualification requirements of the Code by reason of a change in those requirements made by amendments to the Code that are designated by the Commissioner, at his discretion, as disqualifying provisions described in section 1.401(b)-1(b)(2).

Rev. Proc. 89-65 extended the section 401(b) remedial amendment period for disqualifying provisions described in section 1.401(b)-1(b)(2)(ii) until the last day of the first plan year beginning on or after January 1, 1991 and added to the definition of such disqualifying provisions changes in the qualification requirements of the Code made by the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 1988-3 C.B. 1 (TAMRA), and those provisions that became effective on or after January 1, 1990, with respect to collectively bargained plans. Rev. Proc. 89-65 also extended the expiration date of the remedial amendment period for plans adopted or amended after December 31, 1987.

Section 1.401(b)-1(e) of the regulations grants the Commissioner the discretion to extend the section 401(b) remedial amendment period.

B. EXTENSION OF REMEDIAL AMENDMENT PERIOD

Pursuant to the grant of authority in 1.401(b)-1(e) of the regulations, the remedial amendment period is extended for disqualifying provisions described in section 1.401(b)-1(b)(2)(ii) to the last day of the first plan year beginning after December 31, 1991. The remedial amendment period is also extended until the last day of the first plan year beginning after December 31, 1991, for new plans adopted or existing plans amended after December 31, 1987, that fail to satisfy the qualification requirements of sections 401(a) or 403(a) as of the date the plan or amendment is adopted or effective (whichever is earlier).

In addition, pursuant to the authority of section 1.401(b)-1(b)(2)(iii), this notice provides that the definition of disqualifying provision under section 1.401(b)-1(b)(2)(ii) includes a plan provision (or the absence of a plan provision) that causes a plan to fail to satisfy the qualifica-tion requirements of the Code because of changes made in such requirements by the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, 1990-1 C.B. 210 (OBRA '89), or a plan provision that is not required, but is integral to a qualification requirement changed by OBRA '89. Thus, plans that do not satisfy the requirements of section 401(a) or 403(a) because of such a disqualifying provision may also be retroactively amended to meet such requirements at any time up to and including the last day of the 1992 plan year.

In order to be eligible for the extended remedial amendment period, a plan must continue to meet the requirements of section 1140 of TRA '86. Thus, with respect to requirements subject to section 1140, the plan sponsor must continue to operate the plan in compliance with such requirements from the applicable effective dates with respect to the plan. In the case of changed plan provisions that are not required but are integral to a qualification requirement changed by TRA '86, OBRA '86, OBRA '87, TAMRA, or OBRA '89, or any requirement which is treated, directly or indirectly, by the Service as if section 1140 applied to it, the plan will be eligible for the extended remedial amendment period only if the plan is operated in accordance with such changed provisions from the effective date of such changes under the plan. In addition, the plan sponsor must amend the plan for all Tax Reform requirements (including those effective after the 1988 plan year) retroactively to the date the applicable requirements become effective.

IV. EXTENSION OF SAFE HARBORS UNDER SECTION 403(b)(12)

Section 1120 of TRA '86 enacted section 403(b)(12) of the Code, which requires that annuities under section 403(b) be purchased under a nondiscriminatory plan. Notice 89-23 provides that, until further guidance, the Service will deem a section 403(b) annuity plan to comply with section

403(b)(12) if the employer administers it in accordance with a reasonable good faith interpretation of section 403(b)(12). The notice also provides certain safe harbors under which the Service will consider an employer to be operating a section 403(b) annuity plan in accordance with a reasonable, good faith interpretation.

Notice 89-23 makes the safe harbors applicable only to plan years beginning in calendar years 1989 and 1990, even though taxpayers may generally rely on Notice 89-23 until further guidance is published. This limitation is modified to permit reliance on the safe harbors until further guidance provides otherwise.

V. ALTERNATIVE II D DISCONTINUATION, AND ERISA 204(h) NOTICE

A. BACKGROUND

On December 13, 1988, the Service issued Notice 88-131, which provides relief from certain requirements of section 411(d)(6) of the Code to sponsors of qualified pension, profit-sharing and stock bonus plans under section 401(a) and annuity plans under section 403(a). Section 411(d)(6) provides, in general, that a plan amendment (other than an amendment described in section 412(c)(8)) may not decrease a participant's accrued benefit determined as of the later of the date of adoption or the effective date of the amendment. Although section 1140 of TRA '86 and section 401(b) permit an extended period of time for amending plans to comply with the Tax Reform requirements, neither section provides an exception to section 411(d)(6), with respect to plan amendments made to comply with the Tax Reform requirements after benefits accrue during the 1989, 1990, and 1991 plan years.

Plan sponsors may take advantage of the relief offered in Notice 88-131 by adopting one or more of the model amendments described in the Notice and/or following the requirements of an alternative (Alternative II D) set forth in the Notice. The options described in Notice 88-131 provide plan sponsors with additional time in which to make decisions about plan changes that might be necessary or desirable as a result of amendments to the qualification requirements.

Under Alternative II D of Notice 88-131, if a plan satisfied the requirements for qualification immediately before the 1989 plan year, benefit accruals under that plan arising on or after the first day of the first plan year beginning in 1989 under those prior plan provisions will not cause the plan to fail to meet the requirements of sections 401(a)(4) or 401(a)(26) of the Code for the 1989 plan year provided certain requirements are satisfied.

B. RELIANCE ON ALTERNATIVE II D

Notice 89-92 extended the use of Alternative II D through the end of the section 401(b) remedial amendment period. Pursuant to that extension and the extension of the remedial amendment period in Rev. Proc. 89-65, Alternative II D relief is available to plan sponsors until the end of the 1991 plan year. Pursuant to Section III of this notice, the remedial amendment period for Tax Reform requirements is now extended to the end of the 1992 plan year. Notwithstanding the extension of the remedial amendment period, however, plan sponsors may not rely on the relief provided by Alternative II D for benefit accruals after the 1991 plan year. Accordingly, the period for reliance on Alternative II D is severed from the remedial amendment period, and Notice 89-92 is so modified.

Thus, although a plan's provisions before its amendment for Tax Reform requirements might not otherwise meet the requirements of section 401(a)(4), those provisions will continue to produce benefit accruals for all participants, including highly compensated employees, until the plan is amended, retroactive to the 1989 plan year, for the Tax Reform requirements. Furthermore, although the pre-amendment benefit accruals are protected, the level of those pre-amendment benefit accruals for highly compensated employees will not obligate the plan sponsor to increase benefits for nonhighly compensated employees for plan years 1989, 1990 and 1991 under the amended plan, to levels that are nondiscriminatory relative to the pre-amendment accruals. Benefits that accrue in the 1992 plan year, however, must be nondiscriminatory.

Plan sponsors have three alternatives for the 1992 plan year. First, without further action, if a highly compensated employee accrues a benefit during the 1992 plan year under plan provisions before they are amended pursuant to the remedial amendment period described above to comply with the Tax Reform requirements, the plan, as amended, must provide benefit accruals in the 1992 plan year for any nonhighly compensated participants that are sufficient to insure that the benefit accrued in the 1992 plan year by any highly compensated employee is nondiscriminatory. Second, before the first day of the 1992 plan year, the plan sponsor can adopt Model 2 or Model 3 prospectively suspending benefit accruals in the 1992 plan year. As explained below, suspension of benefits in the 1992 plan year will require the notice necessitated by section 204(h) of ERISA. Third, the plan sponsor can amend the plan to comply with the Tax Reform requirements before benefits accrue in the 1992 plan year.

C. ERISA 204(h) NOTICE

In general, section 204(h) of ERISA requires that advance notice be given if a defined benefit plan or an individual account plan that is subject to section 302 of ERISA is amended to provide for a significant reduction in the rate of future benefit accruals. Plan sponsors that either intend to adopt Model 3 or have adopted and are operating under Model 3 are reminded that Rev. Proc. 89-65 provided that the suspension of benefit accruals for all plan participants under Model 3 beyond the last day of the 1990 plan year and until the last day of the remedial amendment period is effective only if the notice described in section 204(h) of ERISA is provided to all participants by the later of the last day of the 1990 plan year or 15 days before Model 3 is effective.

Furthermore, plan sponsors that either intend to adopt Model 2 or have adopted and are operating under Model 2 may suspend benefit accruals for all highly compensated employees under Model 2 beyond the last day of the 1991 plan year and until the end of the remedial amendment period only if the section 204(h) notice is provided to all highly compensated

employees participating in the plan no later than 15 days before the first day of the 1992 plan year. A plan sponsor that suspends benefit accruals after the 1990 plan year in the case of Model 3, or after the 1991 plan year in the case of Model 2, and who provides the 204(h) notice by the time prescribed above for the applicable participants will be deemed to have satisfied the requirements of section 204(h) with respect to prior benefit suspensions under Model 2 or Model 3.

VI. DEADLINE FOR SUBMISSION OF MASTER OR PROTOTYPE AND REGIONAL PROTOTYPE PLANS AND PLANS FOR FURTHER OPENING THE DETERMINATION LETTER PROGRAM

The deadline for submission of applications for master or prototype and regional prototype plans to the Internal Revenue Service by mass submitters, sponsors, and sponsoring organizations of master and prototype plans that seek continued reliance on a prior opinion letter and sponsors of master and prototype plans and regional prototype plans that seek extended reliance on a new letter is extended to March 31, 1991. See Rev. Proc. 89-9, 1989-1 C.B. 780, with respect to master or prototype plans and Rev. Proc. 89-13, 1989-1 C.B. 801, with respect to regional prototype plans; see also Announcement 90-89, 1990-31 I.R.B. 60, July 30, 1990. The guidance necessary for submission of master or prototype and regional prototype plans is now available, and the Service does not anticipate changes in the applicable guidance that would affect plan design or require plan sponsors to reapply for opinion or notification letters for plans approved under TRA '86. Sponsors should note that Lists of Required Modifications (LRMs), which the Service uses in reviewing master and prototype or regional prototype plans, have recently been revised and are an aid to sponsors who are drafting or amending plans.

In the first quarter of 1991, the Service plans to open the determination letter program for additional categories of plans that have been amended for the Tax Reform requirements. The Service anticipates that the additional categories will include many defined benefit plans and adopters of master or prototype or regional prototype plans.

VII. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 89-65 and Notices 88-131, 89-23 and 89-92 are modified.

Family Support Act Notice

Notice 90-74

PURPOSE

This notice provides guidance to employers concerning the withholding and reporting requirements regarding employee business expense reimbursements and allowances.

BACKGROUND

Temporary and proposed regulations regarding employee business expense reimbursements and allowances were published in the Federal Register on December 12, 1989, and in the Cumulative Bulletin (see T.D. 8276, 1990-1 C.B. 14). Final regulations are being issued contemporaneously with this notice. Under the regulations, the withholding rules are effective for payments made under reimbursement or other expense allowance arrangements that are received by an employee on or after July 1, 1990, with respect to expenses paid or incurred on or after July 1, 1990. The reporting rules are effective for payments made under reimbursement or other expense allowance arrangements that are received by an employee on or after January 1, 1989, with respect to expense paid or incurred on or after January 1, 1989. However, a transition rule is provided under the reporting rules for payments made prior to July 1, 1990. To bring their arrangements into compliance with the regulations, some employers have had to make significant modifications in their payroll and accounting procedures. This notice provides guidance regarding the imposition of penalties for failure to comply with these withholding and reporting requirements on employers who have made a substantial and good faith effort to comply with the requirements.

IMPOSITION OF PENALTIES

Where an employer has made a substantial and good faith effort to comply with the regulations regarding withholding and reporting on employee business expense reimbursements and allowances, the Service will not impose penalties for failure to pay and failure to make timely deposits of employment taxes with respect to, and for failure to report, payments made under reimbursement or other expense allowance arrangements before July 1, 1991.

Weighted Average Interest Rate Update

Notice 90-75

Notice 88-73 provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of section 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 (OBRA 1987).

The notice also provides that an announcement will be published monthly to provide the weighted average and the permissible range for the plan years beginning each month. The following rates were determined for the plan years beginning each month. The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	Permissible Range
November	1990	8.63	7.76 to 9.49

Administrative Pronouncement

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

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26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also Part I, Sections 162, 167, 263, 446, 481, 805, 811; 1.162-1, 1.167(a)-1, 1.263(a)-1, 1.446-1, 1.481-1, 1.817-4(d).)

Rev. Proc. 90-36

SECTION 1. PURPOSE

This revenue procedure provides an administrative procedure whereby certain life insurance companies may expeditiously obtain the consent of the Commissioner to change their method of accounting for ceding commissions to comply with the principles of Rev. Rul. 82-69, 1982-1 C.B. 102, and the Supreme Court decision in *Colonial American Life Insurance Co. v. Commissioner,* 109 S. Ct. 2408 (June 15, 1989), 1989-2 C.B. 110. A taxpayer that complies with this revenue procedure will be treated as having obtained the consent of the Commissioner to change its accounting method.

SEC. 2. BACKGROUND

.01 Rev. Rul. 82-69 concerns a reinsuring life insurance company that paid ceding commissions under an indemnity reinsurance agreement. In an indemnity reinsurance agreement, the primary insurer remains directly liable to the policyholders and continues to collect premiums and pay claims. The indemnity reinsurer assumes no direct liability to the policyholders, but agrees to reimburse the primary or direct insurer for a specified percentage of claims and expenses associated with the reinsured risks. In return, the reinsurer receives a specified percentage of the income generated from the policies. In Rev. Rul. 82-69, the taxpayer paid ceding commissions to the direct insurer as consideration for the reinsurance of an existing block of life insurance policies. The stated purpose of these "up-front" ceding commissions was to reimburse the direct insurer for previously incurred expenses associated with selling and maintaining the reinsured policies. The ruling requires the ceding commissions to be treated as the cost of an asset with a useful life extending beyond the close of the tax year, and therefore amortized over the period covered by the agreement.

In the *Colonial American* case, the Supreme Court addressed the tax treatment of ceding commissions paid by a reinsuring life insurance company to a direct insurer under indemnity reinsurance contracts to reinsure blocks of life insurance policies. The case holds that, for purposes of the Internal Revenue Code, ceding commissions are capital expenditures that must be amortized over the anticipated life of the asset (here the reinsurance agreement), and are not current expenses that may be deducted in the year paid or incurred. The Court concluded that ceding commissions represent payments to acquire an asset (the future stream of income from the reinsured policies) with a life extending beyond the tax year. As a result, the ceding commissions must be treated like commissions involved in assumption reinsurance, which must be treated as a deferred expense and amortized over the reasonably estimated life of the policies. *Cf.* section 1.817-4(d) of the Income Tax Regulations.

Rev. Rul. 82-69 also provides for the current deductibility of an "annual ceding commission" paid by the reinsurer to reimburse the ceding company for the reinsurer's share of the current expenses in administering the policies. Consequently, if a taxpayer enters into an indemnity reinsurance contract that provides for the payment of an annual ceding commission to reimburse the direct insurer for the taxpayer's proportionate share of the current expenses involved in administering and servicing the reinsured policies, those ceding commissions may be deducted in the year paid or incurred.

If an up-front ceding commission is paid by the taxpayer to acquire an indemnity reinsurance agreement, but all or a portion of the assumed business is retroceded to third parties, the taxpayer is required to amortize only the portion of the ceding commission that is proportionate to the retained business. Thus, the portion of the ceding commission that is attributable to the retroceded portion of the business may be deducted in the year of the retrocession.

.02 Under the principles of Rev. Rul. 82-69 and the *Colonial American* decision, if an indemnity reinsurance agreement provides for the reinsurance of a block of policies with an income producing life extending beyond the tax year, the reinsurer must treat the up-front ceding commission paid for this asset like the ceding commissions involved in assumption reinsurance, which must be capitalized. The principles of section 1.817-4(d)(2) of the regulations (relating to assumption reinsurance transactions) are relevant in determining the amount of the up-front ceding commission that is subject to amortization. Thus, for transactions occurring during tax years beginning after December 31, 1983, the amount of the up-front ceding commission paid by the reinsurer is equal to the excess of the increase in the reinsurer's tax reserve liabilities resulting from the transaction (computed in accordance with section 807 of the Code) over the value of the net assets received. Unlike assumption reinsurance, however, the up-front ceding commission must be amortized over a period reflecting the life of the reinsurance agreement rather than the reasonably estimated life of the reinsured policies.

The establishment of the life of the reinsurance agreement requires a factual determination. If the reinsurance agreement has (either explicitly or implicitly) a determinate life, then that life should be used for amortization purposes. For example, if a reinsurance agreement is written for an indefinite period but contains terms that demonstrate that the agreement has a limited life (such as a provision granting the direct insurer a recapture right after a specified period), this life is used for amortization purposes. If the reinsurance agreement has an indeterminate life, the reasonably estimated life of the underlying policies should be used. See section 1.817-4(d)(2)(iv) of the regulations with respect to the factors that may be considered in determining the reasonably estimated life of the reinsured policies.

The taxpayer may use the straight-line method for purposes of determining a reasonable allowance for amortization. The taxpayer may also use any amortization method that results in an allowance for amortization that is consistent with the anticipated income stream. For this purpose, both future premiums and investment earnings must be taken into account in determining the anticipated income

stream from the reinsured policies. The annual allowance for amortization must be calculated from the effective date of the reinsurance agreement.

.03 Taxpayers that must change their method of accounting for ceding commissions in order to comply with the principles of Rev. Rul. 82-69 and the *Colonial American* decision must do so in accordance with section 446(e) of the Code and the regulations thereunder.

.04 Section 446(e) of the Code states generally that a taxpayer that changes the method of accounting on the basis of which it regularly computes its income in keeping its books must, before computing taxable income under the new method, secure the consent of the Secretary.

Section 1.446-1(e)(3)(ii) of the regulations states that the Commissioner may prescribe administrative procedures, subject to such limitations, terms, and conditions as deemed necessary to obtain consent, to permit taxpayers to change their accounting practices or methods to an acceptable treatment consistent with applicable regulations. Limitations, terms, and conditions, as may be prescribed in such administrative procedures by the Commissioner, include those necessary to prevent the omission or duplication of items includible in gross income or deductions.

.05 If a taxpayer's taxable income for a tax year (year of change) is computed under a method of accounting different from the method used to compute taxable income in the preceding tax year, then section 481(a) of the Code requires that those adjustments necessary to prevent amounts from being duplicated or omitted be taken into account.

.06 Rev. Proc. 84-74, 1984-2 C.B. 736, contains procedures under section 1.446-1(e) of the regulations for obtaining the consent of the Commissioner to change a method of accounting for federal income tax purposes. Except as otherwise specifically provided by documents published in the Internal Revenue Bulletin, a change in method of accounting initiated by the taxpayer can be made only under the provisions of Rev. Proc. 84-74.

Section 6.02 of Rev. Proc. 84-74 defines a Category A method of accounting as a method of accounting that is specifically not permitted to be used by the taxpayer by the Code, the regulations, or a decision of the Supreme Court of the United States.

Sections 4.01(1), 4.01(2), 4.01(3), and 4.01(5) of Rev. Proc. 84-74 provide that, subject to certain limited exceptions, a taxpayer may not use that revenue procedure to change a method of accounting if, at the time of the filing the Form 3115, one or more of the following conditions exist: (1) the taxpayer is under examination for the year or years in which the erroneous method of accounting was initiated or in which the taxpayer changed to a method of accounting without the consent of the Commissioner, (2) the method being changed is a Category A method and the taxpayer has been contacted in any manner by the Service for purposes of scheduling an examination (and such examination has not been completed), (3) the taxpayer is under examination by the district director, (4) the taxpayer has a return that is under consideration by an appeals office of the Service, (5) a return of the taxpayer is before any federal court with respect to an income tax issue, or (6) there is pending a criminal investigation or proceeding concerning any issue related to the taxpayer's federal tax liability for any year. These limitations are intended to encourage taxpayers to adopt proper methods of accounting prior to becoming subject to examination.

Section 5.06(1)(d) of Rev. Proc. 84-74 provides that if there is a change in method of accounting from a Category A method that results in a positive net adjustment under section 481(a) of the Code, then the adjustment period shall not exceed 3 tax years.

.07 With respect to actions taken by taxpayers, or determinations made by the Service, on or after June 15, 1989 (the date of the *Colonial American* decision), a method of accounting for the treatment of ceding commissions that is inconsistent with the principles of Rev. Rul. 82-69 and the *Colonial American* decision is a Category A method of accounting (as defined in section 6.02 of Rev. Proc. 84-74).

.08 Under this revenue procedure, however, as a matter of administrative convenience, if a life insurance company applies to change its method of accounting for ceding commissions, then it may obtain less stringent treatment than the limitations, terms, and conditions that usually apply for a change from a Category A method. This treatment applies only with respect to the types of taxpayers and the specific changes in method that are within the scope of this revenue procedure. No inference should be drawn from the treatment provided by this revenue procedure as to the procedures that the Service may adopt in other situations in which a change from a Category A method of accounting is required as the result of a Supreme Court decision.

.09 Taxpayers' actions taken to change their method of accounting for ceding commissions to comply with the provisions of Rev. Proc. 82-69, on or after December 5, 1988 (the date certiorari was granted in *Colonial American*) but before June 15, 1989, are subject to the rules of section 14 of this revenue procedure. This section imposes conditions designed to put the taxpayer in the same position as if it had not acted to change its method of accounting until June 15, 1989.

SEC. 3. SCOPE

This revenue procedure must be used by life insurance companies to change their method of accounting for ceding commissions to comply with the principles of Rev. Rul. 82-69 and the *Colonial American* decision for their first tax year ending after June 15, 1989, as set forth below. In general, this revenue procedure applies (i) to taxpayers that as of June 15, 1989 were not under examination by the Service, as described more fully in section 3.01, and (ii) to taxpayers that were under examination on that date if the taxpayer's treatment of ceding commissions was not a "pending issue" as of June 15, 1989, as described more fully in section 3.02. Taxpayers eligible to use this revenue procedure to effect a change in method of accounting must treat the tax year that includes June 15, 1989 as the year of change, as described more fully in section 5.

.01 This revenue procedure applies to any life insurance company that, as of June 15, 1989, had not been

contacted by a representative of the Service for purposes of scheduling an examination and was not otherwise described in sections 4.01(1), 4.01(2), 4.01(3), or 4.01(5) of Rev. Proc. 84-74 on that date, provided the taxpayer complies with the general procedures for implementing the change set forth in section 5 of this revenue procedure. Thus, if at any time after June 15, 1989, but prior to the due date (including extensions) of the taxpayer's tax return for the first year ending after June 15, 1989, a taxpayer described in this section 3.01 has been contacted by the Service for purposes of scheduling an examination, this revenue procedure may be used to change the method of accounting. In such a case, however, the taxpayer must comply with the additional procedures in section 5.04 for notifying the district director of the change.

.02 This revenue procedure also applies to any life insurance company that, as of June 15, 1989, had been contacted for purposes of scheduling an examination or was otherwise subject to section 4.01(1), 4.01(2), or 4.01(3) (without regard to section 4.02) of Rev. Proc. 84-74, provided that an issue concerning the taxpayer's treatment of ceding commissions was not a "pending issue" as of that date. See section 4 of this revenue procedure for the definition of a pending issue. More specifically, if as of June 15, 1989, a life insurance company had a federal income tax return (i) with respect to which the taxpayer had been contacted in any manner by the Service for purposes of scheduling an examination (and such examination was not yet completed), or (ii) which was either (a) under examination by the district director, (b) under consideration by an appeals office of the Service, or (c) before any federal court with respect to an income tax issue, then the taxpayer may use this revenue procedure only if the treatment of ceding commissions on indemnity reinsurance was not a pending issue as of June 15, 1989. See section 5 regarding the general procedures for implementing the change, including section 5.05 with regard to the additional procedures for notifying the Service representative(s) or counsel for the Government and obtaining a statement verifying that the taxpayer's treatment of ceding commissions on indemnity reinsurance was not a pending issue.

SEC. 4. SPECIAL RULES RELATING TO PENDING ISSUE

A taxpayer's treatment of ceding commissions on indemnity reinsurance is considered to have been a pending issue as of June 15, 1989, only if on or before that date the Service had sent the taxpayer written notification indicating that an adjustment was being proposed to the treatment of ceding commissions on a return that was under examination (e.g., by Form 5701, Notice of Proposed Adjustment). Thus, if on or before June 15, 1989, the examining officer had merely notified the taxpayer orally that its indemnity reinsurance transactions were being examined but had not proposed any adjustments in writing to the taxpayer's treatment of ceding commissions on indemnity reinsurance, the taxpayer's treatment of ceding commissions was not a pending issue. Similarly, if on or before June 15, 1989, the examining officer had formally requested relevant documents but had not yet notified the taxpayer in writing of a proposed adjustment in the treatment of ceding commissions, the taxpayer's treatment of ceding commissions was not a pending issue.

SEC. 5. APPLICATION

.01 *Consent.* If a taxpayer properly complies with the provisions of this revenue procedure (i) in accordance with section 1.446-1(e)(3)(ii) of the regulations, the 180-day time period for filing an application is extended to the due date (including extensions) of the taxpayer's federal income tax return for the first tax year ending after June 15, 1989, and (ii) consent is hereby granted to the taxpayer to effect the change in method for the tax year which includes June 15, 1989. If the return for the year of change has already been filed, see section 5.03.

.02 *Method of implementing the change.* A taxpayer applying for a change in method under this revenue procedure must complete and file a current Form 3115 in duplicate. The original must be attached to the taxpayer's timely filed (including extensions) original federal income tax return for the first tax year ending after June 15, 1989. The duplicate of the completed Form 3115 shall be filed with the Commissioner of Internal Revenue, Office of Assistant Chief Counsel (Financial Institutions and Products), CC:FI&P:4, P.O. Box 7616, Ben Franklin Station, Washington, D.C., 20044, no later than the time the original of the Form 3115 is filed as described above. In order to assist in the processing and proper handling of these applications, reference to this revenue procedure shall be made a part of the Form 3115 by either typing or legibly printing the following statement at the top of page 1 of the Form 3115: "FILED UNDER REV. PROC. 90-36." No user fee is required for an application filed under this revenue procedure.

.03 *Return for the year of change already filed.* If on or before August 1, 1990, any taxpayer eligible to change its method of accounting under this revenue procedure files its federal income tax return for the first tax year ending after June 15, 1989, consent is hereby granted to the taxpayer to effect the change in method by filing an amended return for the tax year that included June 15, 1989, provided the taxpayer otherwise complies with the requirements of section 5.02 and the amended return is filed by September 17, 1990.

.04 *Contacted for examination before Form 3115 is filed.* If any taxpayer described in section 3.01 is contacted by the Service for purposes of scheduling an examination at any time after June 15, 1989, but prior to the due date (including extensions) of the taxpayer's tax return for the first year ending after June 15, 1989, the taxpayer must provide the district director a written statement indicating that the taxpayer is changing its method of accounting for ceding commissions under this revenue procedure. This statement must be provided by the later of (i) 90 days after the taxpayer has been contacted by the Service for purposes of scheduling an examination, or (ii) September 30, 1990. In addition, the taxpayer must provide the district director a duplicate of the completed Form 3115 filed with the taxpayer's federal income tax return for the year of change. This duplicate must be provided by the later of the date the above statement is filed or the date the Form 3115 is filed.

.05 *Supporting statement required.* A taxpayer qualifying to use this revenue procedure under section 3.02 may change its method of accounting under this revenue procedure only if on or before September 30, 1990, the taxpayer notifies the Service representative(s) or counsel for the Government with jurisdiction over its tax returns that the taxpayer is changing its method of accounting for ceding commissions under this revenue procedure. The taxpayer must also request that the Service representative(s) or counsel for the Government with jurisdiction over its return(s) provide a written statement concurring that on or before June 15, 1989, there was no pending issue concerning the taxpayer's treatment of ceding commissions on indemnity reinsurance. A copy of this supporting statement must be filed with the completed Form 3115 attached to the return for the tax year of change. The taxpayer must also provide the Service representative(s) or counsel for the Government a duplicate of the Form 3115 filed with the taxpayer's federal income tax return for the tax year of change. If the taxpayer fails to comply with these requirements, then the treatment of ceding commissions on returns under examination or otherwise described in sections 4.01(1), 4.01(2) or 4.01(3) (without regard to section 4.02) of Rev. Proc. 84-74 shall be subject to adjustment in the earliest open year in the manner provided in section 11 of this revenue procedure.

.06 *Year of Change.* The year of change for any change in method of accounting for ceding commissions which is made in accordance with this section 5 is the first tax year ending after June 15, 1989.

SEC. 6. SECTION 481(a) ADJUSTMENT

.01 *Section 481(a) adjustment.* An adjustment (the "section 481(a) adjustment") is required to prevent items from being omitted or duplicated solely by reason of a change in method of accounting. In a situation in which the taxpayer has been treating ceding commissions as currently deductible expenses, the section 481(a) adjustment required by reason of the change in accounting method is the amount that would be the unamortized balance of the ceding commissions as of the beginning of the year of change, if the method to which the taxpayer is changing had always been used. Thus, the section 481(a) adjustment (which is positive) takes into account all of the reinsurance agreements entered into by the taxpayer prior to the year of change for which the taxpayer would, as of the beginning of the year of change, have an unamortized balance of ceding commissions, if the method of amortization to which the taxpayer is changing had originally been applied to such commissions.

.02 *Adjustment period.* If the entire amount of the section 481(a) adjustment is attributable to the tax year immediately preceding the year of change, then the total adjustment must be taken into account in computing taxable income for the year of change. Otherwise, the section 481(a) adjustment must be taken into account in computing taxable income ratably over a period equal to the lesser of (i) the number of tax years the taxpayer has used the method being changed, or (ii) 3 tax years.

.03 *Acceleration of adjustment.* If, during the adjustment period, the aggregate amount of unamortized ceding commissions as of the last day of any tax year is reduced by more than 66 2/3 percent of the aggregate amount of unamortized ceding commissions at the beginning of the year of change, the balance of the section 481(a) adjustment not previously taken into account must be included in income in the year the aggregate amount of unamortized ceding commissions is so reduced.

.04 *Ceasing to engage in the trade or business.* If, during the adjustment period, the taxpayer ceases to engage in the trade or business giving rise to the adjustment, the balance of the section 481(a) adjustment not previously taken into account must be included in income in the year that the taxpayer ceases to engage in the trade or business. See section 5.09 of Rev. Proc. 84-74 for guidance as to when a taxpayer is treated as ceasing to engage in a trade or business.

.05 *Net operating losses.* No limitations on net operating loss and tax credit carryovers apply with respect to any section 481(a) adjustment taken into account as a result of a change in method under this revenue procedure. See section 5.15(3) of Rev. Proc. 84-74.

.06 *Consolidated returns.* If the taxpayer is a member of an affiliated group and more than one member of the group is requesting to change its method of accounting for ceding commissions under this revenue procedure, the section 481(a) adjustment must be computed and separately stated for each taxpayer.

SEC. 7. ESTIMATED TAXES

For purposes of any required quarterly installments and extension payments made on or before August 1, 1990, no penalty shall be assessed for underpayment of estimated taxes under section 6655 of the Code or for late payment of tax under section 6651 of the Code on account of an underpayment or late payment that results from the treatment of ceding commissions on indemnity reinsurance as being currently deductible.

SEC. 8. RECORDS

The taxpayer must maintain adequate records so that the Service may, upon examination, verify the data relating to the change in method of accounting.

SEC. 9. COMPLIANCE WITH CONDITIONS

A taxpayer that attempts to make an accounting method change under this revenue procedure without complying with all the conditions of this revenue procedure has initiated the change without obtaining the consent of the Commissioner.

SEC. 10. ADDITIONAL PROCEDURAL REQUIREMENTS

The signature of the person preparing the request for the change in method of accounting must appear in the space provided on Form 3115. The Form 3115 also must be signed by or on behalf of the taxpayer requesting the change. See the signature requirements set forth in the General Instructions attached to Form 3115 regarding those who are to sign. For example, an officer must sign on behalf of a corporation. If for the year of change the taxpayer is a member of an affiliated group that has elected to file a consolidated federal income tax return, a Form 3115

submitted on behalf of the taxpayer must be signed by a duly authorized officer of the common parent. (*See* section 1.1502-77 of the regulations.)

SEC. 11. TREATMENT OF LIFE INSURANCE COMPANIES WITH PENDING ISSUE

If a life insurance company is ineligible to use this revenue procedure because there was a pending issue concerning the treatment of ceding commissions on indemnity reinsurance on or before June 15, 1989, then the change in method of accounting shall be imposed by the Service under authority of section 446(b) and section 481 of the Code in accordance with the procedures that generally apply when an issue is raised concerning the use of a Category A method of accounting pursuant to an examination of the taxpayer's returns.

SEC. 12. ACCOUNTING METHOD CHANGES BY NON-LIFE COMPANIES

The provisions of this revenue procedure are applicable only to life insurance companies as defined in section 816(a) of the Code. With respect to non-life companies engaged in reinsuring life insurance policies, the Service will not treat a method of accounting for ceding commissions that is inconsistent with the principles of *Colonial American* decision as a Category A method of accounting. Thus, an insurance company taxable under section 831(a) (a non-life company) that has reinsured life insurance business may request to change its method of accounting with respect to the treatment of the related ceding commissions to be consistent with the principles of the *Colonial American* decision by filing a Form 3115 in accordance with the procedures and rules of Rev. Proc. 84-74.

SEC. 13. EXCLUSIVE APPLICATION

If a life insurance company does not implement the change in method of accounting for ceding commissions to comply with the principles of Rev. Rul. 82-69 and the *Colonial American* decision in the manner provided by section 5 above, the company must use Rev. Proc. 84-74 to change the method of accounting. With respect to any application filed by a life insurance company under Rev. Proc. 84-74 prior to January 1, 1992, however, under the authority of section 1.446-1(e)(3)(ii) of the regulations, the Service will require as a condition for its consent that the taxpayer implement the change in method of accounting for the treatment of ceding commissions in the year of change provided under this revenue procedure. Thus, a taxpayer that files an application under Rev. Proc. 84-74 prior to January 1, 1992 to request the change in method will generally be required to file an amended return to implement the change. For applications filed after December 31, 1991, the Service will process these applications in accordance with the general procedures then in effect for obtaining the consent of Commissioner to change a method of accounting for federal income tax purposes.

SEC. 14. APPLICATIONS FOR METHOD CHANGE FILED AFTER DATE CERTIORARI WAS GRANTED

With respect to any application on Form 3115 filed on or after December 5, 1988 (the date certiorari was granted in *Colonial American*) but before June 15, 1989, in order to comply with Rev. Rul. 82-69, the Service will impose the conditions outlined in this section, which are necessary in order to provide treatment that is substantially equivalent to the treatment of taxpayers that change their method of accounting pursuant to section 5. If the taxpayer's treatment of ceding commissions was a pending issue at the time the Form 3115 was filed, then both the year of change and spread period shall be imposed by the Service under the authority of section 1.446-1(e)(3)(ii) of the regulations in accordance with the procedures that generally apply when an issue is raised concerning the use of a Category A method of accounting pursuant to an examination of the taxpayer's returns. If the taxpayer's treatment of ceding commissions was not a pending issue at the time the Form 3115 was filed, then the year of change is the applicable year in which the Form 3115 is filed and the spread period will be determined under section 6.02 of this revenue procedure (*i.e.*, not more than 3 years).

SEC. 15. EFFECTIVE DATE

This revenue procedure is effective June 15, 1990, the date in which notice of its publication in the Internal Revenue Bulletin was given to the public.

SEC. 16. INQUIRIES

Inquiries in regard to this revenue procedure should refer to its number and be addressed to the Commissioner of Internal Revenue, Attention: Office of Assistant Chief Counsel (Financial Institutions and Products), CC:FI&P:4, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044.

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26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also Part I, Sections 446, 481, 1281; 1.446-1, 1.481-5.)

Rev. Proc. 90-37

SECTION 1. PURPOSE

This revenue procedure provides that certain taxpayers may obtain expeditious consent to change their accounting method for reporting interest income on short-term loans to customers to accord with the provisions of section 1281 of the Internal Revenue Code. As used in this revenue procedure, the term "interest income" includes stated interest, original issue discount, and acquisition discount. A taxpayer that complies with this revenue procedure will be deemed to have obtained the consent of the Commissioner to change its accounting method.

SEC. 2. BACKGROUND

.01 In general, section 1281(a) of the Code, as modified by section 1283(c)(1), requires a holder of certain short-term obligations, including a bank as defined in section 581, to include in gross income any accrued interest income on such obligations, regardless of the holder's overall method of accounting. Section 1281(a) applies to all types of interest income, including acquisition discount, original issue discount, and stated interest. *See* S. Rep. No. 99-313, 99th Cong., 2d Sess. 903 (1986), 1986-3 (Vol. 3) C.B. 903.

.02 Section 1283(a)(1) of the Code generally defines a short-term obligation as any bond, debenture, note,

certificate, or other evidence of indebtedness that matures in one year or less from its issue date. A short-term loan is a short-term obligation.

.03 Section 1281(a) of the Code, by its terms, requires only the inclusion of acquisition discount. It is modified by section 1283(c) of the Code, however, to require the inclusion of original issue discount (rather than acquisition discount) on short-term nongovernmental obligations. See section 1273(a)(1) for the definition of original issue discount and section 1283(a)(2) for the definition of acquisition discount.

.04 Under sections 1281(a) and 1283(c) of the Code, the holder of a short-term obligation subject to section 1281 must include in gross income an amount equal to the sum of the daily portions of the acquisition discount or original issue discount, whichever is applicable, on the obligation for each day during the tax year that the obligation is held by the holder. See section 1283(b), as modified by section 1283(c), for the determination of the daily portion of the acquisition discount or original issue discount on a short-term obligation. In addition, section 1281(a) requires the holder of any short-term obligation subject to section 1281 to include in gross income any interest that is payable on the obligation (other than interest taken into account in determining the amount of the acquisition discount or original issue discount) as it accrues.

.05 Section 446(e) of the Code and section 1.446-1(e) of the Income Tax Regulations provide that, except as otherwise provided, a taxpayer must obtain the consent of the Commissioner in order to change a method of accounting for federal income tax purposes. Section 1.446-1(e)(3)(i) of the regulations generally requires that in order to obtain this consent, a Form 3115, Application for Change in Accounting Method, must be filed within 180 days after the beginning of the tax year in which the proposed change is to be made. Section 1.446-1(e)(3)(ii) authorizes the Commissioner to prescribe administrative procedures setting forth the limitations, terms, and conditions deemed necessary to permit a taxpayer to obtain consent to a change in its method of accounting in accordance with section 446(e) of the Code.

.06 Section 481(a) of the Code requires that those adjustments necessary to prevent amounts from being duplicated or omitted be taken into account when the taxpayer's taxable income is computed under a method of accounting different from the method used to compute taxable income for the preceding tax year. Section 481(c) and section 1.481-5 of the regulations provide that the adjustment required by section 481(a) may be taken into account in determining taxable income in the manner and subject to the conditions agreed to by the Commissioner and the taxpayer.

.07 Rev. Proc. 84-74, 1984-2 C.B. 736, contains procedures under section 1.446-1(e) of the regulations for obtaining the consent of the Commissioner to a change in a method of accounting for federal income tax purposes. Section 5.15 of the revenue procedure states, in part, that the Commissioner will impose terms and conditions when consenting to changes in methods of accounting to make certain that taxable income is or will be clearly reflected, and to prevent taxpayers from receiving otherwise unavailable benefits that could arise from a change in method of accounting. Although Rev. Proc. 84-74 also specifies procedures for spreading an adjustment required by section 481(a) of the Code resulting from a change in method of accounting over a number of tax years to ameliorate the otherwise distortive effect of such adjustment, section 2.04 of that revenue procedure provides that, in order to further compliance with proper methods of accounting, certain situations exist when allowing a section 481 adjustment period of more than one tax year is not appropriate.

SEC. 3. SCOPE

.01 Except as provided in section 3.02 below, this revenue procedure applies to a taxpayer described in this subsection that desires to effect a change in method of accounting to comply with section 1281 of the Code for interest income on short-term loans to its customers. A taxpayer is described in this subsection if it satisfies two conditions:

1. The taxpayer is a bank (as that term is defined in section 581 of the Code, which definition includes most thrift institutions); and

2. The taxpayer's present method of accounting is in compliance with section 1281 for all of the taxpayer's short-term obligations described in section 1281(b)(1) other than short-term loans to its customers.

.02 This revenue procedure does not apply to:

(1) Any bank that, as of the date of the filing of the Form 3115 with the National Office, has been contacted in any manner by a representative of the Internal Revenue Service for the purpose of scheduling an examination of its federal income tax return(s) for any year, if the examination has not been completed, unless the bank has obtained and attaches to its Form 3115 an agreement from the revenue agent that there is no objection to the proposed change in method of accounting.

(2) Any bank that, as of the date of the filing of the Form 3115 with the National Office, is:

(a) Before an appeals office of the Service with respect to an examination of its federal income tax return(s) for any year, unless the bank has obtained and attaches to its Form 3115 an agreement from the appeals officer that there is no objection to the proposed change in method of accounting; or

(b) Before any federal court with respect to an income tax issue arising in any year, unless the bank has obtained an agreement from counsel for the government that there is no objection to the proposed change in method of accounting.

(3) Any bank that, as of the date of the filing of the Form 3115 with the National Office, is the subject of a criminal investigation or proceeding concerning (a) directly or indirectly the bank's federal income tax liability for any year, or (b) the possibility of false or fraudulent statements made by the bank with respect to any issue relating to its federal income tax liability for any year.

.03 Any taxpayer to which this revenue procedure does not apply must file a current Form 3115 with the Commissioner in accordance with the requirements of section 1.446-1(e)(3) of the regulations and Rev. Proc. 84-74 in order to secure the consent of the Commissioner to change the taxpayer's method of accounting for reporting interest income on short-term obligations to the

method required by section 1281 of the Code.

SEC. 4. APPLICATION

.01 *Consent.* In accordance with section 1.446-1(e)(3)(ii) of the regulations, the requirement to file an application on Form 3115 within a 180-day period is waived, and under section 1.446-1(e)(2)(i) consent is hereby granted to any taxpayer to which this revenue procedure applies to change its method of accounting for reporting interest income on short-term obligations to the method required by section 1281 of the Code. This consent is granted for the tax year for which the taxpayer requests a change (year of change) by filing a current Form 3115 in the manner described in section 6 of this revenue procedure and by otherwise complying with the provisions of this revenue procedure. See section 5 regarding compliance with the provisions of this revenue procedure. If a taxpayer to which this revenue procedure applies changes its method of accounting for reporting interest income on short-term obligations to the method required by section 1281 of the Code without complying with all the provisions of this revenue procedure, the taxpayer will be deemed to have initiated the change in method of accounting without obtaining the permission of the Commissioner as required under section 446(e) of the Code.

.02 *Section 481(a) adjustment and adjustment period.* Section 481 of the Code prescribes the rules to be followed in computing taxable income of a taxpayer in cases where the taxable income of a taxpayer is computed under a method of accounting different from the method used to compute taxable income for the preceding year. An adjustment is required to prevent amounts from being duplicated or omitted when a change in method of accounting is made. The Service has determined that an adjustment period of one year for a positive section 481(a) adjustment (increase in income) is appropriate in situations in which taxpayers are requesting permission to change to the method of accruing interest income on short-term loans to customers in accordance with the provisions of section 1281. Accordingly, the positive section 481(a) adjustment will be taken into account entirely in the year of change.

.03 Taxpayers to which this revenue procedure applies may not use Rev. Proc. 84-74 but must use the provisions of this revenue procedure to change their method of accounting for reporting interest income on short-term obligations to the method required by section 1281 of the Code.

SEC. 5. MANNER OF EFFECTING THE CHANGE

.01 A taxpayer applying for a change in method of accounting pursuant to this revenue procedure must complete and file a current Form 3115 in duplicate. The original shall be attached to the taxpayer's timely filed (determined with regard to extensions) federal income tax return for the year of change. The copy shall be filed with the National Office of the Internal Revenue Service, CC:IT&A:8, P.O. Box 7616, Benjamin Franklin Station, Washington, D.C. 20044, by the later of 270 days after the beginning of the year of change, or August 31, 1990 (60 days after publication of this revenue procedure). In addition to including all information required on the Form 3115, the taxpayer shall indicate that it will take the entire section 481(a) adjustment into account in the year of change. No user fee is required for an application filed under this revenue procedure.

.02 In order to assist in the processing of these changes in method of accounting and to insure proper handling, reference to this revenue procedure shall be made a part of the Form 3115 by either typing or legibly printing the following statement at the top of Page 1 of Form 3115: "FILED UNDER REV. PROC. 90-37."

.03 The signature of the person requesting the change in method of accounting must appear in the space provided for it on the Form 3115. For example, an officer must sign on behalf of a corporation. See the signature requirements set forth in the General Instructions attached to a current Form 3115 for those who are authorized to sign. If an agent is authorized to represent the taxpayer before the Service, to receive the original or copy of correspondence concerning the request, or to perform any additional act(s) regarding the application on behalf of the taxpayer, a power of attorney reflecting such authorization(s) must be attached to the application. A taxpayer's representative without a power of attorney to represent the taxpayer as indicated in this subsection will not be given any information about the application.

.04 If the taxpayer is a member of an affiliated group that has elected to file a consolidated federal income tax return, a Form 3115 submitted on behalf of the taxpayer must be signed by a duly authorized officer of the common parent. See section 1.1502-77 of the regulations.

SEC. 6. INQUIRIES

Inquiries regarding this revenue procedure may be addressed to the Commissioner of Internal Revenue, Attention: CC:IT&A:8, 1111 Constitution Avenue, N.W., Washington, D.C. 20224.

SEC. 7. EFFECTIVE DATE

This revenue procedure is effective July 2, 1990, the date of its publication. Any request for a change in method of accounting to which this revenue procedure applies that is received by the National Office after the effective date will be returned to the taxpayer. Taxpayers who have already filed a timely Form 3115 with the National Office prior to the effective date of this revenue procedure may use the automatic provisions of this revenue procedure and will be so notified to this effect by the National Office.

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26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.
(Also Part I, Sections 62, 162, 274; 1.62-2T, 1.162-17, 1.274-5T.)

Rev. Proc. 90-38

SECTION 1. PURPOSE

This revenue procedure amplifies Rev. Proc. 89-67, 1989-2 C.B. 795, as amplified by Rev. Proc. 90-15, 1990-1 C.B. 476, by providing a special method for determining the amount of ordinary and necessary expenses of an employee or self-employed individual in the transportation industry for meal and incidental expenses incurred while traveling

away from home that will be deemed substantiated for purposes of section 1.274-5T of the temporary Income Tax Regulations. This revenue procedure also clarifies and modifies Rev. Proc. 89-67 by providing that (1) a per diem allowance is treated as paid only for meal and incidental expenses if the payor pays an employee for actual expenses for lodging, (2) only payors are not required to reduce the Federal per diem rates for meals provided in kind, and (3) the 6-hour/$6 limitation in the Federal Travel Regulations for OCONUS travel does not apply.

SEC. 2. PROCEDURE

Rev. Proc. 89-67 is hereby clarified by revising subsection 4.02, amplified by adding subsection 4.04, and modified by revising subsections 6.03 and 6.04 as follows:

SEC. 4. PER DIEM SUBSTANTIATION METHOD

* * * * *

.02 *Meals only per diem allowance.* If a payor pays a per diem allowance only for meals 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 is equal to the lesser of the per diem allowance or the amount computed at the Federal M&IE rate for the locality of travel for the period the employee is away from home. 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, (2) the payor provides the lodging in kind, (3) the payor pays the actual expenses for lodging directly to the provider of the lodging, or (4) the payor does not have a reasonable belief that lodging expenses were or will be incurred by the employee.

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.04 *Special meals only rate for transportation industry.* This section 4.04 applies to (1) 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 above to an employee in the transportation industry, or (2) an employee or self-employed individual in the transportation industry that computes the amount allowable as a deduction for meal and incidental expenses for travel away from home in accordance with section 4.03 above. Such a taxpayer (1) may treat $30 as the Federal M&IE rate for any locality of travel in CONUS, and/or (2) may treat $34 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 these special rate(s) for all amounts subject to section 4.02 above 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 these special rate(s) for all amounts computed pursuant to section 4.03 above for travel away from home within CONUS and/or OCONUS, as the case may be, during the calendar year. 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 (1) is of the type that directly involves moving people or goods by airplane, barge, bus, ship, train, or truck, and (2) 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.

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SEC. 6. LIMITATIONS

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.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. In addition, a reduction to reflect the 6-hour/$6 limitation provided in 41 C.F.R. Part 301-7.6(c)(2)(iii) (1989) of the Federal Travel Regulations is not required in order to apply the Federal per diem rates and Federal M&IE rates to OCONUS travel.

.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 section 5 above with respect to partial days of travel away from home, either of the following methods may be used to prorate the Federal per diem rate or the Federal M&IE rate:

(1) Such rate may be prorated using the method prescribed by the Federal Travel Regulations under which one-fourth of the applicable Federal M&IE rate is allowed 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 1 1/2 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 1 1/2 times the Federal M&IE rate will be treated as being in accordance with reasonable business practice (even though only 1 1/4 times the Federal M&IE rate would be allowed under the Federal Travel Regulations).

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26 CFR 601.201: Rulings and determination letters.
(Also Part I, Section 1502; 1.1502-33.)

Rev. Proc. 90-39[1]

SECTION 1. PURPOSE

.01 This revenue procedure provides a means for an affiliated group of corporations filing a consolidated federal income tax return to obtain consent, without filing an advance ruling request, to elect or to change its method of allocating the consolidated federal income tax liability to members of the affiliated group for purposes of determining the earnings and profits of each member of the affiliated group.

.02 If an affiliated group qualifies to use this revenue procedure, then this revenue procedure is the exclusive procedure available for obtaining consent to elect or change its method of allocating the consolidated federal income tax liability.

SEC. 2. BACKGROUND

.01 Section 1552(a) of the Internal Revenue Code and section 1.1552-1(a) of the Income Tax Regulations provide four methods for allocating an affiliated group's consolidated federal income tax liability to members of the group (the "basic methods"). Three of these methods (described in section 1552(a)(1), (2), and (3) and section 1.1552-1(a)(1), (2), and (3), respectively) provide specific allocation formulas. The fourth method (described in section 1552(a)(4) and section 1.1552-1(a)(4)) allows the affiliated group to determine its own allocation formula with the prior approval of the Commissioner.

.02 For use in conjunction with one of the four basic methods, three additional allocation methods are described in section 1.1502-33(d)(2) of the regulations (the "complementary methods"). These additional methods allow the affiliated group to compensate a member for its losses that are availed of by profitable members of the affiliated group. Two of these methods (described in section 1.1502-33(d)(2)(i) and (ii)) provide specific formulas. The third method (described in section 1.1502-33(d)(2)(iii)) allows the affiliated group to determine its own formula with the prior approval of the Commissioner.

.03 Section 1552(a) of the Code states that, pursuant to regulations prescribed by the Secretary, the earnings and profits of each member of an affiliated group required to be included in a consolidated return for the group filed for a taxable year shall be determined by allocating the tax liability of the group for the taxable year among the members of the group in accordance with whichever of the following methods the group elects in its first consolidated return filed for the taxable year:

(1) The tax liability shall be apportioned among the members of the group in accordance with the ratio which that portion of the consolidated taxable income attributable to each member of the group having taxable income bears to the consolidated taxable income;

(2) The tax liability of the group shall be allocated to the several members of the group on the basis of the percentage of the total tax which the tax of each member, if computed on a separate return, would bear to the total amount of the taxes for all members of the group so computed;

(3) The tax liability of the group (excluding the tax increases arising from the consolidation) shall be allocated on the basis of the contribution of each member of the group to the consolidated taxable income of the group. Any tax increases arising from the consolidation shall be distributed to the several members in direct proportion to the reduction in tax liability resulting to the members from the filing of the consolidated return as measured by the difference between their tax liabilities determined on a separate return basis and their tax liabilities based on their contributions to the consolidated taxable income; or

(4) The tax liability of the group shall be allocated in accordance with any other method selected by the group with the approval of the Commissioner.

.04 Section 1552(b) of the Code provides that if an allocation method is not elected in the first consolidated return, the tax liability shall be allocated among the several members of the group pursuant to the method prescribed in section 1552(a)(1).

.05 Section 1.1552-1(c)(1) of the regulations provides that an election to use one of the methods described in section 1.1552-1(a)(1), (2), or (3) (which correspond to the methods described in section 1552(a)(1), (2), and (3) of the Code, respectively) shall be made by attaching a statement to the first consolidated return of the group stating which method is elected. In the event that the group desires to allocate its tax liability in accordance with any other method pursuant to section 1.1552-1(a)(4) (and section 1552(a)(4) of the Code), approval of the method by the Commissioner must be obtained prior to its use. An election, once made, is irrevocable and is binding on the group with respect to the year for which it is made and for all future years for which a consolidated return is filed or required to be filed, unless the Commissioner authorizes a change to another method prior to the time prescribed by law for filing the return for the year in which the change is to be effective.

.06 Section 1.1502-33(d)(1) of the regulations provides that, for the purpose of determining the earnings and profits of each member of a group for a consolidated return year, the tax liability of the group for the year may be allocated among the members in accordance with one of the methods prescribed in section 1.1502-33(d)(2)-(i), (ii), or (iii), if an election is made in accordance with section 1.1502-33-(d)(3).

.07 Section 1.1502-33(d)(2)(i) of the regulations provides that the tax liability of the group, as determined under section 1.1552-1(b)(1), shall be allocated to the members in accordance with section 1.1552-1(a)(1), (2), or (3), whichever is applicable, but—

(*a*) The amount of the tax liability allocated to any member for a taxable year shall not exceed the excess of (1) the total of the tax liabilities of the member on a separate return basis for all taxable years to which the election of this method applies, and for which the member joined in the filing of a consolidated return of the group (including the current taxable year), computed as if it

[1]As corrected by Rev. Proc. 90-39A, page 367, this Bulletin.

had actually filed separate returns for all such years, over (2) the total of the portions of the tax liability of the group allocated to the member for all previous taxable years to which the election under this paragraph applies; and

(*b*) The amount of any excess tax liability that would be allocated to a member of a group but for section 1.1502-33(d)(2)(i)(*a*) of the regulations shall be apportioned among the other members in direct proportion to, but limited to, the reduction in tax liability resulting to those other members. The reduction for any member shall be the excess, if any, of (1) the total of its tax liabilities on a separate return basis for all taxable years to which the election under this paragraph applies, and for which the member joined in the filing of a consolidated return of such group (including the current taxable year), computed as if it had actually filed separate returns for all such years, over (2) the total of the portions of the tax liability of the group allocated to the member for all taxable years to which the election under this paragraph applies (including for the current taxable year only the amount allocated under section 1.1552-1(a)(1), (2), or (3)). If any excess tax liability remains after being apportioned among members with a reduction in tax liability to the extent of the reduction, as provided in section 1.1502-33(d)(2)(i)(*b*), the remaining amount shall, notwithstanding section 1.1502-33(d)(2)(i)(*a*), be allocated to the members in accordance with section 1.1552-1(a)(1), (2), or (3), whichever is applicable.

.08 Section 1.1502-33(d)(2)(ii) of the regulations provides that:

(*a*) The tax liability of the group, as determined under section 1.1552-1(b)(1) of the regulations, shall be allocated to the members in accordance with section 1.1552-1(a)(1), (2), or (3), whichever is applicable;

(*b*) An additional amount shall be allocated to each member equal to a fixed percentage (which does not exceed 100 percent) of the excess, if any, of (1) the separate return tax liability of such member for the taxable year (computed as provided in section 1.1552-1(a)(2)(ii) of the regulations), over (2) the tax liability allocated to the member in accordance with section 1.1502-33(d)(2)(ii)(*a*); and

(*c*) The total of any additional amounts allocated pursuant to section 1.1502-33(d)(2)(ii)(*b*) (including amounts allocated as a result of a carryback) shall be credited to the earnings and profits of those members which had items of income, deductions, or credits to which the total is attributable pursuant to a consistent method which fairly reflects those items of income, deductions, or credits, and which is substantiated by specific records maintained by the group for such purpose.

.09 Section 1.1502-33(d)(2)(iii) of the regulations provides that allocations of tax liability to the members may be made in accordance with any other method approved by the Commissioner. A condition of the approval is that the group maintains specific records to substantiate its computations pursuant to the method.

.10 Section 1.1502-33(d)(3)(i) of the regulations provides that in the event a group desires to allocate its tax liability in accordance with a method provided in section 1.1502-33(d)(2)(i) or (ii), an election to that effect shall be made by attaching a statement to the consolidated return for the first consolidated return year of the group. The statement shall indicate which method is elected and which method under section 1.1552-1(a)(1), (2), or (3) is elected in conjunction with the election under section 1.1502-33(d)(3)-(i). In addition, if the method elected is the method provided in section 1.1502-33(d)(2)(ii), the statement shall indicate the percentage used pursuant to section 1.1502-33(d)(2)(ii)(*b*). In the event the group desires to allocate its tax liability in accordance with a method pursuant to section 1.1502-33-(d)(2)(iii), approval of that method by the Commissioner must be obtained prior to its use. An election once made is irrevocable and is binding on the group with respect to the year for which it is made and for all future consolidated return years of the group, unless the Commissioner authorizes a change to another method prior to the time prescribed by law for filing the return for the year in which the change is to be effective.

.11 Section 1.1502-33(d)(3)(ii) of the regulations provides that if a group does not make an election under section 1.1502-33(d)(3)(i) for the first consolidated return year of the group, the group may not thereafter make an election without the approval of the Commissioner.

SEC. 3. SCOPE

.01 Except as provided in section 3.02, this revenue procedure applies to any affiliated group filing consolidated returns that desires to elect or to change its method of allocating the consolidated federal income tax liability to members of the group.

.02 This revenue procedure does not apply to an affiliated group that:

(1) is filing its first consolidated return;

(2) is requesting an allocation of consolidated federal income tax liability under a basic method described in section 1.1552-1(a)-(4) of the regulations or under a complementary method described in section 1.1502-33(d)(2)(iii);

(3) has changed its basic method (not including adoption of the method in the first consolidated return) within the five preceding taxable years; or

(4) has changed its complementary method (not including adoption of the method in the first consolidated return) within the five preceding taxable years.

.03 If this revenue procedure does not apply to an affiliated group by reason of section 3.02 (2), (3), or (4) of this revenue procedure, the group needs the Commissioner's consent to elect or to change its method of allocating the consolidated federal income tax liability to members of the group. Such a group must file a request with the Commissioner as required by sections 1.1502-33(d)(3)(i) and (ii) and 1.1552-1(c)(1) of the regulations.

SEC. 4. MANNER OF EFFECTING THE ELECTION OR CHANGE

.01 In order to obtain the consent of the Commissioner under this revenue procedure, the common parent of

the group must attach a statement to its consolidated federal income tax return (filed on a timely basis, taking into account any extensions). The statement must contain the following information and representations:

(1) The name of the common parent corporation of the affiliated group, its Employer Identification Number (EIN) and its address, the name and EIN of all the members of the affiliated group, and the district office that has jurisdiction over the consolidated return;

(2) A complete description of the present method of allocating the consolidated federal income tax liability. If the present method is not the method that was used for the first filing of a consolidated return, the statement must indicate the date permission to change the affiliated group's allocation method was granted and the taxable year for which the change was effective. If the affiliated group previously used this revenue procedure to elect or to change its method of allocating the consolidated federal income tax liability, a copy of the earlier statement under this section 4.01, including the date such statement was filed and the taxable year of the consolidated return with which it was filed, must be attached to this statement;

(3)A complete description of the affiliated group's proposed method of allocating the consolidated federal income tax liability. If the method described in section 1.1502-33(d)(2)(ii) of the regulations is to be employed, the fixed percentage must be stated; and

(4) A representation that adoption of the proposed method of allocation will not change the taxable status of distributions made during the year of change or in any foreseeable future year to shareholders who are not members of the affiliated group.

.02 The statement must be signed under penalties of perjury by a duly authorized officer of the common parent of the affiliated group. *See* section 1.1502-77 of the regulations.

SEC. 5. CONSENT

In accordance with sections 1.1552-1(c)(1) and 1.1502-33(d)(3)(i) of the regulations, consent is hereby granted to an affiliated group within the scope of this revenue procedure:

(1) To change its method of allocating the consolidated federal income tax liability to one of the basic methods described in section 1.1552-1(a)(1), (2), or (3) of the regulations; and/or

(2) To elect or change to a complementary method described in section 1.1502-33(d)(2)(i) or (ii) of the regulations for use in conjunction with a basic method described in section 1.1552-1(a)(1), (2), or (3). This consent is granted for the consolidated return year for which the statement described in section 4 of this revenue procedure is attached to a timely filed federal consolidated income tax return. *See* section 6 regarding compliance with the conditions of this revenue procedure.

SEC. 6. COMPLIANCE WITH CONDITIONS

An affiliated group that takes the desired action without complying with all the conditions of this revenue procedure has initiated the desired action without obtaining the permission of the Commissioner that is required by sections 1.1502-33(d)(3)(i) and (ii) and 1.1552-1(c)(1) of the regulations.

SEC. 7. INQUIRIES

Inquiries regarding this revenue procedure may be addressed to the Commissioner of Internal Revenue, ATTN: CC:CORP:02, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044.

SEC. 8. EFFECTIVE DATE

This revenue procedure is effective for all consolidated returns timely filed (including extensions) after July 23, 1990, the date of publication of this revenue procedure in the Internal Revenue Bulletin.

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26 CFR 601.201: Rulings and determination letters.
(Also Part I, Section 1552; 1.1552-1.)

Rev. Proc. 90-39A

Rev. Proc. 90-39, page 365, this Bulletin, sets forth a means for an affiliated group of corporations filing a consolidated federal income tax return to obtain consent, without filing an advance ruling request, to elect or to change its method of allocating the consolidated federal income tax liability to members of the affiliated group for purposes of determining the earnings and profits of each member of the affiliated group. The purpose of this revenue procedure is to clarify the scope of Rev. Proc. 90-39. Sections 3.02(3) and (4) of Rev. Proc. 90-39 should read as follows:

(3) has changed its basic method (not including adoption of the method in the first consolidated return) within the five preceding taxable years; or

(4) has changed its complementary method (not including adoption of the method in the first consolidated return) within the five preceding taxable years.

This clarification to Rev. Proc. 90-39 appears in that revenue procedure on page 365, this Bulletin.

EFFECT ON OTHER DOCUMENTS

Rev. Proc. 90-39 is clarified.

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26 CFR 601.201: Rulings and determination letters.
(Also Part I, Sections 265, 441, 448; 1.265-2, 1.441-4T, 1.448-1T.)

Rev. Proc. 90-40

SECTION 1. BACKGROUND

Rev. Proc. 90-3, 1990-1 C.B. 402, sets forth areas of the Internal Revenue Code under the jurisdiction of the Associate Chief Counsel (Technical) in which the Internal Revenue Service will not issue advance rulings or determination letters. Section 4 of Rev. Proc. 90-3 is entitled "AREAS IN WHICH RULINGS OR DETERMINATION LETTERS WILL NOT ORDINARILY BE ISSUED."

SEC. 2. PROCEDURE

Section 4 of Rev. Proc. 90-3 is amplified by adding to section 4.01 the following new sections:

Section 265(a)(2).—Interest Expense Relating to Tax-Exempt Income.—Whether indebtedness is incurred or continued to purchase or carry obligations the interest on which is wholly exempt from the

taxes imposed by subtitle A of the Code.

Section 441(i).—Taxable Year of Personal Service Corporations.—Whether the principal activity of the taxpayer during the testing period for the taxable year is the performance of personal services within the meaning of section 1.441-4T(d)(1)(ii) of the temporary Income Tax Regulations.

Section 448(d)(2)(A).—Method of Accounting for Qualified Personal Service Corporations.—Whether 95 percent or more of the time spent by employees of the corporation, serving in their capacity as such, is devoted to the performance of services within the meaning of section 1.448-1T(e)(4)(i) of the temporary regulations.

SEC. 3. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 90-3 is amplified.

SEC. 4. EFFECTIVE DATE

This revenue procedure will apply to all ruling requests on hand in the National Office on July 30, 1990, the date of the publication of this revenue procedure in the Internal Revenue Bulletin, as well as to all requests received thereafter.

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26 CFR 601.602: Tax forms and instructions.

Rev. Proc. 90-41

NOTE: THIS REVENUE PROCEDURE MAY ONLY BE USED TO PREPARE MAGNETIC MEDIA OR ELECTRONICALLY FILED SUBMISSIONS FOR TAX YEAR 1990 INFORMATION RETURNS TO INTERNAL REVENUE SERVICE (IRS). UPDATED COPIES ARE PUBLISHED EACH YEAR. PLEASE READ THIS PUBLICATION CAREFULLY. PERSONS REQUIRED TO FILE MAY BE SUBJECT TO A FAILURE TO FILE PENALTY IF THEY DO NOT FOLLOW THE INSTRUCTIONS IN THIS REVENUE PROCEDURE OR FOR FAILURE TO INCLUDE CORRECT INFORMATION. THE REVENUE RECONCILIATION ACT OF 1989 HAS CHANGED THE PENALTY PROVISIONS AND SOME OF THE MAGNETIC MEDIA FILING REQUIREMENTS FOR INFORMATION RETURN REPORTING. FOR FURTHER INFORMATION, PLEASE READ THE CHAPTERS CONCERNING "NATURE OF CHANGES," AND "FILING REQUIREMENTS."

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PART A. GENERAL

SECTION 1. PURPOSE

SPECIFICATIONS FOR FILING INFORMATION RETURNS ELECTRONICALLY HAVE BEEN INCLUDED IN THIS REVENUE PROCEDURE. CONDITIONS FOR FILING ON MAGNETIC MEDIA (TAPE OR DISKETTE) AND THROUGH ELECTRONIC FILING ARE IN MOST CASES THE SAME. ANY DIFFERENCES BETWEEN MAGNETIC MEDIA AND ELECTRONIC FILING WILL BE SPECIFIED THROUGHOUT THIS REVENUE PROCEDURE. PART C OF THIS PUBLICATION PROVIDES SPECIFIC INSTRUCTIONS FOR FILING INFORMATION RETURNS ELECTRONICALLY. IF THERE ARE ANY QUESTIONS CONCERNING EITHER MAGNETIC

MEDIA OR ELECTRONIC FILING, YOU MAY CONTACT INTERNAL REVENUE SERVICE (IRS) MARTINSBURG COMPUTING CENTER (MCC) FOR CLARIFICATION (SEE PART A, SEC. 3 FOR ADDRESS AND TELEPHONE NUMBER). IF YOU ARE REQUIRED TO FILE ON MAGNETIC MEDIA, YOU MAY SATISFY THE MAGNETIC MEDIA FILING REQUIREMENTS BY SUBMITTING YOUR DATA ELECTRONICALLY INSTEAD.

.01 The purpose of this revenue procedure is to provide the requirements and conditions for filing Forms 1098, 1099, 5498 and W-2G electronically or on magnetic media to IRS, including ½ inch magnetic tape; 5 ¼ inch and 3½ inch magnetic diskettes; or IBM 3480 compatible tape cartridges. Publication 1255 provides instructions for filing on 8 inch magnetic diskette. THIS REVENUE PROCEDURE IS TO BE USED FOR THE PREPARATION OF 1990 INFORMATION RETURNS ONLY. THIS PROCEDURE IS UPDATED YEARLY TO REFLECT NECESSARY CHANGES. PLEASE READ THIS PUBLICATION CAREFULLY. Specifications for filing the following forms are contained in this procedure:

(a) Form 1098, Mortgage Interest Statement.

(b) Form 1099-A, Information Return for Acquisition or Abandonment of Secured Property.

(c) Form 1099-B, Statement for Recipients of Proceeds From Broker and Barter Exchange Transactions.

(d) Form 1099-DIV, Statement for Recipients of Dividends and Distributions.

(e) Form 1099-G, Statement for Recipients of Certain Government Payments.

(f) Form 1099-INT, Statement for Recipients of Interest Income.

(g) Form 1099-MISC, Statement for Recipients of Miscellaneous Income.

(h) Form 1099-OID, Statement for Recipients of Original Issue Discount.

(i) Form 1099-PATR, Statement for Recipients (Patrons) of Taxable Distributions Received From Cooperatives.

(j) Form 1099-R, Statement for Recipients of Total Distributions From Profit-Sharing, Retirement Plans, Individual Retirement Arrangements, Insurance Contracts, Etc.

(k) Form 1099-S, Statement for Recipients of Proceeds From Real Estate Transactions.

(l) Form 5498, Individual Retirement Arrangement Information.

(m) Form W-2G, Statement for Recipients of Certain Gambling Winnings.

.02 Specifications for filing Forms 1042S and 8027 are contained in separate IRS publications. Specifications for filing Forms W-2 and W-2P on magnetic media are available from the Social Security Administration (SSA) ONLY.

.03 In most cases, the box numbers on the paper forms correspond with the amount codes used to file on magnetic media; however, if discrepancies occur, the instructions in this revenue procedure govern.

.04 The IRS/MCC has the responsibility for processing information returns filed on magnetic media, or by electronic filing. These information returns include Forms 1098, 1099 series, 5498, and W-2G.

IRS/MCC does NOT process Forms W-2 and W-2P; these forms are to be sent to SSA whether you file paper OR magnetic media returns.

IRS/MCC does, however, process magnetic media waiver requests and extension of time requests for filing Forms W-2/W-2P.

Therefore, contact IRS/MCC with questions concerning Forms W-2 and W-2P ONLY IF THE QUESTIONS PERTAIN TO AN EXTENSION OF TIME TO FILE ON PAPER OR MAGNETIC MEDIA OR MAGNETIC MEDIA WAIVER REQUEST. Questions pertaining to magnetic media filing of Forms W-2 or W-2P MUST be directed to SSA. TAX LAW QUESTIONS PERTAINING TO FORMS W-2 OR W-2P SHOULD BE DIRECTED TO IRS TAXPAYER SERVICE at 1-800-424-1040 (1-800-829-1040 after September 30, 1990), or to your local IRS office.

If you contact IRS/MCC with questions concerning Forms W-2/W-2P, and the questions are not pertaining to extensions of time or waivers for Forms W-2/W-2P, we will direct you to either SSA or IRS Taxpayer Service.

.05 Personnel at IRS/MCC are equipped to answer any questions you may have concerning the magnetic media or electronic filing of information returns. Tax law related questions should be directed to IRS Taxpayer Service at 1-800-424-1040 (1-800-829-1040 after September 30, 1990).

.06 This revenue procedure also provides the requirements and specifications for magnetic media or electronic filing under the Combined Federal/State Filing Program. (Refer to Part A, Sec. 16.)

.07 The following revenue procedures and publications provide more detailed filing procedures for certain information returns:

(a) 1990 "Instructions for Forms 1099, 1098, 5498, and W-2G" provides specific instructions on completing and submitting information returns to IRS. IRS/MCC includes this publication in the magnetic media reporting packages that are mailed to the transmitters who participate in the Magnetic Media Reporting Program (MMRP). These instructions are also available at IRS offices and can be obtained by contacting your local office, or by calling 1-800-424-FORM (1-800-829-FORM after September 30, 1990).

(b) Rev. Proc. 84-33, 1984-1 C.B. 502, or other current revenue procedure, regarding the optional method for agents to report and deposit backup withholding.

(c) Publication 1179, Specifications for Paper Document Reporting and Paper Substitutes for Forms 1096, 1098, 1099, 5498, and W-2G.

(d) Publication 1239, Requirements and Conditions for Submitting Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips, on Magnetic Tape.

(e) Publication 1187, Requirements and Conditions for Filing Form 1042S, Foreign Persons U.S. Source Income

Subject to Withholding, on Magnetic Tape.

(f) Publication 1245, Magnetic Tape Reporting for Forms W-4.

(g) Publication 1255, Requirements and Conditions for Filing Forms 1098, 1099, 5498, and W-2G on 8 Inch Diskette.

.08 This procedure supersedes the following:

Rev. Proc. 89-43 published in Publication 1220 (Rev. 7-89) [1989-2 C.B. 494], Requirements and Conditions for Filing Forms 1098, 1099, 5498 and W-2G on Magnetic Tape, 5¼ and 3½ Inch Magnetic Diskettes.

.09 Refer to Part A, Sec. 17 for definitions of terms used in this publication.

SEC. 2. NATURE OF CHANGES—CURRENT YEAR (TAX YEAR 1990)

.01 PROGRAMMING CHANGES—Part B—"Magnetic Media Specifications"

Payer/Transmitter "A" Record:

(a) Field Positions 2-3—"Payment Year"—must be incremented by one year (from 89 to 90).

(b) Field positions 42-43—"Magnetic Tape Filer Indicator"—Starting this year, magnetic tape filers MUST code the letters "LS," in uppercase letters, in Positions 42-43. This change is required for MAGNETIC TAPE FILERS AND TAPE CARTRIDGE FILERS ONLY. Diskette filers may continue to code blanks in these positions.

Payee "B" Record:

(a) Field Positions 2-3—"Payment Year"—must be incremented by one year (from 89 to 90).

(b) Field Positions 4-5—"Document Specific Code"—

The following categories for Form 1099-R Distribution Codes will now be:

(1) "Early (premature) distribution, no known exception"—Code 1

(2) "Early (premature) distribution, exception applies (as defined in section 72(q), (t), or (v))"—Code 2

(3) "Section 1035 exchange"—Code 6

(4) "Normal distribution"—Code 7

(5) Excess contributions plus earnings/excess deferrals (and/or earnings) taxable in 1990—Code 8

(6) Excess contributions plus earnings/excess deferrals taxable in 1989 —Code P

(7) Excess contributions plus earnings/excess deferrals taxable in 1988 —Code D

NOTE: IT WILL NO LONGER BE VALID TO CODE BLANKS IN *BOTH* POSITIONS 4 AND 5 OF THE PAYEE "B" RECORD FOR FORM 1099-R. YOU *MUST* PROVIDE AT LEAST ONE DISTRIBUTION CODE FOR THIS FORM. ALSO, A NUMERIC CODE MUST BE ENTERED IN ALL CASES EXCEPT WHEN CODE P OR D IS USED. HOWEVER, WHEN USING CODE P FOR AN IRA DISTRIBUTION UNDER SECTION 408(d)(4), YOU MAY ALSO ENTER CODE 1, IF IT APPLIES. IF MORE THAN ONE NUMERIC CODE IS APPLICABLE TO A DISTRIBUTION, YOU WILL NOW NEED TO REPORT TWO SEPARATE PAYEE "B" RECORDS.

(c) Field Positions 24-43—"Payer's Account Number for Payee"—In the past, if you had fewer than 20 characters, you were to left-justify the field. Now, you may EITHER left- or right-justify this field, and fill the remaining positions with blanks.

(d) Field Position 44—"IRA/SEP Indicator"—Starting this year, if you Code a "1", "2", "3", "4", "5", or "7" in either Position 4-5 of the Payee "B" Record (Document Specific Code) for Form 1099-R AND if you are reporting a distribution for an IRA or SEP, you will code a "1" in Position 44. If you are not reporting an IRA or SEP distribution, code a blank in this field.

End of Payer "C" Record—No changes.

State Totals "K" Record—No changes.

End of Transmission "F" Record—No changes.

.02 EDITORIAL CHANGES—PART A, "GENERAL"

.01 There have been numerous editorial changes due in part to the impact of the Revenue Reconciliation Act of 1989. IRS recommends that you read this publication in its entirety to ensure that you report properly. The changes are as follows:

(a) The Revenue Reconciliation Act of 1989 changed some of the magnetic media reporting requirements and penalty provisions. See Notice 90-15, printed in the IR Bulletin 1990-7 on February 12, 1990, for further information.

(b) Starting this year, IRS/MCC will be accepting information returns, both originals and corrections, by way of electronic filing as well as magnetic media. Therefore, a new section (Part C) has been added, and references to electronic filing have been made throughout this publication.

(c) The title of Publication 1220 has changed from "Requirements and Conditions for Filing Forms 1098, 1099, 5498, and W-2G on Magnetic Tape, 5¼ and 3½ Inch Magnetic Diskettes" to "Specifications for Filing Forms 1098, 1099 series, 5498, and W-2G Electronically or on Magnetic Tape, Tape Cartridge, 5¼ and 3½ Inch Diskettes," to incorporate the tape cartridge and electronic filing specifications.

(d) Added a new section (Part D) to provide miscellaneous information concerning the magnetic media reporting of information returns. This section contains a list of all of the magnetic media-related forms and publications available from IRS/MCC. This section also contains a table to provide the Federal dollar criteria requirements for reporting of information returns that can be compared with Table 2 in Part A, Section 16 that provides the individual state dollar criteria requirements.

(e) Added the IRS toll-free telephone number for those filers with tax law questions in Part A, Sec. 1.04, and Part A, Sec. 3.05(c).

(f) The title for the publication containing the 1099 instructions has changed in 1990 from "Instructions for Forms 1099, 1098, 5498, 1096, and W-2G" to "Instructions for Forms 1099, 1098, 5498, and W-2G". Therefore, the references in this publication have been changed accordingly.

(g) Part A, Sec. 4, "Filing Requirements", has been changed to reflect the impact of the Revenue Reconciliation Act of 1989, including:

(1) All Forms 1098, 1099 series, 5498, and W-2G are to be filed on magnetic media with IRS if you have 250 or more of any of them SEPARATELY. None of the forms will be aggregated.

(2) The "look-back" rule has been RESCINDED which stated that you are required to file on magnetic media this year if you had the requirement to file in the previous year. You are only required to file this year if you exceed the filing threshold (250) for Tax Year 1990.

(h) Part A, Sec. 6, "Vendor List," has been added to provide the vendor list that IRS/MCC maintains for those filers who wish to file on magnetic media but are having difficulty finding software companies or service bureaus in their area. This section will provide information on how to order the list if you are a filer, and how to be added to the list if you are a vendor.

(i) In the past, filers were required to apply for different Transmitter Control Codes (TCC) for different types of media. This is no longer necessary. (See Part A, Sec. 7, Form 4419, "Application for Filing Information Returns Magnetically/Electronically.") If you have more than one TCC already assigned to you, you may use any that you wish.

(j) A note was added to Part A, Sec. 7, encouraging filers to submit application Form 4419 at least 30 days before the due date of the returns to allow IRS/MCC time to process the application. However, IRS/MCC will still accept applications up to the filing due date.

(k) A note was added to Part A, Sec. 7, concerning filers who file on magnetic media with IRS/MCC, but still submit Form 1096, Annual Summary and Transmittal of U.S. Information Returns, to the IRS Service Center that processes paper information returns. If you file your information returns on magnetic media with IRS/MCC, use transmittal Form 4804 to submit your data, NOT Form 1096.

(l) Beginning this year, IRS/MCC will NOT return media to the filers, whether it is test, original, or correction data, after successfully processing the media. (See Part A, Sec. 12, "Processing of Magnetic Media Returns.") Your files will only be returned if a replacement file is necessary.

(m) A note was added to Part A, Sec. 13, "How to File Corrected Returns," concerning filers who submit late filed information returns as correction documents instead of originals (coding a "G" code in the Payee "B" Record).

(n) In the past, if you were correcting a bad payee address, you were instructed to correct the address using two transactions. This has been changed in the chart in Part A, Sec. 13. It now takes only one transaction to correct a bad payee address, *UNLESS* you are *also* correcting a bad payee name *or* TIN with the same correction. It will then still require two transactions to correct the bad address.

(o) Part A, Sec. 13 has information concerning the impact of the Revenue Reconciliation Act of 1989 upon the submission of corrected returns, and when IRS/MCC can process your corrections. It also refers you to the 1990 "Instructions for Forms 1099, 1098, 5498, and W-2G" for specific information concerning the due date for filing information returns, and any penalties that may apply to returns considered to be filed late or incorrectly.

(p) Part A, Sec. 14, "Taxpayer Identification Number (TIN)," has been rewritten to remove tax law information and to add information concerning the creation of Name Controls.

(q) The section on contacting IRS/MCC has been moved for easy reference to Part A, Sec. 3, "How to Contact the IRS Martinsburg Computing Center." Information was added to this chapter to instruct filers when it is appropriate to contact IRS/MCC, and if it is not appropriate, where the information can be obtained.

(r) In Part A, Sec. 19, "Major Problems Encountered," five problems were added (numbers 11, 12, 13, 14, and 15).

(s) Added the IRS/MCC Telecommunication Devices for the Deaf (TDD) telephone number in Part A, Sec. 3.03.

.03 EDITORIAL CHANGES—PART B, "MAGNETIC MEDIA SPECIFICATIONS"

.01 The following editorial changes were made to Part B, Sec. 1-9:

(a) Part B, Sec. 2, information was added concerning IRS/MCC accepting IBM 3480 compatible tape cartridges for Tax Year 1990 data, and the tape cartridge specifications are provided.

(b) Part B, Sec. 4.04, "Payer/Transmitter "A" Record," indicates that the first record in your magnetic media file will always be a "Payer/Transmitter "A" Record."

(c) Part B, Sec. 4, "Payer/Transmitter "A" Record," the following changes were made to the "AMOUNT INDICATOR FIELDS."

(1) For Forms 1099-B, 1099-DIV, 1099-G, 1099-INT, 1099-MISC, 1099-OID, and 1099-PATR, the term for "Federal Income Tax Withheld" has been further defined as "Backup Withholding."

(2) For Form 1099-R, a Note 2 has been added referring you to the 1990 "Instructions for Forms 1099, 1098, 5498, and W-2G" for the definition of Federal Income Tax Withheld, and how it is applied to Form 1099-R reporting.

(3) For Form 1099-B, Amount Code 7 changed to "Unrealized profit or (loss) on open

contracts— 12/31/89," and Amount Code 8 changed to "Unrealized profit or (loss) on open contracts—12/31/90."

(4) For Form 1099-DIV, the note has been changed to state that Amount Code 1 MUST equal the sum of Amount Codes 2, 3, 4, and 5.

(5) For Form 1099-INT, Amount Code 5, title changed to "Foreign tax paid."

(6) For Form 1099-MISC, Amount Code 3, title changed to "Prizes, awards, etc."

(7) For Form 1099-OID, Amount Code 1, title changed to "Original issue discount for 1990."

(8) For Form 5498, Amount Code 1, title changed to "Regular IRA contributions made in 1990 and 1991 for 1990." In the Note for Form 5498, any references to calendar years have been incremented by one year.

(d) Descriptive information was added, and record layout was revised to add the "Magnetic Tape Filer Indicator" in positions 42-43.

(e) Positions 44-48, Transmitter Control Code (TCC)—added a sentence instructing filers to NOT enter more than one TCC per file.

(f) Position 49—Foreign Corporation Indicator—added a note that some filers are automatically coding a "1" in this position to indicate a foreign corporation, whether it is or not. Since IRS processes foreign payer information differently from domestic payer information, this has caused processing problems. The payer may be subject to a penalty for providing incorrect information to IRS for any records coded as foreign that are not.

(g) Part B, Sec. 6, "Payee "B" Record," for Form 1099-R, the field title "Category of Distribution" was changed to "Distribution Code." Also, some category titles changed under Description and Remarks to:

(1) Early (premature) distribution, (no known exception)—Code 1

(2) Early (premature) distribution, exception applies (as defined in Section 72(q), (t), or (v))—Code 2

(3) Section 1035 exchange—Code 6

(4) Normal distribution—Code 7

(5) Excess contributions plus earnings/excess deferrals (and/or earnings) taxable in 1990—Code 8

(6) Excess contributions plus earnings/excess deferrals taxable in 1989 —Code P

(7) Excess contributions plus earnings/excess deferrals taxable in 1988 —Code D

(h) Part B, Sec. 6, "Payee "B" Record", for Form 1099-R, added a sentence under "Description and Remarks" that you MUST enter at least one numeric code from the table that provides the categories for distribution in positions 4-5 of the Document Specific Code, Payee "B" Record, except when Code P or D is used. Also, if more than one numeric code is applicable, two separate Payee "B" Records are required.

(i) Positions 24-43—"Payer's Account Number for Payee," the instruction to left-justify and fill remaining positions with blanks has changed to EITHER left- or right-justify, and fill remaining positions with blanks.

(j) Positions 45-46—"Percentage of Total Distribution," a note was added to clarify that the field is only two positions in length since the figure MUST be 99% or less, and instructs how to round off fractions. If the percentage is 100, leave this field blank.

(k) Form 1099-S, Field Positions 379-417, "Description", added a statement that if you enter the address of the property being reported, include the state and ZIP code where the property is located.

(l) Part B, Sec. 7, End of Payer "C" Record, instructions were added that submitting files with missing or incorrect End of Payer "C" records will result in your media being returned for correction.

SEC. 3. HOW TO CONTACT THE IRS MARTINSBURG COMPUTING CENTER

.01 Magnetic media processing for all service centers is centralized at IRS/MCC. Your magnetic media files containing information returns covered by this revenue procedure, and all requests for IRS magnetic media-related publications, information, undue hardship waivers, requests for extensions of time to file, or magnetic media-related forms are to be directed to the following addresses:

If by Postal Service:

IRS-Martinsburg Computing Center
P.O. Box 1359
Martinsburg, WV 25401-1359

or

If by truck or air freight:

IRS-Martinsburg Computing Center
Magnetic Media Reporting Section
Route 9 and Needy Road
Martinsburg, WV 25401

.02 Hours of operation are 8:30 AM until 6:00 PM Eastern time. The telephone number is (304) 263-8700 (not a toll-free number). NOTE: The telephone number for the actual electronic filing of information returns is provided in Part C, Section 5.02. If you need to contact the Electronic Filing Coordinator at IRS/MCC, you may call the (304) 263-8700 telephone number.

.03 IRS/MCC has installed Telecommunication Devices for the Deaf (TDD). The number is 304-267-3367.

.04 Requests for 1099 paper returns, publications or forms not related to magnetic media processing, or paper Forms W-2/W-2P, MUST be requested by calling the "Forms Only Number" listed in the local telephone directory, or by calling the IRS toll-free number 1-800-424-FORM (1-800-829-FORM after September 30, 1990).

.05 Do NOT contact IRS/MCC if:

a. You have a question concerning filing Forms W-2/W-2P, either on paper or magnetic media, with SSA. You MUST contact your local SSA office for this information; therefore, IRS/MCC will refer you to SSA.

b. You want to order paper forms for information return filing, including paper Forms W-2/W-2P. IRS/MCC does NOT stock any paper

forms for information return or wage reporting. Call the IRS toll-free number for forms (1-800-424-FORM, 1-800-829-FORM after September 30, 1990), or call your local IRS office to order paper forms.

c. You have a question concerning the completion of the information return or Form W-2/W-2P. (For example, "How do I report a premature distribution on Form 1099-R?"). Call the IRS toll-free number (1-800-424-1040, 1-800-829-1040 after September 30, 1990) for such information.

d. You have received a penalty notice and you need additional information, or you are requesting an abatement of the penalty. Most penalty notices contain an IRS representative's name and phone number to contact with questions. This person will be most familiar with your particular case.

The letter may instruct you to respond in writing within a certain timeframe. IRS/MCC does NOT issue penalty notices, therefore, it does NOT have the authority to abate penalties. You MUST contact the service center that issued the penalty notice if you have questions, or if you are requesting abatement of the proposed penalty.

SEC. 4. FILING REQUIREMENTS

.01 Section 6011(e)(2)(A) of the Internal Revenue Code as amended by the Revenue Reconciliation Act of 1989 (Public Law No. 101-239 (1989) 103 Stat. 2106, Section 7713), requires any person, including corporations, partnerships, individuals, estates, and trusts, who file 250 or more information returns to file such returns on magnetic media. *This requirement applies separately for each type of form.* The filer also has the option of filing such returns electronically in lieu of magnetic media.

Thus, for example, if a person is required to file 200 returns on Form 1099-INT and 350 returns on Form 1099-DIV for a calendar year, the person is *not* required to file Forms 1099-INT on magnetic media, but is required to file Forms 1099-DIV on magnetic media.

.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 you are a corporation with several branches or locations and each uses the same EIN, you 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 The following requirements apply separately to both originals and corrections filed on magnetic media:

1098 1099-A 1099-B 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 100 Forms 1099-B are to filed, they need not be filed magnetically or electronically since they do not meet the threshold of 250. However, if you have 300 Forms 1099-R, they must be filed magnetically or electronically since they do meet the threshold of 250.
W-2/W-2P	250 or more of either form must be filed with SSA.

.04 The above requirements shall not apply if you establish undue hardship (see Part A, Sec. 5).

.05 Filers who are required to submit their information returns on magnetic media may choose to submit their documents by electronic filing instead. (See Part C.) Filers who submit their information returns electronically are considered to have satisfied the magnetic media filing requirements.

.06 In the past, if you were required to file on magnetic media for a particular tax year, you were automatically required to file on magnetic media for the following tax year, regardless of the volume of returns. The Revenue Reconciliation Act of 1989 eliminated this "look-back" rule. Therefore, if you were required to file on magnetic media for Tax Year 1989, and the volume of documents you will be submitting for Tax Year 1990 is less than 250, you are not required to file on magnetic media for Tax Year 1990.

SEC. 5. FORM 8508, REQUEST FOR WAIVER FROM FILING INFORMATION RETURNS ON MAGNETIC MEDIA

.01 If you are required to file on magnetic media but fail to do so (or to file electronically in lieu of magnetic media filing), and you do not have an approved waiver on record, you may be subject to a failure to file penalty.

.02 Any person required to file original or corrected returns on magnetic media may request a waiver from these filing requirements if such filing would create an undue hardship by submitting Form 8508, Request for Waiver From Filing Information Returns on Magnetic Media, with IRS/MCC.

.03 If a waiver for original documents is approved, a waiver for corrections to these documents will be automatically approved. However, if you submit your original returns on magnetic media but not your corrections, then a waiver must be requested for corrections only if they exceed the filing threshold of 250 returns.

.04 Generally, only the Payer may sign the Form 8508; however, the

transmitter may sign if they have a power-of-attorney from the respective payers, and a copy of the power-of-attorney is attached to the Form 8508.

.05 A separate Form 8508 must be submitted for each payer. Do not submit a list of payers. Specify the type of returns for which the waiver is being requested on the Form 8508 (e.g., 1099-DIV, 1099-A, etc.).

.06 The waiver, if approved, will provide exemption from magnetic media filing for one tax year only. Filers 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.

.07 Copies of the Form 8508 are included in this publication, or may be obtained from other IRS offices. Form 8508 may be computer-generated as long as it contains all the information requested on the original form, or it may be photocopied.

.08 All requests for magnetic media related undue hardship exemptions must be submitted to IRS/MCC at least 90 days before the due date of the return except as stated in Sec. 5.08. *IF A REQUEST IS NOT POSTMARKED AT LEAST 90 DAYS BEFORE THE DUE DATE OF THE RETURN, IT WILL NOT BE CONSIDERED.* Therefore, for Forms 1098, 1099 series, and W-2G, the waiver request must be submitted to IRS/MCC with a postmark date of November 30. For Forms 5498, the waiver request must be submitted to IRS/MCC with a postmark date of March 2. Any waiver requests received with postmarks after the deadline(s) will be automatically denied.

.09 All magnetic media-related undue hardship requests for Forms W-2/W-2P are to be filed with IRS/MCC, NOT SSA, and must be postmarked at least 90 days before the due date of the return, also. Since Forms W-2/W-2P are due to SSA by February 28, the due date for the waiver request is November 30.

.10 Waivers are granted on a case-by-case basis and are approved at the discretion of the IRS/MCC. You must allow a minimum of 30 days for IRS/MCC to respond to a waiver request.

.11 If your waiver request is approved, keep it for your records. DO NOT send a copy of the approved waiver to the service center where you file your paper returns.

.12 AN APPROVED WAIVER FROM FILING INFORMATION RETURNS ON MAGNETIC MEDIA DOES NOT PROVIDE EXEMPTION FROM ALL FILING; YOU MUST STILL TIMELY FILE YOUR INFORMATION RETURNS ON ACCEPTABLE PAPER FORMS WITH THE APPROPRIATE SERVICE CENTER.

SEC. 6. VENDOR LIST

.01 IRS/MCC will provide you with a list of vendors who support magnetic media filing upon request. This list contains the names of service bureaus that will produce your files for you on the prescribed types of magnetic media, or via electronic filing. It also contains the names of vendors who can provide software packages for filers who wish to produce magnetic media or electronic files on their own computer systems or personal computers. This list is for filer information only, and in no way implies IRS approval or endorsement of their products or services.

.02 IRS/MCC will provide the vendor list to those filers who contact IRS/MCC at the address and phone number shown in Part A, Sec. 3. IRS/MCC WILL NOT PROVIDE ANY COMPANY NAMES OVER THE TELEPHONE.

.03 If you are a vendor that offers a software package, has the ability to produce magnetic media for your customers, or has the capability to electronically file information returns, and you would like to be included on the list, you MUST submit a written request. The written request must include:

a. The company name
b. Address (include the city, state, and ZIP code)
c. Telephone number (include area code)
d. Contact person
e. Type of service provided (for example, service bureau and/or software)
f. Type(s) of magnetic media offered (for example, ½ inch magnetic tape; tape cartridge; 8 inch, 5¼ inch, and/or 3½ inch diskettes; electronic filing).

.04 You may submit your request to be added to the vendor list at any time. Send the written request to IRS/MCC at the address provided in Part A, Sec. 3. IRS/MCC WILL NOT ACCEPT ANY COMPANY NAMES OVER THE TELEPHONE. The vendor list will be updated once a year, in March, to include new vendors.

SEC. 7. FORM 4419, APPLICATION FOR FILING INFORMATION RETURNS MAGNETICALLY/ELECTRONICALLY

.01 For purposes of this revenue procedure, the PAYER may be the person making payments; a recipient of mortgage interest payments; a broker; a barter exchange; a person reporting a real estate transaction; a trustee or 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 TRANSMITTER is the organization submitting the magnetic media file. The payer and transmitter may be the same organization.

Payers or their transmitters are required to complete Form 4419, Application for Filing Information Returns Magnetically/Electronically, to ensure equipment compatibility. A single Form 4419 should be filed no matter how many types of returns the payer or transmitter will be submitting on magnetic media or by electronic filing. For example, if you plan to file Forms 1099-INT and Forms 1099-DIV on magnetic media, submit one Form 4419. If you later wish to file another type of return on magnetic media in the Form 1099, 1098, 5498 or W-2G series, it is not necessary to submit a new Form 4419. If you wish to file both electronically and magnetically, you need only submit one Form 4419.

Copies of Form 4419, for your use, are included in this publication. Please read the instructions on the back of the form very carefully. This form may be photocopied. Requests for additional forms or other information related to magnetic media processing should be addressed to IRS/MCC. (See Part A, Sec. 3 for address.)

.02 Form 4419 can be submitted at any time during the year. However, Form 4419 should be submitted to IRS/MCC at least 30 days before the due date of the return(s) you wish to file on magnetic media. This will

allow IRS/MCC the minimum amount of time necessary to process your application and send a response back to you. Otherwise, you may not receive the letter assigning your TCC to you in time for you to code the necessary TCC in your Payer/Transmitter "A" Record (see Part B, Sec. 4 for further information). For documents to be filed electronically, Form 4419 should be submitted as soon as possible, but not later than December 1. (See Part C, Sec. 2.) In the event that your computer equipment or software is not compatible with the IRS equipment, a waiver may be requested so that you may file your returns on paper documents for that tax year.

A five character alpha/numeric Transmitter Control Code (TCC) will be assigned and included in an approval letter. If you have more than one TCC, you must use more than one tape or diskette. You *cannot* use two TCCs on the same medium. They must be reported separately.

IRS encourages filers who file for multiple payers to submit one application and to use one Transmitter Control Code for all payers. Include a list of all payers and their TINs with the Form 4419. If you file for additional payers in later years, notify IRS in writing providing the additional names and TINs. Do not submit a new application for these additional payers.

Magnetic tape, diskette and electronically filed returns may not be submitted with IRS until the application has been approved and a TCC assigned. This TCC will be entered in the Transmitter Control Code field of the "A" Record—*DO NOT* enter blanks because your media will be returned.

.03 Upon approval, a magnetic media reporting package containing the appropriate revenue procedures and necessary transmittals, forms, labels, and instructions will be sent to the attention of the contact person indicated on Form 4419. Thereafter, IRS/MCC will send the transmitter a package containing the updated revenue procedure and forms each year. This package will continue to be sent to the contact person indicated on the Form 4419 unless IRS/MCC has received information concerning any changes or updates.

.04 If you have your magnetic media files prepared by a service bureau, you may not need to submit an application to obtain a TCC. Some service bureaus will produce your file for you, code their own TCC on the media, and send it to IRS/MCC for you.

Other service bureaus will prepare your magnetic media files, then send them to you to submit to IRS/MCC. These service bureaus may require you to submit an application to IRS/MCC so that you will be assigned your own TCC to be coded in the Payer/Transmitter "A" Record. (See Part B, Sec. 4.) Contact your service bureau for further information.

.05 Once approved to file magnetically or electronically, you do not need to reapply each year unless:

(a) You discontinue filing magnetically or electronically for a year, since your TCC may have been reassigned by IRS/MCC.

(b) Your magnetic media files were transmitted in the past by a service agency. However, you now have computer equipment compatible with that of IRS and wish to prepare your own files, so you must request your own TCC by filing an application Form 4419.

.06 If any of these conditions apply to you, contact IRS/MCC for clarification. Also, notify IRS/MCC if you had hardware or software changes that would affect the characteristics of the magnetic media or electronic submission. Be sure to refer to your current TCC in all correspondence with IRS/MCC.

.07 If you file on several different types of magnetic media (e.g., tape, 8 inch diskette, and 5¼ inch floppy disk) or by electronic filing, you need only submit one Form 4419. In the past, IRS/MCC required filers submitting different types of media to obtain different TCCs. This is no longer necessary. You may use the same TCC on all of your media. For example, if you submit a magnetic tape, an 8 inch diskette, and a 5¼ inch floppy disk, and an electronic file, you may use the same TCC for all types of filing. If you already have different TCCs assigned to you, you may choose any of the TCCs to be coded into the Payer/Transmitter "A" Record. It doesn't matter which one you use; however, remember to code only one TCC per medium. Please contact IRS/MCC and indicate which TCC(s) you will not be using so that we can remove them from our files. (See Part A, Sec. 3 for the address and telephone number.)

.08 If you are an approved filer on magnetic media and the name, EIN, or address of your organization or contact person changes, please notify IRS/MCC in writing so that your file may be updated to reflect the current information.

.09 In accordance with section 1.6041-7(b) of the Income Tax Regulations, 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.

.10 Approval to file on magnetic media or by electronic filing does not imply endorsement by IRS of the computer software or quality of tax preparation services provided.

.11 The magnetic media or electronic file MUST be accompanied by Form 4804 (see Part A, Sec. 9), which will provide IRS with the necessary information. Filing the same information returns either magnetically or electronically, as well as on paper forms, will result in duplicate filing and may result in erroneous penalty notices being sent to the payees.

SEC. 8. TEST FILES

.01 IRS does not require magnetic media or electronic filers to submit test files, *except* for those filers who wish to participate in the Combined Federal/State Filing Program (see Part A, Sec. 16 for further information concerning combined federal/state filing).

However, IRS encourages first-time magnetic media or electronic filers, and filers of floppy disks or diskettes, to submit a test file for review prior to the filing season.

IRS will determine whether or not your file is formatted correctly, and will check the content of the records to ensure that it meets the

specifications of the current revenue procedure.

For those filers who have submitted magnetic media files in previous tax years, sending a test file provides them the opportunity to ensure that their software reflects the annual programming changes; however, submitting a test file is not mandatory for current filers.

.02 If you are a new filer, you must submit a Form 4419 before you send in a "TEST" file. If approved, you will be assigned a five character alpha/numeric Transmitter Control Code (TCC). This TCC must be entered in the TCC field of your Payer/Transmitter "A" Record (see Part B, Sec. 4).

.03 All tape and diskette "TEST" files must be submitted between October 1 and December 15 of each year. Do not submit tape or diskette "TEST" files after December 15. Only a hardcopy printout of the tape or diskette that shows a sample of each type of record used (A, B, C and F) may be submitted after December 15 and it must be postmarked before January 15.

.04 Electronically filed "TEST" files must be submitted between October 1 and January 15. (See Part C, Sec. 3).

.05 The information in the "A" Record must be ACTUAL information—NOT FICTITIOUS. Clearly mark the hardcopy print as "TEST" data and include identifying information such as name, telephone number, and address of a person who can be contacted to discuss its acceptability. If your "TEST" file is acceptable, we will send you an approval letter.

.06 Form 4804, Transmittal of Information Returns Reported on Magnetic Media, must accompany your test magnetic media file. Indicate that the file contains test data by marking the "TEST" checkbox in block 1 on Form 4804. Also, write "TEST" on the external media label, Form 5064. The "TEST" data must be programmed according to the current revenue procedure.

.07 For magnetic media filers, submit a "TEST" file between October 1 and December 15 for the first year you wish to participate in the Combined/Federal State Filing Program. For electronic filers, the time frame will be between October 1 and January 15. A hardcopy print is NOT an acceptable "TEST" file for this program for either magnetic media or electronic filers.

.08 Approved payers or transmitters should send the "TEST" file to IRS/MCC (see Part A, Sec. 3 for the address). See Part C, Sec. 3 for instructions on submitting electronic test files.

.09 IRS/MCC will send an acknowledgement in writing to indicate whether your "TEST" file was good or bad. If it was formatted incorrectly, we will indicate what the problems are in a letter and your file will be returned to you for replacement and resubmission. The "TEST" must be resubmitted by the deadline of December 15, 1990. After IRS/MCC successfully processes your test file, the media will not be returned.

SEC. 9. FILING OF MAGNETIC MEDIA RETURNS AND RETENTION REQUIREMENTS

.01 Form 4804, Transmittal of Information Returns Reported on Magnetic Media, must accompany all magnetic media and electronic submissions. This includes original, correction, replacement, and test data.

.02 In many cases, you can program your computer to generate a substitute Form 4804/4802 that contains the pertinent information. IRS encourages you to computer-generate your transmittal forms, as long as you include the necessary information contained on the most current revision of the form. You may also photocopy this form. If you file for multiple payers and have the authority to sign the affidavit on Form 4804, you should also submit Form 4802, "Transmittal for Multiple Magnetic Media Reporting."

.03 For magnetic media filers, the transmitter may code any combination of payers and/or documents on their media. For example, if you are reporting Forms 1099-INT for Bank A, Forms 1099-DIV for Bank B, and Forms 1098 for Bank C, you need not create 3 separate tapes or diskettes. All 3 banks and all types of documents can be coded on one tape or diskette. If you do create multiple tapes or diskettes, they can all be sent in one package; you need not send a separate package containing each tape or diskette. Be sure to include Form 4804, 4802, or computer-generated substitute with your magnetic media shipment. DO NOT MAIL THE MAGNETIC MEDIA AND THE TRANSMITTAL DOCUMENTS SEPARATELY. Magnetic media files covered by this revenue procedure are to be sent to IRS/MCC. (See Part A, Sec. 3 for the address.)

.04 Since IRS/MCC only processes returns filed magnetically or electronically, paper information returns for information not being filed magnetically or electronically must be submitted to the appropriate service center using Form 1096, Annual Summary and Transmittal of U.S. Information Returns. *DO NOT send information returns filed on paper forms to IRS/MCC.*

.05 DO NOT REPORT DUPLICATE INFORMATION; I.E., IF YOU SUBMIT PART OF YOUR RETURNS ON PAPER AND PART ON MAGNETIC MEDIA (OR VIA ELECTRONIC FILING), BE SURE THE SAME INFORMATION IS NOT INCLUDED IN BOTH SUBMISSIONS.

.06 Form 4804 contains an affidavit that MUST be signed by the payer; however, the transmitter, service bureau, paying agent, or disbursing agent (all hereafter referred to as agent), may sign the affidavit on behalf of the person required to file/payer 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 will result in your file being returned to you unprocessed.

.07 Although a duly authorized agent may sign the affidavit, the payer is responsible for the accuracy of the Form 4804 and the returns filed, and the payer will be liable for penalties for failure to comply with filing requirements.

.08 If returns from different branches or locations for one payer are submitted on the same file, consolidate each type of information return under one Payer/Transmitter "A" Record. For example, all Forms 1099-INT for the same payer on a single file must be sorted together under one Payer/Transmitter "A" Record followed by the appropriate "B" Records and one "C" Record.

.09 Before shipping magnetic media files, include the following:

(a) A signed Form 4804 (or computer-generated substitute).

(b) A Form 4802 if you transmit for multiple payers and have the authority to sign the affidavit on Form 4804.

(c) The magnetic media with an external identifying label (Form 5064) as described in Part B, Sec. 1.02. Be sure to include the proper sequence on this label.

(d) On the outside of the shipping container, include a Form 4801 or a substitute for the form which reads "DELIVER UNOPENED TO TAPE LIBRARY—MAGNETIC MEDIA REPORTING—BOX ___ of _____." 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).

(e) If you were granted an extension, include a copy of the approval letter with the magnetic media shipment. (See Part A, Sec. 11 for information on how to apply for an extension of time to file.)

NOTE: See Part C, Sec. 4 for electronic filing submission requirements.

.10 IRS will not pay for or accept "Cash-on-Delivery" or "Charge to IRS" shipments of reportable tax information that an individual or organization is legally required to submit.

.11 Files may be returned to you due to coding or format errors. These files are to be corrected and returned to IRS within 45 days from the date of notice or the payer may be subject to a penalty. A copy of page 2 of the letter sent by IRS must be returned with the replacement file.

.12 Payers are required to retain a copy of the information returns filed with IRS or to have the ability to reconstruct the data for at least three years from the reporting due date.

SEC. 10. FILING DATES

.01 The dates prescribed for filing paper returns with IRS also apply to magnetic media or electronic filing. Magnetic media or electronic filing with IRS for Forms 1098, 1099, and W-2G must be on a calendar year basis. Form 5498 is used to report amounts contributed during or after the calendar year but not later than April 15.

.02 Information returns filed on magnetic media for Forms 1098, all types of Forms 1099, and Forms W-2G must be submitted to IRS/MCC postmarked no later than February 28. The due date for furnishing the required copy or statement to the payee is January 31.

.03 Information returns filed on magnetic media for Form 5498 must be submitted to IRS/MCC postmarked no later than May 31. Trustees or issuers of IRAs or SEPs must provide participants with a statement of the value of the participant's account by January 31, in any written format. Statements are due to the participants by May 31 for contributions made to IRAs for the prior calendar year. Form 5498 is filed for contributions to be applied to 1990 that are made between January 1, 1990, and April 15, 1991.

.04 If any due date falls on a Saturday, Sunday, or legal holiday, the due date is extended to the next day that is not a Saturday, Sunday, or legal holiday.

SEC. 11. EXTENSIONS OF TIME TO FILE

.01 A payer may request an extension of time to file information returns by submitting Form 8809, Request for Extension of Time To File Information Returns, to IRS/MCC. This form may be used to request an extension of time for information returns submitted on paper; magnetic media; electronically; or for all three types of submissions.

.02 A transmitter may submit Form 8809 for multiple payers by attaching a list of their names, addresses, and TINs to Form 8809. Also, Form 8809 may be computer-generated or photocopied. Be sure that all the pertinent information is included. If you are requesting extensions of time for more than 50 payers, we strongly encourage you to submit the list of payers, addresses, and EINs on tape or diskette. Contact IRS/MCC for the format. (See Part A, Sec. 3 for the address.) Transmitters who submit the extension of time requests on magnetic media will receive one approval letter from IRS/MCC with an attached listing of the payers with approved extensions.

.03 Request an extension of time in increments of 30 days AS SOON AS YOU ARE AWARE that an extension is necessary but no later than the due date of the return. The request must be sent to IRS/MCC. (See Part A, Sec. 3 for the address.) You must allow a minimum of 30 days for IRS/MCC to respond to an extension request.

.04 Form 8809 must be postmarked no later than the due date of the return(s) for which you are requesting an extension of time. If you are requesting an extension of time to file several types of forms, you may use one Form 8809, but you must submit Form 8809 to IRS/MCC postmarked no later than the earliest due date. For example, if you are requesting an extension of time to file both Forms 1099-INT and Forms 5498, you must submit Form 8809 postmarked on or before February 28. You may complete more than one Form 8809 to avoid this problem.

.05 IRS will process your Form 8809 and respond in writing. If the extension request is granted, a copy of the approved letter ONLY must be included with the transmittal Form 1096 or Form 4804 (or computer-generated substitute) when the file is submitted. INCLUDE ONLY THE APPROVAL LETTER SENT FROM IRS. DO NOT SEND A COPY OF FORM 8809 WITH EITHER YOUR PAPER DOCUMENTS TO THE SERVICE CENTER, OR YOUR MAGNETIC MEDIA FILE TO IRS/MCC. *Also, if you originally requested a 30-day extension and then find you need an additional 30 days, a copy of the first approved extension must accompany your second request.* IRS/MCC will not grant more than two extensions of time for a maximum of 60 days.

.06 You can request an extension for only one tax year on Form 8809.

.07 The extension request must be signed by the payer or a duly authorized representative.

.08 Failure to properly complete and sign the Form 8809 may cause delays in processing the request or result in a denial of your request. Please read the instructions on the back of the Form 8809 very carefully.

.09 Copies of the Form 8809 may be obtained from IRS/MCC (see Part A, Sec. 3 for the address), or from other IRS offices. Form 8809 may also be computer-generated as long as it contains all the information requested on the original form, and it may be photocopied.

SEC. 12. PROCESSING OF MAGNETIC MEDIA RETURNS

.01 All data received at IRS/MCC for processing will be given the same protection as individual returns (Forms 1040). IRS/MCC will process your magnetic media files and check that the records were formatted according to the most current revenue procedure. Please be sure that your record format and coding comply with this revenue procedure, which is to be used for the preparation of Tax Year 1990 information returns *only*.

.02 Revenue procedures are revised annually to reflect legislative and form changes to the information returns.

.03 If your data is formatted incorrectly, or if the file contains information that will cause invalid conditions in the IRS processing (for example, you code all 9's or all zeros in the field for the TIN), we will return your file for replacement.

.04 To distinguish between a correction and a replacement:

A correction is media submitted by the payer to correct records that were successfully processed by IRS, but contained erroneous information.

A replacement is media that IRS has returned to the payer or transmitter due to format errors encountered during processing. After necessary changes have been made, the media must be returned to IRS/MCC to be re-input.

.05 Beginning with Tax Year 1990, (processed in Calendar Year 1991), IRS/MCC will no longer return your files after processing. Therefore, if IRS/MCC returns your file to you, it is because a replacement is needed. *Open all packages immediately.* Files returned due to format or coding errors must be corrected and returned to IRS/MCC within 45 days from the date of the notice to avoid a failure to file penalty.

IRS/MCC will work with magnetic media filers as much as possible to assist with processing problems. If IRS/MCC calls your office, please respond promptly since we may have information that you need to correct your file.

.06 Do not use special shipping containers for transmitting data to IRS/MCC. Because of the high volume of data received and shipping costs involved, they will not be returned.

.07 When submitting your file to IRS/MCC, please keep in mind that:

a. You may include any of the forms covered by this revenue procedure on one tape, tape cartridge, diskette, or electronic submission. You do not have to separate the different types of forms on different media. For example, one tape or diskette could contain Forms 1098, 1099-INT, 1099-DIV, and 5498 for different payers. You need only identify the different forms and payers with different Payer/Transmitter "A" Records which are coded on the magnetic media. (See Part B, Sec. 4 for details.)

b. You may submit multiple types of media in your shipment. However, submit a separate Form 4804 for each type of media.

c. Enclose your transmittal Form 4804 in with your shipment. Do not send it in a separate mailing. If your shipment is packed in several packages, use label Form 4801 to indicate the number of packages, and put the transmittal in the first package.

d. IRS/MCC will NOT be returning your magnetic media to you after successfully processing it. Therefore, if you want proof that IRS/MCC received your shipment, you may choose to send your submission using a service with tracing capabilities, or that will provide proof of delivery (for example, U.S. Postal Service Certified Mail, Federal Express or UPS.)

SEC. 13. HOW TO FILE CORRECTED RETURNS

.01 The filing requirement thresholds listed in Part A, Sec. 4 apply separately to both original and corrected returns.

EXAMPLE: If you have 100 Forms 1099-A to be corrected, they can be filed on paper since they fall under the 250 threshold. However, if you have 300 Forms 1099-A to be corrected, they must be filed on magnetic media since they meet the 250 threshold. If for some reason you cannot file these corrections on magnetic media, you must request a waiver (see Part A, Sec. 5) before filing on paper, or you may be subject to a penalty. No waiver is required for corrections that fall under the required threshold.

.02 Corrections for the current year should be aggregated and filed no later than August 1 of each year. However, if you discover errors after August 1, you are still required to file corrections so that you will not be subject to a penalty for intentional disregard of the filing requirements. Failure to correct information returns submitted with erroneous information may result in penalties being assessed 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. If your entire file is in error, contact IRS/MCC immediately. If you file corrected returns on paper forms, submit Copy A to the appropriate service center. Furnish corrected statements to recipients as soon as possible.

.03 See the 1990 "Instructions for Forms 1099, 1098, 5498 and W-2G" for information concerning the due date for filing information returns, and any penalties that may apply to returns considered to be filed late or incorrectly. A copy of these instructions is included in your MMR (Magnetic Media Reporting) package each year. This will also contain specific information concerning the impact of the Revenue Reconciliation Act of 1989 on the penalty provisions for ANY documents, including corrections, which are filed after the original filing due date for the information return.

.04 There are numerous types of errors. More than one transaction may be required to properly correct the initial error. A "G" in magnetic media position 7 of the "B" Record is used to indicate a corrected return. You are strongly encouraged to read

this ENTIRE section before attempting to make ANY correction.

.05 Corrected returns submitted to IRS on magnetic media, using a "G" coded Payee "B" Record, may be included on the same medium as those corrections without the "G" code; however, separate "A" Records are required. Corrected returns are to be identified as corrections on the transmittal document by marking the appropriate checkbox, and also on the EXTERNAL label of the file.

NOTE: If you discover that your original file omitted certain information returns that should have been included, do *not* submit those documents as "correction," and do not code the Payee "B" Records with the correction "G" code. They will be considered as late filed original documents and may be subject to a penalty.

.06 The instructions that follow will provide information on how to file corrected returns on magnetic media or by electronic filing for the current tax year. However, if you discover errors in previous years' files, please send us a letter with the following information:

(a) Name and address of payer

(b) Type of error. (Please explain clearly.)

(c) Tax year

(d) EIN

(e) TCC

(f) Number of Payees

This information will be forwarded to the appropriate office and may prevent erroneous notices from being generated against payee accounts. You are also required to furnish corrected statements to the payees.

.07 If you are not required to file your corrections on magnetic media and you file them on paper forms, do not submit the paper returns to IRS/MCC. All paper returns, whether original or corrected, must be filed with the appropriate service center. Corrected returns filed on magnetic media must be filed with IRS/MCC. (Refer to Part A, Sec. 3 for the address.) CORRECTED TAPES, TAPE CARTRIDGES, AND/OR DISKETTES WILL NOT BE RETURNED AFTER PROCESSING.

.08 Corrected statements to payees should be clearly identified as "CORRECTED" and should be provided to them as soon as possible.

.09 Use the same name and TIN (SSN or EIN) for the payer on Form 4804/4802 and all related Payer/Transmitter "A" Records.

.10 A transmittal Form 4804 (or computer-generated substitute) is used to transmit magnetic media and electronic files. A Form 4802, Transmittal for Multiple Magnetic Media Reporting, is a continuation sheet for a Form 4804. Use Form 4802 if you file for multiple payers, or submit multiple types of information returns, AND are an authorized agent for the payers. (See Part A, Sec. 9.05.)

.11 On magnetic media and electronic files, the Payee "B" Record provides a 20-position field to enter a Payer's Account Number for the Payee. This same account number may be provided on paper forms. 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 (SSN OR EIN). 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. THIS NUMBER IS ALSO PROVIDED WITH YOUR INVALID/NO-TIN NOTIFICATION BY THE IRS AND MAY HELP YOU DETERMINE THE BRANCH OR SUBSIDIARY REPORTING THE TRANSACTION.

.12 REVIEW THE CHART THAT FOLLOWS. The types of errors made normally fall under one of the two categories listed. Next to each *type* of error made, you will find a list of instructions on how to properly file the corrected return for that type of error. READ ALL OF THE INSTRUCTIONS LISTED AND FOLLOW CAREFULLY FOR THE TYPE OF ERROR MADE ON THE INITIAL RETURN. IN SOME CASES TWO TRANSACTIONS ARE REQUIRED TO PROPERLY FILE CORRECTIONS. IF THE ORIGINAL RETURN WAS FILED AS AN AGGREGATE, YOU MUST CONSIDER THIS IN FILING CORRECTED RETURNS.

Guidelines for Filing Corrected Returns On Magnetic Media

(PLEASE READ SEC. 13.01 THROUGH 13.12 BEFORE MAKING ANY CORRECTIONS).

Error Made on the Original Return Filed on Magnetic Media	How To File the Corrected Return on Magnetic Media
1. Original return was filed with one or more of the following errors: (a) No Payee TIN (SSN or EIN) (b) Incorrect Payee TIN (c) Incorrect Payee Name (d) Wrong type of return indicator TWO SEPARATE TRANSACTIONS ARE REQUIRED TO MAKE THE CORRECTIONS PROPERLY. READ AND FOLLOW ALL INSTRUCTIONS FOR BOTH TRANSACTIONS 1 AND 2.	TRANSACTION 1: Identify incorrect returns A. Form 4804 and 4802 (or computer-generated substitute): 1. Prepare a new transmittal Form 4804 (and 4802 if you file for multiple payers), or a computer-generated substitute, that includes information related to this new file. 2. Mark the Correction box in Block 1 of the new Form 4804. If you submit a computer-generated substitute for Form 4804, indicate "MAGNETIC MEDIA CORRECTION" at the top.

(PLEASE READ SEC. 13.01 THROUGH 13.12 BEFORE MAKING ANY CORRECTIONS).

Error Made on the Original Return Filed on Magnetic Media	How To File the Corrected Return on Magnetic Media
1. (Continued)	3. Provide ALL requested information correctly. 4. If you are a Combined Federal/State filer, it is your responsibility to transmit corrected returns to the state—IRS will not. Do not include "K" Records in your corrected returns. B. Magnetic tape on reel or cartridge, or diskette: (Form 1098, 1099, 5498 or W-2G) 1. Prepare a new file. 2. Use a separate Payer/Transmitter "A" Record for each type of return being reported. The information in the "A" Record will be the same as it was in the original submission. 3. The Payee "B" Record must contain exactly the same information as submitted previously EXCEPT insert a "G" in media position 7 of the "B" Record AND for ALL payment amounts used, enter "0" (zero). 4. Corrected returns submitted to IRS 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. 5. Mark the EXTERNAL label of the tape or diskette "MAGNETIC MEDIA CORRECTION." 6. Submit the magnetic media and the transmittal document(s) to IRS/MCC. (Refer to Part A, Sec. 3 for the address.) TRANSACTION 2: Report the correct information. Magnetic Tape on reel or cartridge, or Diskette: (Forms 1098, 1099, 5498 or W-2G) 1. Provide information on the Form 4804 or 4802 as stated in Transaction IA. 2. Prepare a new file with the correct information in all records. 3. Use a separate Payer/Transmitter "A" Record for each type of return being reported. 4. Do not "G" code the Payee "B" Record as a corrected return for this type of correction. 5. Submit the new returns as though they were originals. Provide all of the correct information including the TIN (SSN or EIN). 6. Mark the EXTERNAL label of the tape or diskette "MAGNETIC MEDIA CORRECTION." 7. Submit the magnetic media and the transmittal document(s) to IRS/MCC. (Refer to Part A, Sec. 3 for the address.)
2. Original return was filed with one or more of the following errors: (a) Incorrect Payment Amount Indicator in the Payer "A" Record. (b) Incorrect Payment amounts in the Payee "B" Record.	A. Forms 4804 and 4802 (or computer-generated substitute) 1. Prepare a *new* Form 4804 (and 4802 if you file for multiple payers), or a computer-generated substitute, that includes information related to this new file.

(PLEASE READ SEC. 13.01 THROUGH 13.12 BEFORE MAKING ANY CORRECTIONS).

Error Made on the Original Return Filed on Magnetic Media	How To File the Corrected Return on Magnetic Media
2. (Continued) (c) Incorrect Code in the Document Specific Code Field in the Payee "B" Record. (d) Incorrect payee address (See note) NOTE: If the only error to be corrected is an incorrect payee address, only one transaction is required. However, if you are correcting the name and/or TIN along with an incorrect address, then two transactions will be required. (See previous information on correcting an incorrect payee name/TIN.) REQUIRES ONLY ONE TRANSACTION.	2. Mark the Correction box in Block 1 of new Form 4804. If you submit a computer-generated substitute for Form 4804, indicate "MAGNETIC MEDIA CORRECTION" at the top. 3. Provide ALL requested information correctly. 4. If you are a Combined Federal/State filer, it is your responsibility to transmit corrected returns to the state—IRS will not. Do not include "K" Records in your corrected returns.
	B. Magnetic tape on reel or cartridge, or diskette: (Forms 1098, 1099, 5498 or W-2G) 1. Prepare a new file. 2. Use a separate Payer/Transmitter "A" Record for each type of return being reported. The information in the "A" Record will be the same as it was in the original submission EXCEPT, the correct Amount Indicators will be used. 3. The Payee "B" Record must contain exactly the same information as submitted previously EXCEPT insert a "G" in tape or diskette position 7 of the "B" Record AND report the correct information as it should have been reported on the original return. 4. Corrected returns submitted 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. 5. Mark the EXTERNAL label of the tape "MAGNETIC MEDIA CORRECTION." 6. Submit the magnetic media and the transmittal document(s) to IRS/MCC. (Refer to Part A, Sec. 3.)

SEC. 14. TAXPAYER IDENTIFICATION NUMBER (TIN)

.01 Section 6109 of the Internal Revenue Code, and the regulations thereunder, require a person whose Taxpayer Identification Number (TIN) must be shown on an information return to furnish his or her TIN to the person required to file the information return. The number must be furnished to the payer whether or not the payee is required to file a tax return or is covered by social security.

.02 The payee's TIN is used to associate and verify amounts reported to IRS with corresponding amounts on tax returns. Therefore, it is particularly important that CORRECT social security and employer identification numbers for payees be provided on magnetic media or paper forms submitted to IRS. DO NOT ENTER HYPHENS, ALPHA CHARACTERS, ALL 9s OR ALL ZEROS. IRS validates the SSN by using the Name Control of the surname (last name) of the individual who has been assigned this number. For this reason, provide the surname in the First Payee Name Line and/or the Name Control in positions 8-11 of the Payee "B" Record (see Part B, Sec. 6). Failure to provide this information may make it impossible for IRS to validate the SSN.

.03 The TIN to be furnished to IRS depends primarily upon the manner in which the account is maintained or set up on the payer's record. 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 Payee "B" Record. For individuals, including sole proprietors, the payee TIN is the payee's social security number. For other entities, the payee TIN is the payee's

employer identification number.

.04 Failure to provide the correct name with the payee TIN, or failure to provide a valid TIN, could result in an Invalid/No TIN notice (sometimes referred to as "B" notice) being generated for that TIN.

.05 The following charts will help you determine the TIN to be furnished to IRS for those persons for whom you 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 (If more than one owner, 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. A sole proprietorship	The owner	The owner, not the business name

CHART 2. Guidelines for Employer Identification Numbers

For this account type—	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
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 the 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

[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 media reporting of the information returns listed in Part A, Sec. 4 applies only to the Copy A information submitted to IRS.

.02 Payers are responsible for providing statements to the payees as outlined in the 1990 "Instructions for Forms 1099, 1098, 5498 and W-2G."

.03 Refer to 1990 "Instructions for Forms 1099, 1098, 5498, and W-2G" for instructions and changes to reporting information returns on paper.

.04 Send all information returns filed on paper to the appropriate service center, not to IRS/MCC.

.05 If you file your information returns on magnetic media, *DO NOT* file the same returns on paper, since that will result in duplicate filing. Filing on magnetic media or by electronic filing takes the place of submitting the documents on paper. In some cases, you may want to file your original documents on magnetic media or electronically, but submit your corrections on paper documents. This is allowable as long as your corrections do not exceed the filing threshold; if the volume of corrections does exceed the threshold, you MUST have an approved waiver to submit your corrections on paper.

SEC. 16. COMBINED FEDERAL/STATE FILING PROGRAM

.01 The Combined Federal/State Program was established to simplify information returns filing for the taxpayer by providing the tax information to participating states free-of-charge. IRS/MCC will forward this information to participating states for approved filers so separate reporting to those states is not necessary. *FORMS 1098, 1099-A, 1099-B, 1099-S AND W-2G CANNOT BE FILED UNDER THIS PROGRAM.*

.02 To request approval to participate, a "TEST" file coded for this program, MUST be submitted by the transmitter to IRS/MCC between October 1 and December 15 using the revenue procedure that will be used for the actual data files.

.03 Attach a letter to the Form 4804 submitted with the "TEST" file which indicates that you wish to participate in this program.

.04 The "TEST" file is only required for the first year. Once you are approved, you need not resubmit tests each year except when notified by IRS. (See Part A, Sec. 8 for general guidelines on submission of "TEST" files.) Each record, both in the "TEST" file and the "ACTUAL" data file, must conform exactly to the revenue procedure for that tax year. Records must be coded using each state's dollar criteria from TABLE 2 of this section for each type of return.

.05 If your "TEST" file is acceptable, we will send you 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. Be sure to write your TCC on Form 6847. If your "TEST" file is not acceptable, we will return your media with a letter indicating what the problems were, and your replacement "TEST" file must be returned to IRS/MCC postmarked on or before December 15.

.06 A separate Form 6847 is required for each payer; therefore, this form may be photocopied so that you may provide copies to all of the payers for whom you submit magnetic media or electronic files. A transmitter may not combine payers on one Form 6847 even though 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. 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 If you file for multiple payers, code the records only for participating states for those payers who have properly submitted Form 6847. Do not submit "ACTUAL" data records coded for the Combined Federal/State Program WITHOUT PRIOR APPROVAL from IRS.

.08 If you had applied to participate in this program in the past but did not meet the requirements, you must resubmit the Form 6847 with the proper signatures as specified.

.09 Some participating states require separate notification that you are filing in this manner. Since IRS acts as a forwarding agent only, IT IS YOUR RESPONSIBILITY TO CONTACT THE APPROPRIATE STATES FOR FURTHER INFORMATION.

.10 Approval to participate in the Combined Federal/State Program will be revoked if files submitted do not totally conform to the specifications in this revenue procedure.

.11 IT IS THE FILER'S RESPONSIBILITY TO TRANSMIT CORRECTED RETURNS TO THE STATES.

.12 Participating states and corresponding valid state codes are listed in TABLE 1 of this section. If the state that you wish information released to does not participate in the program, do not code your records for that state. It is the filer's responsibility to file information returns with those nonparticipating states.

.13 The appropriate state code MUST be entered for those documents which meet the state's filing requirements (see TABLE 1). DO NOT USE STATE ABBREVIATIONS. It is the filer's responsibility to determine the state code to be used and to obtain the filing requirements from the appropriate state(s).

.14 To simplify filing, several of the participating states have provided lists of their information return reporting requirements (see TABLE 2). It is your responsibility to contact the participating states to verify the criteria provided in this table.

.15 If you have met *ALL* of the above conditions:

(a) You must submit all records coded exactly as required by this revenue procedure.

(b) The "C" Record *must* be followed by a "K" Record for each state. The "K" Record indicates the number of payees being reported to each particular state.

(c) Payment amount totals and the valid participating state code must be included in the State Totals "K" Record. (Refer to Part B, Sec. 8, for a description of the "K" Record.)

(d) The last "K" Record is followed by an "A" Record or 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	New York	36
Arizona	04	Kansas	20	North Carolina	37
Arkansas	05	Maine	23	North Dakota	38
California	06	Massachusetts	25	Oregon	41
Delaware	10	Minnesota	27	South Carolina	45
District of Columbia	11	Mississippi	28	Tennessee	47
Georgia	13	Missouri	29	Wisconsin	55
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	[e]
District of Columbia[a]	600	600	600	600	600	600	600	NR
Hawaii	10	[e]	10[b]	600	10	10	600	[e]
Idaho	10	10	10	600	10	10	600	[e]
Iowa	100	1000	1000	1000	1000	1000	1000	NR
Minnesota	10	10	10	600	10	10	600	[e]
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	[e]
New Jersey	1000	1000	1000	1000	1000	1000	1000	NR
New York	NR	600	600	600[d]	NR	600	600	NR
North Carolina	100	100	100	600	100	100	100	[e]
Tennessee	25	NR	25	NR	NR	NR	NR	NR
Wisconsin	NR	NR	NR	600	NR	600	600	NR

NOTE: This cumulative list is for information purposes only and represents dollar criteria. For complete information on state filing requirements including changes which may apply, 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. Amounts are for aggregates of several types of income from the same payer.

b. State regulation changing filing requirement from $600 to $10 is pending.

c. The state would prefer those returns filed with respect to non-Missouri residents to be sent directly to the state agency.

d. Aggregate of several types of income.

e. All amounts are to be reported.

SEC. 17. DEFINITION OF TERMS

Element	*Description*
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.
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.
EIN	A nine-digit number (Employer Identification Number) that has been assigned by IRS to the taxpayer.
Electronic Filing	Submission of information returns using switched telecommunications network circuits. These transmissions use modems, dial-up phone lines, and bi-synchronous protocols. See Part C of this publication for specific information on electronic filing.
File	For purposes of this procedure, a file consists of all records submitted by a Payer or Transmitter, either magnetically or electronically.
Foreign Corporation	Any corporation organized or created other than in or under the laws of the United States or any of its states or territories.

Element	*Description*
Magnetic Media	For purposes of this procedure, the term "magnetic media" refers to ½ inch magnetic tape; IBM 3480 compatible tape cartridge; or 8 inch, 5¼, or 3½ inch diskette. Magnetic media may be produced on mainframe computer systems; mini- or micro-computer systems; or personal computers.
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. 6 Payee "B" Record, Document Specific 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), 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 trustee or 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.
Special Character	Any character that is not a numeral, an alpha, or a blank.
SSA	Social Security Administration.
SSN	Social Security Number.
Taxpayer Identification Number (TIN)	May be either an EIN or SSN.
Transfer Agent (Paying 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 941). The payer may be required to submit to IRS a Form 2678, Employer Appointment of Agent Under Section 3504 of the Internal Revenue Code, which notifies IRS of the transfer agent relationship.
Transmitter	Person or organization *submitting* magnetic media file(s). May be Payer or agent of Payer.
Transmitter Control Code (TCC)	A five character alpha/numeric number assigned by IRS to the transmitter prior to actual filing on magnetic media. This number is inserted in the "A" Record of your files and must be present before the file can be processed. An application Form 4419 must be filed with IRS to receive this number. (See Part A, Sec. 7.)

SEC. 18. STATE ABBREVIATIONS

.01 You MUST use the following state abbreviations 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. For a list of states that participate in the Combined Federal/State Filing Program, refer to Part A, Sec. 16, Table 1.)

State	Code	State	Code	State	Code
Alabama	AL	Kentucky	KY	North Dakota	ND
Alaska	AK	Louisiana	LA	Ohio	OH
American Samoa	AS	Maine	ME	Oklahoma	OK
Arizona	AZ	Mariana Islands	MP	Oregon	OR
Arkansas	AR	Maryland	MD	Pennsylvania	PA
California	CA	Massachusetts	MA	Puerto Rico	PR
Colorado	CO	Michigan	MI	Rhode Island	RI
Connecticut	CT	Minnesota	MN	South Carolina	SC
Delaware	DE	Mississippi	MS	South Dakota	SD
District of Columbia	DC	Missouri	MO	Tennessee	TN
Florida	FL	Montana	MT	Texas	TX
Georgia	GA	Nebraska	NE	Utah	UT
Guam	GU	Nevada	NV	Vermont	VT
Hawaii	HI	New Hampshire	NH	Virgin Islands	VI
Idaho	ID	New Jersey	NJ	Virginia	VA
Illinois	IL	New Mexico	NM	Washington	WA
Indiana	IN	New York	NY	West Virginia	WV
Iowa	IA	North Carolina	NC	Wisconsin	WI
Kansas	KS			Wyoming	WY

.02 You must use the 29-2-9 City, State, and ZIP Code format for U.S. addresses which include American Samoa, Guam, Mariana Islands, Puerto Rico, and the Virgin Islands.

.03 For Foreign Country addresses you may use a 40-position free format in lieu of the 29-2-9 City, State, and ZIP Code format; however, this is only allowable if a "1" appears in the Foreign Country Indicator Field of the "B" Record. You may choose to spell out the name of the foreign country or use abbreviations.

.04 When reporting APO/FPO addresses in Payee documents, the following format should be used:

EXAMPLE:	Payee Name	PVT Willard J. Doe	
	Mailing Address	Company F, PSC Box 100	)
		167 Infantry REGT	) See NOTE
	Payee City	APO New York	
	Payee State		
	Payee ZIP Code	098010100	

NOTE: Mailing address must be reported as one 40-position field.

SEC. 19. MAJOR PROBLEMS ENCOUNTERED

After preparing your files, we encourage you to verify the format and content of each type of record to ensure the accuracy of your data submission. This may eliminate the need for IRS/MCC to return your file for replacement, and therefore reduce the likelihood of a penalty assessment for incorrect submissions. We strongly urge you to print your data before shipping to make sure you have good data in your records according to the format found in this revenue procedure. This is especially true for those filers who have either had their files prepared by a third party service bureau, or who have purchased pre-programmed software packages. If you purchased your software package for a previous tax year, it will no longer be valid for reporting your tax year 1990 information returns, since there were programming changes.

Following are some of the most frequently encountered problems with magnetic media files submitted to IRS/MCC which result in files being returned to the filer:

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1. The Payment Amount Fields in the Payee "B" Record do not correspond to the amount indicators in the Payer "A" Record.

If Amount Indicators 2, 4 and 7 appear in positions 23, 24 and 25 of the Payer "A" Record, then the Payee "B" Record must show payment amounts in Fields 2 (positions 61-70), 4 (positions 81-90) and 7 (positions 111-120), right-justified and unused positions zero filled.

EXAMPLE:	"A" RECORD	247bbbbbb (Pos. 23-31)	— (b = blank)
	"B" RECORD	0000867599 (Pos. 61-70)	— (Payment Amount 2)
		0000709097 (Pos. 81-90)	— (Payment Amount 4)
		0000044985 (Pos. 111-120)	— (Payment Amount 7)

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2. Blanks or invalid characters appear in Payment Amount Fields in the Payee "B" Record.

Money amounts must be right-justified and zero (0) filled. DO NOT USE BLANKS. Each payment amount must be entered in U.S. dollars and cents; however, do not use dollar signs, decimal points, or commas, as these characters are understood. For example, if you are reporting a money amount of $100.00, your payment amount field would be coded "0000010000."

DO NOT ENTER NEGATIVE AMOUNTS EXCEPT for Amount Indicators 2, 6, 7, 8 or 9 of the Form 1099-B. A negative overpunch in the units position may be used instead of a minus sign to indicate negative amounts. If a plus or minus sign or negative overpunch is not used, the amount is assumed to be positive.

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3. Data is in prior year's format.

Revenue procedures are updated each year and you must use the current revenue procedure to format your programs. DO NOT USE 1989 REVENUE PROCEDURES FOR 1990 FILING.

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4. Discrepancy between IRS totals and totals in Payer "C" Records.

The Payer "C" Record is a summary record for a type of return for a given payer as reported in the Payee "B" Records. IRS computers automatically compute the total number of payees and total payment amounts in the Payee "B" Records and these totals are compared against the totals in the Payer "C" Records. These totals are also manually checked against the totals provided on Forms 4804/4802. Payers should verify the accuracy of the records because imbalances necessitate return of files for correction.

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5. Incorrect/Invalid EIN in Payer "A" Record.

The Payer's federal EIN reported in position 7-15 of the Payer "A" Record must be correct in order for IRS to process the media. Be sure the EIN reported on the Forms 4804 and Form 4802 matches the EIN reported in the "A" Record. Do not enter blanks, hyphens, alphas, all 9s or all 0s. This field may be left blank for foreign corporations not required to have an EIN if the foreign indicator code is present in the "A" Record. Also, please double check for transposed numbers because an incorrect EIN will cause records to go unpostable, which means the records will not post to the Master File.

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6. Bad Format.

We receive magnetic tape formatted using 8-inch diskette specifications and vice versa. BE SURE TO USE THE PROPER REVENUE PROCEDURE FOR FORMATTING YOUR DATA. Use this publication (1220) for formatting magnetic tape, tape cartridge, 5 1/4 and 3 1/2 inch diskettes, or your electronic files. Use Publication 1255 for formatting 8-inch diskettes ONLY.

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7. Reporting Payments on Form 1099-R, Payer "A" Record.

There is no provision for reporting the Distribution Code (entered in Box 7 on the paper Form 1099-R) in the Payer "A" Record. This information is reported in the Document Specific Code of the Payee "B" Record. Therefore, the Amount Indicators in the Payer "A" Record should be reported as follows if you are reporting all 8 Amount Codes: 12345689b. Amounts are entered in ascending sequence, left-justified, and unused positions blank filled. The Amount Indicator may change from year to year. Please be sure your Payer "A" Record only contains the Amount Indicators specified in the Revenue Procedure.

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8. Block size exceeds 25,200 positions.

Be sure your records do not span blocks. Even though the size was changed from 10,000 to 25,200 positions, filers are still exceeding the block size.

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9. Bad or incomplete address in the Payer "A" Record.

The Payer's address in Field Position 131-170 of the Payer "A" Record should be left-justified and blank filled, and must agree with the address provided on Forms 4804/4802. Payer's City, State and ZIP MUST appear in positions 171-210 and must be left-justified and blank filled.

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10. Record length is invalid.

Beginning in Tax Year 1987, the record length was changed from 360 to 420 positions. Some filers are still using old programs that create records of 360 positions, which are now unacceptable.

RECORDS MUST BE A FIXED 420 POSITIONS.

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11. The City/State/ZIP Code in the Payee "B" Record is in wrong format.

The Payee City (Positions 282-310), State (Positions 311-312), and ZIP Code (Positions 313-321) in the Payee "B" Record MUST be coded in the correct positions. If your program cannot code this information in the correct fields, you MUST request a deviation in writing from IRS/MCC. Files submitted with the City/State/ZIP Code information coded incorrectly, and for which a deviation has not been approved by IRS/MCC, will be returned for replacement.

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12. Invalid type of return indicator.

You must indicate the type of return submitted by inserting the appropriate code in Position 22 of the Payer/Transmitter "A" Record. For example, if the type of return being reported is Form 1099-INT, a code "6" must be inserted in Position 22.

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13. Form W-2/W-2P information submitted on same media as Form 1099 information.

Form W-2/W-2P information is submitted to the Social Security Administration (SSA), and NOT to IRS/MCC. The Social Security Administration has its own magnetic media reporting program for wage information, and the media containing Forms W-2/W-2P is submitted to SSA. Any media received at IRS/MCC which contains Form W-2/W-2P information will be returned to the filer. Contact your local SSA office for information concerning filing Forms W-2/W-2P on magnetic media.

14. Excessive withholding credits.

For most information returns, other than Form 1099-R, withholding credits should NOT exceed 20 percent of the income reported. Validate the total reported in the withholding field against the total income reported.

15. Incorrect format for TINs in the Payee "B" Record.

A check of your "B" records should be made to ensure the Taxpayer Identification Numbers (TIN) are formatted correctly. There should be nine digits, no alpha characters, no hyphens or commas. Incorrect formatting of TINs may result in a penalty.

PART B. MAGNETIC MEDIA SPECIFICATIONS

SECTION 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. These specifications must be adhered to unless deviations have been specifically granted by IRS.

.02 An external label, Form 5064, must appear on each tape and diskette submitted for processing. 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 will result in the diskette being returned to the filer. The following information is needed on the label:

(a) The transmitter's name.

(b) The five character alpha/numeric Transmitter Control Code.

(c) The tax year of the data (i.e., 1990).

(d) Operating system software and hardware used to create the file (e.g., Apple MacIntosh/MacWrite V2.2).

(e) Document types (e.g., 1098, 5498, INT, DIV, MISC, etc.).

(f) The total number of Payee "B" Records on the media.

(g) An in-house volume serial number which may be assigned by the transmitter to the magnetic media (this is optional for those organizations which assign their own numbers to their media). If you do not assign media numbers, leave this blank.

(h) The sequence of each tape or diskette (e.g., 001 of 008, 002 of 008, etc.). However, if your file is complete on one tape or diskette, then the sequence will be 001 of 001.

The information on the external media label, Form 5064, will assist IRS in processing or in locating a file, should the transmitter request that it be returned due to errors. IRS advises that special shipping containers not be used for transmitting data since they will not be returned.

.03 A provision is made in the Payee "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 their state or local department of revenue for filing instructions. (Also refer to Part A, Sec. 16.)

(b) This field is also reserved for the filer's own personal use and may be used at the discretion of the filer to include information related to each individual return. IRS will not use the information supplied in this field. The length of this field will vary depending on the type of return. For Forms 1098, 1099-DIV, 1099-G, 1099-INT, 1099-MISC, 1099-PATR, 1099-R, and 5498, there are 67 positions reserved for Special Data Entries. For Form 1099-A, there are 21 positions; for Form 1099-B, there are 10 positions; for Forms 1099-OID, there are 28 positions; and for Forms 1099-S, there are 23 positions. Form W-2G has no available space within the Payee "B" Record for Special Data Entries.

.04 All records must be a fixed length of 420 positions. Use "K" Records *only* if you are an approved Combined Federal/State filer.

SEC. 2. TAPE SPECIFICATIONS

.01 In most instances, IRS can process any compatible magnetic tape files. Tape files must be EBCDIC, ASCII or BCD and must meet the following criteria:

(a) 9 track EBCDIC (Extended Binary Coded Decimal Interchange Code) with:
  (1) Odd Parity
  (2) A density of 800, 1600, or 6250 BPI.
  (3) If you use UNISYS Series 1100, you must submit an interchange tape.

(b) 9 track ASCII (American Standard Coded Information Interchange) with:
  (1) Odd Parity
  (2) A density of 800, 1600, or 6250 BPI.

(c) 7 track BCD (Binary Coded Decimal) with:

(1) Either Even or Odd Parity
(2) A density of 556 or 800 BPI. (IRS will accept and process 7 track tapes; however, 9 track is preferred.)

Please be consistent in the use of recording codes and density on your files. If files are generated in more than one recording code and/or density, multiple shipments would be appreciated.

.02 All compatible tape files must have the following characteristics: Type of tape—0.5 inch (12.7 mm) wide, computer grade magnetic tape on reels of up to 2400 feet (731.52 m) within the following specifications:

(a) Tape thickness: 1.0 or 1.5 mils and
(b) Reel diameter: 10.5 inch (26.67 cm), 8.5 inch (21.59 cm), or 7 inch (17.78 cm).

.03 Starting in Tax Year 1990 (reported in calendar year 1991), IRS/MCC will accept IBM 3480 compatible tape cartridges.

THE TAPE CARTRIDGE SPECIFICATIONS WILL BE AS FOLLOWS:

(a) The tape transports that will be processing the tape cartridges will be IBM 3480. Therefore, the tape cartridges must be IBM 3480 compatible.
(b) The tape cartridges 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 will be 18-track parallel.
(4) Cartridges will be double density.
(5) Cartridges will contain 14,907 bytes/cm (37,871 bytes/in).

If your tape/data cartridge does not meet these specifications, you may submit it as a "TEST" file, and IRS/MCC will try to process it. Contact IRS/MCC for further information (see Part A, Sec. 3 for information on contacting IRS/MCC).

.04 Payers who can substantially conform to these specifications, but require some minor deviations, MUST contact IRS/MCC in writing. Tapes deviating from the specifications in this revenue procedure must not be submitted without prior approval from IRS. If you file on the Combined Federal/State Filing Program, your files must conform totally to this revenue procedure.

.05 The tape records defined in this revenue procedure may be blocked subject to the following:

(a) A block must not exceed 25,200 tape positions.
(b) If the use of blocked records would result in a short block, all remaining positions of the block must be filled with 9s; however, the last block of the file may be filled with 9s or truncated. Do not pad a block with blanks.
(c) All records, except the header and trailer labels, may be blocked.
(d) Records may not span blocks.

.06 Labeled or unlabeled tapes may be submitted.

.07 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.

SEC. 3. 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.
(c) Records must be 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 carriage return/line feed (cr/lf) characters.
(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 3 digit extension. This extension will indicate the sequence of the diskettes within the file. For example, the first diskette will be named IRSTAX.001, the second diskette will be IRSTAX.002, etc.
(g) A diskette file may consist of multiple diskettes as long as the filename conventions are adhered to.
(h) Diskettes must meet one of the following specifications:

Capacity	Tracks	Sides/Density	Sector Size
1.44 mb	96tpi	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 prefers that 5 1/4 and 3 1/2 inch diskettes be created using MS/DOS; however, diskettes created using other operating systems may be acceptable. IRS/MCC has equipment that can convert diskettes created under virtually any operating system to the appropriate MS/DOS format. We strongly recommend that you submit a test file for 5 1/4 and 3 1/2 inch diskettes, especially if your data was not created using the operating sys-

tem MS/DOS (see Part A, Sec. 8 for instructions on submitting "TEST" files).

.03 Deviations from the prescribed formats will not be acceptable. Diskettes deviating from the specifications in this revenue procedure must not be submitted without prior approval from IRS. If you file under the Combined Federal/State Filing Program, your files must conform totally to this revenue procedure.

SEC. 4. PAYER/TRANSMITTER "A" RECORD

.01 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 appearing on a tape reel or diskette will depend on the number of payers and the different types of returns being reported. The payment amounts for one payer for one type of return must 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 you are filing Form 1099-DIV to report Amount Codes 1, 2, and 3, all three amount codes must be reported under one "A" Record, not three separate "A" Records. For Payee "B" Records which 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 appearing on the file must be an "A" Record. A transmitter may include Payee "B" Records for more than one payer on a tape or diskette; however, each GROUP of Payee "B" Records must be preceded by an "A" Record.

.05 ALL RECORDS MUST BE A FIXED LENGTH OF 420 POSITIONS.

.06 A single tape or diskette may also contain different types of returns but the types of returns MUST NOT be intermingled. A separate "A" Record is required for each payer and for each type of return being reported. However, once you have written the first Payer "A" Record, you need not write another unless you report for another payer or another type of document, even if you have more than one tape or diskette. An "A" Record may be blocked with "B" Records; however, the initial record on a file must be an "A" Record. IRS 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 should be uppercase.

.09 WHEN REPORTING FORM 1098, MORTGAGE INTEREST STATEMENT, THE "A" RECORD WILL REFLECT THE NAME OF THE RECIPIENT OF THE INTEREST (THE FILER). THE "B" RECORD WILL REFLECT THE INDIVIDUAL PAYING THE INTEREST (BORROWER/PAYER OF RECORD) AND THE AMOUNT PAID.

RECORD NAME: PAYER/TRANSMITTER "A" RECORD

NOTE: For all fields marked REQUIRED, you must provide the information described under Description and Remarks. For those fields not marked REQUIRED, you 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.

Field Position	Field Title	Length	Description and Remarks
1	Record Type	1	REQUIRED. Enter "A".
2-3	Payment Year	2	REQUIRED. Enter "90".
4-6	Reel Sequence Number	3	The reel sequence number incremented by 1 for each tape or diskette on the file starting with 001. You may choose to enter blanks or zeros in this field. IRS bypasses this information. You must indicate the proper sequence on the external label Form 5064.
7-15	Payer's Federal EIN	9	REQUIRED. Must be the valid 9-digit number assigned to the payer by IRS. DO NOT ENTER BLANKS, HYPHENS, ALPHA CHARACTERS, ALL 9s OR ALL ZEROS. (Also see Part A, Sec. 14.) For foreign corporations that are not required to have an EIN, this field may be left blank. Foreign corporations should have the Foreign Corporation Indicator set to "1." (See Part A, Sec. 17 for the definition of a Foreign Corporation.)

Field Position	Field Title	Length	Description and Remarks
16-19	Payer Name Control	4	The Payer Name Control can be obtained from the mail label on the Package 1099 that is mailed to most payers on record each December. To distinguish between Package 1099 and 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 on magnetic media only, and 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 you have not received a Package 1099 or you do not know your Payer Name Control, this field should be blank filled.
20	Blank	1	Enter blank.
21	Combined Federal/ State Filer	1	FORMS 1098, 1099-A, 1099-B, 1099-S, and W-2G CANNOT BE FILED UNDER THIS PROGRAM. Enter the appropriate code from the table below. *Code* — *Meaning* 1 — Participating in the Combined Federal/State Filing Program. blank — Not participating. Prior approval is required. A Consent Form 6847 must be submitted to IRS before tax information will be released to the states. (Refer to Part A, Sec. 16, Table 2 for money criteria.) Not all states participate in this program. If the Payer/Transmitter is not participating in the Combined Federal/State Filing Program, enter blank. (Refer to Part A, Sec. 16 for the requirements that MUST be met *prior* to actual participation in this program.) Filers who participate in this program must incorporate state totals into corresponding "K" Records as described in Part B, Sec. 8.
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-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 Indicators	9	REQUIRED. *In most cases, the box numbers on paper information returns correspond with the amount codes used to file on magnetic media; however, if discrepancies occur, the instructions in this revenue procedure govern.* For a detailed explanation of the information to be reported in each Amount Code, refer to the 1990 "Instructions for Forms 1099, 1098, 5498, and W-2G," included in your Magnetic Media Reporting package. The amount indicators entered for a given type of return indicate type(s) of payment(s) that were made. For each Amount Code entered in this field, a corresponding Payment Amount will appear in the Payee "B" Record.

Field Position	Field Title	Length	Description and Remarks
			EXAMPLE: If position 22 of the Payer/Transmitter "A" Record is "7" (for 1099-PATR) and positions 23-31 are "247bbbbbb" (b = blanks), this indicates that you will be reporting 3 actual Payment Amounts in all of the following Payee "B" Records. *The first* Payment Amount field in the Payee "B" Record will be all "0" (zeros); *the second* will represent Nonpatronage distributions; *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 Energy Investment Credit; and *the eighth and ninth* will be all "0" (zeros). Enter the Amount Indicators in ASCENDING SEQUENCE (*i.e.*, 247bbbbbb, b = blanks), left-justify, filling unused positions with blanks. For any further clarification of the Amount Indicator codes, contact IRS/MCC (see Part A, Sec. 3.)
Amount Indicators Form 1098—Mortgage Interest Statement			For Reporting Interest Received from Payer(s)/Borrower(s) (Payer of Record) on Form 1098: Amount Code — Amount Type 1 — Mortgage interest received from payer(s)/borrower(s)
Amount Indicators Form 1099-A—Acquisition or Abandonment of Secured Property			For Reporting the Acquisition or Abandonment of Secured Property on Form 1099-A: Amount Code — Amount Type 2 — Balance of principal outstanding 3 — Gross foreclosure proceeds 4 — Appraisal value
Amount Indicators Form 1099-B—Proceeds From Broker and Barter Exchange Transactions			For Reporting Payments on Form 1099-B: Amount Code — Amount Type 2 — Stocks, bonds, etc. (For Forward Contracts see Note.) 3 — Bartering (Do not report negative amounts.) 4 — Federal income tax withheld (Backup withholding) 6 — Profit (or loss) realized in 1990 7 — Unrealized profit (or loss) on open contracts—12/31/89 8 — Unrealized profit (or loss) on open contracts—12/31/90 9 — Aggregate profit (or loss)
			NOTE: The Payment Amount field associated with Amount Code 2 may be used to represent a loss when the reporting is for Forward Contracts. Refer to Payee "B" Record— General Field Descriptions, Payment Amount Fields, for instructions on reporting negative amounts. Do not report negative amounts for Amount Codes 3 and 4.
Amount Indicators 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

Field Position	Field Title	Length	Description and Remarks
			9 Noncash liquidation distributions (show fair market value)

NOTE: Amount Code 1 MUST equal the sum of amounts reported in Amount Codes 2, 3, 4 and 5.

Amount Indicators 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
4	Federal income tax withheld (Backup withholding)
5	Discharge of indebtedness
6	Taxable grants
7	Agriculture payments

Amount Indicators Form 1099-INT—Interest Income

For Reporting Payments on Form 1099-INT:

Amount Code	Amount Type
1	Earnings from savings and loan associations, credit unions, bank deposits, bearer certificates of deposit, etc.
2	Early withdrawal penalty
3	U.S. Savings Bonds, etc.
4	Federal income tax withheld (Backup withholding)
5	Foreign tax paid

Amount Indicators Form 1099-MISC—Miscellaneous Income

For Reporting Payments on Form 1099-MISC:

Amount Code	Amount Type
1	Rents
2	Royalties
3	Prizes, awards, etc.
4	Federal income tax withheld (Backup withholding)
5	Fishing boat proceeds
6	Medical and health care payments
7	Nonemployee compensation or Crop Insurance Proceeds (see Note 1)
8	Substitute payments in lieu of dividends or interest
9	Direct sales "indicator" (see Note 2)

NOTE 1: Amount code "7" is normally used to report nonemployee compensation. However, Amount code "7" may also be used to report Crop Insurance Proceeds. If both Nonemployee compensation and Crop Insurance Proceeds are being paid to the same payee, two separate Payee "B" Records are required. See Part B, Section 6, Document Specific Code for instructions on how to indicate Crop Insurance Proceeds.

NOTE 2: Use Amount Code "9" to report the occurrence of 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. Refer to the 1990 "Instructions for Forms 1099, 1098, 5498, and W-2G," for specific instructions. Do not use this indicator for sales of less than $5,000. The use of Amount Code "9" actually reflects an indicator of direct sales of $5,000 or more and is not an actual payment amount or amount code. The corresponding payment amount field in the Payee "B" Record MUST be reflected as 0000000100 if you are reporting direct sales of $5,000 or more. This does not mean that a payment of $1.00 was made or is being reported.

Amount Indicators Form 1099-OID—Original Issue Discount

For Reporting Payments on Form 1099-OID:

Amount Code	Amount Type
1	Original issue discount for 1990
2	Other periodic interest
3	Early withdrawal penalty
4	Federal income tax withheld (Backup withholding)

Field Position	Field Title	Length	Description and Remarks
Amount Indicators 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 6 — Investment credit (see Note) 7 — Energy investment credit (see Note) 8 — Jobs credit (see Note) 9 — Low-income housing credit (see Note)
NOTE: The amounts shown for Amount Indicators 6, 7, 8 and 9 must be reported to the payee; however, they need not be reported to IRS.			
Amount Indicators Form 1099-R — Total Distributions From Profit-Sharing, Retirement Plans, Individual Retirement Arrangements, Insurance Contracts, Etc.			For Reporting Payments on Form 1099-R: Amount Code — Amount Type 1 — Gross distribution 2 — Taxable amount (see Note 1) 3 — Amount in Amount Code 2 eligible for capital gain election 4 — Federal income tax withheld (See Note 2) 5 — Employee contributions or insurance premiums 6 — Net unrealized appreciation in employer's securities 8 — Other 9 — State income tax withheld (see Note 3)
NOTE 1: 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 contribution, enter the value of the stock in Amount Code 1, enter zero (0) in Amount Code 2, and enter the employee's contribution in Amount Code 5.			
NOTE 2. See the 1990 "Instructions for Forms 1099, 1098, 5498, and W-2G" for further information concerning the definition of Federal Income Tax Withheld for Form 1099-R.			
NOTE 3: State income tax withheld has been added for the convenience of the payer but need not be reported to IRS.			
Amount Indicators Form 1099-S — Proceeds From Real Estate Transactions			For Reporting Payments on Form 1099-S: Amount Code — Amount Type 2 — Gross proceeds
Amount Indicators Form 5498— Individual Retirement Arrangement Information (See Note)			For Reporting Payments on Form 5498: Amount Code — Amount Type 1 — Regular IRA contributions made in 1990 and 1991 for 1990 2 — Rollover IRA contributions 3 — Life insurance cost included in Amount Code 1 4 — Fair market value of the account
NOTE: Form 5498 is filed for each person for whom you maintained an Individual Retirement Arrangement (IRA) (including an Individual Retirement Arrangement maintained as part of a Simplified Employee Pension (SEP)) during 1990. Amount Code 4 represents the value of the account. Trustees and issuers of IRAs and SEPs must report the value of accounts in existence during the year, even if no contributions were made during the year. However, if a total distribution was made from an IRA during the year and no contributions were made for that year, you need not file Form 5498 to reflect that the fair market value on December 31 was zero. Do not report employer SEP contributions on Form 5498; however, you must report the value of a SEP account. For an IRA, use all applicable Amount Codes. If no IRA contributions were made for 1990, you will only use Amount Code 4. Only IRA contributions to be applied to 1990 that are made between January 1, 1990 and April 15, 1991 are to be reported in Amount Code 1.			

Field Position	Field Title	Length	Description and Remarks
Amount Indicators 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 has been added for the convenience of the payer but need not be reported to IRS.			
32-41	Blank	10	Enter blanks.
42-43	Magnetic Tape Filer Indicator	2	REQUIRED. Magnetic tape/tape cartridge filers *only*. Enter the letters "LS" (in UPPERCASE *ONLY*) in this field.
44-48	Transmitter Control Code (TCC)	5	REQUIRED. Enter the five character alpha/numeric Transmitter Control Code assigned by IRS. You must have a TCC to file data on this program. DO NOT ENTER MORE THAN ONE TCC PER FILE.
49	Foreign Corporation Indicator	1	Enter a "1" if the payer is a Foreign Corporation and income is paid by the corporation to a U.S. resident from sources outside of the United States. (See Part A, Sec. 17 for a definition of a Foreign Corporation.) If the payer is not a Foreign Corporation, enter a blank. See Note 1.
Note 1. Some filers are submitting their files with a "1" coded in Position 49 in all of the records contained on the file, whether the payer is a foreign corporation or not. Records that are coded as foreign corporations are processed differently than those that are coded with a blank in Position 49. If your program automatically codes a "1" in Position 49, all of the records on your file will be processed as foreign corporations. If you erroneously report corporations as foreign, you may be subject to a penalty for providing incorrect information to IRS. Therefore, be sure to code only those records as foreign corporations that should be coded as such.			
50-89	First Payer Name Line	40	REQUIRED. Must be present or files will be returned for correction. Enter the name of the payer whose Federal EIN appears in positions 7-15 of the "A" Record, in the manner in which it is used on other tax returns. Any extraneous information must be deleted from the name line. Left-justify and fill with blanks. (Do not enter the Transfer Agent's name in this field. The Transfer Agent's name should appear in the Second Payer Name field.) NOTE: WHEN REPORTING FORM 1098, MORTGAGE INTEREST STATEMENT, THE "A" RECORD WILL REFLECT THE NAME AND EIN OF THE RECIPIENT OF THE INTEREST (THE FILER). 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 AND THE "B" RECORD WILL REFLECT THE SELLER.
90-129	Second Payer Name Line	40	The contents of this field are dependent upon the TRANSFER AGENT INDICATOR in position 130 of this record. If the Transfer Agent Indicator contains a "1," this field must contain the name of the Transfer Agent. If the Transfer Agent Indicator contains a "0" (zero), this field must contain either a continuation of the First Payer Name field or blanks. Left-justify and fill unused positions with blanks. IF NO ENTRIES ARE PRESENT FOR THIS FIELD, FILL WITH BLANKS. (See Part A, Sec. 17 for a definition of Transfer Agent.)

Field Position	Field Title	Length	Description and Remarks
130	Transfer Agent Indicator	1	REQUIRED. Identifies the entity in the Second Payer Name field. (See Part A, Sec. 17 for a definition of Transfer Agent.) *Code* — *Meaning* 1 — The entity in the Second Payer Name field is the Transfer Agent (as defined in Part A, Sec. 17). 0 (zero) — The entity shown is *not* the Transfer Agent (*i.e.*, the Second Payer Name field contains either a continuation of the First Payer Name field or blanks).
131–170	Payer Shipping Address	40	REQUIRED. If the TRANSFER AGENT INDICATOR in position 130 is a "1" enter the shipping address of the Transfer Agent. Otherwise, enter the shipping address of the payer. Left-justify and fill with blanks.
171–210	Payer City, State and ZIP Code	40	REQUIRED. If the TRANSFER AGENT INDICATOR in position 130 is a "1" enter the City, State and ZIP Code of the Transfer Agent. Otherwise, enter the City, State and ZIP Code of the payer. Left-justify and fill with blanks.
211–290	Transmitter Name	80	REQUIRED. (Only if the payer and 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 the transmitter must be reported in the same manner throughout the entire file. Left-justify and fill with blanks. If the payer and transmitter are the same, enter blanks in this field.
291–330	Transmitter Mailing Address	40	REQUIRED. (Only if the payer and transmitter are not the same.) Enter the mailing address of the transmitter. Left-justify and fill with blanks. If the payer and transmitter are the same, enter blanks in this field.
331–370	Transmitter City, State and ZIP Code	40	REQUIRED. (Only if the payer and transmitter are not the same.) Enter the City, State and ZIP Code of the transmitter. Left-justify and fill with blanks. If the payer and transmitter are the same, enter blanks in this field.
371–420	Blank	50	Enter blanks. You may enter carriage return/line feed (cr/lf) characters in positions 419–420.

SEC. 5. PAYER/TRANSMITTER "A" RECORD—RECORD LAYOUT

RECORD TYPE	PAYMENT YEAR	REEL SEQUENCE NUMBER	PAYER'S FEDERAL EIN*	PAYER NAME CONTROL*	BLANK
1	2–3	4–6	7–15	16–19	20

COMBINED FEDERAL/STATE FILER	TYPE OF RETURN	AMOUNT INDICATORS	BLANK	MAGNETIC TAPE FILER INDICATOR
21	22	23–31	32–41	42–43

RECORD NAME: PAYER/TRANSMITTER "A" RECORD—Continued

TRANSMITTER CONTROL CODE	FOREIGN CORPORATION INDICATOR	FIRST PAYER NAME*	SECOND PAYER NAME*	TRANSFER AGENT INDICATOR
44-48	49	50-89	90-129	130

PAYER SHIPPING ADDRESS*	PAYER CITY STATE AND ZIP CODE*	TRANSMITTER NAME	TRANSMITTER MAILING ADDRESS
131-170	171-210	211-290	291-330

TRANSMITTER CITY, STATE, AND ZIP CODE	BLANK
331-370	371-420

* When reporting Form 1098 Mortgage Interest Statement, the "A" Record will reflect the name and EIN of the recipient of the interest (the filer). For Form 1099-S, the "A" Record will reflect the person responsible for reporting the transaction.

SEC. 6. PAYEE "B" RECORD—GENERAL FIELD DESCRIPTIONS AND RECORD LAYOUTS

.01 The Payee "B" Record contains the payment information from the individual returns. When filing information documents on magnetic media, the format for the Payee "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 slightly for Forms 1099-A, 1099-B, 1099-OID, 1099-S and W-2G to accommodate variations within these forms. The individual field definitions follow the Payee ZIP Code field in the "B" Record.

All records must be submitted with a fixed length of 420 positions. In the "A" Record, the Amount Indicator Codes that appear in tape or diskette positions 23 through 31 will be left-justified and blank filled. In the "B" Record, you will allow for all nine payment amount fields. For those fields not used enter zeros (0). For example, if you are reporting on Form 1099-PATR, you will enter a "7" in tape position 22 of the "A" Record, Type of Return Indicator field. If you are reporting payments for Amount Codes 2, 4 and 7, then media positions 23 through 31 of the "A" Record will be "247bbbbbb" (b = blanks). In the Payee "B" Record:

Positions 51 through 60 for Payment Amount 1 will be zeros.

Positions 61-70 will reflect the actual payment amount to be reported for "Nonpatronage distributions."

Positions 71-80 for Payment Amount 3 will be zeros.

Positions 81-90 will reflect the actual payment amount to be reported for "Federal income tax withheld."

Positions 91-110 for Payment Amounts 5 and 6 will be zeros.

Positions 111-120 will reflect the actual payment amount to be reported for "Energy investment credit."

Positions 121-140 for Payment Amounts 8 and 9 will be zeros.

.02 IRS must be able to identify the surname or last name associated with the TIN (SSN or EIN) furnished on a return. The specifications below include a field in the payee records called "Name Control" in which the first four characters of the payee's surname or last name are to be entered by the payer. The surname or last name should appear first in the First Payee Name Line field of all Payee "B" Records.

.03 If payers are unable to determine the first four characters of the surname, the Name Control Field may be left blank; however, compliance with the following will facilitate IRS computer programs in generating the Name Control.

(a) The surname of the payee whose TIN (SSN or EIN) is shown in the Payee "B" Record should always appear first. If, however, your records have been developed using the first name first, you 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 Payee "B" Record must be present in the First Payee Name Line. Surnames of any other payees in the record may be entered in the Second Payee Name field.

.04 See Part A, Sec. 14 for further information concerning Taxpayer Identification Numbers (TIN).

.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 filer's own personal use. IRS does not use the data provided in the Special Data Entries field; therefore, the IRS program doesn't check the content or format of the data entered in this field. It is the filer's choice whether or not this field is used. If this field is coded, it will not affect the processing of the Payee "B" Records.

.06 Those filers participating in the Combined Federal/State Filing Program *must* code their records appropriately for the state to receive the information. The state code appears in positions 417 and 418 of the "B" Record. The file should also meet the money criteria described in Part A, Sec. 16, Table 2.

.07 Do not code for the states unless prior approval to participate has been granted by IRS. See Part A, Sec. 16, Table 1 for a list of the valid participating state codes. FORMS 1098, 1099-A, 1099-B, 1099-S, AND W-2G CANNOT BE FILED UNDER THE COMBINED FEDERAL/ STATE FILING PROGRAM. Your files must meet all of the requirements specified in Part A, Sec. 16 in order to participate in this program.

.08 All alpha characters entered in the "B" Record should be uppercase.

.09 Do not use decimal points (.) to indicate dollars and cents on magnetic media.

.10 IRS STRONGLY ENCOURAGES FILERS TO REVIEW THEIR DATA FOR ACCURACY BEFORE SUBMISSION TO PREVENT ISSUANCE OF ERRONEOUS NOTICES TO PERSONS FOR WHOM REPORTS ARE FILED. FILERS SHOULD BE ESPECIALLY CAREFUL THAT THEIR TAXPAYER NAMES, SOCIAL SECURITY NUMBERS (SSNs), ACCOUNT NUMBERS, TYPES OF INCOME, AND INCOME AMOUNTS ARE CORRECT.

.11 WHEN REPORTING FORM 1098, MORTGAGE INTEREST STATEMENT, THE "A" RECORD WILL REFLECT THE NAME AND EIN OF THE RECIPIENT OF THE INTEREST (THE FILER). THE "B" RECORD WILL REFLECT THE INDIVIDUAL PAYING THE INTEREST (THE 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 "B" RECORD WILL REFLECT THE SELLER.

RECORD NAME: PAYEE "B" RECORD

NOTE: For all fields marked REQUIRED, you must provide the information described under Description and Remarks. For those fields not marked REQUIRED, you 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.

Field Position	Field Title	Length	Description and Remarks
1	Record Type	1	REQUIRED. Enter "B".
2-3	Payment Year	2	REQUIRED. Enter "90".
4-5	Document Specific Code	2	REQUIRED for Forms 1099-R, 1099-MISC, 1099-G and W-2G. FOR ALL OTHER FORMS, OR IF NOT USED, ENTER BLANKS. *For Form 1099-R,* enter the appropriate code(s) for the Distribution Code. More than one code may apply for Form 1099-R; however, if only one code is required, it will be entered in position 4. Position 5 will be blank. NOTE: You MUST enter at least one (1) Distribution Code for Form 1099-R. BLANKS in BOTH positions 4 and 5 are NOT acceptable for Form 1099-R. *For Form 1099-MISC*, position 4 is used to indicate Crop Insurance Proceeds. Position 5 will be blank. *For Form 1099-G*, enter the year of income tax refund in position 4. Position 5 will be blank. *For Form W-2G*, enter the Type of Wager in position 4. Position 5 will be blank.
	Distribution Code (Form 1099-R only)		Use only for reporting on Form 1099-R to identify the Distribution Code. Enter the applicable code from the table that follows. A "0" (zero) is not a valid code for Form 1099-R. A numeric code MUST be entered in all cases except when Code P or D is used. However, when using Code P for an IRA distribution under section 408(d)(4), you may also enter Code 1, if it applies. If you are reporting a total distribution from a plan that includes a distribution of a DEC, you must report two separate "B" Records: one to report the distribution of DEC's; the other to report the distribution from the other part of the plan. In addition, if more than one numeric code is applicable to a distribution, report two separate Payee "B" Records. *Category* (See Note) — *Code* Early (premature) distribution, no known exception* — 1* Early (premature) distribution, exception applies (as defined in Section 72(q), (t), or (v)) other than disability or death* — 2*

Field Position	Field Title	Length	Description and Remarks
			Disability* 3*
			Death (includes payments to a beneficiary)* 4*
			Prohibited transaction* 5*
			Section 1035 Exchange 6
			Normal distribution* 7*
			Excess contributions plus earnings/excess deferrals (and/or earnings) taxable in 1990 8
			PS 58 costs 9
			Excess contributions plus earnings/excess deferrals taxable in 1989 P
			Qualifies for 5-year/10-year averaging A
			Qualifies for death benefit exclusion B
			Category (See Note) *Code*
			Qualifies for both A and B C
			Excess contributions plus earnings/excess deferrals taxable in 1988 D

* If you are reporting an IRA or SEP distribution for Code 1, 2, 3, 4, 5, or 7, you must code a "1" in Position 44 of the Payee "B" Record.

NOTE: For detailed explanations of the distribution codes, see the 1990 "Instructions for Form 1099, 1098, 5498, and W-2G" included in your Magnetic Media Reporting Packages.

Crop Insurance Proceeds (Form 1099-MISC only)

If the payment amount reported for Amount Code 7 is crop insurance proceeds, enter a "1" in Position 4. Position 5 will be blank.

Tax Year of Refund (Form 1099-G only)

Use only for reporting the tax year for which the refund was issued. Enter the NUMERIC year for which the refund was issued (e.g., for 1989, enter 9). However, if the payment amount for Amount Code 2, State or Local Income Tax Refunds, contains a refund, credit or offset that is attributable to an income tax that applies exclusively to income from a trade or business and is not of general application, then enter the ALPHA equivalent of the year for which the refund was issued, from the table below (e.g., for 1989, enter I). This code should appear in position 4. Position 5 will be blank.

Year for Which Trade or Business Refund was Issued	*Alpha Equivalent**
1	A
2	B
3	C
4	D
5	E
6	F
7	G
8	H
9	I
0	J

* To be used for trade or business refunds only.

Type of Wager (Form W-2G only)

Use only for reporting the Type of Wager on Form W-2G. This code will appear 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

Field Position	Field Title	Length	Description and Remarks
			Casino Type Bingo. DO NOT use this code for any other type of Bingo winnings (e.g., Church or Fire Dept.) 6 Slot Machines 7 Any other type of gambling winnings. (This includes Church Bingo, Fire Dept. Bingo, unlabeled winnings, etc.) 8
6	Blank	1	Enter blank.
7	Corrected Return Indicator	1	Enter blank. Position 7 is used to indicate a corrected return. Refer to Part A, Sec. 13 for specific instructions on how to file corrected returns.
8–11	Name Control	4	Enter the first four (4) characters of the surname (last name) of the payee. The surname of the person whose TIN is being reported in positions 15–23 of the "B" Record MUST be used to determine the Name Control. This is especially important in the case of trustee accounts. IF THE NAME THAT CORRESPONDS TO THE TIN IS NOT INCLUDED IN THE FIRST OR SECOND PAYEE NAME LINE, EVERY EFFORT SHOULD BE MADE TO DEVELOP THE CORRECT NAME CONTROL OF THE NAME THAT CORRESPONDS TO THE TIN. 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, 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. IF THE NAME CONTROL IS NOT DETERMINABLE BY THE PAYER, LEAVE THIS FIELD BLANK. (See Part A, Sec. 14 for information on Name Controls). A dash (-) and ampersand (&) are the only acceptable special characters.

The following examples may be helpful to you in developing the Name Control:

	NAME	*NAME CONTROL*
Individuals:		
	Jane Brown	BROW
	John A. Lee	LEE*
	James P. En, Sr.	EN*
	John O'Neill	ONEI
	Mary Van Buren	VANB
	Juan De Jesus	DEJE
	Gloria A. El-Roy	EL-R
	Mr. John Smith	SMIT
	Joe McCarthy	MCCA
	Pedro Torres-Lopes	TORR
	Maria Lopez Moreno	LOPE
	Binh To La	LA*
	Nhat Thi Pham	PHAM
	Mark D'Allesandro	DALL
Corporations:		
	The First National Bank	FIRS
	The Hideaway	THEH
	A & B Cafe	A&BC
Sole Proprietor:		
	Jane and Mark Hemlock c/o The Sunshine Club	HEML

Field Position	Field Title	Length	Description and Remarks
		NAME	*NAME CONTROL*
Partnership:			
		Robert Aspen and Bess Willow	ASPE
		Harold Fir, Bruce Elm, and Joyce Spruce et al Ptr	FIR*
Estate:			
		Frank White Estate	WHIT
		Sheila Blue Estate	BLUE
Trusts and Fiduciaries:			
		Daisy Corporation Employee Benefit Trust	DAIS
		Trust FBO The Cherryblossom Society	CHER
Exempt Organization:			
		Laborer's Union, AFL-CIO	LABO
		St. Bernard's Methodist Church Bldg. Fund	STBE

* Name Controls of less than four (4) significant characters must be left-justified and blank filled.

12–13	Blank	2	Enter blanks.
14	Type of TIN	1	REQUIRED. This field is used to identify the Taxpayer Identification Number (TIN) in positions 15–23 as either an Employer Identification Number, a Social Security Number, or that the type is undeterminable. Enter the appropriate code from the following table: *Type of TIN* / *TIN* / *Type of Account* 1 / EIN / A business, organization, or other entity that is not an individual 2 / SSN / An individual blank / N/A / If the type of TIN is undeterminable, enter a blank.
15–23	Taxpayer Identification Number	9	REQUIRED. Enter the valid 9-digit Taxpayer Identification Number of the payee (SSN or EIN, as appropriate). If an identification number has been applied for but not received, enter blanks. DO NOT ENTER HYPHENS, ALPHA CHARACTERS, ALL 9s OR ALL ZEROS.
24–43	Payer's Account Number For Payee	20	DO NOT ENTER A TAXPAYER IDENTIFICATION NUMBER IN THIS FIELD. We strongly encourage the payer to use this field to enter the payee's account number, which can be any account number assigned by the payer to the payee (e.g., checking account or savings account). THIS NUMBER WILL HELP TO DISTINGUISH THE INDIVIDUAL PAYEE'S ACCOUNT WITH YOU AND SHOULD BE UNIQUE FOR EACH DOCUMENT SO AS TO IDENTIFY THE SPECIFIC TRANSACTION MADE WITH THE ORGANIZATION SHOULD MULTIPLE RETURNS BE FILED FOR ONE PAYEE. This information is particularly useful if corrections are filed. This number is also provided with your Invalid/No-TIN notification from the IRS and may help you determine the branch or subsidiary reporting the transaction. YOU ARE STRONGLY ENCOURAGED TO USE THIS FIELD. Do not define data in this field in packed decimal format. If fewer than twenty characters are required, you may either left- or right-justify, filling the remaining positions with blanks.

Field Position	Field Title	Length	Description and Remarks
44	IRA/SEP Indicator	1	*This field is only used when reporting Forms 1099-R.* This field will be coded ONLY if you entered a code 1, 2, 3, 4, 5, or 7 in either Position 4 or 5, Document Specific Code, of the Payee "B" Record, AND you are reporting a distribution from an IRA or SEP. Enter the appropriate indicator from the table below: *Indicator* — *Usage* 1 — You are reporting an IRA or SEP Distribution. Blank — You are NOT reporting an IRA or SEP Distribution.
45–46	Percentage of Total Distribution	2	THIS FIELD IS ONLY USED WHEN REPORTING *FORMS 1099-R*, and ONLY if you are reporting a total distribution to more than one person. This field is only 2 positions in length because when a total distribution is made to more than one person, the figure MUST be 99% or less. 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% will be 10%; 10.5% or more will be 11%). 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. You need not enter a percentage for IRA or SEP distributions.
47–50	Blank	4	Enter blanks.
	Payment Amount Fields (Must be numeric)		REQUIRED. *You must allow for all payment amounts.* For those not used you will enter zeros. For example: If position 22 of the Payer/Transmitter "A" Record is "7" (for 1099-PATR) and positions 23–31 are "247bbbbbb" (b = blank), this indicates that you will be reporting 3 actual payment amounts in the following Payee "B" Records. Payment Amount 1 will be all "0" (zeros), Payment Amount 2 will represent Nonpatronage distributions, Payment Amount 3 will be all "0" (zeros), Payment Amount 4 will represent Federal income tax withheld, Payment Amounts 5 and 6 will be all "0" (zeros), Payment Amount 7 will represent Energy investment credit, and Payment Amounts 8 and 9 will be all "0" (zeros). Each payment field must contain 10 numeric characters (see Note). Each payment amount must be entered in U.S. dollars and cents. The rightmost 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 "+" or "–" (minus sign) in the leftmost position of the payment amount field. A negative overpunch 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 overpunch is not used, the number is assumed to be positive. 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: *If you are 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.*

Field Position	Field Title	Length	Description and Remarks
			(2) The second Payee "B" Record will contain the remaining money amounts. *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 Payer/Transmitter "A" Record.
61-70	Payment Amount 2*	10	The amount reported in this field represents payments for Amount Code 2 in the Payer/Transmitter "A" Record.
71-80	Payment Amount 3*	10	The amount reported in this field represents payments for Amount Code 3 in the Payer/Transmitter "A" Record.
81-90	Payment Amount 4*	10	The amount reported in this field represents payments for Amount Code 4 in the Payer/Transmitter "A" Record.
91-100	Payment Amount 5*	10	The amount reported in this field represents payments for Amount Code 5 in the Payer/Transmitter "A" Record.
101-110	Payment Amount 6*	10	The amount reported in this field represents payments for Amount Code 6 in the Payer/Transmitter "A" Record.
111-120	Payment Amount 7*	10	The amount reported in this field represents payments for Amount Code 7 in the Payer/Transmitter "A" Record.
121-130	Payment Amount 8*	10	The amount reported in this field represents payments for Amount Code 8 in the Payer/Transmitter "A" Record.
131-140	Payment Amount 9*	10	The amount reported in this field represents payments for Amount Code 9 in the Payer/Transmitter "A" Record.

* If there are discrepancies between these Payment Amount Codes 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	REQUIRED. If the payee address is in a foreign country enter a "1" in this field. This will allow you to use any format for the Payee Address, City, State and ZIP Code. Address information must not appear in the First or Second Payee Name Line. If the address for the payee is a U.S. address, you must enter a blank in this field. The free address format may only be used for foreign addresses. For U.S. addresses, you must use the U.S. Postal Service state abbreviations in magnetic media positions 311 and 312 of the "B" Record. These abbreviations are provided in Part A, Sec. 18.
162-201	First Payee Name Line	40	REQUIRED. Do not enter address information in this field. Enter the name of the payee (preferably surname (last name) first) whose Taxpayer Identification Number appears in positions 15-23 of the "B" Record. If fewer than 40 characters are required, left-justify and fill unused positions with blanks. If more space is required for the name, utilize the Second Payee Name Line field below. If there are multiple payees, only the name of the payee whose Taxpayer Identification Number 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. NOTE: WHEN REPORTING FORM 1098, MORTGAGE INTEREST STATEMENT, THE "A" RECORD WILL REFLECT THE NAME OF THE RECIPIENT OF THE INTEREST (THE FILER). THE "B" RECORD WILL REFLECT THE INDIVIDUAL PAYING THE INTEREST (THE BORROWER/PAYER OF RECORD) AND THE AMOUNT PAID. FOR FORMS 1099-S, THE "B" RECORD WILL REFLECT THE SELLER INFORMATION.

RECORD NAME: PAYEE "B" RECORD—Continued

Field Position	Field Title	Length	Description and Remarks
202-241	Second Payee Name Line	40	If the payee name requires more space than is available in the First Payee Name Line, *enter only the remaining portion of the name in this field.* If there are multiple payees, (*e.g.*, partners or joint owners) we encourage you to use this field for those payees' names not associated with the Taxpayer Identification Number provided in positions 15-23 of the "B" Record. *Do not enter address information in this field.* NOTE: It is important that you provide as much payee information to IRS as possible to identify the owner of the Taxpayer Identification Number. 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. Left-justify and fill unused positions with blanks. The address MUST be present. This field MUST NOT contain any data other than the payee's mailing address. Any format can be used in reporting a foreign mailing address.

For U.S. addresses, the Payee City, Payee State and Payee ZIP Code must be reported as a 29, 2 and 9 position field, respectively. For foreign addresses, the Payee City, Payee State (Country) and Payee ZIP Code can be reported as a continuous 40 position field. When reporting a foreign address, the Foreign Country Indicator in position 161 must contain a "1."

282-310	Payee City	29	REQUIRED. Enter the city, left-justified and fill the unused positions with blanks. Do not enter state and ZIP Code information in this field.
311-312	Payee State	2	REQUIRED. Enter the abbreviation for the state as shown in Part A, Sec. 18. You MUST use valid U.S. Postal Service state abbreviations for U.S. addresses.
313-321	Payee ZIP Code	9	REQUIRED. Enter the valid 9 digit ZIP Code assigned by the U.S. Postal Service. If only the first 5 digits are known, left-justify and fill the unused positions with blanks. Use this field for the ZIP Code only. For foreign countries, alpha characters are acceptable as long as you have entered a "1" in the Foreign Country Indicator field, located in position 161 of the "B" Record.

THE FOLLOWING FIELD DEFINITIONS DESCRIBE PAYEE "B" RECORD POSITIONS FOLLOWING THE PAYEE ZIP CODE FOR:

(1) Forms 1098, 1099-DIV, 1099-G, 1099-INT, 1099-MISC, 1099-PATR, 1099-R and 5498
(2) Form 1099-A
(3) Form 1099-B
(4) Form 1099-OID
(5) Form 1099-S
(6) Form W-2G

(1) FORMS 1098, 1099-DIV, 1099-G, 1099-INT, 1099-MISC, 1099-PATR, 1099-R and 5498 (For detailed explanations of the following fields, see the 1990 "Instructions for Form 1099, 1098, 5498, and W-2G" included in your magnetic media reporting packages.)

NEXT FIELD AFTER PAYEE ZIP CODE:

322-349	Blank	28	Enter blanks.

RECORD NAME: PAYEE "B"
FORMS 1098, 1099-DIV, 1099-G, 1099-INT, 1099-MISC, 1099-PATR, 1099-R, and 5498

Field Position	Field Title	Length	Description and Remarks
350-416	Special Data Entries	67	This portion of the Payee "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact their state or local revenue departments for their 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 filers or states NOT participating in this program or for Form 1098, ENTER BLANKS.
419-420	Blank	2	Enter blanks, or carriage return/line feed (cr/lf) characters.

PAYEE "B" RECORD - RECORD LAYOUT
FORMS 1098, 1099-DIV, 1099-G, 1099-INT, 1099-MISC, 1099-PATR, 1099-R, and 5498

RECORD TYPE	PAYMENT YEAR	DOCUMENT SPECIFIC CODE	BLANK	CORRECTED RETURN INDICATOR	NAME CONTROL*
1	2-3	4-5	6	7	8-11

BLANK	TYPE OF TIN*	TAXPAYER IDENTIFICATION NUMBER*	PAYER'S ACCOUNT NUMBER FOR PAYEE*	IRA/SEP INDICATOR
12-13	14	15-23	24-43	44

PERCENTAGE OF TOTAL DISTRIBUTION	BLANK	PAYMENT AMOUNT 1	PAYMENT AMOUNT 2	PAYMENT AMOUNT 3
45-46	47-50	51-60	61-70	71-80

PAYMENT AMOUNT 4	PAYMENT AMOUNT 5	PAYMENT AMOUNT 6	PAYMENT MOUNT 7	PAYMENT AMOUNT 8	PAYMENT AMOUNT 9
81-90	91-100	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*	BLANK	SPECIAL DATA ENTRIES	COMBINED FEDERAL/ STATE CODE	BLANK
282-310	311-312	313-321	322-349	350-416	417-418	419-420

*When reporting Form 1098, Mortgage Interest Statement, the "B" Record will reflect the individual paying the interest (the borrower/payer of record) and the amount paid.

(2) FORM 1099-A (For detailed explanations of the following fields, see the 1990 "Instructions for Forms 1099, 1098, 5498, and W-2G," included in your magnetic media reporting packages.)

RECORD NAME: PAYEE "B" RECORD—Continued
FORM 1099-A

Field Position	Field Title	Length	Description and Remarks
			NEXT FIELD AFTER PAYEE ZIP CODE:
322-349	Blank	28	Enter blanks.
350-370	Special Data Entries	21	This portion of the Payee "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact their state or local revenue departments for their filing requirements. If this field is not utilized, ENTER BLANKS.
371-376	Date of Lender's Acquisition or Knowledge of Abandonment	6	*REQUIRED FOR FORM 1099-A ONLY.* Enter the date of your acquisition of the secured property or the date you first knew or had reason to know that the property was abandoned, in the format MMDDYY (e.g., 102490). DO NOT ENTER HYPHENS OR SLASHES.
377	Liability Indicator	1	*REQUIRED FOR FORM 1099-A ONLY.* Enter the appropriate indicator from the table below: *Indicator* — *Usage* 1 — Borrower is personally liable for repayment of the debt. Blank — Borrower is not liable for repayment of the debt.
378-416	Description	39	*REQUIRED FOR FORM 1099-A ONLY.* Enter a brief description of the property. For example, 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-1987 Buick Regal or Office Equipment). Enter "CCC" for crops forfeited on Commodity Credit Corporation loans. If fewer than 39 positions are required, left-justify and fill unused positions with blanks.
417-420	Blank	4	Enter blanks, or carriage return/line feed (cr/lf) characters in positions 419-420.

PAYEE "B" RECORD - RECORD LAYOUT
FORM 1099-A

RECORD TYPE	PAYMENT YEAR	BLANK	CORRECTED RETURN INDICATOR	NAME CONTROL	BLANK
1	2-3	4-6	7	8-11	12-13

TYPE OF TIN	TAXPAYER IDENTIFICATION NUMBER	PAYER'S ACCOUNT NUMBER FOR PAYEE	BLANK	PAYMENT AMOUNT 1
14	15-23	24-43	44-50	51-60

PAYMENT AMOUNT 2	APAYMENT AMOUNT 3	PAYMENT AMOUNT 4	PAYMENT AMOUNT 5	PAYMENT AMOUNT 6	PAYMENT AMOUNT 7
61-70	71-80	81-90	91-100	101-110	111-120

Field Position	Field Title	Length	Description and Remarks

PAYMENT AMOUNT 8	PAYMENT AMOUNT 9	BLANK	FOREIGN COUNTRY INDICATOR	FIRST PAYEE NAME LINE
121–130	131–140	141–160	161	162–201

SECOND PAYEE NAME LINE	PAYEE MAILING ADDRESS	PAYEE CITY	PAYEE STATE	PAYEE ZIP CODE	BLANK
202–241	242–281	282–310	311–312	313–321	322–349

SPECIAL DATA ENTRIES	DATE OF LENDER'S ACQUISITION OR ABANDONMENT	LIABILITY INDICATOR	DESCRIPTION	BLANK
350–370	371–376	377	378–416	417–420

(3) FORM 1099-B (For detailed explanations of the following fields see the 1990 "Instructions for Forms 1099, 1098, 5498, and W-2G.")

NEXT FIELD AFTER PAYEE ZIP CODE:

322–349	Blank	28	Enter blanks.
350–359	Special Data Entries	10	This portion of the Payee "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact their state or local revenue departments for their filing requirements. If this field is not utilized, ENTER BLANKS.
360	Gross Proceeds Reported to IRS Indicator	1	*REQUIRED FOR FORM 1099-B ONLY.* Enter appropriate indicator from the table below. If this field is not utilized, ENTER BLANKS. *Indicator* — *Usage* 1 — Gross proceeds 2 — Gross proceeds less commissions and option premiums
361–366	Date of Sale	6	*REQUIRED FOR FORM 1099-B ONLY.* For broker transactions, enter the trade date of the transaction in the format MMDDYY (*e.g.*, 102490). For barter exchanges, enter the date that cash, property, a credit, or scrip is actually or constructively received. Enter blanks if this is an aggregate transaction. DO NOT ENTER HYPHENS OR SLASHES.
367–379	CUSIP Number	13	*REQUIRED FOR FORM 1099-B ONLY.* For broker transactions only, enter the CUSIP (Committee on Uniform Security Identification Procedures) number of the item reported for Amount Indicator "2" (Stocks, bonds, etc.). Enter blanks if this is an aggregate transaction. Enter "0" (zeros) if the number is not available or applicable. For CUSIP numbers with less than 13 characters, right-justify and fill the remaining positions with blanks.

RECORD NAME: PAYEE "B" RECORD—Continued
FORM 1099-B

Field Position	Field Title	Length	Description and Remarks
380-418	Description	39	*REQUIRED FOR FORM 1099-B ONLY.* Enter a brief description of the item or services for which the proceeds are being reported. If fewer than 39 characters are required, left-justify and fill unused positions with blanks. For regulated futures contracts, enter "RFC" and any amount subject to backup withholding. Enter blanks if this is an aggregate transaction.
419-420	Blank	2	Enter blanks, or carriage return/ line feed (cr/lf) characters.

PAYEE "B" RECORD - RECORD LAYOUT
FORM 1099-B

RECORD TYPE	PAYMENT YEAR	BLANK	CORRECTED RETURN INDICATOR	NAME CONTROL	BLANK	TYPE OF TIN
1	2-3	4-6	7	8-11	12-13	14

TAXPAYER IDENTIFICATION NUMBER	PAYER'S ACCOUNT NUMBER FOR PAYEE	BLANK	PAYMENT AMOUNT 1	PAYMENT AMOUNT 2
15-23	24-43	44-50	51-60	61-70

PAYMENT AMOUNT 3	PAYMENT AMOUNT 4	PAYMENT AMOUNT 5	PAYMENT AMOUNT 6	PAYMENT AMOUNT 7	PAYMENT AMOUNT 8
71-80	81-90	91-100	101-110	111-120	121-130

PAYMENT AMOUNT 9	BLANK	FOREIGN COUNTRY INDICATOR	FIRST PAYEE NAME LINE	SECOND PAYEE NAME LINE
131-140	141-160	161	162-201	202-241

PAYEE MAILING ADDRESS	PAYEE CITY	PAYEE STATE	PAYEE ZIP CODE	BLANK	SPECIAL DATA ENTRIES
242-281	282-310	311-312	313-321	322-349	350-359

GROSS PROCEEDS INDICATOR	DATE OF SALE	CUSIP NUMBER	DESCRIPTION	BLANK
360	361-366	367-379	380-418	419-420

(4) FORM 1099-OID (For detailed explanations of the following fields see the 1990 "Instructions for Forms 1099, 1098, 5498, and W-2G.")

RECORD NAME: PAYEE "B" RECORD—Continued
FORM 1099-OID

Field Position	Field Title	Length	Description and Remarks
			NEXT FIELD AFTER PAYEE ZIP CODE:
322-349	Blank	28	Enter blanks.
350-377	Special Data Entries	28	This portion of the Payee "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact their state or local revenue departments for filing requirements. If this field is not used, ENTER BLANKS.
378-416	Description	39	*REQUIRED FOR FORM 1099-OID ONLY.* Enter the identification number (CUSIP Number) or description of the obligation. The description may include the stock exchange, issuer, coupon rate and year of maturity. If fewer than 39 characters are required, left-justify and fill unused positions with blanks.
417-418	Combined Federal/ State Code	2	If a 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 filers or states NOT participating in this program, ENTER BLANKS.
419-420	Blank	2	Enter blanks or carriage return/line feed (cr/lf) characters.

PAYEE "B" RECORD - RECORD LAYOUT
FORM 1099-OID

RECORD TYPE	PAYMENT YEAR	BLANK	CORRECTED RETURN INDICATOR	NAME CONTROL	BLANK
1	2-3	4-6	7	8-11	12-13

TYPE OF TIN	TAXPAYER IDENTIFICATION NUMBER	PAYER'S ACCOUNT NUMBER FOR PAYEE	BLANK	PAYMENT AMOUNT 1
14	15-23	24-43	44-50	51-60

PAYMENT AMOUNT 2	PAYMENT AMOUNT 3	PAYMENT AMOUNT 4	PAYMENT AMOUNT 5	PAYMENT AMOUNT 6
61-70	71-80	81-90	91-100	101-110

PAYMENT AMOUNT 7	PAYMENT AMOUNT 8	PAYMENT AMOUNT 9	BLANK	FOREIGN COUNTRY INDICATOR
111-120	121-130	131-140	141-160	161

FIRST PAYEE NAME LINE	SECOND PAYEE NAME LINE	PAYEE MAILING ADDRESS	PAYEE CITY	PAYEE STATE	PAYEE ZIP CODE
162-201	202-241	242-281	282-310	311-312	313-321

Field Position	Field Title	Length	Description and Remarks

BLANK	SPECIAL DATA ENTRIES	DESCRIPTION	COMINED FEDERAL/ STATE CODE	BLANK
322-349	350-377	378-416	417-418	419-420

(5) FORM 1099-S (for detailed explanations of the following fields see the 1990 "Instructions for Forms 1099, 1098, 5498, and W-2G.")

NEXT FIELD AFTER PAYEE ZIP CODE:

322-349	Blank	28	Enter blanks.
350-372	Special Data Entries	23	This portion of the Payee "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact their state or local revenue departments for filing requirements. If this field is not used, ENTER BLANKS.
373-378	Date of Closing	6	*REQUIRED FOR FORM 1099-S ONLY.* Enter the closing date in the format MMDDYY (e.g., 102490). Do not enter hyphens or slashes.
379-417	Description	39	*REQUIRED FOR FORM 1099-S ONLY.* Enter the address of the property transferred, or a legal description of the property. If you are entering an address, include the state and ZIP Code where the property is located. If fewer than 39 positions are required, left-justify and fill unused positions with blanks.
418	Property or Services Received	1	*REQUIRED FOR FORM 1099-S ONLY.* If the transferor received or will receive property (other than cash) or services as part of the consideration for the property transferred, enter "1." If this field is not used, enter blank.
419-420	Blank	2	Enter blanks or carriage return/line feed (cr/lf) characters.

PAYEE "B" RECORD - RECORD LAYOUT
FORM 1099-S

RECORD TYPE	PAYMENT YEAR	BLANK	CORRECTED RETURN INDICATOR	NAME CONTROL	BLANK	TYPE OF TIN
1	2-3	4-6	7	8-11	12-13	14

TAXPAYER IDENTIFICATION NUMBER	PAYER'S ACCOUNT NUMBER FOR PAYEE	BLANK	PAYMENT AMOUNT 1	PAYMENT AMOUNT 2
15-23	24-43	44-50	51-60	61-70

PAYMENT AMOUNT 3	PAYMENT AMOUNT 4	PAYMENT AMOUNT 5	PAYMENT AMOUNT 6	PAYMENT AMOUNT 7
71-80	81-90	91-100	101-110	111-120

Field Position	Field Title	Length	Description and Remarks

PAYMENT AMOUNT 8	PAYMENT AMOUNT 9	BLANK	FOREIGN COUNTRY INDICATOR	FIRST PAYEE NAME LINE*
121-130	131-140	141-160	161	162-201

SECOND PAYEE NAME LINE*	PAYEE MAILING ADDRESS*	PAYEE CITY*	PAYEE STATE*	PAYEE ZIP CODE*	BLANK
202-241	242-281	282-310	311-312	313-321	322-349

SPECIAL DATA ENTRIES	DATE OF CLOSING	DESCRIPTION	PROPERTY OR SERVICES RECEIVED	BLANK
350-372	373-378	379-417	418	419-420

*When reporting Form 1099-S, the "B" Record will reflect the seller information.

(6) FORM W-2G (For detailed explanations of the following fields see the 1990 "Instructions for Forms 1099, 1098, 5498, and W-2G.")

NEXT FIELD AFTER PAYEE ZIP CODE:

322-352	Blank	31	Enter blanks.
353-358	Date Won	6	*REQUIRED FOR FORM W-2G ONLY.* Enter the date of the winning event in the format MMDDYY (e.g., 102490). This is not the date the money was paid, if paid after the date of the race (or game). DO NOT ENTER HYPHENS OR SLASHES.
359-373	Transaction	15	*REQUIRED FOR FORM W-2G ONLY.* If applicable, the ticket number, card number (and color, if applicable), machine serial number or any other information that will help identify the winning transaction. Not applicable for horse and dog racing, jai-alai and certain other wagering transactions, sweepstakes, wagering pools and certain lotteries. If no entry, enter blanks.
374-378	Race	5	*REQUIRED FOR FORM W-2G ONLY.* If applicable, the race (or game) applicable to the winning ticket. If no entry, enter blanks.
379-383	Cashier	5	*REQUIRED FOR FORM W-2G ONLY.* If applicable, the initials of the cashier making the winning payment. If no entry, enter blanks.
384-388	Window	5	*REQUIRED FOR FORM W-2G ONLY.* The window number or location of the person paying the winnings. If no entry, enter blanks.
389-403	First ID	15	*REQUIRED FOR FORM W-2G ONLY.* If applicable, the first identification number of the person receiving the winnings. If no entry, enter blanks.

RECORD NAME: PAYEE "B" RECORD—Continued
FORM W-2G

Field Position	Field Title	Length	Description and Remarks
404-418	Second ID	15	*REQUIRED FOR FORM W-2G ONLY.* If applicable, the second identification number of the person receiving the winnings. If no entry, enter blanks.
419-420	Blank	2	REQUIRED. Enter blanks, or carriage return/line feed (cr/lf) characters.

PAYEE "B" RECORD - RECORD LAYOUT
FORM W-2G

RECORD TYPE	PAYMENT YEAR	DOCUMENT SPECIFIC CODE	BLANK	CORRECTED RETURN INDICATOR	NAME CONTROL
1	2-3	4	5-6	7	8-11

BLANK	TYPE OF TIN	TAXPAYER IDENTIFICATION NUMBER	PAYER'S ACCOUNT NUMBER FOR PAYEE	BLANK
12-13	14	15-23	24-43	44-50

PAYMENT AMOUNT 1	PAYMENT AMOUNT 2	PAYMENT AMOUNT 3	PAYMENT AMOUNT 4	PAYMENT AMOUNT 5	PAYMENT AMOUNT 6
51-60	61-70	71-80	81-90	91-100	101-110

PAYMENT AMOUNT 7	PAYMENT AMOUNT 8	PAYMENT AMOUNT 9	BLANK	FOREIGN COUNTRY INDICATOR	FIRST PAYEE NAME LINE
111-120	121-130	131-140	141-160	161	162-201

SECOND PAYEE NAME LINE	PAYEE MAILING ADDRESS	PAYEE CITY	PAYEE STATE	PAYEE ZIP CODE	BLANK	DATE WON
202-241	242-281	282-310	311-312	313-321	322-352	353-358

TRANSACTION	RACE	CASHIER	WINDOW	FIRST ID	SECOND ID	BLANK
359-373	374-378	379-383	384-388	389-403	404-418	419-420

SECTION 7. END OF PAYER "C" RECORD

.01 THE "C" RECORD IS A FIXED RECORD LENGTH OF 420 POSITIONS. The Control Total fields are each 15 positions in length.

.02 The End of Payer "C" Record is a summary record for a type of return for a given payer.

.03 The "C" Record will contain the total number of payees and the totals of the payment amount fields filed by a given payer. The "C" Record MUST be written after the last Payee "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.

.04 In developing the "C" Record, for example, if you 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.

.05 Payers/Transmitters must verify the accuracy of the totals in the "C" Record and must enter the totals on Forms 4804, 4802 or computer-generated substitute, which will accompany the shipment. The lines used on Forms 4804 and 4802 to record payment amounts correspond with the Amount Codes used in the "A" Record.

.06 Missing or incorrect End of Payer "C" Records will result in the media being returned for correction.

RECORD NAME: END OF PAYER "C" RECORD

Field Position	Field Title	Length	Description and Remarks
1	Record Type	1	REQUIRED. Enter "C".
2-7	Number of Payees	6	REQUIRED. Enter the total number of Payee "B" Records covered by the preceding Payer/Transmitter "A" Record. Right-justify and zero fill.
8-10	Blank	3	Enter blanks.
			REQUIRED. If any corresponding Payment Amount fields are present in the Payee "B" Records, accumulate into the appropriate Control Total fields. CONTROL TOTALS MUST BE RIGHT-JUSTIFIED, AND UNUSED CONTROL TOTAL FIELDS MUST BE ZERO FILLED. Please note that 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. You may enter carriage return/line feed (cr/lf) characters in positions 419-420.

END OF PAYER "C" RECORD - RECORD LAYOUT

RECORD TYPE	NUMBER OF PAYEES	BLANK	CONTROL TOTAL 1	CONTROL TOTAL 2	CONTROL TOTAL 3
1	2-7	8-10	11-25	26-40	41-55

CONTROL TOTAL 4	CONTROL TOTAL 5	CONTROL TOTAL 6	CONTROL TOTAL 7	CONTROL TOTAL 8	CONTROL TOTAL 9	BLANK
56-70	71-85	86-100	101-115	116-130	131-145	146-420

SECTION 8. STATE TOTALS "K" RECORD

.01 THE "K" RECORD IS A FIXED RECORD LENGTH OF 420 POSITIONS. The Control Total fields are each 15 positions in length.

.02 The State Totals "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 you 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 on this program.

RECORD NAME: STATE TOTALS "K" RECORD

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 Payee "B" Records being coded for this state. Right-justify and zero fill.
8–10	Blank	3	Enter blanks.

REQUIRED. If any corresponding Payment Amount fields are present in the Payee "B" Records, accumulate into the appropriate Control Total fields. CONTROL TOTALS MUST BE RIGHT-JUSTIFIED, AND UNUSED CONTROL TOTAL FIELDS MUST BE ZERO FILLED. Please note that 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	Reserved	271	Reserved for IRS use. Enter blanks.
417–418	Combined Federal/ State Code	2	REQUIRED. Enter the code assigned to the state which is to receive the information. (Refer to Part A, Sec. 16 Table 1.)
419–420	Blank	2	Enter blanks, or carriage return/line feed (cr/lf) characters.

STATE TOTALS "K" RECORD - RECORD LAYOUT

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

RESERVED	COMBINED FEDERAL/ STATE CODE	BLANK
146–416	417–418	419–420

SECTION 9. END OF TRANSMISSION "F" RECORD

.01 THE "F" RECORD IS A FIXED RECORD LENGTH OF 420 POSITIONS. The "F" Record is a summary of the number of payers in the entire file.

.02 This record should be written after the last "C" Record (or last "K" Record, when applicable) of the *entire* file.

RECORD NAME: END OF TRANSMISSION "F" RECORD

Field Position	Field Title	Length	Description and Remarks
1	Record Type	1	REQUIRED. Enter "F".
2-5	Number of "A" Records	4	You may enter the total number of Payer/Transmitter "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.

END OF TRANSMISSION "F" RECORD - RECORD LAYOUT

RECORD TYPE	NUMBER OF "A" RECORDS	ZEROS	BLANK
1	2-5	6-30	31-420

PART C. ELECTRONIC FILING SPECIFICATIONS

SECTION 1. GENERAL

.01 Electronic filing of information returns is being offered by IRS/MCC as an alternative to magnetic media (tape or diskette) or paper filing, but is not a requirement. Electronic filing can be used in place of magnetic media filing by filers who are required to file magnetically and will fulfill the magnetic media requirements. It may also be used by those payers who are under the filing threshold requirement, but would prefer to file their information returns electronically. For Tax Year 1990, any Forms 1098, 1099 series, 5498, and W-2G, both originals and corrections, may be filed electronically.

The electronic filing of information returns is not affiliated with the Form 1040 electronic filing program. These two programs are totally independent of each other, and you 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. However, 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 (1-800-424-1040, 1-800-829-1040 after September 30, 1990) for assistance.

.02 Filers participating in the electronic filing program for information returns will submit their returns to IRS/MCC by way of modems, and not through either magnetic media or paper filing. Upon receipt of Form 4804, the electronically filed data will be released for processing (see Part A, Sec. 9 for further information on submitting Form 4804). Form 4804 must be submitted to IRS/MCC postmarked on or before the due date of the return, or within two (2) workdays of the electronic transmission, whichever is earlier. No return is considered filed until a completed Form 4804 is timely received by IRS/MCC. Filers who transmit unprocessable files will be notified either by telephone or letter within 10 workdays of our receipt of the electronic transmission and associated Form 4804.

.03 Filers who choose to file electronically will be granted, upon request, an extension of time to file for 30 days after the due date of the return being submitted. See Part A, Sec. 11 for specific information on requesting an extension of time. This extension will be liberally granted to electronic filers to avoid the problem of filers not being able to timely transmit their data due to inaccessibility of phone lines. It is suggested, however, that filers transmit their data as soon as possible.

.04 For Tax Year 1990 information filed in calendar year 1991, IRS/MCC will accept electronically filed transmissions using IBM 3780 bisynchronous protocols. In order to make electronic filing as accessible as possible, IRS/MCC is also exploring the possibility of accepting electronic transmission using asynchronous protocols. Asynchronous protocols would allow filers to submit data to IRS/MCC using modems available in many personal computers. When this publication was being revised, the procedure for accepting asynchronous transmissions had not been determined. As soon as this determination is made, IRS/MCC will publish an announcement.

.05 The formats of the "A", "B", "C", "K", and "F" records are the same for electronically filed records as they are for magnetic media. For electronically filed documents, each transmission is considered a separate file; therefore, each transmission MUST have an End of File "F" Record. See Part B, Sec. 4 through 9 for information on the record formats.

SECTION 2. ELECTRONIC FILING PROCEDURE

.01 Filers who want to file electronically, but do not have a Trans-

mitter Control Code (TCC) assigned to them, must submit Form 4419, Application for Filing Information Returns Magnetically/Electronically, prior to transmitting data (see Part A, Sec. 7).

Filers who already have a TCC must submit either Form 4419, or a letter, to indicate that they wish to file information returns electronically. The purpose of this is so IRS/MCC can determine the compatibility of the electronic filing parameters, and another TCC will NOT be assigned to current filers. If a letter is submitted, it must contain the following:

1) Name and address of transmitter.
2) Transmitter Control Code already assigned.
3) Type of modem and communication software that will be used in transmitting the data.
4) Name and phone number of a contact person within your organization to whom a password will be assigned.

.02 Within 30 days of receiving the application or letter, IRS/MCC will send Form 6086, TSO Password Assignment, to the filer which will contain the password to be used for electronic submissions. After a password is received and the acknowledgement returned, the filer may submit a test file.

.03 Upon receipt of Form 6086, the user (person who will actually transmit the data) will separate the acknowledgement from the password. Both the user and the user's manager MUST sign the acknowledgement and mail to:

Chief, Security and Disclosure Branch
IRS, Martinsburg Computing Center
P.O. Box 1208
Martinsburg, WV 25401

THIS SIGNED ACKNOWLEDGEMENT MUST BE RECEIVED AT IRS/MCC PRIOR TO ANY DATA TRANSMISSIONS. The user or filer should retain a copy of the signed acknowledgement for their records. It is the user's responsibility to ensure that the password is not compromised. Access to IRS/MCC computers will not be allowed without a valid password.

.04 For security reasons, at the end of each filing season, all passwords will be obsoleted. In December, filers who filed electronically in the prior year will automatically receive a new password via Form 6086. If electronic filing is to be used again, the filer must respond to IRS/MCC as specified in Part C, Sec. 2.03. If you have any questions relating to the security procedures, and/or you need to report that your password was compromised, contact IRS/MCC as soon as possible (see Part A, Sec. 3).

.05 If filers have no experience with data transmission, they may choose to use a third party to transmit their data electronically. Filers can obtain a list of approved electronic transmitters by contacting IRS/MCC and requesting a copy of the vendor list (see Part A, Sec. 6). Vendors wishing to be included on this list should notify IRS/MCC in writing. An acceptable test file must be submitted prior to being included on the vendor list as an electronic filer.

SECTION 3. TEST FILES

.01 Filers transmitting directly to IRS/MCC are not required to submit a test file. The purpose of test files is to resolve any data or communication problems prior to the filing season. However, if you wish to submit an electronic test file for Tax Year 1990, it MUST be submitted to IRS/MCC between October 15, 1990, and January 15, 1991.

You MUST obtain a password before submitting an electronic test file (see Part C, Sec. 2 for information on obtaining a password). Electronic test files will be processed and filers will be notified as to the acceptability of their data within ten (10) workdays of the date the transmittal Form 4804 is received by IRS/MCC.

.02 Electronic test files must be verified by transmittal Form 4804. Form 4804 can be ordered from IRS/MCC (see Part A, Sec. 3), or it may be computer-generated. If you choose 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 (see Part A, Sec. 9).

.03 If problems are encountered while transmitting your electronic test file, contact the Electronic Filing Coordinator at IRS/MCC for assistance (see Part A, Sec. 3 for the telephone number).

SECTION 4. ELECTRONIC SUBMISSIONS

.01 After the information returns are electronically filed, a signed Form 4804 must be submitted to IRS/MCC postmarked on or before the due date of the returns, or postmarked within 2 (two) workdays of the transmission, whichever is earlier. The filer whose TCC is used in the Payer/Transmitter "A" Record is responsible for submitting the transmittal Form 4804. Only one (1) TCC can be used per transmission. When transmitting your electronic file to IRS/MCC, you MUST use the password assigned to your organization.

.02 Electronically filed information return data may be transmitted to IRS/MCC 24 hours a day; however, transmissions should be limited to a maximum of 1 1/2 hours duration. This limitation is to prevent line noise problems encountered during longer transmissions. Technical assistance will be available at IRS/MCC between 8:30 AM and 4:30 PM Eastern time.

.03 Actual information return data may be electronically transmitted to IRS/MCC between January 22 and December 31, 1991 (for Tax Year 1990 submissions). However, the due date(s) for electronically filed returns are not extended. (See Part A, Sec. 10.)

.04 Completed transmittal Forms 4804 should be mailed to the following addresses:

If by Postal Service:

IRS-Martinsburg Computing Center
ATTN: Electronic Filing Coordinator
P.O. Box 1359
Martinsburg, WV 25401-1359

If by truck or air freight:

IRS-Martinsburg Computing Center
ATTN: Electronic Filing Coordinator
Route 9 and Needy Road
Martinsburg, WV 25401

.05 Form 4804 submitted for electronically filed information returns may be faxed to IRS/MCC at the following number: (304) 267-3366.

SECTION 5. COMMUNICATION SPECIFICATIONS

.01 Transmissions are made by using IBM 3780 bisynchronous (BSC) protocols and must be in EBCDIC character code. Modems must be compatible with either Bell 208B for 4800 BPS transmissions, or AT&T 2296A for 9600 BPS transmissions. Both modems are dial-up type modems using the Public Switched Telephone Network. IBM 3780 data compression is acceptable for any transmission.

.02 IRS/MCC will accept information returns filed electronically over switched tele-communications network circuits. For 4800 BPS, the circuit will be (304) 267-0807. For 9600 BPS, the circuit will be (304) 267-9572. Both of these circuits are equipped for bisynchronous (BSC) transmission, using the IBM 3780 protocol.

.03 The 4800 BPS line terminates at an AT&T 208BR modem. The AT&T 208BR modem uses phase-shift keying and 8-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

SECTION 6. ELECTRONIC FILING RECORD SPECIFICATIONS

.01 There are two additional identifier records which must be used to transmit data electronically. 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 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	Blank

ELECTRONIC FILING IDENTIFIER $$REQUEST RECORD - RECORD LAYOUT

$$REQUEST IDENTIFIER RECORD	BLANK
1-20	21-420

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. This password will be provided to you on Form 6806. For more information concerning the password, see Part C, Sec. 2.
18	Blank	1	Enter a blank.
19-26	BATCHID	8	Enter the following characters: BATCHID=

RECORD NAME: $$ADD—Continued

Field Position	Field Title	Length	Description and Remarks
27	Quote	1	Enter a single quote (').
28–43	Transmitter Name	16	Enter the transmitter's 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
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 you in the letter notifying you that a replacement file is necessary. If contact is made by telephone, the replacement file name will be given to you by IRS/MCC at that time. For other than replacement files, this field will contain blanks.
52	Quote	1	Enter a single quote (')
53–420	Blanks	368	Enter blanks.

With the exception of these additional records, the file format for electronic filing is the same as for magnetic media filing.

.02 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 "F" Record is received. At the end of each transmission, the following message should be received electronically by the filer: "DATA RECEIVED AT MCC." If this message is not received there may be a problem with your electronic submission, and you should contact IRS/MCC immediately. After this message is sent to the filer by IRS/MCC to indicate a successful transmission, the line will be disconnected.

.03 Upon receiving a data file and transmittal Form 4804, IRS/MCC will release the data for further processing. If the data is found to be unprocessable, the filer will be contacted by either letter or telephone and notified that the data must be re-transmitted. For re-transmitted files, the filer will be assigned a replacement file name to be used during the re-transmission. This file name will be provided by IRS/MCC either by letter or telephone, and is to be placed in positions 45-51 of the $$ADD record when the file is re-transmitted.

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. MISCELLANEOUS INFORMATION

SECTION 1. MAGNETIC MEDIA-RELATED FORMS AND PUBLICATIONS AVAILABLE AT THE IRS MARTINSBURG COMPUTING CENTER

.01 IRS/MCC maintains supplies of magnetic media-related forms and publications including:

—Publication 1220, Specifications for Filing Forms 1098, 1099 Series, 5498, and W-2G Electronically or on Magnetic Tape, Tape Cartridge, 5 1/4 and 3 1/2 Inch Diskettes

—Publication 1255, Requirements and Conditions for Filing Forms 1098, 1099 Series, 5498, and W-2G on 8 Inch Magnetic Diskette
—Publication 1187, Requirements and Conditions for Filing Form 1042S, Foreign Person's U.S. Source Income Subject to Withholding, on Magnetic Tape
—Publication 1239, Requirements and Conditions for Submitting Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips, on Magnetic Tape
—Publication 1245, Magnetic Tape Reporting for Forms W-4
—Publication 1437, Revenue Procedure and File Specifications for Magnetic Tape Filing of Fiduciary Returns Forms 1041, and Partnership Returns Form 1065, for Tax Year 1989
—Instructions for Forms 1099, 1098, 5498, and W-2G
—Form 8508, Request for Waiver from Filing Information Returns on Magnetic Media
—Form 4419, Application for Filing Information Returns Magnetically/Electronically
—Form 8809, Request for Extension of Time to File Information Returns
—Form 4804, Transmittal of Information Returns Reported on Magnetic Media
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—Form 5064, Media Label
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—Form 6466, Transmittal of Magnetic Tape of Form W-4, Employee's Withholding Allowance Certificate
—Form 6467, Multiple Employer Transmittal for Magnetic Tape Reporting of Form W-4
—Form 6468, How to Prepare Form 6469, Tape Label for Form W-4
—Form 6469, Tape Label for Form W-4

.02 To order any of these forms or publications, you may contact IRS/MCC (see Part A, Sec. 3 for the address, telephone number, and hours of operation). You may also call the IRS toll-free forms and publications order number (1-800-424-FORM, 1-800-829-FORM after September 30, 1990), or contact your local IRS office.

SECTION 2. FEDERAL DOLLAR CRITERIA

.01 For your convenience, the federal requirements for reporting the information returns to IRS is provided in Table 1.

TABLE 1. FEDERAL DOLLAR REQUIREMENTS

FORM	DOLLAR CRITERIA
1098	$600
1099-A	ALL
1099-B	ALL
1099-DIV	$10 ($600 for Liquidations)
1099-G	$10 - Unemployment and Tax Refunds
	$600 - All others
1099-INT	$10
	$600 (In some cases)
1099-MISC	$600
	ALL (Fishing boat proceeds)
	$10 (Royalties or Substitute Dividend and Tax-exempt Interest Payments Reportable by Brokers)
	$5,000 - Direct sales indicator
1099-OID	$10
1099-PATR	$10
1099-R	ALL
1099-S	ALL
5498	ALL
W-2G	$600
	$1200 (Bingo or Slot Machines)
	$1500 (Keno)

For specific information, refer to the 1990 "Instructions for Forms 1099, 1098, 5498, and W-2G."

26 CFR 601.201: Rulings and determination letters.

Rev. Proc. 90-42

SECTION 1. BACKGROUND AND PURPOSE

.01 Rev. Proc. 90-1, 1990-1 C.B. 356, provides procedures for issuing ruling letters involving substantive areas under the jurisdiction of the Associate Chief Counsel (Technical).

.02 Announcement 90-65, 1990-20 I.R.B. 23, states that the "comfort ruling" policy set forth in section 3.01 and section 18.02 of Rev. Proc. 90-1 (the effective date of which was extended by Rev. Proc. 90-13, 1990-1 C.B. 473), will not go into effect and will be replaced with a variety of measures. These measures include specific no-rule areas, model documents, published ruling checklists, and automatic action revenue procedures.

SEC. 2. PROCEDURE

The procedures set forth in sections 3.10 and 18.02 of Rev. Proc. 90-1 are eliminated.

SEC. 3. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 90-1 is modified by deleting sections 3.10 and 18.02; Rev. Proc. 90-13 is revoked.

SEC. 4. EFFECTIVE DATE

This revenue procedure is effective for all ruling requests received under the procedures of Rev. Proc. 90-1.

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26 CFR 601.602: Tax forms and instructions.

Rev. Proc. 90-43

NOTE: THIS REVENUE PROCEDURE MAY ONLY BE USED TO PREPARE 8 INCH MAGNETIC DISKETTE FILED SUBMISSIONS FOR TAX YEAR 1990 INFORMATION RETURNS TO INTERNAL REVENUE SERVICE (IRS). UPDATED COPIES ARE PUBLISHED EACH YEAR. PLEASE READ THIS PUBLICATION CAREFULLY. PERSONS REQUIRED TO FILE MAY BE SUBJECT TO A FAILURE TO FILE PENALTY IF THEY DO NOT FOLLOW THE INSTRUCTIONS IN THIS REVENUE PROCEDURE OR FOR FAILURE TO INCLUDE CORRECT INFORMATION. THE REVENUE RECONCILIATION ACT OF 1989 HAS CHANGED THE PENALTY PROVISIONS AND SOME OF THE MAGNETIC MEDIA FILING REQUIREMENTS FOR INFORMATION RETURN REPORTING. FOR FURTHER INFORMATION, PLEASE READ THE CHAPTERS CONCERNING "NATURE OF CHANGES," AND "FILING REQUIREMENTS."

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PART A. GENERAL

SECTION 1. PURPOSE

.01 The purpose of this revenue procedure is to provide the requirements and conditions for filing Forms 1098, 1099, 5498, and W-2G on 8 inch magnetic diskette to Internal Revenue Service (IRS). Publication 1220, "Specifications for Filing Forms 1098, 1099 Series, 5498, and W-2G Electronically or on Magnetic Tape, Tape Cartridge, 5¼ and 3½ Inch Diskettes," contains instructions for filing information returns both electronically, and on certain types of magnetic media, and is not to be used for formatting 8 inch diskettes. THIS REVENUE PROCEDURE IS TO BE USED FOR THE PREPARATION OF 8 INCH DISKETTES FOR 1990 INFORMATION RETURNS ONLY. THIS PROCEDURE IS UPDATED YEARLY TO REFLECT NECESSARY CHANGES. PLEASE READ THIS PUBLICATION CAREFULLY. IF THERE ARE ANY QUESTIONS CONCERNING YOUR FILING, YOU MAY CONTACT THE INTERNAL REVENUE SERVICE (IRS) MARTINSBURG COMPUTING CENTER (MCC) FOR CLARIFICATION. (See Part A, Sec. 3 for address and telephone number.) Specifications for filing the following forms are contained in this procedure:

(a) Form 1098, Mortgage Interest Statement.
(b) Form 1099-A, Information Return for Acquisition or Abandonment of Secured Property.
(c) Form 1099-B, Statement for Recipients of Proceeds From Broker and Barter Exchange Transactions.
(d) Form 1099-DIV, Statement for Recipients of Dividends and Distributions.
(e) Form 1099-G, Statement for Recipients of Certain Government Payments.
(f) Form 1099-INT, Statement for Recipients of Interest Income.
(g) Form 1099-MISC, Statement for Recipients of Miscellaneous Income.
(h) Form 1099-OID, Statement for Recipients of Original Issue Discount.
(i) Form 1099-PATR, Statement for Recipients (Patrons) of Taxable Distributions Received From Cooperatives.
(j) Form 1099-R, Statement for Recipients of Total Distributions From Profit-Sharing, Retirement Plans, Individual Retirement Arrangements, Insurance Contracts, Etc.
(k) Form 1099-S, Statement for Recipients of Proceeds from Real Estate Transactions.
(l) Form 5498, Individual Retirement Arrangement Information.
(m) Form W-2G, Statement for Recipients of Certain Gambling Winnings.

.02 Specifications for filing Forms 1042S and 8027 are contained in separate IRS publications. Specifications for filing Forms W-2 and W-2P on magnetic media are available from the Social Security Administration (SSA) ONLY.

.03 In most cases, the box numbers on the paper forms correspond with the amount codes used to file on magnetic media; however, if discrepancies occur, the instructions in this revenue procedure govern.

.04 The IRS/MCC has the responsibility for processing information returns filed on magnetic media. These information returns include Forms 1098, 1099 series, 5498, and W-2G.

IRS/MCC does NOT process Forms W-2 and W-2P; these forms are to be sent to SSA whether you file paper OR magnetic media returns.

IRS/MCC does, however, process magnetic media waiver requests and extension of time requests for Forms W-2/W-2P.

Therefore, contact IRS/MCC with questions concerning Forms W-2 and W-2P ONLY IF THE QUES-

TIONS PERTAIN TO AN EXTENSION OF TIME TO FILE ON PAPER OR MAGNETIC MEDIA OR MAGNETIC MEDIA WAIVER REQUEST. Questions pertaining to magnetic media filing of forms W-2 or W-2P MUST be directed to SSA. TAX LAW QUESTIONS PERTAINING TO FORMS W-2 OR W-2P SHOULD BE DIRECTED TO IRS TAXPAYER SERVICE at 1-800-424-1040 (1-800-829-1040 after September 30, 1990), or to your local IRS office.

If you contact IRS/MCC with questions concerning Forms W-2/W-2P, and the questions are not pertaining to extensions of time or waivers for Forms W-2/W-2P, we will direct you to either SSA or IRS Taxpayer Service.

.05 Personnel at the IRS/MCC are equipped to answer any questions you may have concerning the magnetic media filing of information returns. Tax law related questions should be directed to IRS Taxpayer Service at 1-800-424-1040 (1-800-829-1040 after September 30, 1990).

.06 This revenue procedure also provides the requirements and specifications for filing 8 inch magnetic diskettes under the Combined Federal/State Filing Program. (Refer to Part A, Sec. 16.)

.07 The following revenue procedures and publications provide more detailed filing procedures for certain information returns:

(a) 1990 "Instructions for Forms 1099, 1098, 5498, and W-2G," provides specific instructions on completing and submitting information returns to IRS. IRS/MCC includes this publication in the magnetic media reporting packages that are mailed to the transmitters who participate in the Magnetic Media Reporting Program (MMRP). These instructions are also available from IRS offices and can be obtained by contacting your local office or by calling 1-800-424-FORM (1-800-829-FORM after September 30, 1990).

(b) Rev. Proc. 84-33, 1984-1 C.B. 502, or other current revenue procedure, regarding the optional method for agents to report and deposit backup withholding.

(c) Publication 1179, Specifications for Paper Document Reporting and Paper Substitutes for Forms 1096, 1098, 1099, 5498 and W-2G.

(d) Publication 1239, Requirements and Conditions for Submitting Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips, on Magnetic Tape.

(e) Publication 1187, Requirements and Conditions for Filing Form 1042S, Foreign Persons U.S. Source Income Subject to Withholding, on Magnetic Tape.

(f) Publication 1245, Magnetic Tape Reporting for Forms W-4.

(g) Publication 1220, Specifications for Filing Forms 1098, 1099 Series, 5498, and W-2G Electronically or on Magnetic Tape, Tape Cartridge, 5¼ and 3½ inch diskettes.

.08 This procedure supersedes the following:

Rev. Proc. 89-44 published in Publication 1255 (Rev. 7-89) [1989-2 C.B. 532], Requirements and Conditions for Filing Forms 1098, 1099, 5498 and W-2G series on 8 Inch Magnetic Diskette.

.09 Refer to Part A, Sec. 17 for definitions of terms used in this publication.

SEC. 2. NATURE OF CHANGES—CURRENT YEAR (TAX YEAR 1990)

.01 PROGRAMMING CHANGES —PART B—"Magnetic Media Specifications"

Payer/Transmitter "A" Record:

Field Positions 3-4—"Payment Year"—must be incremented by one year (from 89 to 90).

Payee "B" Record:

(a) Field Positions 3-4—"Payment Year"—must be incremented by one year (from 89 to 90).

(b) Field Positions 5-6—"Document Specific Code"

The following categories for Form 1099-R Distribution Codes will now be:

(1) "Early (premature) distribution, no known exception"—Code 1

(2) "Early (premature) distribution, exception applies (as defined in section 72(q), (t), or (v))"—Code 2

(3) "Section 1035 exchange"—Code 6

(4) "Normal distribution"—Code 7

(5) Excess contributions plus earnings/excess deferrals (and/or earnings) taxable in 1990—Code 8

(6) Excess contributions plus earnings/excess deferrals taxable in 1989—Code P

(7) Excess contributions plus earnings/excess deferrals taxable in 1988—Code D

NOTE: IT WILL NO LONGER BE VALID TO CODE BLANKS IN *BOTH* POSITIONS 5 AND 6 OF SECTOR 1 OF THE PAYEE "B" RECORD FOR FORM 1099-R. YOU MUST PROVIDE AT LEAST ONE DISTRIBUTION CODE FOR THIS FORM. ALSO, A NUMERIC CODE MUST BE ENTERED IN ALL CASES EXCEPT WHEN CODE P OR D IS USED. HOWEVER, WHEN USING CODE P OR D FOR AN IRA DISTRIBUTION UNDER SECTION 408(d)(4), YOU MAY ALSO ENTER CODE 1, IF IT APPLIES. IF MORE THAN ONE NUMERIC CODE IS APPLICABLE TO A DISTRIBUTION, YOU WILL NOW NEED TO REPORT TWO SEPARATE PAYEE "B" RECORDS.

(c) Field Positions 25-44—"Payer's Account Number for Payee"—In the past, if you had fewer than 20 characters, you were to left-justify the field. Now, you may EITHER left- or right-justify this field, and fill the remaining positions with blanks.

(d) Field Position 45—"IRA/SEP Indicator"—Starting this year, if you Code a "1", "2", "3", "4", "5", or "7" in either Position 5-6 of the Payee "B" Record (Document Specific Code) for Form 1099-R; AND if you are reporting a distribution for an IRA or SEP, you will code a "1" in Position 45. If you are not reporting an IRA or SEP distribution, code a blank in this field.

End of Payer "C" Record—No changes.

State Totals "K" Record—No changes.

End of Transmission "F" Record—No changes.

.02 EDITORIAL CHANGES—PART A, "GENERAL"

There have been numerous editorial changes due in part to the impact of the Revenue Reconciliation Act of 1989. IRS recommends that you read this publication in its entirety to ensure that you report properly. The changes are as follows:

(a) The Revenue Reconciliation Act of 1989 changed some of the magnetic media reporting requirements and penalty provisions. See Notice 90-15, printed in 1990-1 C.B. 326, for further information.

(b) Starting this year, IRS/MCC will be accepting information returns, both originals and corrections, by way of electronic filing as well as magnetic media. See Publication 1220, "Specifications For Filing Forms 1098, 1099 Series, 5498, and W-2G Electronically or on Magnetic Tape, Tape Cartridge, 5¼ and 3½ Inch Diskettes" for information on electronic filing of information returns.

(c) The title of Publication 1255 has changed to "Requirements and Conditions for Filing Forms 1098, 1099 Series, 5498, and W-2G on 8 Inch Magnetic Diskettes."

(d) Added the IRS toll-free telephone number for those filers with tax law questions in Part A, Sec. 1.05, and Part A, Sec. 3.04(c).

(e) The title for the publication containing the 1099 instructions has changed in 1990 from "Instructions for Forms 1099, 1098, 5498, 1096, and W-2G" to "Instructions for Forms 1099, 1098, 5498, and W-2G." Therefore, the references in this publication have been changed accordingly.

(f) Part A, Sec. 4, "Filing Requirements," has been changed to reflect the impact of the Revenue Reconciliation Act of 1989, including:

(1) All Forms 1098, 1099 series, 5498, and W-2G are to be filed on magnetic media with IRS if you have 250 or more of any of them SEPARATELY. None of the forms will be aggregated.

(2) The "look-back" rule has been rescinded which stated that you are required to file on magnetic media this year if you had the requirement to file in the previous year. You are only required to file this year if you exceed the filing threshold (250) for Tax Year 1990.

(g) Part A, Sec. 6, "Vendor List," has been added to provide information concerning the vendor list that IRS/MCC maintains for those payers who wish to file on magnetic media but are having difficulty finding software companies or service bureaus in their area. This section will provide information on how to order the list if you are a filer, and how to be added to the list if you are a vendor.

(h) In the past, filers were required to apply for different Transmitter Control Codes (TCC) for different types of media. This is no longer necessary. (See Part A, Sec. 7, Form 4419, "Application for Filing Information Returns Magnetically/Electronically.") If you have more than one TCC already assigned to you, you may use any that you wish. Notify IRS/MCC to remove those TCC's not used.

(i) A note was added to Part A, Sec. 7, encouraging filers to submit application Form 4419 at least 30 days before the due date of the returns to allow IRS/MCC time to process the application. However, IRS/MCC will still accept applications up to the filing due date.

(j) A note was added to Part A, Sec. 7, concerning filers who file on magnetic media with IRS/MCC, but still submit Form 1096, Annual Summary and Transmittal of U.S. Information Returns, to the IRS Service Center that processes paper information returns. If you file your information returns on magnetic media with IRS/MCC, use transmittal Form 4804 to submit your data, and NOT Form 1096.

(k) Beginning this year, IRS/MCC will NOT return media to the filers, whether it is test, original, or correction data, after successfully processing the media. (See Part A, Sec. 12, "Processing of Magnetic Media Returns.") Your files will only be returned if a replacement file is necessary.

(l) A note was added to Part A, Sec. 13, "How to File Corrected Returns," concerning filers who submit late filed information returns as correction documents instead of originals (coding a "G" code in the Payee "B" Record).

(m) In the past, if you were correcting a bad payee address, you were instructed to correct the address using two transactions. This has been changed in the chart in Part A, Sec. 13. It now takes only one transaction to correct a bad payee address, UNLESS you are also correcting a bad payee name or TIN with the same correction. It will then still require two transactions to correct the bad address.

(n) Part A, Sec. 13 has information concerning the impact of the Revenue Reconciliation Act of 1989 upon the submission of corrected returns. It also refers you to the 1990 "Instructions for Forms 1099, 1098, 5498, and W-2G" for specific information concerning the due date for filing information returns, and any penalties that may apply to returns considered to be filed late or incorrectly.

(o) Part A, Sec. 14, "Taxpayer Identification Number (TIN)," has been rewritten to remove tax law information and to add information concerning the creation of Name Controls.

(p) The section on contacting IRS/MCC has been moved for easy reference to Part A, Sec. 3, "How to Contact the IRS Martinsburg Computing Center." Information was added to this chapter to instruct filers when it is appropriate to contact IRS/MCC, and if it is not appropriate, where the information can be obtained.

(q) In Part A, Sec. 19, "Major Problems Encountered," five problems were added (numbers 11, 12, 13, 14, and 15).

(r) Added the IRS/MCC Telecommunication Devices for the Deaf (TDD) telephone number in Part A, Sec. 3.03.

(s) Part D, Miscellaneous Information, has been added concerning what magnetic media-related forms and publications are available from IRS/MCC, and to provide a table listing the federal dollar criteria for reporting information returns.

.03 EDITORIAL CHANGES—PART B, "SINGLE DENSITY DISKETTE SPECIFICATIONS"

The following editorial changes were made to Part B, Sec. 1-15:

(a) Part B, Sec. 3, Sector 1, "Payer/Transmitter "A" Record," the following changes were made to the "AMOUNT INDICATOR FIELDS."

(1) For Forms 1099-B, 1099-DIV, 1099-G, 1099-INT, 1099-MISC, 1099-OID, and 1099-PATR, the term for "Federal Income Tax Withheld," has been further defined as "Backup Withholding."

(2) For Form 1099-R, a Note 2 has been added referring you to the 1990 "Instructions for Forms 1099, 1098, 5498, and W-2G" for the definition of Federal Income Tax Withheld, and how it is applied to Form 1099-R reporting.

(3) For Forms 1099-B, Amount Code 7 changed to "Unrealized profit or (loss) on open contracts 12/31/89," and Amount Code 8 to "Unrealized profit or (loss) on open contracts—12/31/90."

(4) For Form 1099-DIV, the note has been changed to state that Amount Code 1 MUST equal the sum of Amount Codes 2, 3, 4, and 5.

(5) For Form 1099-INT, Amount Code 5, title changed to "Foreign tax paid."

(6) For Form 1099-MISC, Amount Code 3, title changed to "Prizes, awards, etc."

(7) For Form 1099-OID, Amount Code 1, title changed to "Original issue discount for 1990."

(8) For Form 5498, Amount Code 1, title changed to "Regular IRA contributions made in 1990 and 1991 for 1990." In the Note for Form 5498, any references to calendar years have been incremented by one year.

(b) Positions 45-49, Transmitter Control Code (TCC)—added a sentence instructing filers to NOT enter more than one TCC per file.

(c) Position 50—Foreign Corporation Indicator—added a note that some filers are automatically coding a "1" in this position to indicate a foreign corporation, whether it is or not. Since IRS processes foreign payer information differently from domestic payer information, this has caused processing problems. The payer may be subject to a penalty for providing incorrect information to IRS.

(d) Part B, Sec. 6, Sector 1, "Payee "B" Record," for Form 1099-R, the field title "Document Specific Code" was changed to "Distribution Code." Also, some category titles changed under Description and Remarks to:

(1) Early (premature) distribution, (no known exception)—Code 1

(2) Early (premature) distribution, exception applies (as defined in section 72(q), (t), or (v))—Code 2

(3) Section 1035 Exchange—Code 6

(4) Normal distribution—Code 7

(5) Excess contributions plus earning/excess deferrals (and/or earnings) taxable in 1990—Code 8

(6) Excess contributions plus earnings/excess deferrals taxable in 1989—Code P

(7) Excess contributions plus earnings/excess deferrals taxable in 1988—Code D

(e) Part B, Sec. 6, Sector 1, "Payee "B" Record for Form 1099-R, added a sentence under "Description and Remarks" that you MUST enter at least one numeric code from the table that provides the categories for distribution in positions 5-6 of the Document Specific Code, Payee "B" Record, except when Code P or D is used. Also, if more than one numeric code applies, two separate Payee "B" Records are required.

(f) Positions 25-44—"Payer's Account Number for Payee," the instruction to left-justify and fill remaining positions with blanks has changed to EITHER left-or right-justify, and fill remaining positions with blanks.

(g) Positions 46-47—"Percentage of Total Distribution," a note was added to clarify that the field is only two positions in length since the figure MUST be 99% or less, and includes instructions on how to round off fractions. If the percentage is 100, leave this field blank.

(h) Form 1099-S, Part B, Sec. 11, Sector 4, Field Positions 32-70, "Description", and Part C, Sec. 10, Sector 2, Field Positions 140-178, "Description," added a statement that if you enter the address of the property being reported, include the state and ZIP code where the property is located.

(i) Part B, Sec. 13 and Part C, Sec. 12, End of Payer "C" Record, instructions were added that submitting files with a missing or incorrect End of Payer "C" Record will result in your media being returned for correction.

SEC. 3. HOW TO CONTACT THE IRS MARTINSBURG COMPUTING CENTER

.01 Magnetic media processing for all service centers is centralized at the IRS/MCC. Your magnetic media files containing information returns covered by this revenue procedure, and all requests for IRS magnetic media-related publications, information, undue hardship waivers, requests for extensions of time to file, or magnetic media related forms are to be directed to the following addresses:

If by Postal Service:

IRS-Martinsburg Computing Center
Post Office Box 1359
Martinsburg, WV 25401-1359

or

If by Truck or Air Freight:
IRS-Martinsburg Computing Center
Magnetic Media Reporting Section
Route 9 & Needy Road
Martinsburg, WV 25401

.02 Hours of operation are 8:30 A.M. until 6 P.M. Eastern time. The telephone number is (304) 263-8700 (not a toll-free number). NOTE: IRS/MCC has installed Telecommunication Devices for the Deaf (TDD). The number is 304-267-3367.

.03 Requests for 1099 paper returns, publications or forms not related to magnetic media processing, or paper Forms W-2/W-2P, MUST be requested by calling the "Forms Only Number" listed in the local telephone directory, or by calling the IRS toll-free number 1-800-424-FORM (1-800-829-FORM after September 30, 1990).

.04 Do NOT contact IRS/MCC if:

(a) You have a question concerning filing Forms W-2/W-2P, either on paper or magnetic media, with SSA. You MUST contact your local SSA office for this information.

(b) You want to order paper forms for information return filing, including paper Forms W-2/W-2P. IRS/MCC does NOT stock any paper forms for information return or wage reporting. Call the IRS toll-free number for forms (1-800-424-FORM, 1-800-829-FORM after September 30, 1990), or call your local IRS office to order paper forms.

(c) You have a question concerning the completion of the information return or Form W-2/W-2P. (For example, "How do I report a premature distribution on Form 1099-R?"). Call the IRS toll-free number (1-800-424-1040, 1-800-829-1040 after September 30, 1990) for such information.

(d) You have received a penalty notice and you need additional information, or you are requesting an abatement of the penalty. Most penalty notices contain an IRS representative's name and phone number to contact with questions. This person will be most familiar with your particular case. The letter may instruct you to respond in writing within a certain timeframe. IRS/MCC does NOT issue penalty notices, therefore, it does NOT have the authority to abate penalties. You MUST contact the service center that issued the penalty notice if you have questions, or if you are requesting abatement of the proposed penalty.

SEC. 4. FILING REQUIREMENTS

.01 Section 6011(e)(2)(A) of the Internal Revenue Code as amended by the Revenue Reconciliation Act of 1989 (Public Law No. 101-239 (1989) 103 Stat. 2106, Section 7713), requires any person, including corporations, partnerships, individuals, estates, and trusts, who files 250 or more information returns to file such returns on magnetic media. *This requirement applies separately for each type of form.* The filer also has the option of filing such returns electronically in lieu of magnetic media.

Thus, for example, if a person is required to file 200 returns on Form 1099-INT and 350 returns on Form 1099-DIV for a calendar year, the person is not required to file Forms 1099-INT on magnetic media, but is required to file forms 1099-DIV on magnetic media.

.02 All filing requirements 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 has several branches or locations and each uses the same EIN, aggregate the total volume of returns to be filed and apply the filing requirements to each type of return accordingly.

.03 The following filing requirements apply separately to both originals and corrections filed on magnetic media:

1098 1099-A 1099-B 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 100 Forms 1099-B are to be filed, they need not be filed magnetically or electronically since they do not meet the threshold of 250. However, if you have 300 Forms 1099-R, they must be filed magnetically or electronically since they meet the threshold of 250.
W-2/W-2P	250 or more of either form must be filed on magnetic media with SSA.

.04 The above requirements shall not apply if you establish undue hardship (see Part A, Sec. 5).

.05 Filers who are required to submit their information returns on magnetic media may choose to submit their documents by electronic filing instead (See Publication 1220 for information concerning the electronic filing of information returns). Filers who submit their information returns electronically will have satisfied the magnetic media filing requirements.

.06 In the past, if you were required to file on magnetic media for a particular tax year, you were automatically required to file on magnetic media for the following tax year,

regardless of the volume of returns. The Revenue Reconciliation Act of 1989 eliminated this "look-back" rule. Therefore, if you were required to file on magnetic media for Tax Year 1989, and the volume of documents you will be submitting for Tax Year 1990 is less than 250, you are not required to file on magnetic media for Tax Year 1990.

SEC. 5. FORM 8508, REQUEST FOR WAIVER FROM FILING INFORMATION RETURNS ON MAGNETIC MEDIA

.01 If you are required to file on magnetic media but fail to do so, and do not have an approved waiver on record, you may be subject to a failure to file penalty.

.02 Any person required to file original or corrected returns on magnetic media may request a waiver from these filing requirements if such filing would create an undue hardship by submitting Form 8508, Request for Waiver from Filing Information Returns on Magnetic Media, with IRS/MCC.

.03 If a waiver for original documents is approved, a waiver for corrections to these documents will be automatically approved. However, if you submit your original returns on magnetic media but not your corrections, then a waiver must be requested for the corrections only if they exceed the filing threshold of 249 returns.

.04 Generally, only the payer may sign the Form 8508; however, the transmitter may sign if the transmitter has a power-of-attorney from the respective payers, and a copy of the power-of-attorney is attached to the Form 8508.

.05 A separate Form 8508 must be submitted for each payer. Do not submit a list of payers. Specify the type of returns for which the waiver is being requested on the Form 8508 (i.e., 1099-DIV, 1099-A, etc.).

.06 The waiver, if approved, will provide exemption from magnetic media filing for one tax year only. Filers 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.

.07 Copies of Form 8508 are included in this publication, or may be obtained from other IRS offices. Form 8508 may be computer-generated as long as it contains all the information requested on the original form, or it may be photocopied.

.08 All requests for magnetic media-related undue hardship exemptions must be submitted to the IRS/MCC at least 90 days before the due date of the return except as stated in Sec. 5.08. *IF A REQUEST IS NOT POSTMARKED AT LEAST 90 DAYS BEFORE THE DUE DATE OF THE RETURNS, IT WILL NOT BE CONSIDERED.* Therefore, for Forms 1098, 1099 series, and W-2G, the waiver request must be submitted to IRS/MCC with a postmark date of November 30. For Forms 5498, the waiver request must be submitted to IRS/MCC with a postmark date of March 2. Any waiver requests received with postmarks after the deadline(s) will be automatically denied.

.09 All magnetic media-related undue hardship requests for Forms W-2/W-2P are to be filed with the IRS/MCC, NOT SSA, and must be postmarked at least 90 days before the due date of the return. Since Forms W-2/W-2P are due to SSA by February 28, the due date for the waiver request is November 30.

.10 Waivers are granted on a case-by-case basis and are approved at the discretion of the IRS/MCC. You must allow a minimum of 30 days for IRS/MCC to respond to a waiver request.

.11 If your waiver request is approved, keep it for your records. DO NOT send a copy of the approved waiver to the IRS with your paper returns.

.12 AN APPROVED WAIVER FROM FILING INFORMATION RETURNS ON MAGNETIC MEDIA DOES NOT PROVIDE EXEMPTION FROM ALL FILING; YOU MUST STILL TIMELY FILE YOUR INFORMATION RETURNS ON ACCEPTABLE PAPER FORMS WITH THE APPROPRIATE SERVICE CENTER.

SEC. 6. VENDOR LIST

.01 IRS/MCC will provide you with a list of vendors who support magnetic media filing upon request. This list contains the names of service bureaus that will produce your files for you on the prescribed types of magnetic media, or via electronic filing. It also contains the names of vendors who can provide software packages for payers who wish to produce magnetic media or electronic files on their own computer systems or personal computers. This list is for filer information only, and in no way implies IRS approval or endorsement of these products or services.

.02 IRS/MCC will provide the vendor list to those filers who contact IRS/MCC at the address and phone number shown in Part A, Sec. 3. IRS/MCC WILL NOT PROVIDE ANY COMPANY NAMES OVER THE TELEPHONE.

.03 If you are a vendor who offers a software package, has the ability to produce magnetic media for your customers, or has the capability to electronically file information returns, and you would like to be included on the list, you MUST submit a written request. The written request must include:

(a) The company name
(b) Address (include the city, state, and ZIP code)
(c) Telephone number (include area code)
(d) Contact person
(e) Type of service provided (for example, service bureau and/or software)
(f) Type(s) of magnetic media offered (for example, ½ inch magnetic tape; tape cartridge; 8 inch, 5¼ inch, and/or 3½ inch diskettes; electronic filing).

.04 You may submit your request to be added to the vendor list at any time. Send the written request to IRS/MCC at the address provided in Part A, Sec. 3. IRS/MCC WILL NOT ACCEPT ANY COMPANY NAMES OVER THE TELEPHONE. The list will be updated once a year, in March, to include new vendors.

SEC. 7. FORM 4419, APPLICATION FOR FILING INFORMATION RETURNS MAGNETICALLY/ ELECTRONICALLY

.01 For purposes of this revenue procedure, the PAYER may be the person making payments; a recipient of mortgage interest payments; a bro-

ker; a barter exchange; a person reporting a real estate transaction; a trustee or 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 TRANSMITTER is the organization submitting the magnetic media file. The payer and transmitter may be the same organization.

Payers or their transmitters are required to complete Form 4419, Application for Filing Information Returns Magnetically/Electronically, to ensure equipment compatibility. A single Form 4419 should be filed no matter how many types of returns the payer or transmitter will be submitting on magnetic media or by electronic filing. For example, if you plan to file Forms 1099-INT and Forms 1099-DIV on magnetic media, submit one Form 4419. If you later wish to file another type of return on magnetic media in the Form 1099, 1098, 5498 or W-2G series, it is not necessary to submit a new Form 4419.

Copies of Form 4419, for your use, are included in this publication. Please read the instructions on the back of the form very carefully. This form may be photocopied. Requests for additional forms or other information related to magnetic media processing should be addressed to the IRS/MCC. (See Part A, Sec. 3 for the address.)

.02 Form 4419 can be submitted at any time during the year. However, Form 4419 should be submitted to IRS/MCC at least 30 days before the due date of the return(s) you wish to file on magnetic media. This will allow IRS/MCC the minimum amount of time necessary to process your application and send a response back to you. Otherwise, you may not receive your five character alpha/numeric Transmitter Control Code (TCC) in time to code in your Payer/Transmitter "A" Record (see Part B, Sec. 3 for further information). In the event that your computer equipment or software is not compatible with the IRS equipment, a waiver may be granted so that you may file your returns on paper documents for that tax year. If you have more than one TCC, you must use more than one tape or diskette; i.e., you cannot use two TCCs on the same medium. They must be reported separately.

IRS encourages transmitters who file for multiple payers, to submit one application and to use one Transmitter Control Code for all payers. Include a list of all payers and their TINS with the Form 4419. If you file for additional payers in later years, notify IRS in writing providing the additional names and TINS. Do not submit a new application for these additional payers.

Returns submitted on 8 inch diskette may not be filed with IRS until the application has been approved and a TCC assigned. This TCC will be entered in the Transmitter Control Code field of the "A" Record. Magnetic media submitted without a TCC will be held for processing until an application is approved.

.03 Upon approval, a magnetic media reporting package containing the appropriate revenue procedure and necessary transmittals, forms, labels, and instructions will be sent to the attention of the contact person indicated on Form 4419. Thereafter, IRS/MCC will send the transmitter a package containing the updated revenue procedure and forms each year. This package will continue to be sent to the contact person indicated on the Form 4419 unless IRS/MCC has received changes or updates.

.04 If you have your files prepared by a service bureau, you may not need to submit an application to obtain a TCC. Some service bureaus will produce your file using their TCC and send it to IRS/MCC for you.

Other service bureaus will prepare your magnetic media files, then send them to you to submit to IRS/MCC. These service bureaus may require you to submit an application to IRS/MCC to be assigned your own TCC to be coded in the Payer/Transmitter "A" Record. (See Part B, Sec. 3.) Contact your service bureau for further information.

.05 Once approved to file magnetically or electronically, you do not need to reapply each year unless:

(a) You discontinue filing magnetically or electronically for a year. Your TCC may have been reassigned by IRS/MCC.

(b) Your magnetic media files were transmitted in the past by a service agency. However, you now have computer equipment compatible with that of IRS and wish to prepare your own files. You must request your own TCC by filing an application Form 4419.

If any of these conditions apply to you, contact IRS/MCC for clarification.

.06 Also notify IRS/MCC if you had hardware or software changes that would affect the characteristics of the magnetic media submission. Be sure to refer to your current TCC in all correspondence with IRS/MCC.

.07 If you file on several different types of magnetic media (*e.g.*, tape, 8 inch diskette, and 5¼ inch floppy disk), you need only submit one Form 4419. In the past, IRS/MCC required filers submitting different types of media to obtain different TCCs. This is no longer necessary. You may use the same TCC on all of your media. For example, if you submit a magnetic tape, an 8 inch diskette, and a 5¼ inch floppy disk, you may use the same TCC for all 3 types of media. If you already have different TCCs assigned to you, you may choose any of the TCCs to be coded into the Payer/Transmitter "A" Record. It doesn't matter which one you use; however, remember to code only one TCC per medium. Please contact IRS/MCC and indicate which TCC(s) you will not be using so that we can remove them from our files. (See Part A, Sec. 3 for the address and telephone number).

.08 If you are an approved filer on magnetic media and the name, EIN, or address of your organization or contact person changes, please notify IRS/MCC in writing so that your file may be updated to reflect the current information.

.09 In accordance with section 1.6041-7(b) of the Income Tax Regulations, 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.

.10 Approval to file on magnetic media does not imply endorsement by

the IRS of the computer software or quality of tax preparation services provided.

.11 The magnetic media file must be transmitted with Form 4804 (see Part A, Sec. 9), which will provide IRS with the necessary information. Filing the same information returns either magnetically or electronically, as well as on paper forms, will result in duplicate filing and may result in erroneous penalty notices being sent to the payees.

SEC. 8. TEST FILES

.01 IRS does not require magnetic media filers to submit test files, *except* for those filers who wish to participate in the Combined Federal/State Filing Program (see Part A, Sec. 16 for further information concerning combined federal/state filing).

However, IRS encourages first-time magnetic media filers, and filers of floppy disks or diskettes, to send a test for review prior to the filing season.

IRS will determine whether or not your file is formatted correctly, and will check the content of the records to ensure that it meets the specifications of the current revenue procedure.

For those filers who have submitted magnetic media files in previous tax years, sending a test file provides them the opportunity to ensure that their software reflects the annual programming changes.

.02 If you are a new filer, you must submit a Form 4419 before you send in a "TEST" file. If approved, you will be assigned a five character Alpha/Numeric Transmitter Control Code (TCC). This TCC must be entered in the TCC field of your Payer/Transmitter "A" Record (see Part B, Sec. 3).

.03 All tape and diskette "TEST" files must be submitted between October 1 and December 15 of each year. Do not submit tape or diskette "TEST" files after December 15. Only a hardcopy printout of the tape or diskette that shows a sample of each type of record used (A, B, C and F) may be submitted after December 15 and it must be postmarked before January 15. Clearly mark the hardcopy print as "TEST" data and include identifying information such as name, telephone number, and address of a person who can be contacted to discuss its acceptability. If your "TEST" file is acceptable, we will send you an approval letter.

.04 The information in the "A" Record must be "ACTUAL" information—NOT FICTITIOUS.

.05 Form 4804, Transmittal of Information Returns Reported on Magnetic Media, must accompany your magnetic media test file. Indicate that the file contains test data by marking the "TEST" checkbox in block 1 on Form 4804. Also, write "TEST" on the external media label, Form 5064. The "TEST" data must be programmed according to the current revenue procedure.

.06 Submit a "TEST" file between October 1 and December 15 for the first year you wish to participate in the Combined Federal/State Filing Program. A hardcopy print is NOT an acceptable "TEST" file for this program.

.07 Approved payers or transmitters should send the "TEST" file to the IRS/MCC (see Part A, Sec. 3 for the address).

.08 IRS/MCC will send an acknowledgement in writing to indicate whether your "TEST" file was good or bad. If it was formatted incorrectly, we will indicate what the problems are and your file will be returned to you for replacement and resubmission. The "TEST" must be resubmitted by the deadline of December 15, 1990. After IRS/MCC successfully processes your test file, the diskette will not be returned.

SEC. 9. FILING OF MAGNETIC MEDIA REPORTS AND RETENTION REQUIREMENTS

.01 Form 4804, Transmittal of Information Returns Reported on Magnetic Media, must accompany all magnetic media submissions. This includes original, correction, replacement, and test data.

.02 In many cases, you can program your computer to generate a substitute Form 4804/4802 that contains the pertinent information. IRS encourages you to computer-generate your transmittal forms, as long as you include the necessary information contained on the most current revision of the form. You may also photocopy this form. If you file for multiple payers and have the authority to sign the affidavit on Form 4804, you should also submit Form 4802, "Transmittal for Multiple Magnetic Media Reporting."

.03 The transmitter may code any combination of payers and/or documents on their media. For example, if you are reporting Forms 1099-INT for Bank A, Forms 1099-DIV for Bank B, and Forms 1098 for Bank C, you need not create 3 separate diskettes. All 3 banks and all types of documents can be coded on one diskette. If you do create multiple diskettes, they can all be sent in one package; you need not send a separate package containing each diskette. Be sure to include Form 4804, 4802, or computer-generated substitute with your magnetic media shipment. DO NOT MAIL THE MAGNETIC MEDIA AND THE TRANSMITTAL DOCUMENTS SEPARATELY. Magnetic media files covered by this revenue procedure are to be sent to the IRS/MCC. (See Part A, Sec. 3 for the address.)

.04 IRS/MCC only processes returns filed magnetically or electronically, so paper information returns for information not being filed magnetically or electronically must be submitted to the appropriate service center using Form 1096, Annual Summary and Transmittal of U.S. Information Returns. *DO NOT send information returns filed on paper forms to IRS/MCC.*

.05 DO NOT REPORT DUPLICATE INFORMATION; *I.E.*, IF YOU SUBMIT PART OF YOUR RETURNS ON PAPER AND PART ON MAGNETIC MEDIA, BE SURE THE SAME INFORMATION IS NOT INCLUDED IN BOTH SUBMISSIONS.

.06 Form 4804 contains an affidavit that must be signed by the payer; however, the transmitter, service bureau, paying agent, or disbursing agent (all hereafter referred to as agent), may sign the affidavit on behalf of the person required to file/payer 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)".

.07 Although a duly authorized agent may sign the affidavit, the payer is responsible for the accuracy of the Form 4804 and the returns filed,

and the payer will be liable for penalties for failure to comply with filing requirements.

.08 If returns from different branches or locations for one payer are submitted on the same file, consolidate each type of information return under one Payer/Transmitter "A" Record. For example, all Forms 1099-INT for the same payer on a single file must be sorted together under one Payer/Transmitter "A" Record followed by the appropriate "B" Records and one "C" Record.

.09 Before shipping magnetic media files, include the following:

(a) A signed Form 4804 (or computer-generated substitute).

(b) A Form 4802 if you transmit for multiple payers and have the authority to sign the affidavit on Form 4804.

(c) The magnetic media with an external identifying label (Form 5064) as described in Part B, Sec. 1.02. Be sure to include the proper sequence on this label.

(d) On the outside of the shipping container, include a Form 4801 or a substitute for the form which reads "DELIVER UNOPENED TO TAPE LIBRARY —MAGNETIC MEDIA REPORTING—BOX __ of __ ." 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).

(e) If you were granted an extension, include a copy of the approval letter with the magnetic media shipment. (See Part A, Sec. 11 for information on how to apply for an extension of time to file.)

.10 IRS will not pay for or accept "Cash-on-Delivery" or "Charge to IRS" shipments of reportable tax information that an individual or organization is legally required to submit.

.11 Files may be returned to you due to coding or format errors. These files are to be corrected and returned to IRS within 45 days from the date of notice or the payer may be subject to a penalty. A copy of page 2 of the letter sent by IRS must be returned with the replacement file.

.12 Payers are required to retain a copy of the information returns filed with IRS or to have the ability to reconstruct the data for at least three years from the reporting due date.

SEC. 10. FILING DATES

.01 The dates prescribed for filing paper returns with IRS also apply to magnetic media filing. Magnetic media filing with IRS for Forms 1098, 1099, and W-2G must be on a calendar year basis. Form 5498 is used to report amounts contributed during or after the calendar year but not later than April 15.

.02 Information returns filed on magnetic media for Forms 1098, all types of Forms 1099, and Forms W-2G must be submitted to IRS/MCC postmarked no later than February 28. The due date for furnishing the required copy or statement to the payee is January 31.

.03 Information returns filed on magnetic media for Form 5498 must be submitted to IRS/MCC postmarked no later than May 31. Trustees or issuers of IRAs or SEPs must provide participants with a statement of the value of the participant's account by January 31, in any written format. Statements are due to the participants by May 31 for contributions made to IRAs for the prior calendar year. Form 5498 is filed for contributions to be applied to 1990 that are made between January 1, 1990, and April 15, 1991.

.04 If any due date falls on a Saturday, Sunday, or legal holiday, the due date is extended to the next day that is not a Saturday, Sunday, or legal holiday.

SEC. 11. EXTENSIONS OF TIME TO FILE

.01 A payer may request an extension of time to file information returns by submitting Form 8809, Request for Extension of Time To File Information Returns, to IRS/MCC. This form may be used to request an extension of time for information returns filed on paper; magnetic media; and/or electronically.

.02 A transmitter may request an extension of time to file for multiple payers by attaching a list of their names, addresses, and TINs to Form 8809. Form 8809 may be computer-generated or photocopied; however, be sure that all the pertinent information is included. If you are requesting extensions of time for more than 50 payers, we strongly encourage you to submit the list of payers, addresses, and EINs on tape or diskette. Contact IRS/MCC for the format. (See Part A, Sec. 3 for the address.) Transmitters who submit the extension of time requests on magnetic media will receive one approval letter from IRS/MCC with an attached listing of the payers with approved extensions.

.03 Request an extension of time in increments of 30 days, AS SOON AS YOU ARE AWARE that an extension is necessary but no later than the due date of the return. The request must be sent to IRS/MCC. (See Part A, Sec. 3 for the address.) You must allow a minimum of 30 days for IRS/MCC to respond to an extension request.

.04 Form 8809 must be postmarked no later than the due date of the return(s) for which you are requesting an extension of time. If you are requesting an extension of time to file several types of forms, you may use one Form 8809, but you must submit Form 8809 to IRS/MCC postmarked no later than the earliest due date. For example, if you are requesting an extension of time to file both Forms 1099-INT and Forms 5498, you must submit Form 8809 postmarked on or before February 28. You may submit more than one Form 8809 to avoid this problem.

.05 IRS will process your Form 8809 and respond in writing. If the extension request is granted, a copy of the approval letter only MUST be included with the transmittal Form 1096, Form 4804 (or computer generated substitute) when the file is submitted. INCLUDE ONLY THE APPROVAL LETTER SENT FROM IRS. DO NOT SEND A COPY OF FORM 8809 WITH EITHER YOUR PAPER DOCUMENTS TO THE SERVICE CENTER, OR YOUR MAGNETIC MEDIA FILE TO IRS/MCC. *Also, if you originally requested a 30-day extension and then find you need an additional 30 days, a copy of the first approved extension must accompany your second request.* IRS/MCC will not grant more than two extensions of time for a maximum of 60 days.

.06 You can request an extension for only one tax year on Form 8809.

.07 The extension request must be signed by the payer or a duly authorized representative.

.08 Failure to properly complete and sign the Form 8809 may cause delays in processing the request or result in a denial of your request. Please read the instructions on the back of the Form 8809 very carefully.

.09 Copies of the Form 8809 may be obtained from IRS/MCC (see Part A, Sec. 3 for the address) or from other IRS offices. Form 8809 may also be computer-generated as long as it contains all the information requested on the original form, and it may be photocopied.

SEC. 12. PROCESSING OF MAGNETIC MEDIA RETURNS

.01 All data received at IRS/MCC for processing will be given the same protection as individual returns (Forms 1040). IRS/MCC will process your magnetic media files and check that the records were formatted according to the most current revenue procedure. Please be sure that your record format and coding comply with this revenue procedure, which is to be used for the preparation of Tax Year 1990 information returns only.

.02 Revenue procedures are revised annually to reflect legislative and form changes to the information returns.

.03 If your data is formatted incorrectly, or if the file contains information that will cause invalid conditions in the IRS processing (for example, you code all 9's or all zeros in the field for the TIN), we will return your file for replacement.

.04 To distinguish between a correction and a replacement:

A correction is media submitted by the payer to correct records that were successfully processed by IRS, but contained erroneous information.

A replacement is media that IRS has returned to the payer or transmitter due to format errors encountered during processing. After necessary changes have been made, the media must be returned to IRS/MCC to be re-input.

.05 Beginning with Tax Year 1990, (processed in Calendar Year 1991), IRS/MCC will no longer return your files after processing. Therefore, if IRS/MCC returns your file to you, it is because a replacement is needed. *Open all packages immediately.* Files returned due to format or coding errors must be corrected and returned to IRS/MCC within 45 days from the date of the notice to avoid a failure to file penalty. IRS/MCC will work with magnetic media filers as much as possible to assist with processing problems. If IRS/MCC calls your office, please respond promptly since we may have information that you need to correct your file.

.06 Do not use special shipping containers for transmitting data to IRS/MCC. Because of the high volume of data received and shipping costs involved, they will not be returned.

.07 When submitting your file to IRS/MCC, please keep in mind that:

(a) You may include any of the types of returns covered by this revenue procedure on one diskette. You do not have to separate the different types of forms on different media. For example, one diskette could contain Forms 1098, 1099-INT, 1099-DIV, and 5498 for different payers. You need only identify the different types of returns and payers with different Payer/Transmitter "A" Records which are coded on the magnetic media. (See Part B, Sec. 3 for details.)

(b) You may submit multiple types of media in your shipment. However, submit a separate Form 4804 for each type of media.

(c) Enclose your transmittal Form 4804 with your shipment. Do not send it in a separate mailing. If your shipment is packed in several packages, use label Form 4801 to indicate the number of packages, and put the transmittal in the first package.

(d) IRS/MCC will NOT be returning your magnetic media to you after successfully processing it. Therefore, if you want proof that IRS/MCC received your shipment, you may choose to send your submission using a service with tracing capabilities, or that will provide proof of delivery (for example, U.S. Postal Service Certified Mail, Federal Express or UPS.)

SEC. 13. HOW TO FILE CORRECTED RETURNS

.01 The filing requirement thresholds listed in Part A, Sec. 4 apply separately to both original and corrected returns.

EXAMPLE: If you have 100 Forms 1099-A to be corrected, they can be filed on paper since they fall under the 250 threshold. However, if you have 300 Forms 1099-A to be corrected, they must be filed on magnetic media since they meet the 250 threshold. If for some reason you cannot file these corrections on magnetic media, you must request a waiver (see Part A, Sec. 5) before filing them on paper or you may be subject to a penalty. No waiver is required for corrections that fall under the required threshold.

.02 Corrections for the current year should be aggregated and filed no later than August 1 of each year. However, if you discover errors after August 1, you are still required to file corrections so that you will not be subject to a penalty for intentional disregard of the filing requirements. Failure to correct information returns submitted with erroneous information may result in penalties being assessed for failure to provide correct information.

.03 See the 1990 "Instructions for Forms 1099, 1098, 5498, and W-2G" for information concerning the due date for filing information returns, and any penalties that may apply to returns considered to be filed late or incorrectly. A copy of these instructions is included in your MMR (Magnetic Media Reporting) package each year. This will also contain specific information concerning the impact of the Revenue Reconciliation Act of 1989 on the penalty provisions for ANY documents, including corrections, which are filed after the original filing due date for the information return.

.04 ALL FIELDS MUST BE COMPLETED WITH THE CORRECT INFORMATION, NOT JUST THE DATA FIELDS NEEDING CORRECTION. If your entire file is in error, contact IRS/MCC immediately. If you file corrected returns on paper forms, submit Copy A to the appropriate service center. Furnish corrected statements to recipients as soon as possible.

.05 There are numerous types of errors. More than one transaction may be required to properly correct the initial error. A "G" in magnetic media position 8 of the "B" Record is used to indicate a corrected return. You are strongly encouraged to read

this ENTIRE section before attempting to make ANY correction.

.06 Corrected returns submitted to IRS on magnetic media, using a "G" coded Payee "B" Record, may be included on the same medium as those corrections without the "G" code; however, separate "A" Records are required. Corrected returns are to be identified as corrections on the transmittal document by marking the appropriate checkbox and also on the EXTERNAL label of the file.

NOTE: If you discover that your original file omitted certain information returns that should have been included, do *not* submit those documents as "corrections," and do not code the Payee "B" Record with the correction "G" code. They will be considered as late filed original documents and may be subject to the penalty.

.07 The instructions that follow will provide information on how to file corrected returns on magnetic media for the current tax year. However, if you discover errors in previous years' files, please send us a letter with the following information:

(a) Name and address of payer
(b) Type of error (Please explain clearly.)
(c) Tax year
(d) EIN
(e) TCC
(f) Number of Payees

This information will be forwarded to the appropriate office and may prevent erroneous notices from being generated against payee accounts. You are also required to furnish corrected statements to the payees.

.08 If you are not required to file your corrections on magnetic media and you file them on paper forms, do not submit the paper returns to IRS/MCC. All paper returns, whether original or corrected, must be filed with the appropriate service center. Corrected returns filed on magnetic media must be filed with IRS/MCC. (Refer to Part A, Sec. 3 for the address.) CORRECTED DISKETTES WILL NOT BE RETURNED AFTER PROCESSING.

.09 Corrected statements to payees should be clearly identified as "CORRECTED" and should be provided to them as soon as possible.

.10 A transmittal Form 4804 (or computer-generated substitute) is used to transmit magnetic media. A Form 4802, "Transmittal for Multiple Magnetic Media Reporting," is a continuation sheet for a Form 4804. Use Form 4802 if you file for multiple payers, or submit multiple types of information returns, AND are an authorized agent for the payers. (See Part A, Sec. 9.05.)

.11 On magnetic media files, the Payee "B" Record provides a 20-position field to enter a Payer's Account Number for the Payee. This same account number may be provided on paper forms. 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 (SSN OR EIN). 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. THIS NUMBER IS ALSO PROVIDED WITH YOUR INVALID/NO-TIN NOTIFICATION BY THE IRS AND MAY HELP YOU DETERMINE THE BRANCH OR SUBSIDIARY REPORTING THE TRANSACTION.

.12 REVIEW THE CHART THAT FOLLOWS. The types of errors made normally fall under one of the two categories listed. Next to each type of error made, you will find a list of instructions on how to properly file the corrected return for that type of error. READ AND FOLLOW CAREFULLY ALL OF THE INSTRUCTIONS LISTED FOR THE TYPES OF ERRORS MADE ON THE INITIAL RETURN. IN SOME CASES TWO TRANSACTIONS ARE REQUIRED TO PROPERLY FILE CORRECTIONS. IF THE ORIGINAL RETURN WAS FILED AS AN AGGREGATE, YOU MUST CONSIDER THIS IN FILING CORRECTED RETURNS.

Guidelines for Filing Corrected Returns On Magnetic Media

(PLEASE READ SEC. 13.01 THROUGH 13.11 BEFORE MAKING ANY CORRECTIONS)

Error Made on the Original Return Filed on Magnetic Media	How To File the Corrected Return on Magnetic Media
1. Original return was filed with one or more of the following errors: (a) No Payee TIN (SSN or EIN) (b) Incorrect Payee TIN (c) Incorrect Payee Name (e) Wrong type of return indicator TWO SEPARATE TRANSACTIONS ARE REQUIRED TO MAKE THE CORRECTION PROPERLY. READ AND FOLLOW ALL INSTRUCTIONS FOR BOTH TRANSACTIONS 1 AND 2.	TRANSACTION 1: Identify incorrect returns: A. Forms 4804 and 4802 (or computer-generated substitute): 1. Prepare a new transmittal Form 4804 (and 4802 if you file for multiple payers), or a computer-generated substitute, that includes information related to this new file. 2. Mark the Correction box in Block 1 of the new Form 4804. If you submit a computer-generated substitute for Form 4804, indicate "MAGNETIC MEDIA CORRECTION" at the top. 3. Provide ALL requested information correctly.

(PLEASE READ SEC. 13.01 THROUGH 13.11 BEFORE MAKING ANY CORRECTIONS)

Error Made on the Original Return Filed on Magnetic Media	How To File the Corrected Return on Magnetic Media
1. (Continued)	4. If you are a Combined Federal/State filer, it is your responsibility to transmit corrected returns to the state—IRS will not. Do not include "K" Records in your corrected returns. B. 8 Inch Diskette: (Forms 1098, 1099, 5498 or W-2G) 1. Prepare a new file. 2. Use a separate Payer/Transmitter "A" Record for each type of return being reported. The information in the "A" Record will be the same as it was in the original submission. 3. The Payee "B" Record must contain exactly the same information as submitted previously EXCEPT insert a "G" in diskette position 8 of Sector 1 of the "B" Record AND for ALL payment amounts used, enter "0" (zero). 4. Corrected returns submitted to IRS using a "G" coded "B" Record may be on the same diskette as those returns submitted without the "G" code; however, separate "A" Records are required. 5. Mark the EXTERNAL label of the diskette "MAGNETIC MEDIA CORRECTION." 6. Submit the magnetic diskette and the transmittal document(s) to IRS/MCC. (Refer to Part A, Sec. 3 for the address.) TRANSACTION 2: Report the correct information: 8 Inch Diskette: (Forms 1098, 1099, 5498 or W-2G) 1. Provide information on the Form 4804 or 4802 as stated in Transaction 1A. 2. Prepare a new file with the correct information in all records. 3. Use a separate Payer/Transmitter "A" Record for each type of return being reported. 4. Do not "G" code the Payee "B" Record as a corrected return for this type of correction. 5. Submit the new returns as though they were originals. Provide all of the correct information including the TIN (SSN or EIN). 6. Mark the EXTERNAL label of the diskette "MAGNETIC MEDIA CORRECTION." 7. Submit the magnetic diskette and the transmittal document(s) to IRS/MCC. (Refer to Part A, Sec. 3 for the address.)
2. Original return was filed with one or more of the following errors: (a) Incorrect Payment Amount indicator in the Payer "A" Record. (b) Incorrect Payment amounts in the Payee "B" Record. (c) Incorrect Code in the Document Specific Code Field in the Payee "B" Record. (d) Incorrect payee address (See NOTE) NOTE: If the only error to be corrected is an incorrect payee address, only one transac-	A. Forms 4804 and 4802 (or computer-generated substitute) 1. Prepare a *new* Form 4804 (and 4802 if you file for multiple payers), or a computer-generated substitute, that includes information related to this new file. 2. Mark the Correction box in Block 1 of new Form 4804. If you submit a computer-generated substitute for Form 4804, indicate "Magnetic Media Correction" at the top. 3. Provide *ALL* requested information correctly.

Error Made on the Original Return Filed on Magnetic Media	How To File the Corrected Return on Magnetic Media
2. (Continued) tion is required. However, if you are correcting the name and/or TIN along with an incorrect address, then two transactions will be required (See previous information on correcting an incorrect payee name/TIN). REQUIRES ONLY ONE TRANSACTION.	4. If you are a Combined Federal/State filer it is your responsibility to transmit corrected returns to the state—IRS will not. Do not include "K" Records in your corrected returns. B. 8 Inch Diskette: (Forms 1098, 1099, 5498 or W-2G) 1. Prepare a new file. 2. Use a separate Payer/Transmitter "A" Record for each *type* of return being reported. The information in the "A" Record will be the same as it was in the original submission EXCEPT, the correct Amount Indicators will be used. 3. The Payee "B" Record must contain exactly the same information as submitted previously *EXCEPT* insert a "G" in diskette position 8, Sector 1, of the "B" Record AND report the correct information as it should have been reported on the original return. 4. Corrected returns submitted using a "G" coded "B" Record may be on the same diskette as those returns submitted without the "G" code; however, separate "A" Records are required. 5. Mark the EXTERNAL label of the diskette "MAGNETIC MEDIA CORRECTION." 6. Submit the magnetic diskette and the transmittal document(s) to IRS/MCC. (Refer to Part A, Sec. 3.)

SEC. 14. TAXPAYER IDENTIFICATION NUMBERS (TIN)

.01 Section 6109 of the Internal Revenue Code, and the regulations thereunder, require a person whose Taxpayer Identification Number (TIN) must be shown on an information return to furnish his or her TIN to the person required to file the information return. The number must be furnished to the payer whether or not the payee is required to file a tax return or is covered by social security.

.02 The payee's TIN is used to associate and verify amounts reported to IRS with corresponding amounts on tax returns. Therefore, it is particularly important that CORRECT social security and employer identification numbers for payees be provided on magnetic media or paper forms submitted to IRS. DO NOT ENTER HYPHENS, ALPHA CHARACTERS, ALL 9S OR ALL ZEROS. IRS validates the SSN by using the Name Control of the surname (last name) of the individual who has been assigned this number. For this reason, provide the surname in the First Payee Name Line and/or the Name Control in positions 9–12 of the Payee "B" Record (see Part B, Sec. 6). Failure to provide this information may make it impossible for IRS to validate the SSN.

.03 The TIN to be furnished to IRS depends primarily upon the manner in which the account is maintained or set up on the payer's record. 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 Payee "B" Record. For individuals, including sole proprietors, the payee TIN is the payee's social security number. For other entities, the payee TIN is the payee's employer identification number.

.04 Failure to provide the correct name with the payee TIN, or failure to provide a valid TIN, could result in an Invalid/No TIN notice (sometimes referred to as "B" notice) being generated for that TIN.

.05 The following charts will help you determine the TIN to be furnished to IRS for those persons for whom you 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. (If more than one owner, 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. A sole proprietorship	The owner	The owner, not the business name

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 SSN 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
4. Partnership account held in then 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 the 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

[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 media reporting of the information returns listed in Part A, Sec. 4 applies only to the information submitted to IRS (Copy A).

.02 Payers are responsible for providing statements to the payees as outlined in the 1990 "Instructions for Forms 1099, 1098, 5498 and W-2G."

.03 Refer to 1990 "Instructions for Forms 1099, 1098, 5498, and W-2G" for instructions and changes to reporting information returns on paper.

.04 Send all information returns filed on paper to the appropriate service center, not to IRS/MCC.

.05 If you file your information returns on magnetic media, *DO NOT* file the same returns on paper, since that will result in duplicate filing. Filing on magnetic media or by electronic filing takes the place of submitting the documents on paper. In some cases, you may want to file your original documents on magnetic media, but submit your corrections on paper documents. This is allowable as long as your corrections do not exceed the filing threshold; if the volume of corrections does exceed the threshold, you MUST have an approved waiver to submit your corrections on paper.

SEC. 16. COMBINED FEDERAL/STATE FILING PROGRAM

.01 The Combined Federal/State Program was established to simplify information returns filing for the taxpayer by providing the tax information to participating states free-of-charge. IRS/MCC will forward this

information to participating states for approved filers so that separate reporting to those states is not necessary. *FORMS 1098, 1099-A, 1099-B, 1099-S, AND W-2G CANNOT BE FILED UNDER THIS PROGRAM.*

.02 To request approval to participate, a "TEST" file coded for this program, MUST be submitted by the transmitter to IRS/MCC between October 1 and December 15 using the revenue procedure that will be used to submit the actual data files.

.03 Attach a letter to the Form 4804 submitted with the "TEST" file which indicates that you wish to participate in this program.

.04 The "TEST" file is only required for the first year. Once you are approved, you need not resubmit tests each year except when notified by IRS. (See Part A, Sec. 8 for general guidelines on submission of "TEST" files.) Each record, both in the "TEST" file and the "ACTUAL" data file, must conform exactly to the revenue procedure for that tax year. Records must be coded using each state's dollar criteria from TABLE 2 of this section for each type of return.

.05 If your "TEST" file is acceptable, we will send you 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. Be sure to write your TCC on Form 6847. If your "TEST" file is not acceptable, we will return your media with a letter indicating what the problems were, and your replacement "TEST" file must be returned to IRS/MCC postmarked on or before December 15.

.06 A separate Form 6847 is required for each payer; therefore, this form may be photocopied so that you may provide copies to all of the payers for whom you submit magnetic media or electronic files. A transmitter may not combine payers on one Form 6847 even though 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. 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 If you file for multiple payers, code the records only for participating states and for those payers who have properly submitted Form 6847. Do not submit records coded for the Combined Federal/State Program WITHOUT PRIOR APPROVAL from IRS.

.08 If you had applied to participate in this program in the past but did not meet the requirements, you must resubmit a test and the Form 6847 with the proper signatures as specified.

.09 Some participating states require separate notification that you are filing in this manner. Since IRS acts as a forwarding agent only, IT IS YOUR RESPONSIBILITY TO CONTACT THE APPROPRIATE STATES FOR FURTHER INFORMATION.

.10 Approval to participate in the Combined Federal/State Program will be revoked if files submitted do not totally conform to the specifications in this revenue procedure.

.11 IT IS THE FILER'S RESPONSIBILITY TO TRANSMIT CORRECTED RETURNS TO THE STATES.

.12 Participating states and corresponding valid state codes are listed in TABLE 1 of this section. If the state that you wish information released to does not participate in the program, do not code your records for that state. It is the filer's responsibility to file information returns with those states not participating in the Combined Federal/State program.

.13 The appropriate state code MUST be entered for those documents which meet the state's filing requirements (see TABLE 1). DO NOT USE STATE ABBREVIATIONS. It is the filer's responsibility to determine the state code to be used and to obtain the filing requirements from the appropriate state(s).

.14 To simplify filing, several of the participating states have provided lists of their information return reporting requirements (see TABLE 2). It is your responsibility to contact the participating states to verify the criteria provided in this table.

.15 If you have met *ALL* of the above conditions:

(a) You must submit all records coded exactly as required by this revenue procedure.

(b) The "C" Record must be followed by a "K" Record for each state. The "K" Record indicates the number of payees being reported to each particular state.

(c) Payment amount totals and the valid participating state code must be included in the State Totals "K" Record. Refer to Part B, Sec. 8, for a description of the "K" Record.

(d) The last "K" Record is followed by an "A" Record or 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	New York	36
Arizona	04	Kansas	20	North Carolina	37
Arkansas	05	Maine	23	North Dakota	38
California	06	Massachusetts	25	Oregon	41
Delaware	10	Minnesota	27	South Carolina	45
District of Columbia	11	Mississippi	28	Tennessee	47
Georgia	13	Missouri	29	Wisconsin	55
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	[g]
District of Columbia[b]	600	600	600	600	600	600	600	NR
Hawaii	10	g	10[c]	600	10	10	600	[g]
Idaho	10	10	10	600	10	10	600	[g]
Iowa	100	1000	1000	1000	1000	1000	1000	NR
Minnesota	10	10	10	600	10	10	600	[g]
Mississippi	600	600	600	600	600	600	600	NR
Missouri	NR	NR	NR	1200[d]	NR	NR	NR	NR
Montana	10	10	10	600	10	10	600	[g]
New Jersey	1000	1000	1000	1000	1000	1000	1000	NR
New York	NR	600	600	600[e]	NR	600	600	NR
North Carolina	100	100	100	600	100	100	100	[g]
Tennessee	25	NR	25	NR	NR	NR	NR	NR
Wisconsin	NR	NR	NR	600	NR	600	600	NR

NOTE: This cumulative list is for information purposes only and represents dollar criteria. For complete information on state filing requirements, including any changes which may apply, 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. These requirements apply to individuals and business entities.
b. Amounts are for aggregates of several types of income from the same payer.
c. State regulation changing filing requirement from $600 to $10 is pending.
d. The state would prefer those returns filed with respect to non-Missouri residents to be sent directly to the state agency.
e. Aggregate of several types of income.
f. Same as Federal requirement for this type of return.
g. All amounts are to be reported.

SEC. 17. DEFINITIONS OF TERMS

Element	*Description*
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.
CUSIP Number	A number developed by the Committee on Uniform Security Identification Procedure to serve as a common denominator in communications among users for security transactions and security information.
EIN	A nine-digit number (Employer Identification Number) that has been assigned by IRS to the taxpayer.
Electronic Filing	Submission of information returns using switched telecommunications network circuits. These transmissions use modems, dial-up phone lines, and bi-synchronous protocols. See Publication 1220 for specific information on electronic filing.
File	For purposes of this procedure, a file consists of all records submitted by a Payer or Transmitter, either magnetically or electronically.
Foreign Corporation	Any corporation organized or created other than in or under the laws of the United States or any of its states or territories.
Magnetic Media	For purposes of this procedure, the term "magnetic media" refers to ½ inch magnetic tape; IBM 3480 compatible tape cartridge; or 8 inch, 5¼, or 3½ inch diskette. Magnetic media may be produced on mainframe computer systems; mini- or micro-computer systems; or personal computers.
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. 6 Payee "B" Record, Document Specific Code, Category of Distribution, Code 9.)

Element	*Description*
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), 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 trustee or 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.
Special Character	Any character that is not a numeral, an alpha, or a blank.
SSA	Social Security Administration.
SSN	Social Security Number.
Taxpayer Identification Number (TIN)	May be either an EIN or SSN.
Transfer Agent (Paying 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 941). The payer may be required to submit to IRS a Form 2678, Employer Appointment of Agent Under Section 3504 of the Internal Revenue Code, which notifies IRS of the transfer agent relationship.
Transmitter	Person or organization *submitting* magnetic media file(s). May be Payer or agent of Payer.
Transmitter Control Code (TCC)	A five character alpha/numeric number assigned by IRS to the transmitter prior to actual filing on magnetic media. This number is inserted in the "A" Record of your files and *must* be present before the file can be processed. An application Form 4419 must be filed with IRS to receive this number. (See Part A, Sec. 7.)

SEC. 18. STATE ABBREVIATIONS

.01 You MUST use the following state abbreviations 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. For a list of states that participate in the Combined Federal/State Program, refer to Part A, Sec. 16, Table 1.)

State	Code	State	Code	State	Code
Alabama	AL	Kentucky	KY	North Dakota	ND
Alaska	AK	Louisiana	LA	Ohio	OH
American Samoa	AS	Maine	ME	Oklahoma	OK
Arizona	AZ	Mariana Islands	CM	Oregon	OR
Arkansas	AR	Maryland	MD	Pennsylvania	PA
California	CA	Massachusetts	MA	Puerto Rico	PR
Colorado	CO	Michigan	MI	Rhode Island	RI
Connecticut	CT	Minnesota	MN	South Carolina	SC
Delaware	DE	Mississippi	MS	South Dakota	SD
District of Columbia	DC	Missouri	MO	Tennessee	TN
Florida	FL	Montana	MT	Texas	TX
Georgia	GA	Nebraska	NE	Utah	UT
Guam	GU	Nevada	NV	Vermont	VT
Hawaii	HI	New Hampshire	NH	Virgin Islands	VI
Idaho	ID	New Jersey	NJ	Virginia	VA
Illinois	IL	New Mexico	NM	Washington	WA
Indiana	IN	New York	NY	West Virginia	WV
Iowa	IA	North Carolina	NC	Wisconsin	WI
Kansas	KS			Wyoming	WY

.02 You must use the 29-2-9 City, State, and ZIP Code format for U.S. addresses which include American Somoa, Guam, Mariana Islands, Puerto Rico, and the Virgin Islands.

.03 For Foreign Country addresses you may use a 40-position free format in lieu of the 29-2-9 City, State, and ZIP Code format; however, this is only allowable if a "1" appears in the Foreign Country Indicator field of the "B" Record. You may choose to spell out the name of the foreign country or use abbreviations.

.04 When reporting APO/FPO addresses in Payee documents, the following format should be used:

EXAMPLE:	Payee Name	PVT Willard J. Doe		
	Mailing Address	Company F, PSC Box 100	)	
		167 Infantry REGT	)	See NOTE
	Payee City	APO New York		
	Payee State			
	Payee ZIP Code	098010100		

NOTE: Mailing address must be reported as one 40-position field.

SEC. 19. MAJOR PROBLEMS ENCOUNTERED

After preparing your files, we encourage you to verify the format and content of each type of record to ensure the accuracy of your data submission. This may eliminate the need for IRS/MCC to return your file for replacement, and reduce the likelihood of a penalty assessment for incorrect submissions. We strongly urge you to print your data before shipping to make sure you have good data in your records according to the format found in this revenue procedure. This is especially true for those filers who have either had their files prepared by a third party service bureau, or who have purchased pre-programmed software packages. If you purchased your software package for a previous tax year, it will no longer be valid for reporting your tax year 1990 information returns, since there were programming changes.

Following are some of the most frequently encountered problems with magnetic media files submitted to IRS/MCC which result in files being returned to the filer:

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1. The Payment Amount Fields in the Payee "B" Record do not correspond to the amount indicators in the Payer "A" Record.

If Amount Indicators 2, 4 and 7 appear in Sector 1, positions 24, 25 and 26 of the Payer "A" Record, then the Payee "B" Record must show payment amounts in Fields 2 (Sector 1, position 62–71), 4 (Sector 1, position 82–91) and 7 (Sector 1, position 112–121), right-justified and unused positions zero filled.

EXAMPLE:	"A" RECORD	247bbbbbbb (Sector 1, pos. 24–32)	— (b = blank)
	"B" RECORD	0000867599 (Sector 1, pos. 62–71)	— (Payment Amount 2)
		0000709097 (Sector 1, pos. 82–91)	— (Payment Amount 4)
		0000044985 (Sector 1, pos. 112–121)	— (Payment Amount 7)

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2. Blanks or invalid characters appear in Payment Amount Fields in the Payee "B" Record.

Money amounts must be right-justified and zero (0) filled. DO NOT USE BLANKS. Each payment amount must be entered in U.S. dollars and cents; however, do not use dollar signs, decimal points, or commas, as these characters are understood. For example, if you are reporting a money amount of $100.00, your payment amount field would be coded "0000010000."

DO NOT ENTER NEGATIVE AMOUNTS EXCEPT for Amount Indicators 2, 6, 7, 8 or 9 of the Form 1099-B. A negative overpunch in the units position may be used instead of a minus sign in the leftmost position to indicate negative amounts. If a minus sign or negative overpunch is not used, the amount is assumed to be positive.

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3. Data is in prior year's format.

Revenue procedures are updated each year and you must use the current revenue procedure to format your records. DO NOT USE 1989 REVENUE PROCEDURES FOR 1990 FILING.

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4. Discrepancy between IRS totals and totals in Payer "C" Records.

The Payer "C" Record is a summary record for a type of return for a given payer as reported in the Payee "B" Records. IRS computers automatically compute the total number of payees and total payment amounts in the Payee "B" records and these totals are compared against the totals in the Payer "C" Records. These totals are also manually checked against the totals provided on Forms 4804/4802. Payers should verify the accuracy of the records because imbalances necessitate return of files for correction.

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5. Incorrect/Invalid EIN in Payer "A" Record.

The Payer's federal EIN reported in Sector 1, positions 8–16 of the Payer "A" Record must be correct in order for IRS to process the media. Be sure the EIN reported on the Form 4804 and Form 4802 matches the EIN reported in the "A" Record. Do not enter blanks, hyphens, alphas, all 9s or all 0s. This field may be left blank for foreign corporations not required to have an EIN if the foreign indicator code is present in the "A" Record. Also, please double check for transposed numbers because an incorrect EIN will cause records to go unpostable; i.e., the records will not post to the Master File.

6. Bad Format.

We receive magnetic tape formatted using 8-inch diskette specifications and vice versa.

BE SURE TO USE THE PROPER REVENUE PROCEDURE FOR FORMATTING YOUR DATA. Use Publication 1220 for formatting magnetic tape, tape cartridge, 5¼ and 3½ inch diskettes, and for electronic filing. Use Publication 1255 for formatting 8-inch diskettes only.

7. Reporting Payments on Form 1099-R, Payer "A" Record.

There is no provision for reporting the Distribution Code (entered in Box 7 on the paper Form 1099-R) in the Payer "A" Record. This information is reported in the Document Specific Code of the Payee "B" Record. Therefore, the Amount Indicators in the Payer "A" Record should be reported as follows if you are reporting all 8 Amount Codes: 12345689b. Amounts are entered in ascending sequence, left-justified, and unused positions blank filled. The Amount Indicators may change from year to year. Please be sure your Payer "A" Record only contains the Amount Indicators specified in the revenue procedure.

8. Block size exceeds 25,200 positions.

Be sure your records do not span blocks. Even though the size was changed from 10,000 to 25,200 positions, filers are still exceeding the block size.

9. Bad or incomplete address in the Payer "A" Record.

The Payer's address in Part B, Sector 2, positions 44–83 and Part C, Sector 1, positions 132–171 of the Payer "A" Record should be left-justified and blank filled, and must agree with the address provided on Forms 4804/4802. Payer's City, State and ZIP must appear in Part B, Sector 2, positions 84–123 and Part C, Sector 1, positions 172–211 and must be left-justified and blank filled.

10. Record length is invalid.

Beginning in Tax Year 1987, the record length was changed from 360 to 420 positions. Some filers are still using old programs that create records of 360 positions, which are now unacceptable.

RECORDS MUST BE A FIXED 420 POSITIONS.

11. The City/State/ZIP Code in the Payee "B" Record is in wrong format.

The Payee City (Part B, Sector 3, positions 43–71 and Part C, Sector 2, positions 43–71), State (Part B, Sector 3, positions 72–73 and Part C, Sector 2, positions 72–73), and ZIP Code (Part B, Sector 3, positions 74–82 and Part C, Sector 2, positions 74–82 and Part C, Sector 2, positions 74–82) in the Payee "B" Record MUST be coded in the correct positions. If your program cannot code this information in the correct fields, you MUST request a deviation in writing from IRS/MCC. Files submitted with the City/State/ZIP Code information coded incorrectly, and for which a deviation has not been approved by IRS/MCC, will be returned for replacement.

12. Invalid type of return indicator.

You must indicate the type of return submitted by inserting the appropriate code in Position 23 of the Payer/Transmitter "A" Record. For example, if the type of return being reported is Form 1099-INT, a code "6" must be inserted in Position 23.

13. Form W-2/W-2P information submitted on same media as Form 1099 information.

Form W-2/W-2P information is processed by the Social Security Administration (SSA). The Social Security Administration has its own magnetic media reporting program for wage information; therefore, the media containing Forms W-2/W-2P is submitted to SSA. Any media received at IRS/MCC which contains Form W-2/W-2P information will be returned to the filer. Contact your local SSA office for information concerning filing Forms W-2/W-2P on magnetic media.

14. Excessive withholding credits.

For most information returns other than Form 1099-R, withholding credits should not exceed 20 percent of the income reported. Validate the total reported in the withholding field against the total income reported.

15. Incorrect format for Taxpayer Identification Numbers (TIN) in the Payee "B" Record.

A check of your Payee "B" Records should be made to ensure the TIN's are formatted correctly. There should be nine digits, no alpha characters, no hyphens or commas. Incorrect formatting of TIN's may result in a penalty.

PART B. SINGLE DENSITY DISKETTE SPECIFICATIONS

SECTION 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 a single density diskette file and must be strictly adhered to unless deviations have been specifically granted by IRS.

.02 To be compatible, a single density diskette file must meet the following specifications in total:

(a) 8 inches in diameter.

(b) Recorded in EBCDIC.

(c) Contain 77 tracks of which:

(1) Track 0 is the index track (the operating system reserves track 0 for the directory information and writes the file name and location in the directory; data cannot be written in track 0).

(2) Tracks 1 through 73 are data tracks.

(3) Track 74 is unused.

(4) Tracks 75 and 76 are alternate data tracks.

(d) Each Track must contain 26 sectors.

(e) Each Sector must contain 128 bytes.

(f) Data must be recorded on only one side of the diskette.

(g) IRS can process single sided, single density, soft sectored diskettes as well as double sided, double density, soft sectored diskettes. Part C provides specifications for double density diskettes which have sectors of 256 bytes.

(h) An IBM 5360 compatible diskette would meet the above specifications.

(i) Hard sectored diskettes are not compatible.

(j) A diskette should be clearly marked as to which type of data (single sided/single density or double sided/double density) is on each diskette, and preferably, the entire file should consist of either all single sided/single density or all double sided/double density diskettes.

.03 Payers who can substantially conform to these specifications, but require some minor deviations, MUST contact IRS/MCC. Diskettes deviating from the specifications in this revenue procedure must not be submitted without prior approval from IRS. If you file under the Combined Federal/State Filing Program, your files must conform totally to this revenue procedure.

.04 Form 5064, Media Label, must be affixed to each diskette submitted for processing. The following information is needed:

(a) The transmitter's name.

(b) The five character alpha/numeric Transmitter Control Code (TCC).

(c) The tax year of the data (*e.g.*, 1990).

(d) Operating system/software and hardware.

(e) Document types (*e.g.*, 1098, 5498, INT, DIV, MISC, etc.).

(f) The total number of "B" Records on the diskette.

(g) An in-house volume serial number assigned by the transmitter to the diskette, if applicable. (This is optional for those organizations which assign their own numbers to ther media.) If you do not assign media numbers, leave this blank.

(h) The sequence of each diskette (*e.g.*, 001 of 008; 002 of 008, etc.) However, if your file is complete on one diskette (ends with an "F" Record) the sequence will be 001 of 001. The information on the external label, Form 5064, will assist IRS in processing the file, or in locating a file if the transmitter requests its return due to errors.

SEC. 2. DISKETTE HEADER LABEL

The following header label format applies to both single and double density diskettes.

The header label on the diskette must be located in track 0, sector 8 and must be formatted as shown in the following layout. If your system automatically creates a header label, this is not necessary. If the file will consist of multiple diskettes, the Multi-Volume indicator in the diskette header label must contain a "C".

HDR1	Blank	Data Set (File) Name (For Transmitter's Use)	Blank	Sector Length	Blank	Beginning of Data
(a)	(b)	(c)	(b)	(d)	(b)	(e)
1-4	5	6-13	14-22	23-27	28	29-33

Blank	End of Data	Blank	Bypass Data Set	Data Set Accessibility	Write Protect	Blank
(b)	(f)	(b)	(g)	(h)	(i)	(j)
34	35-39	40	41	42	43	44

Multi-Volume (k)	Blank (b)	Expiration Date YYMMDD (l)	Verify Mark (m)	Blank (b)	Next Available Data Position (n)
45	46-66	67-72	73	74	75-79

(a) Header 1—Positions 1 through 4; enter HDR1.

(b) Unused—Any field marked blank is unused and should contain only blanks.

(c) Data Set (File) Name—Positions 6 through 13; you can use this field to identify your data set. The Data Set Name must begin with an alphabetic character and consist of only alphabetic or numeric characters.

(d) Sector Length—Positions 23 through 27; enter the sector length 128 or 256 in positions 25-27 and fill positions 23 and 24 with zeros.

(e) Beginning of Data—Positions 29 through 33; enter the five-digit address designated for the first record of this data set. For example, if the first record is to go in track 01, sector 02, enter 01002, or xx0yy where xx is the track number and yy is the sector number.

(f) End of Data—Positions 35 through 39; enter the five-digit address of the last position of the diskette reserved for this data set. For example, to reserve the entire diskette for a data set, enter 73026.

(g) Bypass Data Set—Position 41; enter B if you want to bypass this data set; otherwise, enter a blank.

(h) Data Set Accessibility—Position 42; enter a blank. Any other character in this field causes the equipment to refuse the diskette.

(i) Write Protect—Position 43; this field defines the protected status of the associated data set. P = read only; blank = read/write. With P in this position, you can only select the Update (U) mode.

(j) Position 44 is blank only for Single Sided/Single Density; enter "e" if Double Sided/Double Density to indicate exchange file.

(k) Multi-Volume—Position 45; this field indicates whether a complete data set is on a diskette. Blank = data set complete; C = data set continued on another diskette; L = last diskette of a multi-diskette data set.

(l) Expiration Date—Positions 67 through 72; may be used to contain the date that the data set expires. The format is YYMMDD where YY is the year, MM is the month and DD is the day.

(m) Verify Mark—Position 73; this single character field shows if the data set is verified. If it is, enter V, if it is not verified, enter a blank.

(n) Next Available Data Position—Enter the address of the next available position after End of Data (f). Positions 75-79; enter the track number in positions 75 and 76, enter a "0" (zero) in position 77 and enter the sector number in positions 78 and 79.

SEC. 3. PAYER/TRANSMITTER "A" RECORD

.01 The Payer/Transmitter "A" Record identifies the payer and transmitter of the diskette 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 appearing on a diskette will depend on the number of payers and the different types of returns being reported. The payment amounts for one payer for one type of return must 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 you are filing Form 1099-DIV to report Amount Codes 1, 2, and 3, all three amount codes must be reported under one "A" Record, not three separate "A" Records. For Payee "B" Records that do not contain payment amounts for all three amount codes, enter zeros for those which have no amount to be reported.

.04 After the header label on the diskette, the first record appearing in the file *must be an "A" Record.* When a single density diskette is used each "A" Record will consist of at least 2 sectors of 128 positions each; however, if you are transmitting for someone other than yourself, 4 sectors are required.

.05 A transmitter may include Payee "B" Records for more than one payer on a diskette; however, each GROUP of Payee "B" Records must be preceded by an "A" Record.

.06 A single diskette may also contain different types of returns, but the returns MUST NOT be intermingled. A separate "A" Record is required for each payer and each type of return being reported. An "A" Record may be blocked with "B" Records; however, the initial record on a file must be an "A" Record. IRS will accept an "A" Record after a "C" Record.

.07 All alpha characters entered in the "A" Record should be uppercase.

.08 WHEN REPORTING FORM 1098, MORTGAGE INTEREST

STATEMENT, THE "A" RECORD WILL REFLECT THE NAME OF THE RECIPIENT OF THE INTEREST (THE FILER). THE "B" RECORD WILL REFLECT THE INDIVIDUAL PAYING THE INTEREST (BORROWER/PAYER OF RECORD) AND THE AMOUNT PAID.

NOTE: For all fields marked REQUIRED, you must provide the information described under Description and Remarks. For fields not marked REQUIRED, you must allow for the field but may be instructed to enter blanks or zeros in the indicated diskette position(s) and for the indicated length.

RECORD NAME: PAYER/TRANSMITTER "A" RECORD

SECTOR 1

Diskette Position	Field Title	Length	Description and Remarks
1	Record Sequence	1	REQUIRED. Must be a "1". It is used to sequence the sectors making up a PAYER Record.
2	Record Type	1	REQUIRED. Enter "A".
3–4	Payment Year	2	REQUIRED. Enter "90".
5–7	Diskette Sequence Number	3	Sequence number assigned by the transmitter to each diskette starting with 001. (You may choose to enter blanks or zeros in this field. IRS bypasses this information.) You must indicate the proper sequence on the external label Form 5064.
8–16	Payer's Federal EIN	9	REQUIRED. Must be the valid 9-digit number assigned to the payer by IRS. DO NOT ENTER BLANKS, HYPHENS, ALPHA CHARACTERS, ALL 9's OR ALL ZEROS. (Also see Part A, Sec. 14.) For foreign corporations not required to have an EIN, this field may be left blank. Foreign corporations should have the Foreign Corporation Indicator set to "1". (See Part A, Sec. 17 for the definition of a Foreign Corporation.)
17–20	Payer Name Control	4	The Payer Name Control can be obtained from the mail label on the Package 1099 which is mailed to most payers on record each December. To distinguish between the Package 1099 and 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 on magnetic media only, and 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 you have not received a Package 1099 or you do not know your Payer Name Control, this field should be blank filled.
21	Blank	1	Enter blank.
22	Combined Federal/ State Filer	1	FORMS 1098, 1099-A, 1099-B, 1099-S AND W2-G CANNOT BE FILED ON THIS PROGRAM. Enter the appropriate code from the following table: *Code* — *Meaning* 1 — Participating in the Combined Federal/State Filing Program blank — Not participating Prior approval is required. A Consent Form 6847 *must* be submitted to IRS before tax information will be released to the states. (Refer to Part A, Sec. 16, Table 2, for money criteria.) Not all states participate in this program. If the Payer/Transmitter is not participating in the Combined Federal/State Filing Program, enter blank. (Refer to Part A, Sec. 16 for the requirements that *must* be met *prior* to actual participation in this program.) Filers participating in this program must incorporate state totals into corresponding "K" Records as described in Part A, Sec. 16.

RECORD NAME: PAYER/TRANSMITTER "A" RECORD—Continued

SECTOR 1 (Continued)

Diskette Position	Field Title	Length	Description and Remarks
23	Type of Return	1	REQUIRED. Enter appropriate code from table below: *Type of Return* — *Code* 1098 — 3 1099-A — 4 1099-B — B 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
24-32	Amount Indicators	9	REQUIRED. In most cases, the box numbers on paper information returns and the amount codes on magnetic media correspond. However, if discrepancies do occur, the instructions in this revenue procedure govern. For a detailed explanation of the information to be reported in each Amount Code, refer to the 1990 "Instructions for Forms 1099, 1098, 5498, and W-2G", included in your magnetic media reporting package. The amount indicators entered for a given type of return indicate type(s) of payment(s) which were made. For each Amount Code entered in this field, a corresponding Payment Amount will appear in the Payee "B" Record. EXAMPLE: If Sector 1, position 23 of the Payer/Transmitter "A" Record is "7" (for 1099-PATR) and positions 24-32 are "247bbbbbb", (b = blanks), this indicates that you will be reporting 3 actual Payment Amounts in all of the following Payee "B" Records. The first Payment Amount field in the Payee "B" Record will be all "0" (zeros); the second will represent Nonpatronage distributions; 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 Energy investment credit; and, the eighth and ninth will be all "0" (zeros). Enter the Amount Indicators in ASCENDING SEQUENCE (*i.e.,* 247bbbbbb, b = blanks) left-justify, filling unused positions with blanks. For further clarification of the Amount Indicator codes, contact IRS/MCC. (See Part A, Sec. 3)
	Amount Indicators Form 1098—Mortgage Interest Statement		For Reporting Interest Received from Payer(s)/Borrower(s) (Payer of Record) on Form 1098: Amount Code — Amount Type 1 — Mortgage interest received from payer(s)/borrower(s)
	Amount Indicators Form 1099-A—Acquisition or Abandonment of Secured Property		For Reporting the Acquisition or Abandonment of Secured Property on Form 1099-A: Amount Code — Amount Type 2 — Balance of principal outstanding 3 — Gross foreclosure proceeds 4 — Appraisal value

SECTOR 1 (Continued)

Diskette Position	Field Title	Length	Description and Remarks
	Amount Indicators Form 1099-B—Proceeds from Broker and Barter Exchange Transactions		For Reporting Payments on Form 1099-B: Amount Code — Amount Type 2 — Stocks, bonds, etc. (For Forward Contracts see Note below.) 3 — Bartering (Do not report negative amounts.) 4 — Federal income tax withheld (Backup Withholding) 6 — Profit (or loss) realized in 1990 7 — Unrealized profit (or loss) on open contracts—12/31/89 8 — Unrealized profit (or loss) on open contracts—12/31/90 9 — Aggregate profit (or loss)

NOTE: The Payment Amount field associated with Amount Code 2 may be used to represent a loss when the reporting is for Forward Contracts. Refer to Payee "B" Record—General Field Descriptions, Payment Amount Fields, for instructions on reporting negative amounts. Do not report negative amounts for Amount Codes 3 and 4.

	Amount Indicators 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 equal the sum of amounts reported in Amount Codes 2, 3, 4 and 5.

	Amount Indicators 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 4 — Federal income tax withheld (Backup Withholding) 5 — Discharge of indebtedness 6 — Taxable grants 7 — Agriculture payments
	Amount Indicators Form 1099-INT—Interest Income		For Reporting Payments on Form 1099-INT: Amount Code — Amount Type 1 — Earnings from savings and loan associations, credit unions, bank deposits, bearer certificates of deposit, etc.

SECTOR 1 (Continued)

Diskette Position	Field Title	Length	Description and Remarks	
			2	Early withdrawal penalty
			3	U.S. Savings Bonds, etc.
			4	Federal Income Tax withheld (Backup Withholding)
			5	Foreign tax paid
	Amount Indicators Form 1099-MISC—Miscellaneous Income		For Reporting Payments on Form 1099-MISC:	
			Amount Code	Amount Type
			1	Rents
			2	Royalties
			3	Prizes, awards, etc.
			4	Federal income tax withheld (Backup Withholding)
			5	Fishing boat proceeds
			6	Medical and health care payments
			7	Nonemployee compensation or Crop Insurance Proceeds (See Note 1)
			8	Substitute payments in lieu of dividends or interest
			9	Direct sales "indicator" (See Note 2)

NOTE 1: Amount Code "7" is normally used to report Nonemployee Compensation. However, Amount Code "7" may also be used to report Crop Insurance proceeds. If both Nonemployee Compensation and Crop Insurance Proceeds are being paid to the same payee, two separate Payee "B" Records are required. See Part B, Sec. 6, Document Specific Code, for instructions on how to indicate Crop Insurance Proceeds.

NOTE 2: Use Amount Code "9" to report the occurrence of 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. Refer to the 1990 "Instructions for Forms 1099, 1098, 5498, and W-2G," for specific instructions. Amount Code "9" actually reflects an indicator of direct sales of $5,000 or more and is not an actual payment amount. The corresponding payment amount field in the payee "B" Record MUST be 0000000100 to reflect direct sales of $5,000 or more. This does not mean that a payment of $1.00 was made or is being reported.

	Amount Indicators Form 1099-OID—Original Issue Discount		For Reporting Payments on Form 1099-OID:	
			Amount Code	Amount Type
			1	Original issue discount for 1990
			2	Other periodic interest
			3	Early withdrawal penalty
			4	Federal income tax withheld (Backup Withholding)
	Amount Indicators 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
			6	Investment credit (See Note)
			7	Energy investment credit (See Note)
			8	Jobs credit (See NOTE)
			9	Low-income housing credit (See Note)

SECTOR 1 (Continued)

Diskette Position	Field Title	Length	Description and Remarks

NOTE: The amounts shown for Amount Indicators 6, 7, 8 and 9 must be reported to the payee; however, they need not be reported to IRS.

Amount Indicators Form 1099-R— Total Distributions from Profit-Sharing, Retirement Plans, Individual Retirement Arrangements, Insurance Contracts, Etc.	For Reporting Payments on Form 1099-R: Amount Code	Amount Type
	1	Gross distribution
	2	Taxable amount (See NOTE 1)
	3	Amount in Amount Code 2 eligible for capital gain election
	4	Federal income tax withheld (See NOTE 2)
	5	Employee contributions or insurance premiums
	6	Net unrealized appreciation in employer's securities
	8	Other
	9	State income tax withheld (See NOTE 3)

NOTE 1: 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 contribution, enter the value of the stock in Amount Code 1, enter (0) zero in Amount Code 2, and enter the employee's contribution in Amount Code 5.

NOTE 2: See the 1990 "Instructions for Forms 1099, 1098, 5498, and W-2G" for further information concerning the definition of Federal Income Tax Withheld for Form 1099-R.

NOTE 3: State income tax withheld has been added for the convenience of the payer but need not be reported to IRS.

Amount Indicators Form 1099-S— Proceeds from Real Estate Transactions	For Reporting Payments on Form 1099-S: Amount Code	Amount Type
	2	Gross Proceeds

Amount Indicators Form 5498— Individual Retirement Arrangement Information (See Note)	For Reporting Payments on Form 5498: Amount Code	Amount Type
	1	Regular IRA contributions made in 1990 and 1991 for 1990
	2	Rollover IRA contributions
	3	Life insurance cost included in Amount Code 1
	4	Fair market value of the account

NOTE: Form 5498 is filed for each person for whom you maintained an individual retirement arrangement (IRA) (including an Individual Retirement Arrangement maintained as part of a simplified employee pension (SEP)) during 1990. Amount Code 4 represents the value of the account. Trustees and issuers of IRAs and SEPs must report the value of accounts in existence during the year, even if no contributions were made during the year. However, if a total distribution was made from an IRA during the year and no contributions were made for that year, you need not file Form 5498 to reflect that the fair market value on December 31 was zero. Do not report employer SEP contributions on Form 5498; however, you must report the value of a SEP account. For an IRA, use all applicable Amount Codes. If no IRA contributions were made for 1990, you will only use Amount Code 4. Only IRA contributions to be applied to 1990 that are made between January 1, 1990, and April 15, 1991, are to be reported in Amount Code 1. For further information concerning IRA reporting, see Rev. Proc. 89-52, printed in IR Bulletin 1989-37 on September 11, 1989.

Amount Indicators 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

RECORD NAME: PAYER/TRANSMITTER "A" RECORD—Continued

SECTOR 1 (Continued)

Diskette Position	Field Title	Length	Description and Remarks
			3 State income tax withheld (see Note) 7 Winnings from identical wagers
NOTE: State income tax withheld has been added for the convenience of the payer but need not be reported to IRS.			
33-44	Blank	12	Enter blanks.
45-49	Transmitter Control Code (TCC)	5	REQUIRED. Enter the five character alpha/numeric Transmitter Control Code assigned by IRS. You must have a TCC to file data on this program. DO NOT ENTER MORE THAN ONE TCC PER FILE.
50	Foreign Corporation Indicator	1	Enter a "1" if the payer is a foreign corporation and income is paid by the corporation to a U.S. resident from sources outside of the United States. (See Part A, Sec. 17 for the definition of a Foreign Corporation.) If the payer is not a Foreign Corporation, enter a blank. (See NOTE.)
NOTE: Some filers are submitting their files with a "1" coded in Position 50 in all of the records contained on the file, whether the payer is a foreign corporation or not. Records that are coded as foreign corporations are processed differently than those that are coded with a blank in Position 50. If your program automatically codes a "1" in Position 50, all of the records on your file will be processed as foreign corporations. If you erroneously report corporations as foreign, you may be subject to a penalty for providing incorrect information to IRS. Therefore, be sure to code only those records as foreign corporations that should be coded as such.			
51-90	First Payer Name	40	REQUIRED. Must be present or files will be returned for correction. Enter the name of the payer whose Federal EIN appears in Sector 1, position 8-16, in the manner in which it is used on other tax returns. Any extraneous information must be deleted from the name line. Left-justify and fill with blanks. (Do not enter the Transfer Agent's name in this field. The Transfer Agent's name should appear in the Second Payer Name field.)
NOTE: WHEN REPORTING FORM 1098, MORTGAGE INTEREST STATEMENT, THE "A" RECORD WILL REFLECT THE NAME AND EIN OF THE RECIPIENT OF THE INTEREST (THE FILER). 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 "B" Record will reflect the Seller.*			
91-128	Blank	38	Enter blanks.
SECTOR 2			
1	Record Sequence	1	REQUIRED. Must be a "2". Used to sequence the sectors making up a PAYER Record.
2	Record Type	1	REQUIRED. Enter "A".
3-42	Second Payer Name	40	The contents of this field are dependent upon the TRANSFER AGENT INDICATOR in Sector 2, position 43 of this record. If the Transfer Agent Indicator contains a "1", this field must contain the name of the Transfer Agent. If the Transfer Agent Indicator contains a "0" (zero), this field must contain either a continuation of the First Payer Name field or blanks. Left-justify and fill unused positions with blanks. IF NO ENTRIES ARE PRESENT FOR THIS FIELD, FILL WITH BLANKS. (See Part A, Sec. 17 for a definition of Transfer Agent.)

RECORD NAME: PAYER/TRANSMITTER "A" RECORD—Continued

SECTOR 2 (Continued)

Diskette Position	Field Title	Length	Description and Remarks
43	Transfer Agent Indicator	1	REQUIRED. Identifies the entity in the Second Payer Name field. (See Part A, Sec. 17 for a definition of Transfer Agent.) *Code* — *Meaning* 1 — The entity in the Second Payer Name field is the Transfer Agent, (as defined in Part A, Sec. 17.) 0 (zero) — The entity shown is *not* the Transfer Agent (*i.e.*, the Second Payer Name field contains either a continuation of the First Payer Name field or blanks).
44–83	Payer Shipping Address	40	REQUIRED. If the TRANSFER AGENT INDICATOR in Sector 2, position 43 is a "1," enter the shipping address of the Transfer Agent. Otherwise, enter the shipping address of the payer. Left-justify and fill with blanks.
84–123	Payer City, State and ZIP Code	40	REQUIRED. If the TRANSFER AGENT INDICATOR in Sector 2, position 43 of this Record is a "1", enter the City, State and ZIP Code of the Transfer Agent. Otherwise, enter the City, State and ZIP Code of the payer. Left-justify and fill with blanks.
124–128	Blank	5	Enter blanks.
SECTOR 3	Sectors 3 and 4 are only required if the payer and transmitter are not the same.		
1	Record Sequence	1	REQUIRED. Must be a "3". Used to sequence the sectors making up a PAYER Record.
2	Record Type	1	REQUIRED. Enter "A".
3–82	Transmitter Name	80	REQUIRED. (Only if payer and 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 the transmitter *must* be reported in the same manner throughout the entire file. Left-justify and fill with blanks. If the payer and transmitter are the same, enter blanks in this field.
83–122	Transmitter Mailing Address	40	REQUIRED. (Only if payer and transmitter are not the same.) Enter the mailing address of transmitter. Left-justify and fill with blanks. If the payer and transmitter are the same, enter blanks in this field.
123–128	Blank	6	Enter blanks.
SECTOR 4	Sectors 3 and 4 are only required if the payer and transmitter are not the same.		
1	Record Sequence	1	REQUIRED. Must be a "4". Used to sequence the sectors making up a PAYER Record.
2	Record Type	1	REQUIRED. Enter "A".
3–42	Transmitter City, State and ZIP Code	40	REQUIRED. (Only if the payer and transmitter are not the same). Enter the City, State and ZIP Code of the transmitter. Left-justify and fill with blanks. If the payer and transmitter are the same, enter blanks in this field.
43–128	Blank	86	Enter blanks.

SEC. 4. PAYER/TRANSMITTER "A" RECORD—RECORD LAYOUT

Sector 1

RECORD SEQUENCE	RECORD TYPE	PAYMENT YEAR	DISKETTE SEQUENCE NUMBER	PAYER'S FEDERAL EIN	PAYER NAME CONTROL*
1	2	3-4	5-7	8-16	17-20

BLANK	COMBINED FEDERAL/STATE FILER	TYPE OF RETURN	AMOUNT INDICATORS	BLANK
21	22	23	24-32	33-44

TRANSMITTER CONTROL CODE	FOREIGN CORPORATION INDICATOR	FIRST PAYER NAME*	BLANK
45-49	50	51-90	91-128

Sector 2

RECORD SEQUENCE	RECORD TYPE	SECOND PAYER NAME*	TRANSFER AGENT INDICATOR	PAYER SHIPPING ADDRESS	PAYER CITY STATE AND ZIP	BLANK
1	2	3-42	43	44-83	84-123	124-128

Sector 3

RECORD SEQUENCE	RECORD TYPE	TRANSMITTER NAME	TRANSMITTER MAILING ADDRESS	BLANK
1	2	3-82	83-122	123-128

Sector 4

RECORD SEQUENCE	RECORD TYPE	TRANSMITTER CITY, STATE AND ZIP CODE	BLANK
1	2	3-42	43-128

* WHEN REPORTING FORM 1098, MORTGAGE INTEREST STATEMENT, THE "A" RECORD WILL REFLECT THE NAME AND EIN OF THE RECIPIENT OF THE INTEREST (THE FILER). FOR FORM 1099-S THE "A" RECORD WILL REFLECT THE PERSON RESPONSIBLE FOR REPORTING THE TRANSACTION.

SEC. 5. PAYEE "B" RECORD—GENERAL INFORMATION FOR ALL FORMS

.01 This section contains the general information concerning the Payee "B" Record for all information returns filed on single sided/single density soft-sectored diskettes. For a detailed description of the record refer to the following in Part B:

(a) Sec. 6. PAYEE "B" RECORD—FIELD DESCRIPTIONS FOR SECTORS 1 THROUGH 4 OF FORMS 1098, 1099-DIV, 1099-G, 1099-INT, 1099-MISC, 1099-PATR, 1099-R, 5498 AND SECTORS 1 THROUGH 3 OF FORMS 1099-A, 1099-B, 1099-OID, 1099-S AND W-2G.

(b) Sec. 7. PAYEE "B" RECORD LAYOUTS FOR SECTORS 1 THROUGH 4 OF FORMS 1098, 1099-DIV, 1099-G, 1099-INT, 1099-MISC, 1099-PATR, 1099-R, 5498 AND SECTORS 1 THROUGH 3 OF FORMS 1099-A, 1099-B, 1099-OID, 1099-S AND W-2G.

(c) Sec. 8. PAYEE "B" RECORD—FIELD DESCRIPTIONS AND RECORD LAY-

OUT FOR SECTOR 4 OF FORM 1099-A.

(d) Sec. 9. PAYEE "B" RECORD—FIELD DESCRIPTIONS AND RECORD LAYOUT FOR SECTOR 4 OF FORM 1099-B.

(e) Sec. 10. PAYEE "B" RECORD—FIELD DESCRIPTIONS AND RECORD LAYOUT FOR SECTOR 4 OF FORM 1099-OID.

(f) Sec. 11. PAYEE "B" RECORD—FIELD DESCRIPTIONS AND RECORD LAYOUT FOR SECTOR 4 OF FORM 1099-S.

(g) Sec. 12. PAYEE "B" RECORD—FIELD DESCRIPTIONS AND RECORD LAYOUT FOR SECTOR 4 OF FORM W-2G.

For tax year 1990 data, all "B" Records will consist of at least 3 sectors of 128 positions each. If you are not a Combined Federal/State filer or if you are not utilizing the Special Data Entries field, Sector 4 can be eliminated for Forms 1098, 1099-DIV, 1099-G, 1099-INT, 1099-MISC, 1099-PATR, 1099-R, and 5498.

The "B" Record will always consist of 4 Sectors for Forms 1099-A, 1099-B, 1099-OID, 1099-S, and W-2G.

In the "A" Record, the Amount Indicator Codes that appear in diskette positions 24 through 32 of Sector 1 will be left-justified and blank filled. In the "B" Record, allow for all nine payment amount fields. For those fields not used, enter zeros. For example, if you are reporting on Form 1099-PATR, enter a "7" in diskette position 23 of Sector 1 of the "A" Record, Type of Return Indicator field. If you are reporting payments for Amount Codes 2, 4, and 7, then diskette positions 24 through 32 of Sector 1 of the "A" Record will be "247bbbbbb" (b = blanks). In the Payee "B" Record:

Positions 52 through 61 of Sector 1 for Payment Amount 1 will be zeros.

Positions 62-71 of Sector 1 will reflect the actual payment amount to be reported for "Nonpatronage distributions."

Positions 72-81 of Sector 1 for Payment Amount 3 will be zeros.

Positions 82-91 of Sector 1 will reflect the actual payment amount to be reported for "Federal income tax withheld."

Positions 92-111 of Sector 1 for Payment Amounts 5 and 6 will be zeros.

Positions 112-121 of Sector 1 will reflect the actual payment amount to be reported for "Energy investment credit."

Positions 3-22 of Sector 2 for Payment Amounts 8 and 9 will be zeros.

.02 The record layout for Sectors 1, 2 and 3 will be the same for all "B" records. Sector 4, however, will be different for Forms 1099-A, 1099-B, 1099-OID, 1099-S and W-2G. Refer to Part B, Sec. 8, 9, 10, 11 or 12, respectively for the layout of Sector 4 of these records.

.03 IRS must be able to identify the surname or last name associated with the TIN (SSN or EIN) furnished on a return. The specifications below include a field in the payee records called "Name Control" in which the first four characters of the payee's surname or last name are to be entered by the payers. The surname or last name should appear first in the First Payee field of all Payee "B" Records; however, if your records have been developed using the first name first, a blank must appear between the first and last names.

.04 If payers are unable to determine the first four characters of the surname, the Name Control Field may be left blank; however, compliance with the following will facilitate IRS computer programs in generating the Name Control.

(a) The surname of the payee whose TIN (SSN or EIN) is shown in the Payee "B" Record should always appear first. If, however, you enter the first name first, you 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 Payee "B" Record must be present in the First Payee Name field. Surnames of any other payees in the record may be entered in the Second Payee Name field.

.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 filer's own personal use. 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 choice whether or not this field is used. If this field is coded, it will not affect the processing of the Payee "B" Records.

.06 For those filers participating in the Combined Federal/State Filing Program, positions 70 and 71 of Sector 4 in the Payee "B" Record *must* contain the appropriate state code for the state to receive the information. The file should also meet the money criteria described in Part A, Sec. 16, Table 2.

.07 Do not code for the states unless prior approval to participate has been granted by IRS. (See Part A, Sec. 16) Table 1 for a list of the valid participating state codes.) FORMS 1098, 1099-A, 1099-B, 1099-S AND W-2G CANNOT BE FILED UNDER THE COMBINED FEDERAL/STATE FILING PROGRAM. Your files must meet all of the requirements specified in Part A, Sec. 16, in order to participate in this program.

.08 All alpha characters entered in the "B" Record should be uppercase.

.09 Do not use decimal points (.) to indicate dollars and cents.

.10 IRS STRONGLY ENCOURAGES FILERS TO REVIEW THEIR DATA FOR ACCURACY BEFORE SUBMISSION TO PREVENT ISSUANCE OF ERRONEOUS NOTICES TO PERSONS FOR WHOM REPORTS ARE FILED. FILERS SHOULD BE ESPECIALLY CAREFUL THAT THEIR TAXPAYER NAMES, SOCIAL SECURITY NUMBERS (SSNs), ACCOUNT NUMBERS, TYPES OF INCOME, AND INCOME AMOUNTS ARE CORRECT.

.11 WHEN REPORTING FORM 1098, MORTGAGE INTEREST STATEMENT, THE "A" RECORD WILL REFLECT THE NAME AND EIN OF THE RECIPIENT OF THE INTEREST (THE FILER). THE "B" RECORD WILL REFLECT THE INDIVIDUAL PAYING THE INTEREST (THE BORROWER/PAYER OF RECORD) AND THE

AMOUNT PAID. FOR FORMS 1099-S THE "A" RECORD WILL REFLECT THE PERSON RESPONSIBLE FOR REPORTING THE TRANSACTION. THE "B" RECORD WILL REFLECT THE SELLER.

SEC. 6. PAYEE "B" RECORD—FIELD DESCRIPTIONS FOR SECTORS 1 THROUGH 4 OF FORMS 1098, 1099-DIV, 1099-G, 1099-INT, 1099-MISC, 1099-PATR, 1099-R, 5498 AND SECTORS 1 THROUGH 3 OF FORMS 1099-A, 1099-B, 1099-OID, 1099-S AND W-2G.

.01 For Forms 1099-A, 1099-B, 1099-OID, 1099-S, and W-2G, see Part B, Sec. 8, 9, 10, 11 and 12, respectively for the field descriptions and record layouts for Sector 4 of these records.

NOTE: For all fields marked REQUIRED, you must provide the information described under Description and Remarks. For those fields *not* marked REQUIRED, you must allow for the field but may be instructed to enter blanks or zeros in the indicated position(s) and for the indicated length.

RECORD NAME: PAYEE "B" RECORD

SECTOR 1

Diskette Position	Field Title	Length	Description and Remarks
1	Record	1	REQUIRED. Must be a "1". It is used to sequence the sectors making up a PAYEE Record.
2	Record Type	1	REQUIRED. Enter "B".
3-4	Payment Year	2	REQUIRED. Enter "90".
5-6	Document Specific Code	2	REQUIRED FOR FORMS 1099-R, 1099-MISC, 1099-G, AND W-2G. FOR ALL OTHER FORMS, OR IF NOT USED, ENTER BLANKS. For *Form 1099-R*, enter the appropriate code(s) for the Distribution Code. More than one code may apply for Form 1099-R; however, if only one code is required, it will be entered in position 5. Position 6 will be blank. NOTE: You MUST enter at least one (1) Distribution Code for Form 1099-R. BLANKS in *BOTH* positions 5 and 6 are NOT acceptable for Form 1099-R. For Form *1099-MISC*, position 5 is used to indicate Crop Insurance Proceeds. Position 6 will be blank. For *Form 1099-G*, enter the year of income tax refund in position 5. Position 6 will be blank. For Form *W-2G*, enter the Type of Wager in position 5. Position 6 will be blank.
	Distribution Code (For 1099-R)		Use only for reporting on *Form 1099-R* to identify the Distribution Code. Enter the applicable code from the table below. A "0" (zero) is not a valid code for Form 1099-R. A numeric code MUST be entered in all cases except when Code P or D is used. However, when using Code P for an IRA distribution under section 408(d)(4), you may also enter Code 1, if it applies. In addition, if more than one numeric code is applicable to a distribution, report two (2) separate Payee "B" Records. If you are reporting a total distribution from a plan that includes a distribution of a DEC, you must report two separate "B" Records: one to report the distribution of DECs and the other to report the distribution from the other part of the plan. *Category* (See Note) — *Code* Early (premature) distribution, no known exception* — 1* Early (premature) distribution, exception applies (as defined in section 72(q), (t), or (v)) other than disability or death* — 2* Disability* — 3* Death (includes payments to a beneficiary)* — 4* Prohibited transaction* — 5* Section 1035 Exchange — 6

SECTOR 1 (Continued)

Diskette Position	Field Title	Length	Description and Remarks	
			Normal distribution*	7*
			Excess contributions plus earnings/excess deferrals (and/or earnings taxable in 1990)	8
			PS 58 Costs	9
			Excess contributions plus earnings/excess deferrals taxable in 1989	P
			Qualifies for 5-year/10-year averaging	A
			Qualifies for death benefit exclusion	B
			Qualifies for both A and B	C
			Excess Contributions plus earnings/excess deferrals taxable in 1988	D

NOTE: For detailed explanations of the distribution codes, see the 1990 "Instructions for Form 1099, 1098, 5498, and W-2G" included in your magnetic media reporting packages.

*If you are reporting a distribution of an IRA or SEP for Codes 1, 2, 3, 4, 5, or 7, you must code a "1" in position 45 Sector 1 of the Payee "B" Record.

Crop Insurance Proceeds (Form 1099-MISC only)

If the payment amount reported for Amount Code 7 is crop insurance proceeds, enter a "1" in position 5. Position 6 will be blank.

Tax Year of Refund (Form 1099-G only)

Use only for reporting the tax year for which the refund was issued. Enter the NUMERIC Year for which the refund was issued (*i.e.*, for 1989 enter 9). However, if the payment amount for Amount Code 2, State or Local Income Tax Refunds, contains a refund, credit, or offset that is attributable to an income tax which applies exclusively to income from a trade or business and is not of general application, then enter the ALPHA equivalent of the year for which the refund was issued from the table below (i.e., for 1989 enter I). This code should appear in position 5. Position 6 will be blank.

Year for Which Trade or Business Refund was Issued	*Alpha Equivalent**
1	A
2	B
3	C
4	D
5	E
6	F
7	G
8	H
9	I
0	J

*To be used for trade or business refunds only.

Type of Wager (Form W-2G only)

Use only for reporting the Type of Wager on *Form W-2G*. This code will appear in position 5. Position 6 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

SECTOR 1 (Continued)

Diskette Position	Field Title	Length	Description and Remarks
			Casino Type Bingo. DO NOT use this code for any other type of bingo winnings (*e.g.*, church or fire dept.) 6 Slot Machines 7 Any other type of gambling winnings. (This includes church bingo, fire dept. bingo, unlabeled winnings, etc.) 8
7	Blank	1	Enter blank.
8	Corrected Return Indicator	1	Diskette position 8 is used to indicate a corrected return. Refer to Part A, Sec. 13 for specific instructions on how to file corrected returns.
9-12	Name Control	4	Enter the first four (4) characters of the surname (last name) of the payee. The surname of the person whose TIN is being reported in positions 16-24, Sector 1 of the "B" Record should be used to determine the Name Control. This is especially important in the case of trustee accounts. IF THE NAME THAT CORRESPONDS TO THE TIN IS NOT INCLUDED IN THE FIRST OR SECOND PAYEE NAME LINE, EVERY EFFORT SHOULD BE MADE TO DEVELOP THE CORRECT NAME CONTROL FOR THE NAME THAT CORRESPONDS TO THE TIN. 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, 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. IF THE NAME CONTROL IS NOT DETERMINABLE BY THE PAYER, LEAVE THIS FIELD BLANK. (See Part A, Sec. 14 for information on Name Controls.) A dash (—) and ampersand (&) are the only acceptable special characters.

The following examples may be helpful to you in developing the name control:

	Name	*Name Control*
Individuals:		
	Jane Brown	BROW
	John A. Lee	LEE*
	James P. En, Sr.	EN*
	John O'Neill	ONEI
	Mary Van Buren	VANB
	Juan De Jesus	DEJE
	Gloria A. El-Roy	EL-R
	Mr. John Smith	SMIT
	Joe McCarthy	MCCA
	Pedro Torres-Lopes	TORR
	Maria Lopez Moreno	LOPE
	Binh To La	LA*
	Nhat Thi Pham	PHAM
	Mark D'Allesandro	DALL
Corporations:		
	The First National Bank	FIRS
	The Hideaway	THEH
	A & B Cafe	A&BC

SECTOR 1 (Continued)

Diskette Position	Field Title	Length	Description and Remarks
			Name — *Name Control*
	Sole Proprietor:		
			Jane and Mark Hemlock c/o The Sunshine Club — HEML
	Partnership:		
			Robert Aspen and Bess Willow — ASPE
			Harold Fir, Bruce Elm, and Joyce Spruce et al Ptr — FIR*
	Estate:		
			Frank White Estate — WHIT
			Sheila Blue Estate — BLUE
	Trusts and Fiduciaries:		
			Daisy Corporation Employee Benefit Trust — DAIS
			Trust FBO The Cherryblossom Society — CHER
	Exempt Organization:		
			Laborer's Union, AFL-CIO — LABO
			St. Bernard's Methodist Church Bldg. Fund — STBE
	*Name Controls of less than four (4) significant characters must be left-justified and blank filled.		
13-14	Blank	2	Enter blanks.
15	Type of TIN	1	REQUIRED. This field is used to identify the Taxpayer Identification Number (TIN) in positions 16-24 as either an Employer Identification Number, a Social Security Number, or that the type is undeterminable. Enter the appropriate code from the following table: *Type of TIN* — *TIN* — *Type of Account* 1 — EIN — A business, organization, or other entity that is not an individual 2 — SSN — An individual blank — N/A — If the type of TIN is undeter minable, enter a blank.
16-24	Taxpayer Identification Number	9	REQUIRED. Enter the valid 9-digit Taxpayer Identification Number of the payee (SSN or EIN, as appropriate). If an identification number has been applied for but not received, enter blanks. DO NOT ENTER HYPHENS, ALPHA CHARACTERS, ALL 9's OR ALL ZEROS.
25-44	Payer's Account Number for Payee	20	DO NOT ENTER A TAXPAYER IDENTIFICATION NUMBER IN THIS FIELD. We strongly encourage the payer to use this field to enter the payee's account number which can be any number assigned by the payer to the payee (*e.g.*, checking or savings account number). THIS WILL DISTINGUISH THE INDIVIDUAL PAYEE'S ACCOUNT WITH YOU, AND SHOULD BE UNIQUE FOR EACH DOCUMENT SO AS TO IDENTIFY SPECIFIC TRANSACTIONS IF MULTIPLE RETURNS ARE FILED FOR ONE PAYEE. This information is particularly helpful if corrections are filed. This number is also provided with your Invalid/No-TIN notification from the IRS and may help you determine the branch or subsidiary reporting the transaction. YOU ARE STRONGLY ENCOURAGED TO

RECORD NAME: PAYEE "B" RECORD—Continued

SECTOR 1 (Continued)

Diskette Position	Field Title	Length	Description and Remarks
			USE THIS FIELD. Do not define data in this field in packed decimal format. If fewer than twenty characters are required, you may either left-or right-justify, filling the remaining positions with blanks.
45	IRA/SEP Indicator	1	*THIS FIELD IS ONLY USED WHEN REPORTING FORMS 1099-R.* This field will be coded ONLY if you entered a code "1", "2", "3", "4", "5", or "7" in either Position 5 or 6, Document Specific Code, of Sector 1 of the Payee "B" Record, *AND* you are reporting a distribution of an IRA or SEP. Enter the appropriate indicator from the table below. *Indicator* — *Usage* 1 — You are reporting an IRA or SEP Distribution. Blank — You are NOT reporting an IRA or SEP Distribution.
46-47	Percentage of Total Distribution	2	THIS FIELD IS ONLY USED WHEN REPORTING FORMS 1099-R, and ONLY if you are reporting a total distribution to more than one person. This field is only two (2) positions in length because when a total distribution is made to more than one person, the figure MUST be 99% or less. 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% will be 10%; 10.5% or more will be 11%). Enter the percentage received by the person whose TIN in included in positions 16-24 of Sector 1 of the "B" Record. This field must be right-justified, and unused positions must be zero filled. If not applicable, enter blanks. You need not enter a percentage for IRA or SEP distributors.
48-51	Blank	4	Enter blanks.
	Payment Amount Fields (Must be numeric)		REQUIRED. You must allow for all payment amounts. For those not used you will enter zeros. For example: If position 23 of Sector 1 of the Payer/Transmitter "A" Record is "7" (for 1099-PATR) and Sector 1, positions 24-32 are "247bbbbbb", this indicates that you will be reporting 3 actual payment amounts in the following Payee "B" Records. *Payment Amount 1 of Sector 1* will be all "0" (zeros); *Payment Amount 2 of Sector 1* will represent Nonpatronage distributions; *Payment Amount 3 of Sector 1* will be all "0" (zeros); *Payment Amount 4 of Sector 1* will represent Federal income tax withheld; *Payment Amounts 5 and 6 of Sector 1* will be all "0" (zeros); *Payment Amount 7 of Sector 1* will be energy investment credit; and, *Payment Amounts 8 and 9 of Sector 2* will be all "0" (zeros). Each payment field must contain 10 numeric characters (see Note). Each payment amount must be entered in U.S. dollars and cents. The rightmost 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 "+" or "−" (minus sign) in the leftmost position of the payment amount field. A negative over-punch in the units position may be used, instead

RECORD NAME: PAYEE "B" RECORD—Continued

SECTOR 1 (Continued)

Diskette Position	Field Title	Length	Description and Remarks
			of a minus sign, to indicate a negative amount. If a plus sign, minus sign, or negative overpunch is not used, the number is assumed to be positive. 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: If any one payment amount exceeds "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 amounts. DO NOT SPLIT THIS FIGURE IN HALF.
52-61	Payment* Amount 1	10	The amount reported in this field represents payments for Amount Code 1 in the Payer/Transmitter "A" Record.
62-71	Payment* Amount 2	10	The amount reported in this field represents payments for Amount Code 2 in the Payer/Transmitter "A" Record.
72-81	Payment* Amount 3	10	The amount reported in this field represents payments for Amount Code 3 in the Payer/Transmitter "A" Record.
82-91	Payment* Amount 4	10	The amount reported in this field represents payments for Amount Code 4 in the Payer/Transmitter "A" Record.
92-101	Payment* Amount 5	10	The amount reported in this field represents payments for Amount Code 5 in the Payer/Transmitter "A" Record.
102-111	Payment* Amount 6	10	The amount reported in this field represents payments for Amount Code 6 in the Payer/Transmitter "A" Record.
112-121	Payment* Amount 7	10	The amount reported in this field represents payments for Amount Code 7 in the Payer/Transmitter "A" Record.

*If there are discrepancies between these Payment Amount Codes and the boxes on the paper forms, the instructions in this revenue procedure govern.

122-128	Blank	7	Enter blanks.
SECTOR 2			
1	Record Sequence	1	REQUIRED. Must be a "2". It is used to sequence the sectors making up a PAYEE Record.
2	Record Type	1	REQUIRED. Enter "B".
3-12	Payment Amount 8	10	The amount reported in this field represents payments for Amount Code 8 in the Payer/Transmitter "A" Record.
13-22	Payment Amount 9	10	The amount reported in this field represents payments for Amount Code 9 in the Payer/Transmitter "A" Record.
23-42	Blank	20	Enter blanks.
43	Foreign Country Indicator	1	REQUIRED. If the payee address is in a foreign country, enter a "1" in this field. This will allow you to use any format for the Payee Address, City, State and ZIP Code. Address information must not appear in the First or Second Payee Name Lines. If the address for the payee is a U.S. address, you must enter a blank in this field. The free address format may only be used

RECORD NAME: PAYEE "B" RECORD—Continued

SECTOR 2 (Continued)

Diskette Position	Field Title	Length	Description and Remarks
			for foreign addresses. For U.S. addresses, you must use the U.S. Postal Service state abbreviations in diskette positions 72 and 73 of Sector 3 of the "B" Record. These abbreviations are provided in Part A, Sec. 18.
44–83	First Payee Name Line	40	REQUIRED. Do not enter address information in this field. Enter the name of the payee (preferably surname (last name) first) whose Taxpayer Identification Number appears in Sector 1, positions 16–24 of the "B" Record. If fewer than 40 characters are required, 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 Taxpayer Identification Number has been provided may be entered in this field. The names of the other payees should be entered 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 FILER). The "B" RECORD WILL REFLECT THE INDIVIDUAL PAYING THE INTEREST (THE BORROWER/PAYER OF RECORD) AND THE AMOUNT PAID. FOR FORMS 1099-S, THE "B" RECORD WILL REFLECT THE SELLER INFORMATION.
84–123	Second Payee Name Line	40	If the payee name requires more space than is available in the First Payee Name Line, enter only the remaining portion of the name in this field. If there are multiple payees (e.g., partners or joint owners), we encourage you to use this field for those payees' names not associated with the Taxpayer Identification Number in Sector 1, positions 16–24 of the "B" Record. Do not enter address information in this field. IT IS IMPORTANT THAT YOU PROVIDE AS MUCH PAYEE INFORMATION TO IRS AS POSSIBLE TO IDENTIFY THE OWNER OF THE TAXPAYER IDENTIFICATION NUMBER (TIN). Left-justify and fill unused positions with blanks. FILL WITH BLANKS IF NO ENTRIES ARE PRESENT FOR THIS FIELD.
124–128	Blank	5	Enter blanks.
SECTOR 3			
1	Record Sequence	1	REQUIRED. Must be a "3". Used to sequence the sectors making up a PAYEE Record.
2	Record Type	1	REQUIRED. Enter "B".
3–42	Payee Mailing Address	40	REQUIRED. Enter mailing address of payee. Left-justify and fill unused positions with blanks. The address MUST be present. This field MUST NOT contain any data other than the payee's mailing address. Any format can be used in reporting a foreign mailing address.

For U.S. addresses, the Payee City, Payee State and Payee ZIP Code must be reported as a 29, 2 and 9 position field, respectively. For foreign addresses, the Payee City, Payee State (Country) and Payee ZIP Code can be reported as a continuous 40 position field. When reporting a foreign address, the Foreign Country Indicator must contain a "1."

RECORD NAME: PAYEE "B" RECORD—Continued

SECTOR 3 (Continued)

Diskette Position	Field Title	Length	Description and Remarks
43–71	Payee City	29	REQUIRED. Enter the city, left-justified and fill the unused positions with blanks. Do not enter state and ZIP Code information in this field.
72–73	Payee State	2	REQUIRED. Enter the abbreviation for the state as shown in Part A, Sec. 18. You MUST use valid U.S. Postal Service state abbreviations for U.S. addresses.
74–82	Payee ZIP Code	9	REQUIRED. Enter the valid 9 digit ZIP Code assigned by the U.S. Postal Service. If only the first 5 digits are known, left-justify and fill the unused positions with blanks. Use this field for the ZIP Code only. For foreign countries, alpha characters are acceptable as long as you have entered a "1" in the Foreign Country Indicator field which is located in Sector 2, position 43 of the "B" Record.
83–128	Blank	46	Enter blanks.
SECTOR 4	THE FOLLOWING FIELD DESCRIPTIONS DESCRIBE THE RECORD POSITIONS FOR SECTOR 4 OF THE PAYEE "B" RECORD FOR FORMS 1098, 1099-DIV, 1099-G, 1099-INT, 1099-MISC, 1099-PATR, 1099-R, AND 5498. IF YOU ARE NOT A COMBINED FEDERAL/STATE FILER, OR IF YOU ARE NOT UTILIZING THE SPECIAL DATA ENTRIES FIELD, SECTOR 4 CAN BE ELIMINATED FOR ALL "B" RECORDS EXCEPT FORMS 1099-A, 1099-B, 1099-OID, 1099-S, AND W-2G. SEE PART B, SEC. 8, 9, 10, 11 and 12 FOR THE FIELD DESCRIPTIONS FOR SECTOR 4 OF FORMS 1099-A, 1099-B, 1099-OID, 1099-S AND W-2G.		
1	Record Sequence	1	REQUIRED. Must be a "4". Used to sequence the sectors making up a PAYEE Record.
2	Record Type	1	REQUIRED. Enter "B".
3–69	Special Data Entries	67	This portion of the Payee "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact their state or local revenue departments for filing requirements. If this field is not utilized, ENTER BLANKS.
70–71	Combined Federal/State Code	2	If a 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 states NOT participating in this program or for Form 1098, ENTER BLANKS.
72–128	Blank	57	Enter blanks.

SEC. 7. PAYEE "B" RECORD—RECORD LAYOUTS FOR SECTORS 1 THROUGH 4 OF FORMS 1098, 1099-DIV, 1099-G, 1099-INT, 1099-MISC, 1099-PATR, 1099-R, 5498 AND SECTORS 1 THROUGH 3 OF FORMS 1099-A, 1099-B, 1099-OID, 1099-S, AND W-2G

Sector 1

RECORD SEQUENCE	RECORD TYPE	PAYMENT YEAR	DOCUMENT SPECIFIC CODE	BLANK	CORRECTED RETURN INDICATOR
1	2	3–4	5–6	7	8

PAYEE "B" RECORD—RECORD LAYOUTS—Continued

Sector 1 (Continued)

NAME CONTROL	BLANK	TYPE OF TIN*	TAXPAYER IDENTIFICATION NUMBER*	PAYER'S ACCOUNT NUMBER FOR PAYEE*	IRA/SEP INDICATOR
9-12	13-14	15	16-24	25-44	45

PERCENTAGE OF TOTAL DISTRIBUTION	BLANK	PAYMENT AMOUNT ONE	PAYMENT AMOUNT TWO	PAYMENT AMOUNT THREE	PAYMENT AMOUNT FOUR
46-47	48-51	52-61	62-71	72-81	82-91

PAYMENT AMOUNT FIVE	PAYMENT AMOUNT SIX	PAYMENT AMOUNT SEVEN	BLANK
92-101	102-111	112-121	122-128

Sector 2

RECORD SEQUENCE	RECORD TYPE	PAYMENT AMOUNT EIGHT	PAYMENT AMOUNT NINE	BLANK	FOREIGN COUNTRY INDICATOR
1	2	3-12	13-22	23-42	43

FIRST PAYEE NAME LINE*	SECOND PAYEE NAME LINE*	BLANK
44-83	84-123	124-128

Sector 3

RECORD SEQUENCE	RECORD TYPE	PAYEE MAILING ADDRESS*	PAYEE CITY*	PAYEE STATE*	PAYEE ZIP CODE*	BLANK
1	2	3-42	43-71	72-73	74-82	83-128

Sector 4 (See Part B, Sec. 8, 9, 10, 11 and 12 for the Record Layouts for Sector 4 of Forms 1099-A, 1099-B, 1099-OID, 1099-S, and W-2G.)

RECORD SEQUENCE	RECORD TYPE	SPECIAL DATA ENTRIES	COMBINED FEDERAL/ STATE CODE	BLANKS
1	2	3-69	70-71	72-128

*When reporting Form 1098, Mortgage Interest Statement, the "B" Record will reflect the individual paying the interest (the borrower/payer of record) and the amount paid. For Forms 1099-S, the "B" Record will reflect the seller information.

SEC. 8. PAYEE "B" RECORD— FIELD DESCRIPTIONS AND RECORD LAYOUT FOR SECTOR 4 OF FORM 1099-A

.01 This section contains information pertaining to Sector 4 of Form 1099-A. For detailed explanations of the 1099-A fields see the 1990 "Instructions for Forms 1099, 1098, 5498, and W-2G" included in your reporting package.

.02 See Part B. Sec. 6 for field descriptions of Sectors 1, 2 and 3 of the Payee "B" Record for Form 1099-A.

.03 FORM 1099-A CANNOT BE FILED UNDER THE COMBINED FEDERAL/STATE FILING PROGRAM.

RECORD NAME: PAYEE "B" RECORD—Continued
FORM 1099-A—SECTOR 4 ONLY

SECTOR 4			
1	Record Sequence	1	REQUIRED. Must be a "4". Used to sequence the sectors making up a PAYEE Record.
2	Record Type	1	REQUIRED. Enter "B".
3–23	Special Data Entries	21	This portion of the payee "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact their state or local revenue departments for filing requirements. If this field is not utilized, ENTER BLANKS.
24–29	Date of Lender's Acquisition or Knowledge of Abandonment	6	*REQUIRED FOR FORMS 1099-A ONLY.* Enter the date of the acquisition of the secured property or the date you first knew or had reason to know that the property was abandoned in the format MMDDYY (*e.g.*, 102490). DO NOT ENTER HYPHENS OR SLASHES.
30	Liability Indicator	1	*REQUIRED FOR FORM 1099-A ONLY.* Enter the appropriate indicator from the table below: *Indicator* — *Usage* 1 — Borrower is personally liable for repayment of the debt. Blank — Borrower is not liable for repayment of the debt.
31–69	Description	39	*REQUIRED FOR FORM 1099-A ONLY.* Enter a brief description of the property. For example, 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-1988 Buick Regal or Office Equipment). Enter "CCC" for crops forfeited on Commodity Credit Corporation Loans. If fewer than 39 positions are required, left-justify and fill unused positions with blanks.
70–128	Blank	59	Enter blanks.

PAYEE "B" RECORD—RECORD LAYOUT FOR SECTION 4 OF FORM 1099-A

Sector 4—Form 1099-A

RECORD SEQUENCE	RECORD TYPE	SPECIAL DATA ENTRIES	DATE OF LENDER'S ACQUISITION	LIABILITY INDICATOR
1	2	3–23	24–29	30

DESCRIPTION	BLANK
31–69	70–128

SEC. 9. PAYEE "B" RECORD—FIELD DESCRIPTIONS AND RECORD LAYOUT FOR SECTOR 4 OF FORM 1099-B

.01 This section contains the general payment information for Sector 4 of Form 1099-B. For detailed explanations of the 1099-B fields see the 1990 "Instructions for Forms 1099, 1098, 5498, and W-2G" included in your reporting package.

.02 See Part B, Sec. 6 for field descriptions for Sectors 1, 2 and 3 of the Payee "B" Record for Form 1099-B.

.03 FORM 1099-B CANNOT BE FILED UNDER THE COMBINED FEDERAL/ STATE FILING PROGRAM.

RECORD NAME: PAYEE "B" RECORD—Continued
FORM 1099-B—SECTOR 4 ONLY

SECTOR 4

Diskette Position	Field Title	Length	Description and Remarks
1	Record Sequence	1	REQUIRED. Must be a "4". Used to sequence the sectors making up a PAYEE Record.
2	Record Type	1	REQUIRED. Enter "B".
3-12	Special Data Entries	10	This portion of the payee "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact their state or local revenue departments for filing requirements. If this field is not utilized, ENTER BLANKS.
13	Gross Proceeds Reported to IRS Indicator	1	*REQUIRED FOR FORM 1099-B ONLY.* Enter appropriate indicator from the table below. If this field is not utilized, ENTER BLANKS. *Indicator* — *Usage* 1 — Gross Proceeds 2 — Gross Proceeds less commission and option premiums.
14-19	Date of Sale	6	*REQUIRED FOR FORM 1099-B ONLY.* For broker transactions, enter the trade date of the transaction in the format MMDDYY (*e.g.*, 102490). For barter exchanges, enter the date cash, property, a credit, or scrip is actually or constructively received. Enter blanks if this is an aggregate transaction. DO NOT ENTER HYPHENS OR SLASHES.
20-32	CUSIP Number	13	*REQUIRED FOR FORM 1099-B ONLY.* For broker transactions only, enter the CUSIP (Committee on Uniform Security Identification Procedures) number of the item reported for Amount Indicator "2" (Stocks, bonds, etc.). Enter blanks if this is an aggregate transaction. Enter "0" (zeros) if the number is not available or applicable. For CUSIP numbers with less than 13 characters, right-justify and fill the remaining positions with blanks.
33-71	Description	39	REQUIRED FOR FORM 1099-B ONLY. Enter a brief description of the item or services for which the proceeds are being reported. If fewer than 39 characters are required, left-justify and fill unused positions with blanks. For regulated futures contracts, enter "RFC" and any amount subject to backup withholding. Enter blanks if this is an aggregate transaction.
72-128	Blank	57	Enter blanks.

PAYEE "B" RECORD—RECORD LAYOUT FOR SECTOR 4 OF FORM 1099-B

Sector 4—1099-B

RECORD SEQUENCE	RECORD TYPE	SPECIAL DATA ENTRIES	GROSS PROCEEDS INDICATOR	DATE OF SALE	CUSIP NUMBER
1	2	3-12	13	14-19	20-32

DESCRIPTION	BLANK
33-71	72-128

SEC. 10. PAYEE "B" RECORD—FIELD DESCRIPTIONS AND RECORD LAYOUT FOR SECTOR 4 OF FORM 1099-OID

.01 This section contains information pertaining to Sector 4 of Form 1099-OID. For detailed explanations of the 1099-OID fields see the 1990 "Instructions for Forms 1099, 1098, 5498, and W-2G" included in your reporting package.

.02 See Part B, Sec. 6 for field descriptions of Sectors 1, 2 and 3 of the Payee "B" Record for Form 1099-OID.

RECORD NAME: PAYEE "B" RECORD
FORM 1099-OID—SECTOR 4 ONLY

SECTOR 4

Diskette Position	Field Title	Length	Description and Remarks
1	Record Sequence	1	REQUIRED. Must be a "4". Used to sequence the sectors making up a PAYEE Record.
2	Record Type	1	REQUIRED. Enter "B".
3-30	Special Data	28	This portion of the payee "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact their state or local revenue departments for filing requirements. If this field is not utilized, ENTER BLANKS.
31-69	Description	39	*REQUIRED FOR FORM 1099-OID ONLY.* Enter identification number (CUSIP number) or description of the obligation. The description may include the stock exchange, issuer, coupon rate, and year of maturity. If fewer than 39 characters are required, left-justify and fill unused positions with blanks.
70-71	Combined Federal/ State Code	2	If a 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 states NOT participating in this program, ENTER BLANKS.
72-128	Blank	57	Enter blanks.

PAYEE "B" RECORD—RECORD LAYOUT FOR SECTOR 4 OF FORM 1099-OID

Sector 4—1099-OID

RECORD SEQUENCE	RECORD TYPE	SPECIAL DATA ENTRIES	DESCRIPTION	COMBINED FEDERAL/ STATE CODE	BLANK
1	2	3-30	31-69	70-71	72-128

SEC. 11. PAYEE "B" RECORD—FIELD DESCRIPTIONS AND RECORD LAYOUT FOR SECTOR 4 OF FORM 1099-S

.01 This section contains the general payment information for Sector 4 of Form 1099-S. For detailed explanations of the 1099-S fields see the 1990 "Instructions for Forms 1099, 1098, 5498, and W-2G," included in your reporting package.

.02 See Part B, Sec. 6 for field descriptions for Sectors 1, 2 and 3 of the Payee "B" Record for Form 1099-S.

.03 FORM 1099-S CANNOT BE FILED UNDER THE COMBINED FEDERAL/STATE FILING PROGRAM.

RECORD NAME: PAYEE "B" RECORD
FORM 1099-S—SECTOR 4 ONLY

SECTOR 4

Diskette Position	Field Title	Length	Description and Remarks
1	Record Sequence	1	REQUIRED. Must be a "4". Used to sequence the sectors making up a PAYEE Record.
2	Record Type	1	REQUIRED. Enter "B".
3-25	Special Data Entries	23	This portion of the payee "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact their state or local revenue departments for filing requirements. If this field is not utilized, ENTER BLANKS.
26-31	Date of Closing	6	*REQUIRED FOR FORM 1099-S ONLY.* Enter the closing date in the format MMDDYY (*e.g.*, 102490). DO NOT ENTER HYPHENS OR SLASHES.
32-70	Description	39	*REQUIRED FOR FORM 1099-S ONLY.* Enter the address of the property transferred or a legal description of the property. If you are entering an address, include the state and ZIP code where this property is located. If fewer than 39 positions are required, left-justify and fill unused positions with blanks.
71	Property or Services Received	1	*REQUIRED FOR FORM 1099-S ONLY.* If the transferor received or will receive property (other than cash) or services as part of the consideration for the property transferred, enter "1." Otherwise, enter "Blank."
72-128	Blank	57	Enter blanks.

PAYEE "B" RECORD—RECORD LAYOUT FOR SECTOR 4 OF FORM 1099-S

Sector 4—1099-S

RECORD SEQUENCE	RECORD TYPE	SPECIAL DATA ENTRIES	DATE OF CLOSING	DESCRIPTION
1	2	3-25	26-31	32-70

PROPERTY OR SERVICES RECEIVED	BLANK
71	72-128

SEC. 12. PAYEE "B" RECORD—FIELD DESCRIPTIONS AND RECORD LAYOUT FOR SECTOR 4 OF FORM W-2G.

.01 This section contains the general payment information for Sector 4 of Form W-2G. For detailed explanations of the W-2G fields see the 1990 "Instructions for Forms 1099, 1098, 5498, and W-2G" included in your reporting package.

.02 See Part B, Sec. 6 for field descriptions for Sectors 1, 2 and 3 of the Payee "B" Record for Form W-2G.
.03 FORM W-2G CANNOT BE FILED UNDER THE COMBINED FEDERAL/STATE FILING PROGRAM.

RECORD NAME: PAYEE "B" RECORD
FORM W-2G—SECTOR 4 ONLY

SECTOR 4

Diskette Position	Field Title	Length	Description and Remarks
1	Record Sequence	1	REQUIRED. Must be a "4". Used to sequence the sectors making up a PAYEE Record.
2	Record Type	1	REQUIRED. Enter "B".
3–8	Date Won	6	*REQUIRED FOR FORM W-2G ONLY.* Enter the date of the winning event in the format MMDDYY (e.g., 102490). This is not the date the money was paid, if paid after the date of the race (or game). DO NOT ENTER HYPHENS OR SLASHES.
9–23	Transaction	15	*REQUIRED FOR FORM W-2G ONLY.* If applicable, the ticket number, card number (and color, if applicable), machine serial number or any other information that will help identify the winning transaction. Not applicable for horse and dog racing, jai alai, and certain other wagering transactions, sweepstakes, wagering pools, and certain lotteries. If no entry, enter blanks.
24–28	Race	5	*REQUIRED FOR FORM W-2G ONLY.* If applicable, the race (or game) applicable to the winning ticket. If no entry, enter blanks.
29–33	Cashier	5	*REQUIRED FOR FORM W-2G ONLY.* If applicable, the initials of the cashier making the winning payment. If no entry, enter blanks.
34–38	Window	5	*REQUIRED FOR FORM W-2G ONLY.* The window number or location of the person paying the winnings. If no entry, enter blanks.
39–53	First ID	15	*REQUIRED FOR FORM W-2G ONLY.* If applicable, the first identification number of the person receiving the winnings. If no entry, enter blanks.
54–68	Second ID	15	*REQUIRED FOR FORM W-2G ONLY.* If applicable, the second identification number of the person receiving the winnings. If no entry, enter blanks.
69–128	Blank	60	Enter blanks.

PAYEE "B" RECORD—RECORD LAYOUT FOR SECTOR 4 OF FORM W-2G

Sector 4—W-2G

RECORD SEQUENCE	RECORD TYPE	DATE WON	TRANSACTION	RACE	CASHIER
1	2	3–8	9–23	24–28	29–33

WINDOW	FIRST ID	SECOND ID	BLANK
34–38	39–53	54–68	69–128

SEC. 13. END OF PAYER "C" RECORD

.01 The "C" Record consists of 2 Sectors of 128 positions each. The Control Total fields are each 15 positions in length.

.02 The End of Payer "C" Record is a summary record for a type of return for a given payer.

.03 The "C" Record will contain the total number of payees and the totals of the payment amount fields filed by a given payer. The "C" Record MUST be written after the last Payee "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.

.04 In developing the "C" Record, for example, if you 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 27–41, 57–86, and 102–116 of Sector 1 and positions 3–32 of Sector 2 would be zero filled.

.05 Payers/Transmitters must verify the accuracy of the totals in the "C" Record and must enter the totals on the Forms 4804, 4802, or computer-generated substitute, which will accompany the shipment. The lines used on Forms 4804 and 4802 to record payment amounts correspond with the Amount Codes used in the "A" Record.

.06 Missing or incorrect End of Payer "C" Records will result in the diskette being returned for correction.

RECORD NAME: END OF PAYER "C" RECORD

SECTOR 1

Diskette Position	Field Title	Length	Description and Remarks
1	Record Sequence	1	REQUIRED. Must be a "1". Used to sequence the sectors making up a PAYER Record.
2	Record Type	1	REQUIRED. Enter "C".
3-8	Number of Payees	6	REQUIRED. Enter the total number of Payee "B" Records covered by the preceding Payer/Transmitter "A" Record. Right-justify and zero fill.
9-11	Blank	3	Enter blanks.

REQUIRED. If any corresponding Payment Amount fields are present in the Payee "B" Records, accumulate into the appropriate Control Total fields. CONTROL TOTALS MUST BE RIGHT-JUSTIFIED, AND UNUSED CONTROL TOTAL FIELDS MUST BE ZERO FILLED. Please note that all Control Total fields are 15 positions in length.

12-26	Control Total 1	15	
27-41	Control Total 2	15	
42-56	Control Total 3	15	
57-71	Control Total 4	15	
72-86	Control Total 5	15	
87-101	Control Total 6	15	
102-116	Control Total 7	15	
117-128	Blank	12	Enter blanks.

SECTOR 2

Diskette Position	Field Title	Length	Description and Remarks
1	Record Sequence	1	REQUIRED. Must be a "2". Used to sequence the sectors making up a PAYER Record.
2	Record Type	1	REQUIRED. Enter "C".
3-17	Control Total 8	15	
18-32	Control Total 9	15	
33-128	Blank	96	Enter blanks.

END OF PAYER "C" RECORD—RECORD LAYOUT

Sector 1

RECORD SEQUENCE	RECORD TYPE	NUMBER OF PAYEES	BLANK	CONTROL TOTAL 1	CONTROL TOTAL 2
1	2	3–8	9–11	12–26	27–41

Sector 1 (Continued)

CONTROL TOTAL 3	CONTROL TOTAL 4	CONTROL TOTAL 5	CONTROL TOTAL 6	CONTROL TOTAL 7	BLANK
42–56	57–71	72–86	87–101	102–116	117–128

Sector 2

RECORD SEQUENCE	RECORD TYPE	CONTROL TOTAL 8	CONTROL TOTAL 9	BLANK
1	2	3–17	18–32	33–128

SEC. 14. STATE TOTALS "K" RECORD

.01 The "K" Record consists of 2 Sectors of 128 positions each. The Control Total fields are each 15 positions in length.

.02 The State Totals "K" Record is a summary for a given payer and type of return to a given state in the Combined Federal/State Filing Program. Use 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 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 you 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 on this program.

RECORD NAME: STATE TOTALS "K" RECORD

SECTOR 1

Diskette Position	Field Title	Length	Description and Remarks
1	Record Sequence	1	REQUIRED. Must be a "1". Used to sequence the sectors making up a PAYER Record.
2	Record Type	1	REQUIRED. Enter "K".
3–8	Number of Payees	6	REQUIRED. Enter the total number of Payee "B" Records being coded for this state. Right-justify and zero fill.
9–11	Blank	3	Enter blanks.
	REQUIRED. If any corresponding Payment Amount fields are present in the Payee "B" Records, accumulate into the appropriate Control Total fields. CONTROL TOTALS MUST BE RIGHT-JUSTIFIED, AND UNUSED CONTROL TOTAL FIELDS MUST BE ZERO FILLED. Please note that all Control Total fields are 15 positions in length.		
12–26	Control Total 1	15	
27–41	Control Total 2	15	
42–56	Control Total 3	15	
57–71	Control Total 4	15	
72–86	Control Total 5	15	
87–101	Control Total 6	15	
102–116	Control Total 7	15	
117–128	Blank	12	Enter blanks.

RECORD NAME: STATE TOTALS "K" RECORD—Continued

SECTOR 2

Diskette Position	Field Title	Length	Description and Remarks
1	Record Sequence	1	REQUIRED. Must be a "2". Used to sequence the sectors making up a PAYER Record.
2	Record Type	1	REQUIRED. Enter "K".
3-17	Control Total 8	15	
18-32	Control Total 9	15	
33-126	Blank	94	Enter blanks.
127-128	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.)

END OF PAYER "K" RECORD—RECORD LAYOUT

Sector 1

RECORD SEQUENCE	RECORD TYPE	NUMBER OF PAYEES	BLANK	CONTROL TOTAL 1	CONTROL TOTAL 2
1	2	3-8	9-11	12-26	27-41

CONTROL TOTAL 3	CONTROL TOTAL 4	CONTROL TOTAL 5	CONTROL TOTAL 6	CONTROL TOTAL 7	BLANK
42-56	57-71	72-86	87-101	102-116	117-128

END OF PAYER "K" RECORD—RECORD LAYOUT—Continued

Sector 2

RECORD SEQUENCE	RECORD TYPE	CONTROL TOTAL 8	CONTROL TOTAL 9	BLANK	COMBINED FEDERAL/ STATE CODE
1	2	3-17	18-32	33-126	127-128

SEC. 15. END OF TRANSMISSION "F" RECORD

.01 The "F" Record consists of one 128-position Sector. 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

Diskette Position	Field Title	Length	Description and Remarks
1	Record Type	1	REQUIRED. Enter "F".
2-5	Number of "A" Records	4	You may enter the total number of Payer/Transmitter "A" Records in the entire file. Right-justify and zero fill or enter all zeros.
6-30	Zero	25	Enter zeros.
31-128	Blank	98	Enter blanks.

END OF TRANSMISSION "F" RECORD—RECORD LAYOUT

Sector 1

RECORD TYPE	NUMBER OF "A" RECORDS	ZERO	BLANK
1	2-5	6-30	31-128

PART C. DOUBLE DENSITY DISKETTE SPECIFICATIONS

SECTION 1. GENERAL

.01 The specifications contained in this part of the revenue procedure describe the required format and contents of the records to be included in a double density diskette file. These specifications must be adhered to unless deviations have been specifically granted by IRS.

.02 To be compatible, a double density diskette file must meet the following specifications in total:

(a) 8 inches in diameter.

(b) Recorded in EBCDIC.

(c) Contains 77 cylinders (A cylinder refers to both of the tracks available to the read/write heads at any of the 77 locations on the double sided, double density diskette).

(1) Cylinder 00 is the index cylinder (the operating system reserves cylinder 00 for the directory information and writes the file name and location in the directory; data cannot be written in cylinder 00).

(2) Cylinders 1-74 are the primary data cylinders.

(3) Cylinders 75 and 76 are reserved for alternate cylinder assignment.

(d) Each track contains 26 sectors; therefore, each cylinder contains 52 sectors.

(e) Each sector must contain 256 bytes.

(f) Data may be recorded on both sides of the diskette.

(g) IRS can process single sided, single density, soft sectored diskettes as well as double sided, double density, soft sectored diskettes.

Part B provides specifications for single density diskettes which have sectors of 128 bytes.

(h) An IBM 5360 compatible diskette would meet the above specifications. If using other processors, data should be recorded in the Basic Data Exchange (EBCDIC) format.

(i) Hard sectored diskettes are not compatible.

(j) A diskette should be clearly marked as to which type of data (single sided/single density or double sided/double density) is on each diskette, and preferably, the entire file should consist of either all single sided/single density or all double sided/double density diskettes. .03 Refer to Part B, Sec. 1.03 through Sec. 2 for further information concerning diskette requirements which apply to both single and double density diskettes.

SEC. 2. PAYER/TRANSMITTER "A" RECORD

.01 The Payer/Transmitter "A" Record identifies the payer and transmitter of the diskette 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 appearing on a diskette will depend on the number of payers and the different types of returns being reported. The payment amounts for one payer for one type of return must 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 you are filing Form 1099-DIV to report Amount Codes 1, 2 and 3, all three amount codes must be reported under one "A" Record, not three separate "A" Records. For Payee "B" Records which do not contain payment amounts for all three amount codes, enter zeros for those which have no payment to be reported.

.04 After the header label on the diskette (See Part B, Sec. 2, for format of the header label), the first record appearing in the file MUST be an "A" Record. When a double density diskette is used, each "A" Record will consist of at least one 256 position sector; however, if you are transmitting for someone other than yourself, 2 sectors are required.

.05 A transmitter may include Payee "B" Records for more than one payer on a diskette; however, each GROUP of Payee "B" Records must be preceded by an "A" Record.

.06 A single diskette may also contain different types of returns, but the returns MUST NOT be intermingled. A separate "A" Record is required for each payer and each type of return being reported. An "A" Record may be blocked with "B" Records; however, the initial record on a file must be an "A" Record. IRS will accept an "A" Record after a "C" Record.

.07 All alpha characters entered in the "A" Record should be uppercase.

.08 WHEN REPORTING FORM 1098, MORTGAGE INTEREST STATEMENT, THE "A" RECORD WILL REFLECT THE NAME OF THE RECIPIENT OF THE INTEREST (THE FILER). THE "B" RECORD WILL REFLECT THE INDIVIDUAL PAYING THE INTEREST (BORROWER/PAYER OF RECORD) AND THE AMOUNT PAID.

RECORD NAME: PAYER/TRANSMITTER "A" RECORD

NOTE: For all fields marked REQUIRED, you must provide the information described under Description and Remarks. For fields not marked REQUIRED, you must allow for the field but may be instructed to enter blanks or zeros in the indicated diskette position(s) and for the indicated length. When using double density diskettes, each "A"

RECORD NAME: PAYER/TRANSMITTER "A" RECORD—Continued

Record will consist of at least one 256 position sector; however, if you are transmitting for someone other than yourself, two sectors are required.

SECTOR 1

Diskette Position	Field Title	Length	Description and Remarks
1	Record Sequence	1	REQUIRED. Must be "1". It is used to sequence the sectors making up a PAYER Record.
2	Record Type	1	REQUIRED. Enter "A".
3-4	Payment Year	2	REQUIRED. Enter "90".
5-7	Diskette Sequence Number	3	Sequence number assigned by the Transmitter to each diskette starting with 001. You may choose to enter blanks or zeros in this field. IRS bypasses this information. You must indicate the proper sequence on the external label Form 5064.
8-16	Payer's Federal EIN	9	REQUIRED. Must be the valid 9-digit number assigned to the payer by IRS. DO NOT ENTER BLANKS, HYPHENS, ALPHA CHARACTERS, ALL 9's OR ALL ZEROS. (Also see Part A, Sec. 14.) For foreign corporations not required to have an EIN, this field may be left blank. Foreign corporations should have the Foreign Corporation Indicator set to "1." (See Part A, Sec. 17 for the definition of a Foreign Corporation.)
17-20	Payer Name Control	4	The Payer Name Control can be obtained from the mail label on the Package 1099 which is mailed to most payers on record each December. To distinguish between the Package 1099 and the Magnetic Media Reporting (MMR) package, 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 on magnetic media only, and 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 you have not received a Package 1099 or you do not know your Payer Name Control, this field should be blank filled.
21	Blank	1	Enter blank.
22	Combined Federal/State Filer	1	FORMS 1098, 1099-A, 1099-B, 1099-S, AND W-2G CANNOT BE FILED ON THIS PROGRAM. Enter the appropriate code from the table below: Code — Meaning 1 — Participating in the Combined Federal/State Filing Program blank — Not participating Prior approval is required. A Consent Form 6847 must be submitted to IRS before tax information will be released to the states. (Refer to Part A, Sec. 16, Table 2, for money criteria.) Not all states participate in this program. If the Payer/Transmitter is not participating in the Combined Federal/State Filing Program, enter blank. (Refer to Part A, Sec. 16 for the requirements that *must* be met *prior* to actual participation in this program.) Filers who participate in this program must incorporate state totals into corresponding "K" Records as described in Part C, Sec. 13.

RECORD NAME: PAYER/TRANSMITTER "A" RECORD—Continued

SECTOR 1 (Continued)

Diskette Position	Field Title	Length	Description and Remarks
23	Type of Return	1	REQUIRED. Enter appropriate code from table below: Type of Return — Code 1098 — 3 1099-A — 4 1099-B — B 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
24-32	Amount Indicators	9	REQUIRED. In most cases, the box numbers on paper information returns correspond with the amount codes on magnetic media. However, if discrepancies do occur, the instructions in this revenue procedure govern. For a detailed explanation of the information to be reported in each Amount Code, refer to the 1990 "Instructions for Forms 1099, 1098, 5498, and W-2G," included in your magnetic media reporting package. The amount indicators entered for a given type of return indicate type(s) of payment(s) which were made. For each Amount Code entered in this field, a corresponding payment amount must appear in the Payee "B" Record. Example: If position 23 of the Payer/Transmitter "A" Record is "7" (for 1099-PATR) and positions 24-32 are "247bbbbbb" (b = blanks), this indicates that you will be reporting 3 actual payment amounts in all of the following Payee "B" Records. The first payment amount field in the Payee "B" Record will be all "0" (zeros); the second will represent Nonpatronage distributions; 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 Energy investment credit; and, the eighth and ninth will be all "0" (zeros). Enter the Amount Indicators in ASCENDING SEQUENCE (e.g., 247bbbbbb; b = blanks), left-justify, filling unused positions with blanks. For further clarification of the Amount Indicator codes, contact the IRS/MCC. (See Part A, Sec. 3).
	Amount Indicators Form 1098—Mortgage Interest Statement		For Reporting Interest Received from Payer(s)/Borrower(s) (Payer of Record) on Form 1098- Amount Code — Amount Type 1 — Mortgage interest received from payer(s)/borrower(s)
	Amount Indicators Form 1099-A—Acquisition or Abandonment of Secured Property		For Reporting the Acquisition or Abandonment of Secured Property on Form 1099-A: Amount Code — Amount Type 2 — Balance of principal outstanding

SECTOR 1 (Continued)

Diskette Position	Field Title	Length	Description and Remarks	
			3	Gross foreclosure proceeds
			4	Appraisal value
	Amount Indicators Form 1099-B—Proceeds from Broker and Barter Exchange Transactions		For Reporting Payments on Form 1099-B: Amount Code	Amount Type
			2	Stocks, bonds, etc. (For Forward Contracts see Note)
			3	Bartering (Do not report negative amounts.)
			4	Federal income tax withheld (Backup Withholding)
			6	Profit (or loss) realized in 1990
			7	Unrealized profit (or loss) on open contracts—12/31/89
			8	Unrealized profit (or loss) on open contracts—12/31/90
			9	Aggregate profit (or loss)

NOTE: The Payment Amount field associated with Amount Code 2 may be used to represent a loss when the reporting is for Forward Contracts. Refer to Payee "B" Record—General Field Descriptions, Payment Amount Fields, for instructions on reporting negative amounts. Do not report negative amounts for Amount Codes 3 and 4.

	Amount Indicators 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 equal the sum of Amounts reported in Amount Codes 2, 3, 4 and 5.

	Amount Indicators 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
			4	Federal income tax withheld (Backup Withholding)
			5	Discharge of indebtedness
			6	Taxable grants
			7	Agriculture payments

SECTOR 1 (Continued)

Diskette Position	Field Title	Length	Description and Remarks
	Amount Indicators Form 1099-INT—Interest Income		For Reporting Payments on Form 1099-INT: Amount Code — Amount Type 1 — Earnings from savings and loan associations, credit unions, bank deposits, bearer certificates of deposit, etc. 2 — Early withdrawal penalty 3 — U.S. Savings Bonds, etc. 4 — Federal income tax withheld (Backup Withholding) 5 — Foreign tax paid
	Amount Indicators Form 1099-MISC—Miscellaneous Income		For Reporting Payments on Form 1099-MISC: Amount Code — Amount Type 1 — Rents 2 — Royalties 3 — Prizes, awards, etc. 4 — Federal income tax withheld (Backup Withholding) 5 — Fishing boat proceeds 6 — Medical and health care payments 7 — Nonemployee compensation or Crop Insurance Proceeds (see Note 1) 8 — Substitute payments in lieu of dividends or interest 9 — Direct sales "indicator" (see Note 2)

NOTE 1: Amount Code "7" is normally used to report Nonemployee Compensation. However, Amount Code "7" may also be used to report Crop Insurance Proceeds. If both Nonemployee compensation and Crop Insurance Proceeds are being paid to the same payee, two separate Payee "B" Records are required. See Part B, Sec. 6, Document Specific Code for instructions on how to indicate Crop Insurance Proceeds.

NOTE 2: Use Amount Code "9" to report the occurrence of 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. Refer to the 1990 "Instructions for Forms 1099, 1098, 5498, and W-2G," for specific instructions. Amount Code "9" actually reflects an indicator of direct sales of $5,000 or more and not the actual payment amount. The corresponding payment amount field in the payee "B" Record MUST be 0000000100 to reflect direct sales of $5,000 or more. This does not mean that a payment of $1.00 was made or is being reported.

	Amount Indicators Form 1099-OID—Original Issue Discount		For Reporting Payments on Form 1099-OID: Amount Code — Amount Type 1 — Original issue discount for 1990 2 — Other periodic interest 3 — Early withdrawal penalty 4 — Federal income tax withheld (Backup Withholding)
	Amount Indicators Form 1099-PATR—Taxable Distributions Received From Cooperatives		For Reporting Payments on Form 1099-PATR: Amount Code — Amount Type 1 — Patronage dividends

SECTOR 1 (Continued)

Diskette Position	Field Title	Length	Description and Remarks	
			2	Nonpatronage distributions
			3	Per-unit retain allocations
			4	Federal income tax withheld (Backup Withholding)
			5	Redemption of nonqualified notices and retain allocations
			6	Investment credit (see Note)
			7	Energy investment credit (see Note)
			8	Jobs credit (see Note)
			9	Low income housing credit (see Note)

NOTE: The amounts shown for Amount Indicators 6, 7, 8 and 9 must be reported to the payee; however, they need not be reported to IRS.

Amount Indicators	For Reporting Payments on Form 1099-R:	
Form 1099-R—Total Distributions from Profit-Sharing, Retirement Plans, Individual Retirement Arrangements, Insurance Contracts, Etc.	Amount Code	Amount Type
	1	Gross distribution
	2	Taxable amount (see Note 1)
	3	Amount in Amount Code 2 eligible for capital gain election
	4	Federal income tax withheld (see Note 2)
	5	Employee contributions or insurance premiums
	6	Net unrealized appreciation in employer's securities
	8	Other
	9	State income tax withheld (see Note 3)

NOTE 1: 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 contribution, enter the value of the stock in Amount Code 1, enter zero (0) in Amount Code 2, and enter the employee's contribution in Amount Code 5.

NOTE 2: See the 1990 "Instructions for Forms 1099, 1098, 5498, and W-2G" for further information concerning the definition of federal income tax withheld for Form 1099-R.

NOTE 3: State income tax withheld has been added for the convenience of the payer but need not be reported to IRS.

Amount Indicators	For Reporting Payments on Form 1099-S:	
Form 1099-S—Proceeds From Real Estate Transactions	Amount Code	Amount Type
	2	Gross Proceeds

Amount Indicators	For Reporting Payments on Form 5498:	
Form 5498—Individual Retirement Arrangement Information (see Note)	Amount Code	Amount Type
	1	Regular IRA contributions made in 1990 and 1991 for 1990
	2	Rollover IRA contributions
	3	Life insurance cost included in Amount Code 1
	4	Fair market value of the account

NOTE: Form 5498 is filed for each person for whom you maintained an Individual Retirement Arrangement (IRA) (including an Individual Retirement Arrangement maintained as part of a Simplified Employee Pension (SEP)) during 1990. Amount Code 4 represents the value of the account. Trustees and issuers of IRAs and SEPs must report the value of accounts in existence during the year, even if no contributions were made during the year. However, if a total distribution was made from an IRA during the year and no contributions were made for that year, you need not file Form 5498 to reflect that the fair market value on December 31 was zero. Do not report employer SEP contributions

SECTOR 1 (Continued)

Diskette Position	Field Title	Length	Description and Remarks

on Form 5498; however, you must report the value of the SEP account. For an IRA, use all applicable Amount Codes. If no IRA contributions were made for 1990, you will only use Amount Code 4. Only IRA contributions to be applied to 1990 that are made between January 1, 1990 and April 15, 1991 are to be reported in Amount Code 1. For further information concerning IRA reporting, see Rev. Proc. 89-52, printed in IR Bulletin 1989-37 on September 11, 1989.

Amount Indicators 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 has been added for the convenience of the payer but need not be reported to IRS.

33-44	Blank	12	Enter blanks.
45-49	Transmitter Control Code (TCC)	5	REQUIRED. Enter the five character alpha/numeric Transmitter Control Code assigned by IRS. You MUST have a TCC to file data on this program. DO NOT ENTER MORE THAN ONE TCC PER FILE.
50	Foreign Corporation Indicator	1	Enter a "1" if the payer is a foreign corporation and income is paid by the corporation to a U.S. resident from sources outside of the United States. (See Part A, Sec. 17 for the definition of a Foreign Corporation.) If the payer is not a foreign corporation, enter a blank. (See Note).

NOTE: Some filers are submitting their files with a "1" coded in Position 50 in all of the records contained on the file, whether the payer is a foreign corporation or not. Records that are coded as foreign corporations are processed differently than those that are coded with a blank in Position 50. If your program automatically codes a "1" in Position 50, all of the records on your file will be processed as foreign corporations. If you erroneously report corporations as foreign, you may be subject to a penalty for providing incorrect information to IRS. Therefore, be sure to code only those records as foreign corporations that should be coded as such.

51-90	First Payer Name	40	REQUIRED. Must be present or files will be returned for correction. Enter the name of the payer whose Federal EIN appears in positions 8-16 of the "A" Record, in the manner in which it is used on other tax returns. Any extraneous information must be deleted from the name line. Left-justify and fill with blanks. (Do not enter the Transfer Agent's name in this field. The Transfer Agent's name should appear in the Second Payer Name field.) NOTE: WHEN REPORTING FORM 1098, MORTGAGE INTEREST STATEMENT, THE "A" RECORD WILL REFLECT THE NAME AND EIN OF THE RECIPIENT OF THE INTEREST (THE FILER). 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 "B" RECORD WILL REFLECT THE SELLER.
91-130	Second Payer Name	40	The contents of this field are dependent upon the TRANSFER AGENT INDICATOR in Sector 1, Position 131. If the Transfer Agent Indicator contains a "1", this field must contain the name of the Transfer Agent. If the Transfer Agent Indicator contains a "0" (zero), this field must contain either a continuation of the First Payer Name field or blanks. Left-

RECORD NAME: PAYER/TRANSMITTER "A" RECORD—Continued

SECTOR 1 (Continued)

Diskette Position	Field Title	Length	Description and Remarks
			justify and fill unused positions with blanks. IF NO ENTRIES ARE PRESENT FOR THIS FIELD, FILL WITH BLANKS. (See Part A, Sec. 17 for a definition of Transfer Agent.)
131	Transfer Agent Indicator	1	REQUIRED. Identifies the entity in the Second Payer Name field. (See Part A, Sec. 17 for a definition of Transfer Agent.) Code — Meaning 1 — The entity in the Second Payer Name field is the Transfer Agent. 0 (zero) — The entity shown is not the Transfer Agent (e.g., the Second Payer Name field contains either a continuation of the First Payer Name field or blanks).
132-171	Payer Shipping Address	40	REQUIRED. If the TRANSFER AGENT INDICATOR in Sector 1, position 131 of this record is a "1" enter the shipping address of the Transfer Agent. Otherwise, enter the shipping address of the payer. Left-justify and fill with blanks.
172-211	Payer City, State and ZIP Code	40	REQUIRED. If the TRANSFER AGENT INDICATOR in Sector 1, position 131 of this Record is a "1", enter the City, State and ZIP Code of the Transfer Agent. Otherwise, enter the City, State and ZIP Code of the payer. Left-justify and fill with blanks.
212-256	Blank	45	Enter blanks.
SECTOR 2—Sector 2 need only be used if the Payer and Transmitter are not the same.			
1	Record Sequence	1	REQUIRED. Must be "2". Used to sequence the sectors making up a PAYER Record.
2	Record Type	1	REQUIRED. Enter "A".
3-82	Transmitter Name	80	REQUIRED. (Only if payer and 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 the transmitter must be reported in the same manner throughout the entire file. Left-justify and fill with blanks. If the payer and transmitter are the same, enter blanks in this field.
83-122	Transmitter Mailing Address	40	REQUIRED. (Only if payer and transmitter are not the same.) Enter the mailing address of the transmitter. Left-justify and fill with blanks. If the payer and transmitter are the same, enter blanks in this field.
123-162	Transmitter City, State and ZIP Code	40	REQUIRED. (Only if the payer and transmitter are not the same.) Enter the City, State and ZIP Code of the transmitter. Left-justify and fill with blanks. If the payer and transmitter are the same, enter blanks in this field.
163-256	Blank	94	Enter blanks.

SEC. 3. PAYER/TRANSMITTER "A" RECORD—RECORD LAYOUT

Sector 1

RECORD SEQUENCE	RECORD TYPE	PAYMENT YEAR	DISKETTE SEQUENCE NUMBER	PAYER'S FEDERAL EIN*	PAYER NAME CONTROL*
1	2	3-4	5-7	8-16	17-20

Sector 1 (Continued)

BLANK	COMBINED FEDERAL/STATE FILER	TYPE OF RETURN	AMOUNT INDICATORS	BLANK
21	22	23	24-32	33-44

Sector 1 (Continued)

TRANSMITTER CONTROL CODE	FOREIGN CORPORATION INDICATOR	FIRST PAYER NAME*	SECOND PAYER NAME*	TRANSFER AGENT INDICATOR
45-49	50	51-90	91-130	131

Sector 1 (Continued)

PAYER SHIPPING ADDRESS*	PAYER CITY, STATE AND ZIP CODE*	BLANK
132-171	172-211	212-256

Sector 2

RECORD SEQUENCE	RECORD TYPE	TRANSMITTER NAME	TRANSMITTER MAILING ADDRESS	TRANSMITTER CITY, STATE AND ZIP CODE	BLANK
1	2	3-82	83-122	123-162	163-256

* WHEN REPORTING FORM 1098, MORTGAGE INTEREST STATEMENT, THE "A" RECORD WILL REFLECT THE NAME AND EIN OF THE RECIPIENT OF THE INTEREST (THE FILER). FOR FORM 1099-S, THE "A" RECORD WILL REFLECT THE PERSON RESPONSIBLE FOR REPORTING THE TRANSACTION.

SEC. 4. PAYEE "B" RECORD—GENERAL INFORMATION FOR ALL FORMS

.01 This section contains the general information concerning the Payee "B" Record for all information returns filed on double sided/double density soft sectored diskettes. For a detailed description of the record refer to the following in Part C:

(a) Sec. 5. PAYEE "B" RECORD—FIELD DESCRIPTIONS FOR SECTORS 1 AND 2 OF FORMS 1098, 1099-DIV, 1099-G, 1099-INT, 1099-MISC, 1099-PATR, 1099-R, 5498 AND SECTOR 1 OF FORMS 1099-A, 1099-B, 1099-OID, 1099-S AND W-2G. (See Part C, Sec. 7, 8, 9, 10 and 11 for field descriptions for Sector 2 of Forms 1099-A, 1099-B, 1099-OID, 1099-S and W-2G.)

(b) Sec. 6. PAYEE "B" RECORD LAYOUTS FOR SECTORS 1 AND 2 OF FORMS 1098, 1099-DIV, 1099-G, 1099-INT, 1099-MISC, 1099-PATR, 1099-R, 5498 AND SECTOR 1 OF FORMS 1099-A, 1099-B, 1099-OID, 1099-S AND W-2G.

(c) Sec. 7. PAYEE "B" RECORD—FIELD DESCRIPTIONS AND RECORD LAYOUT FOR SECTOR 2 OF FORM 1099-A.

(d) Sec. 8. PAYEE "B" RECORD—FIELD DESCRIPTIONS AND RECORD LAYOUT FOR SECTOR 2 OF FORM 1099-B.

(e) Sec. 9. PAYEE "B" RECORD—FIELD DESCRIPTIONS AND RECORD LAYOUT FOR SECTOR 2 OF FORM 1099-OID.

(f) Sec. 10. PAYEE "B" RECORD—FIELD DESCRIPTIONS AND RECORD LAYOUT FOR SECTOR 2 OF FORM 1099-S.

(g) Sec. 11. PAYEE "B" RECORD—FIELD DESCRIPTIONS AND RECORD LAYOUT FOR SECTOR 2 OF FORM W-2G.

For tax year 1990 data, all "B" Records will consist of two sectors of

256 positions each. In the "A" Record, the Amount Indicator Codes that appear in diskette positions 24 through 32 of Sector 1 will be left-justified and blank filled. In the "B" Record, you will allow for all nine payment amount fields and for those not used, enter zeros. For example, if you are reporting on Form 1099-PATR, you will enter a "7" in diskette position 23 of Sector 1 of the "A" Record, Type of Return Indicator field. If you are reporting payments for Amount Codes 2, 4 and 7, then diskette positions 24 through 32 of Sector 1 of the "A" Record will be "247bbbbbb" (b = blanks). In the Payee "B" Record:

Positions 52 through 61 of Sector 1 for Payment Amount 1 will be zeros.

Positions 62-71 of Sector 1 will reflect the actual payment amount to be reported for "Nonpatronage distributions."

Positions 72-81 of Sector 1 for Payment Amount 3 will be zeros.

Positions 82-91 of Sector 1 will reflect the actual payment amount to be reported for "Federal income tax withheld."

Positions 92-111 of Sector 1 for Payment Amounts 5 and 6 will be zeros.

Positions 112-121 of Sector 1 will reflect the actual payment amount to be reported for "Energy investment credit."

Positions 122-141 of Sector 1 for Payment Amounts 8 and 9 will be zeros.

.02 The record layout for Sector 1 will be the same for all "B" Records. Sector 2, however, will be different for Forms 1099-A, 1099-B, 1099-OID, 1099-S and W-2G. Refer to Part C, Sec. 7, 8, 9, 10 and 11 respectively for the record layouts for Sector 2 of these records.

.03 IRS must be able to identify the surname (last name) associated with the TIN (SSN or EIN) furnished on a statement. The specifications below include a field in the payee records called "Name Control" in which the first four characters of the payee's surname or last name are to be entered by the payers. The surname or last name should appear first in the First Payee Name field of all Payee "B" Records; however, if your records have been developed using the first name first, a blank must appear between the first and last names.

.04 If payers are unable to provide the first four characters of the surname, the Name Control Field may be left blank; however, compliance with the following will facilitate IRS computer programs in generating the Name Control.

(a) The surname of the payee whose TIN (SSN or EIN) is shown in the Payee "B" Record should always appear first. If, however, you enter the first name first, you 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 Payee "B" Record, must be present in the First Payee Name field. Surnames of any other payees in the record may be entered in the Second Payee Name field.

.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 filer's own personal use. IRS does not use the data provided in the Special Data Entries field; therefore, the IRS program doesn't check the content or format of the data entered in this field. It is the filer's choice whether or not this field is used. If this field is coded, it will not affect the processing of the Payee "B" Records.

.06 Those filers participating in the Combined Federal/State Filing Program must code their records appropriately for the state to receive the information. The state code appears in Sector 2, positions 180 and 181. The file should also meet the money criteria described in Part A, Sec. 16, Table 2.

.07 Do not code for the states unless prior approval to participate has been granted by IRS. See Part A, Sec. 16, Table 1 for a list of the participating states.

FORMS 1098, 1099-A, 1099-B, 1099-S AND W-2G CANNOT BE FILED UNDER THE COMBINED FEDERAL/STATE FILING PROGRAM. Your files must meet all of the requirements specified in Part A, Sec. 16 in order to participate in this program.

.08 All alpha characters entered in the "B" Record should be uppercase.

.09 Do not use decimal points (.) to indicate dollars and cents.

.10 IRS STRONGLY ENCOURAGES FILERS TO REVIEW THEIR DATA FOR ACCURACY BEFORE SUBMISSION TO PREVENT ISSUANCE OF ERRONEOUS NOTICES TO PERSONS FOR WHOM REPORTS ARE FILED. FILERS SHOULD BE ESPECIALLY CAREFUL THAT THEIR TAXPAYER NAMES, SOCIAL SECURITY NUMBERS (SSNs), ACCOUNT NUMBERS, TYPES OF INCOME AND INCOME AMOUNTS ARE CORRECT.

.11 WHEN REPORTING FORM 1098, MORTGAGE INTEREST STATEMENT, THE "A" RECORD WILL REFLECT THE NAME AND EIN OF THE RECIPIENT OF THE INTEREST (THE FILER). THE "B" RECORD WILL REFLECT THE INDIVIDUAL PAYING THE INTEREST (BORROWER/PAYER OF RECORD) AND THE AMOUNT PAID.

SEC. 5. PAYEE "B" RECORD—FIELD DESCRIPTIONS FOR SECTORS 1 AND 2 OF FORMS 1098, 1099-DIV, 1099-G, 1099-INT, 1099-MISC, 1099-PATR, 1099-R, 5498 AND SECTOR 1 OF FORMS 1099-A, 1099-B, 1099-OID, 1099-S AND W-2G.

.01 For Forms 1099-A, 1099-B, 1099-OID, 1099-S and W-2G, see Part C, Sec. 7, 8, 9, 10 and 11 respectively for the field descriptions and record layouts for Sector 2 of these records.

RECORD NAME: PAYEE "B" RECORD

NOTE: For all fields marked REQUIRED, you must provide the information described under Description and Remarks. For fields not marked REQUIRED, you must allow for the field but may be instructed to enter blanks or zeros in the indicated diskette position(s) and for the indicated length. When using double density diskettes, each "B"

RECORD NAME: PAYEE "B" RECORD—Continued

Record will consist of two 256 position sectors.

SECTOR 1

Diskette Position	Field Title	Length	Description and Remarks
1	Record Sequence	1	REQUIRED. Must be a "1". It is used to sequence the sectors making up a PAYEE Record.
2	Record Type	1	REQUIRED. Enter "B".
3–4	Payment Year	2	REQUIRED. Enter "90".
5–6	Document Specific Code	2	REQUIRED FOR FORMS 1099-R, 1099-MISC, 1099-G, AND W-2G. FOR ALL OTHER FORMS, OR IF NOT USED, ENTER BLANKS. For Form 1099-R, enter the appropriate code(s) for the Distribution Code. More than one code may apply for Form 1099-R; however, if only one code is required, it will be entered in position 5. Position 6 will be blank. NOTE: You *MUST* enter at least one (1) Distribution Code for Form 1099-R. *BLANKS* in *BOTH* positions 5 and 6 are *NOT* acceptable for Form 1099-R.For Form 1099-MISC, position 5 is used to indicate Crop Insurance Proceeds. Position 6 will be blank. For Form 1099-G, enter the year of income tax refund in position 5. Position 6 will be blank. For Form W-2G enter the Type of Wager in position 5. Position 6 will be blank.
	Distribution Code (Form 1099-R)		Use only for reporting on Form 1099-R to identify the Distribution Code. Enter the applicable code from the following table. A "0" (zero) is not a valid code for Form 1099-R. A numeric code MUST be entered in all cases except when Code P or D is used. However, when using Code P for an IRA distribution under section 408(d)(4), you may also enter Code 1, if it applies. If you are reporting a total distribution from a plan that includes a distribution from a DEC, you must report two separate "B" Records; one to report the distribution of DECs and the other to report the distribution from the other part of the plan. In addition, if more than one numeric code is applicable to a distribution, report two separate Payee "B" Records.

Category (See Note)	Code
Early (premature) distribution, no known exception*	1*
Early (premature) distribution, exception applies (as defined in Sec. 72(q), (t), or (v)) other than disability or death	2*
Disability*	3*
Death (includes payments to a beneficiary)*	4*
Prohibited transaction*	5*
Section 1035 Exchange	6
Normal distribution*	7*
Excess contributions plus earnings/excess deferrals (and/or earnings) taxable in 1990	8
PS58 costs	9
Excess contributions plus earnings/excess deferrals taxable in 1989	P
Qualifies for 5-year/10-year averaging	A
Qualifies for death benefit exclusion	B
Qualifies for both A and B	C
Excess contributions plus earnings/excess deferrals taxable in 1988	D

SECTOR 1 (Continued)

Diskette Position	Field Title	Length	Description and Remarks

*If you are reporting a distribution for an IRA or SEP for Codes 1, 2, 3, 4, 5, or 7, you MUST code a "1" in Sector 1, Position 45, of the Payee "B" Record.

NOTE: For detailed explanations of the distribution codes, see the 1990 "Instructions for Form 1099, 1098, 5498, and W-2G" included in your magnetic media reporting packages.

Crop Insurance Proceeds (Form 1099-MISC only)

If the payment amount reported for Amount Code 7 is crop insurance proceeds, enter a "1" in position 5. Position 6 will be blank.

Tax Year of Refund (Form 1099-G only)

Use only for reporting the tax year for which the refund was issued. Enter the NUMERIC year for which the refund was issued (e.g., for 1989 enter 9). However, if the payment amount field associated with Amount Indicator 2, State or Local Income Tax Refunds, contains a refund, credit or offset that is attributable to an income tax which applies exclusively to income from a trade or business and is not of general application, then enter the ALPHA equivalent of the year for which the refund was issued from the table below (e.g., for 1989 enter I). This code should appear in position 5. Position 6 will be blank.

Year for Which Trade or Business Refund was Issued	*Alpha * Equivalent*
1	A
2	B
3	C
4	D
5	E
6	F
7	G
8	H
9	I
0	J

* To be used for trade or business refunds only.

Type of Wager (Form W-2G only)

Use only for reporting the Type of Wager on Form W-2G. This code will appear in position 5. Position 6 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
Casino Type Bingo. DO NOT use this code for any other type of bingo winnings (e.g., church or fire dept.)	6
Slot Machines	7
Any other type of gambling winnings. (This includes church bingo, fire dept. bingo, unlabeled winnings, etc.)	8

7	Blank	1	Enter blank.

RECORD NAME: PAYEE "B" RECORD—Continued

SECTOR 1 (Continued)

Diskette Position	Field Title	Length	Description and Remarks
8	Corrected Return Indicator	1	Diskette position 8 is used to indicate a corrected return. Refer to Part A, Sec. 13 for specific instructions on how to file corrected returns using magnetic media.
9–12	Name Control	4	Enter the first four (4) characters of the surname (last name) of the payee. The surname of the person whose TIN is being reported in positions 16–24 of the "B" Record should be used to determine the Name Control. This is especially important in the case of trustee accounts. IF THE NAME THAT CORRESPONDS TO THE TIN IS NOT INCLUDED IN THE FIRST OR SECOND PAYEE NAME LINE, EVERY EFFORT SHOULD BE MADE TO DEVELOP THE CORRECT NAME CONTROL FOR THE NAME THAT CORRESPONDS TO THE TIN. 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, 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. IF THE NAME CONTROL IS NOT DETERMINABLE BY THE PAYER, LEAVE THIS FIELD BLANK. A dash (-) and ampersand (&) are the only acceptable special characters. (See Part A, Sec. 14 for information on Name Controls.)

The following examples may be helpful to you in developing the name control:

	Name	*Name Control*
Individuals:		
	Jane Brown	BROW
	John A. Lee	LEE*
	James P. En, Sr.	EN*
	John O'Neill	ONEI
	Mary Van Buren	VANB
	Juan De Jesus	DEJE
	Gloria A. El-Roy	EL-R
	Mr. John Smith	SMIT
	Joe McCarthy	MCCA
	Pedro Torres-Lopes	TORR
	Maria Lopez Moreno	LOPE
	Binh To La	LA*
	Nhat Thi Pham	PHAM
	Mark D'Allesandro	DALL
Corporations:		
	The First National Bank	FIRS
	The Hideaway	THEH
	A & B Cafe	A&BC
Sole Proprietor:		
	Jane and Mark Hemlock c/o The Sunshine Club	HEML
Partnership:		
	Robert Aspen and Bess Willow	ASPE
	Harold Fir, Bruce Elm, and Joyce Spruce et al Ptr	FIR*

SECTOR 1 (Continued)

Diskette Position	Field Title	Length	Description and Remarks
			Name — *Name Control*
Estate:			
			Frank White Estate — WHIT
			Sheila Blue Estate — BLUE
Trusts and Fiduciaries:			
			Daisy Corporation Employee Benefit Trust — DAIS
			Trust FBO The Cherryblossom Society — CHER
Labor Organization:			
			Laborer's Union, AFL-CIO — LABO
			St. Bernard's Methodist Church Bldg. Fund — STBE
* Name Controls of less than four (4) significant characters must be left-justified and blank filled.			
13–14	Blank	2	Enter blanks.
15	Type of TIN	1	REQUIRED. This field is used to identify the Taxpayer Identification Number (TIN) in positions 16–24 as either an Employer Identification Number, a Social Security Number, or that the type is undeterminable. Enter the appropriate code from the following table: Type of TIN — TIN — Type of Account 1 — EIN — A business, organization, or other entity that is not an individual 2 — SSN — An individual blank — N/A — If the type of TIN is undeterminable, enter a blank.
16–24	Taxpayer Identification Number	9	REQUIRED. Enter the valid 9-digit Taxpayer Identification Number of the payee (SSN or EIN, as appropriate). If an identification number has been applied for but not received, enter blanks. DO NOT ENTER HYPHENS, ALPHA CHARACTERS, ALL 9's OR ALL ZEROS.
25–44	Payer's Account Number for Payee	20	DO NOT ENTER A TAXPAYER IDENTIFICATION NUMBER IN THIS FIELD. We strongly encourage the payer to use this field to enter the payee's account number which can be any number assigned by the payer to the payee (*e.g.*, checking or savings account number). THIS NUMBER SHOULD BE UNIQUE AND WILL HELP TO DISTINGUISH THE INDIVIDUAL PAYEE'S ACCOUNT, AND WILL HELP IDENTIFY A SPECIFIC TRANSACTION IF MULTIPLE RETURNS ARE FILED FOR ONE PAYEE. This information is helpful if corrected returns are filed. This number is also provided with your Invalid/No-TIN notification from IRS and may help you determine the branch or subsidiary reporting the transaction. YOU ARE STRONGLY ENCOURAGED TO USE THIS FIELD. Do not define data in this field in packed decimal format. If fewer than twenty characters are required, you may either left- or right-justify, filling the remaining positions with blanks.
45	IRA/SEP Indicator	1	*This field is only used when reporting Forms 1099–R.* This field will be coded ONLY if you entered a code 1, 2, 3, 4, 5, or 7 in either Position 5 or 6, Document Specific Code, of Sector 1 of

RECORD NAME: PAYEE "B" RECORD—Continued

SECTOR 1 (Continued)

Diskette Position	Field Title	Length	Description and Remarks
			the Payee "B" Record, AND you are reporting a distribution from an IRA or SEP. Enter the appropriate indicator from the table below: *Indicator* — *Usage* 1 — You are reporting an IRA or SEP Distribution. Blank — You are NOT reporting an IRA or SEP Distribution.
46–47	Percentage of Total Distribution	2	*THIS FIELD IS ONLY USED WHEN REPORTING FORM 1099-R,* and ONLY if you are reporting a total distribution to more than one person. This field is only 2 positions in length because when a total distribution is made to more than one person, the figure MUST be 99% or less. 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% will be 10%; 10.5% or more will be 11%). Enter the percentage received by the person whose TIN is included in positions 16–24, Sector 1, of the Payee "B" Record. This field must be right-justified, and unused positions must be zero filled. If not applicable, enter blanks. You need not enter a percentage for IRA or SEP distribution.
48–51	Blank	4	Enter blanks.
	Payment Amount Fields (Must be numeric)		REQUIRED. You must allow for all payment amounts; for those not used enter ZEROS. For example, if position 23 of Sector 1 of the "A" Record is "7" (for 1099-PATR) and positions 24–32 are "247bbbbbb" (b = blank), this indicates you are reporting 3 actual payment amounts in all of the following Payee "B" Records. Payment Amount 1 will be all "0" (zeros), Payment Amount 2 will represent Nonpatronage distributions, Payment Amount 3 will be all "0" (zeros), Payment Amount 4 will represent Federal income tax withheld, Payment Amounts 5 and 6 will be all "0" (zeros), Payment Amount 7 will represent energy investment credit, and Payment Amounts 8 and 9 will be all "0" (zeros). Each payment field must contain 10 numeric characters (see Note). Each payment amount must be entered in U.S. dollars and cents. The rightmost 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). You may *NOT* enter *ANY* negative payments for Form 1099-MISC. Positive and negative amounts are indicated by placing a "+" or "–" (minus sign) in the leftmost position of the payment amount field. A negative overpunch in the units position may be used, instead of the minus sign, to indicate a negative amount. If a plus sign, minus sign, or negative overpunch is not used, the number will be assumed to be positive. 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: If you are reporting money amounts in excess of 9999999999 (dollars and cents), it must be reported as follows:

RECORD NAME: PAYEE "B" RECORD—Continued

SECTOR 1 (Continued)

Diskette Position	Field Title	Length	Description and Remarks
			(1) The first Payee "B" Record MUST contain 9999999999. (2) The second Payee "B" record will contain the remaining money amounts. DO NOT SPLIT THIS FIGURE IN HALF.
52–61	Payment* Amount 1	10	The amount reported in this field represents payments for Amount Code 1 in the Payer/Transmitter "A" Record.
62–71	Payment* Amount 2	10	The amount reported in this field represents payments for Amount Code 2 in the Payer/Transmitter "A" Record.
72–81	Payment* Amount 3	10	The amount reported in this field represents payments for Amount Code 3 in the Payer/Transmitter "A" Record.
82–91	Payment* Amount 4	10	The amount reported in this field represents payments for Amount Code 4 in the Payer/Transmitter "A" Record.
92–101	Payment* Amount 5	10	The amount reported in this field represents payments for Amount Code 5 in the Payer/Transmitter "A" Record.
102–111	Payment* Amount 6	10	The amount reported in this field represents payments for Amount Code 6 in the Payer/Transmitter "A" Record.
112–121	Payment* Amount 7	10	The amount reported in this field represents payments for Amount Code 7 in the Payer/Transmitter "A" Record.
122–131	Payment* Amount 8	10	The amount reported in this field represents payments for Amount Code 8 in the Payer/Transmitter "A" Record.
132–141	Payment* Amount 9	10	The amount reported in this field represents payments for Amount Code 9 in the Payer/Transmitter "A" Record.

* If there are discrepancies between these Payment Amount Codes and the boxes on the paper forms, the instructions in this revenue procedure govern.

142–161	Blank	20	Enter blanks.
162	Foreign Country Indicator	1	REQUIRED. If the payee's address is in a foreign country, enter a "1" in this field. This will allow you to use any format for the Payee Address, City, State and ZIP Code. Address information must not appear in the First or Second Payee Name Lines. If the address for the payee is a U.S. address, you must enter a blank in this field. The free address format may only be used for foreign addresses. For U.S. addresses, you must use the U.S. Postal Service state abbreviations in diskette positions 72 and 73 of Sector 2 of the "B" Record. These abbreviations are provided in Part A, Sec. 18.
163–202	First Payee Name Line	40	REQUIRED. Do not enter address information in this field. Enter the name of the payee (preferably surname (last name) first) whose Taxpayer Identification Number appears in positions 16–24 of Sector 1 of the "B" Record. If fewer than 40 characters are required, left-justify and fill unused positions with blanks. If more space is required for the name, utilize the Second Payee Name Line field below. If there are multiple payees, only the name of the payee whose Taxpayer Identification Number has been provided may be entered in this field. The names of the other payees should be entered 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 FILER). THE "B"

RECORD NAME: PAYEE "B" RECORD—Continued

SECTOR 1 (Continued)

Diskette Position	Field Title	Length	Description and Remarks
			RECORD WILL REFLECT THE INDIVIDUAL PAYING THE INTEREST (THE BORROWER/PAYER OF RECORD) AND THE AMOUNT PAID. FOR FORMS 1099-S, THE "B" RECORD WILL REFLECT THE SELLER INFORMATION.
203-242	Second Payee Name Line	40	If the payee name requires more space than is available in the First Payee Name Line, enter only the remaining portion of the name in this field. If there are multiple payees (e.g., partners or joint owners), we encourage you to use this field for those payees' names not associated with the Taxpayer Identification Number in positions 16-24 of Sector 1 of the "B" Record. *Do not enter address information in this field.* NOTE: It is important that you provide as much payee information to IRS as possible to identify the owner of the Taxpayer Identification Number. Left-justify and fill unused positions with blanks. FILL WITH BLANKS IF NO ENTRIES ARE PRESENT FOR THIS FIELD.
243-256	Blank	14	Enter blanks.

SECTOR 2—See Part C, Sec. 7, 8, 9, 10 and 11 for field descriptions for Sector 2 of Forms 1099-A, 1099-B, 1099-OID, 1099-S and W-2G.

Diskette Position	Field Title	Length	Description and Remarks
1	Record Sequence	1	REQUIRED. Must be a "2". Used to sequence the sectors making up a PAYEE Record.
2	Record Type	1	REQUIRED. Enter "B".
3-42	Payee Mailing Address	40	REQUIRED. Enter mailing address of payee. Left-justify and fill unused positions with blanks. The address MUST be present. This field MUST NOT contain any data other than the payee's mailing address. Any format may be used in reporting a foreign mailing address.

For U.S. addresses, the Payee City, Payee State and Payee ZIP Code must be reported as a 29, 2 and 9 position field, respectively. For foreign addresses, the Payee City, Payee State (Country) and Payee ZIP Code may be reported as a continuous 40 position field. When reporting a foreign address, the Foreign Country Indicator must contain a "1."

43-71	Payee City	29	REQUIRED. Enter the city, left-justified, and fill the unused positions with blanks. Do not enter state and ZIP Code information in this field.
72-73	Payee State	2	REQUIRED. Enter the abbreviation for the state as shown in Part A, Sec. 18. You MUST use valid U.S. Postal Service state abbreviations for U.S. addresses.
74-82	Payee ZIP Code	9	REQUIRED. Enter the valid 9 digit ZIP Code assigned by the U.S. Postal Service. If only the first 5 digits are known, left-justify and fill the unused positions with blanks. Use this field for the ZIP Code only. For foreign countries, alpha characters are acceptable as long as you have entered a "1" in the Foreign Country Indicator field, which is located in position 162 of Sector 1 of the "B" Record.
83-112	Blank	30	Enter blanks.

RECORD NAME: PAYEE "B" RECORD—Continued

SECTOR 2 (Continued)

Diskette Position	Field Title	Length	Description and Remarks
113-179	Special Data Entries	67	This portion of the Payee "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact their state or local revenue departments for filing requirements. If this field is not utilized, ENTER BLANKS.
180-181	Combined Federal/ State Code	2	If a 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 filers or states NOT participating in this program or filers of Form 1098, ENTER BLANKS.
182-256	Blank	75	Enter blanks.

SEC. 6. PAYEE "B" RECORD—RECORD LAYOUTS FOR SECTORS 1 AND 2 OF FORMS 1098, 1099-DIV, 1099-G, 1099-INT, 1099-MISC, 1099-PATR, 1099-R, 5498 AND SECTOR 1 OF FORMS 1099-A, 1099-B, 1099-OID, 1099-S AND W-2G.

01. See Part C, Sec. 7, 8, 9, 10 and 11 for the field descriptions and record layouts for Sector 2 of Form 1099-A, 1099-B, 1099-OID, 1099-S and W-2G.

Sector 1

RECORD SEQUENCE	RECORD TYPE	PAYMENT YEAR	DOCUMENT SPECIFIC CODE	BLANK	CORRECTED RETURN INDICATOR
1	2	3-4	5-6	7	8

Sector 1 (Continued)

NAME CONTROL*	BLANK	TYPE OF TIN*	TAXPAYER IDENTIFICATION NUMBER*	PAYER'S ACCOUNT NUMBER FOR PAYEE*
9-12	13-14	15	16-24	25-44

Sector 1 (Continued)

IRA/SEP INDICATOR	PERCENTAGE OF TOTAL DISTRIBUTION	BLANK	PAYMENT AMOUNT ONE	PAYMENT AMOUNT TWO	PAYMENT AMOUNT THREE
45	46-47	48-51	52-61	62-71	72-81

Sector 1 (Continued)

PAYMENT AMOUNT FOUR	PAYMENT AMOUNT FIVE	PAYMENT AMOUNT SIX	PAYMENT AMOUNT SEVEN	PAYMENT AMOUNT EIGHT	PAYMENT AMOUNT NINE
82-91	92-101	102-111	112-121	122-131	132-141

Sector 1 (Continued)

BLANK	FOREIGN COUNTRY INDICATOR	FIRST PAYEE NAME LINE*	SECOND PAYEE NAME LINE*	BLANK
142–161	162	163–202	203–242	243–256

Sector 2 See Part C, Sec. 7, 8, 9, 10 and 11 for field descriptions for Sector 2 of Forms 1099-A, 1099-B, 1099-OID, 1099-S and W-2G.

RECORD SEQUENCE	RECORD TYPE	PAYEE MAILING ADDRESS*	PAYEE CITY*	PAYEE STATE*	PAYEE ZIP CODE*
1	2	3–42	43–71	72–73	74–82

Sector 2 (Continued)

BLANK	SPECIAL DATA ENTRIES	COMBINED FEDERAL/ STATE CODE	BLANK
83–112	113–179	180–181	182–256

* WHEN REPORTING FORM 1098, MORTGAGE INTEREST STATEMENT, 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 INFORMATION.

SEC. 7. PAYEE "B" RECORD—FIELD DESCRIPTIONS AND RECORD LAYOUT FOR SECTOR 2 OF FORM 1099-A

.01 This section contains information pertaining to Sector 2 of Form 1099-A. For detailed explanations of the 1099-A fields see the 1990 "Instructions for Forms 1099, 1098, 5498, and W-2G" included in your reporting package.

.02 See Part C, Sec. 5 for field descriptions for Sector 1 of the Payee "B" Record for Forms 1099-A.

.03 FORM 1099-A CANNOT BE FILED UNDER THE COMBINED FEDERAL/ STATE FILING PROGRAM.

RECORD NAME: PAYEE "B" RECORD
FORM 1099-A—SECTOR 2 ONLY

SECTOR 2

Diskette Position	Field Title	Length	Description and Remarks
1	Record Sequence	1	REQUIRED. Must be a "2". Used to sequence the sectors making up a PAYEE Record.
2	Record Type	1	REQUIRED. Enter "B".
3-42	Payee Mailing Address	40	REQUIRED. Enter mailing address of payee. Left-justify and fill unused positions with blanks. The address MUST be present. This field MUST NOT contain any data other than the payee's mailing address. Any format may be used in reporting a foreign mailing address.

For U.S addresses, the Payee City, Payee State and Payee ZIP Code must be reported as a 29, 2 and 9 position field, respectively. For foreign addresses, the Payee City, Payee State (Country) and Payee ZIP Code may be reported as a continuous 40 position field. When reporting a foreign address, the Foreign Country Indicator must contain a "1".

RECORD NAME: PAYEE "B" RECORD—Continued
FORM 1099-A—SECTOR 2 ONLY

SECTOR 2 (Continued)

Diskette Position	Field Title	Length	Description and Remarks
43-71	Payee City	29	REQUIRED. Enter the city, left-justified and fill the unused positions with blanks. Do not enter state and ZIP Code information in this field.
72-73	Payee State	2	REQUIRED. Enter the abbreviation for the state as shown in Part A, Sec. 18. You MUST use valid U.S. Postal Service state abbreviations for U.S. addresses.
74-82	Payee ZIP	9	REQUIRED. Enter the valid 9 Code digit ZIP Code assigned by the U.S. Postal Service. If only the first 5 digits are known, left-justify and fill the unused positions with blanks. Use this field for the ZIP Code only. For foreign countries, alpha characters are acceptable as long as you have entered a "1" in the Foreign Country Indicator field, which is located in position 162 of Sector 1 of the "B" Record.
83-112	Blank	30	Enter blanks.
113-133	Special Data Entries	21	This portion of the payee "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact their state or local revenue departments for filing requirements. If this field is not utilized, ENTER BLANKS.
134-139	Date of Lender's Acquisition or Knowledge of Abandonment	6	REQUIRED FOR FORM 1099-A ONLY. Enter the date of the acquisition of the secured property or the date you first knew or had reason to know that the property was abandoned in the format MMDDYY (e.g., 102490). DO NOT ENTER HYPHENS OR SLASHES.
140	Liability Indicator	1	REQUIRED FOR FORM 1099-A ONLY. Enter the appropriate indicator from the table below: Indicator — Usage 1 — Borrower is personally liable for repayment of the debt. Blank — Borrower is not liable for repayment of the debt.
141-179	Description	39	REQUIRED FOR FORM 1099-A ONLY. Enter a brief description of the property. For example, 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-1988 Buick Regal or Office Equipment). Enter "CCC" for crops forfeited on Commodity Credit Corporation loans. If fewer than 39 positions are required, left-justify and fill unused positions with blanks.
180-256	Blank	77	Enter blanks.

RECORD NAME: PAYEE "B" RECORD
FORM 1099-A—SECTOR 2 ONLY

PAYEE "B" RECORD—RECORD LAYOUT FOR SECTOR 2 OF FORM 1099-A

Sector 2—Form 1099-A ONLY

RECORD SEQUENCE	RECORD TYPE	PAYEE MAILING ADDRESS	PAYEE CITY	PAYEE STATE	PAYEE ZIP CODE	BLANK
1	2	3-42	43-71	72-73	74-82	83-112

Sector 2 (Continued)

SPECIAL DATA ENTRIES	DATE OF LENDER'S ACQUISITION	LIABILITY INDICATOR	DESCRIPTION	BLANK
113-133	134-139	140	141-179	180-256

SEC. 8. PAYEE "B" RECORD—FIELD DESCRIPTIONS AND RECORD LAYOUT FOR SECTOR 2 OF FORM 1099-B

.01 This section contains the general payment information for Sector 2 of Form 1099-B. For detailed explanations of the 1099-B fields see the 1990 "Instructions for Forms 1099, 1098, 5498, and W-2G" included in your reporting package.

.02 See Part C, Sec. 5 for field descriptions for Sector 1 of the Payee "B" Record for Form 1099-B.

.03 FORM 1099-B CANNOT BE FILED UNDER THE COMBINED FEDERAL/ STATE FILING PROGRAM.

RECORD NAME: PAYEE "B" RECORD
FORM 1099-B—SECTOR 2 ONLY

SECTOR 2

Diskette Position	Field Title	Length	Description and Remarks
1	Record Sequence	1	REQUIRED. Must be a "2". Used to sequence the sectors making up a PAYEE Record.
2	Record Type	1	REQUIRED. Enter "B".
3-42	Payee Mailing Address	40	REQUIRED. Enter mailing address of payee. Left-justify and fill unused positions with blanks. The address MUST be present. This field MUST NOT contain any data other than the payee's mailing address. Any format may be used in reporting a foreign mailing address.

For U.S addresses, the Payee City, Payee State and Payee ZIP Code must be reported as a 29, 2 and 9 position field, respectively. For foreign addresses, the Payee City, Payee State (country) and Payee ZIP Code may be reported as a continuous 40 position field. When reporting a foreign address, the Foreign Country Indicator must contain a "1".

43-71	Payee City	29	REQUIRED. Enter the city, left-justified and fill the unused positions with blanks. Do not enter state and ZIP Code information in this field.
72-73	Payee State	2	REQUIRED. Enter the abbreviation for the state as shown in Part A, Sec. 18. You MUST use valid U.S. Postal Service state abbreviations for U.S. addresses.
74-82	Payee ZIP Code	9	REQUIRED. Enter the valid 9 digit ZIP Code assigned by the U.S. Postal Service. If only the first 5 digits are known, left-justify and fill the unused positions with blanks. Use this field for the ZIP Code only. For foreign countries, alpha characters are acceptable as long as you have entered a "1" in the Foreign Country Indicator field, which is located in position 162 of Sector 1 of the "B" Record.

RECORD NAME: PAYEE "B" RECORD—Continued
FORM 1099-B—SECTOR 2 ONLY

SECTOR 2 (Continued)

Diskette Position	Field Title	Length	Description and Remarks
83-112	Blank	30	Enter blanks.
113-122	Special Data Entries	10	This portion of the payee "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact their state or local revenue departments for filing requirements. If this field is not utilized, ENTER BLANKS.
123	Gross Proceeds Reported to IRS Indicator	1	REQUIRED FOR FORM 1099-B ONLY. Enter appropriate indicator from the table below. If this field is not utilized, ENTER BLANKS. Indicator — Usage 1 — Gross Proceeds 2 — Gross Proceeds less commission and option premiums
124-129	Date of Sale	6	REQUIRED FOR FORM 1099-B ONLY. For broker transactions, enter the trade date of the transaction in the format MMDDYY (e.g., 102490). For barter exchanges, enter the date cash, property, a credit, or scrip is actually or constructively received. Enter blanks if this is an aggregate transaction. DO NOT ENTER HYPHENS OR SLASHES.
130-142	CUSIP Number	13	REQUIRED FOR FORM 1099-B ONLY. For broker transactions only, enter the CUSIP (Committee on Uniform Security Identification Procedures) number of the item reported for Amount Indicator "2" (Stocks, bonds, etc.). Enter blanks if this is an aggregate transaction. Enter "0" (zeros) if the number is not available or applicable. For CUSIP numbers with less than 13 characters, right-justify and fill the remaining positions with blanks.
143-181	Description	39	REQUIRED FOR FORM 1099-B ONLY. Enter a brief description of the item or services for which the proceeds are being reported. If fewer than 39 characters are required, left-justify and fill unused positions with blanks. For regulated futures contracts, enter "RFC" and any amount subject to backup withholding. Enter blanks if this is an aggregate transaction.
182-256	Blank	75	Enter blanks.

PAYEE "B" RECORD—RECORD LAYOUT FOR SECTOR 2 OF FORM 1099-B

Sector 2—1099-B ONLY

RECORD SEQUENCE	RECORD TYPE	PAYEE MAILING ADDRESS	PAYEE CITY	PAYEE STATE	PAYEE ZIP CODE	BLANK
1	2	3-42	43-71	72-73	74-82	83-112

Sector 2 (Continued)

SPECIAL DATA ENTRIES	GROSS PROCEEDS INDICATOR	DATE OF SALE	CUSIP NUMBER	DESCRIPTION	BLANK
113-122	123	124-129	130-142	143-181	182-256

SEC. 9. PAYEE "B" RECORD—FIELD DESCRIPTIONS AND RECORD LAYOUT FOR SECTOR 2 OF FORM 1099-OID

.01 This section contains the general payment information for Sector 2 of Form 1099-OID. For detailed explanations of the 1099-OID fields see the 1990 "Instructions for Forms 1099, 1098, 5498, and W-2G" included in your reporting package.

.02 See Part C, Sec. 5 for field descriptions for Sector 1 of the Payee "B" Record for Form 1099-OID.

RECORD NAME: PAYEE "B" RECORD
FORM 1099-OID—SECTOR 2 ONLY

SECTOR 2

Diskette Position	Field Title	Length	Description and Remarks
1	Record Sequence	1	REQUIRED. Must be a "2". Used to sequence the sectors making up a PAYEE Record.
2	Record Type	1	REQUIRED. Enter "B".
3-42	Payee Mailing Address	40	REQUIRED. Enter mailing address of payee. Left-justify and fill unused positions with blanks. The address MUST be present. This field MUST NOT contain any data other than the payee's mailing address. Any format may be used in reporting a foreign mailing address.

For U.S addresses, the Payee City, Payee State and Payee ZIP Code must be reported as a 29, 2 and 9 position field, respectively. For foreign addresses, the Payee City, Payee State (country) and Payee ZIP Code may be reported as a continuous 40 position field. When reporting a foreign address, the Foreign Country Indicator must contain a "1".

43-71	Payee City	29	REQUIRED. Enter the city, left-justified, and fill the unused positions with blanks. Do not enter state and ZIP Code information in this field.
72-73	Payee State	2	REQUIRED. Enter the abbreviation for the state as shown in Part A, Sec. 18. You MUST use valid U.S. Postal Service state abbreviations for U.S. addresses.
74-82	Payee ZIP Code	9	REQUIRED. Enter the valid 9 digit ZIP Code assigned by the U.S. Postal Service. If only the first 5 digits are known, left-justify and fill the unused positions with blanks. Use this field for the ZIP Code only. For foreign countries, alpha characters are acceptable as long as you have entered a "1" in the Foreign Country Indicator field, which is located in position 162 of Sector 1 of the "B" Record.
83-112	Blank	30	Enter blanks.
113-140	Special Data Entries	28	This portion of the payee "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact their state or local revenue departments for filing requirements. If this field is not utilized, ENTER BLANKS.
141-179	Description	39	REQUIRED. Enter identification number (CUSIP Number) or description of the obligation. The description may include the stock exchange, issuer, coupon rate and year of maturity. If fewer than 39 characters are required, left-justify and fill unused positions with blanks.
180-181	Combined Federal/ StateCode	2	If a 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 filers or states NOT participating in this program, ENTER BLANKS.
182-256	Blank	75	Enter blanks.

PAYEE "B" RECORD—RECORD LAYOUT FOR SECTOR 2 OF FORM 1099-OID

Sector 2—1099-OID ONLY

RECORD SEQUENCE	RECORD TYPE	PAYEE MAILING ADDRESS	PAYEE CITY	PAYEE STATE	PAYEE ZIP CODE	BLANK
1	2	3-42	43-71	72-73	74-82	83-112

SPECIAL DATA ENTRIES	DESCRIPTION	COMBINED FEDERAL/ STATE CODE	BLANK
113-140	141-179	180-181	182-256

SEC. 10. PAYEE "B" RECORD—FIELD DESCRIPTIONS AND RECORD LAYOUT FOR SECTOR 2 OF FORM 1099-S

.01 This section contains the general payment information for Sector 2 of Form 1099-S. For detailed explanations of the 1099-S fields see the 1990 "Instructions for Forms 1099, 1098, 5498, and W-2G" included in your reporting package.

.02 See Part C, Sec. 5 for field descriptions for Sector 1 of the Payee "B" Record for Forms 1099-S.

.03 FORM 1099-S CANNOT BE FILED UNDER THE COMBINED FEDERAL/ STATE FILING PROGRAM.

RECORD NAME: PAYEE "B" RECORD
FORM 1099-S—SECTOR 2 ONLY

SECTOR 2

Diskette Position	Field Title	Length	Description and Remarks
1	Record Sequence	1	REQUIRED. Must be a "2". Used to sequence the sectors making up a PAYEE Record.
2	Record Type	1	REQUIRED. Enter "B".
3-42	Payee Mailing Address	40	REQUIRED. Enter mailing address of payee. Left-justify and fill unused positions with blanks. The address MUST be present. This field MUST NOT contain any data other than the payee's mailing address. Any format may be used in reporting a foreign mailing address.
			For U.S addresses, the Payee City, Payee State and Payee ZIP Code must be reported as a 29, 2 and 9 position field, respectively. For foreign addresses, the Payee City, Payee State (Country) and Payee ZIP Code may be reported as a continuous 40 position field. When reporting a foreign address, the Foreign Country Indicator must contain a "1".
43-71	Payee City	29	REQUIRED. Enter the city, left-justified, and fill the unused positions with blanks. Do not enter state and ZIP Code information in this field.
72-73	Payee State	2	REQUIRED. Enter the abbreviation for the state as shown in Part A, Sec. 18. You MUST use valid U.S. Postal Service state abbreviations for U.S. addresses.
74-82	Payee ZIP Code	9	REQUIRED. Enter the valid 9 digit ZIP Code assigned by the U.S. Postal Service. If only the first 5 digits are known, left-justify and fill the unused positions with blanks. Use this field for the ZIP Code only. For foreign countries, alpha characters are acceptable as long as you have entered a "1" in the Foreign Country Indicator field, which is located in position 162 of Sector 1 of the "B" Record.
83-110	Blank	28	Enter blanks.

RECORD NAME: PAYEE "B" RECORD—Continued
FORM 1099-S—SECTOR 2 ONLY

SECTOR 2 (Continued)

Diskette Position	Field Title	Length	Description and Remarks
111–133	Special Data Entries	23	This portion of the payee "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact their state or local revenue departments for their filing requirements. If this field is not utilized, ENTER BLANKS.
134–139	Date of Closing	6	REQUIRED FOR FORM 1099-S ONLY. Enter the closing date in the format MMDDYY (e.g., 102490). DO NOT ENTER HYPHENS OR SLASHES.
140–178	Description	39	REQUIRED FOR FORM 1099-S ONLY. Enter the address of the property transferred or a legal description of the property. If you are entering an address, include the state and ZIP code where the property is located. If fewer than 39 positions are required, left-justify and fill unused positions with blanks.
179	Property or Services Received	1	REQUIRED FOR FORM 1099-S ONLY. If the transferor received or will receive property (other than cash) or services as part of the consideration for the property transferred, enter "1." If this field is not utilized, enter blank.
180–256	Blank	77	Enter blanks.

PAYEE "B" RECORD—RECORD LAYOUT FOR SECTOR 2 OF FORM 1099-S

Sector 2—1099-S ONLY

RECORD SEQUENCE	RECORD TYPE	PAYEE MAILING ADDRESS	PAYEE CITY	PAYEE STATE	PAYEE ZIP CODE	BLANK
1	2	3-42	43-71	72-73	74-82	83-110

Sector 2 (Continued)

SPECIAL DATA ENTRIES	DATE OF CLOSING	DESCRITPION	PROPERTY OR SERVICES RECEIVED	BLANK
111-133	134-139	140-178	179	180-256

SEC. 11. PAYEE "B" RECORD—FIELD DESCRIPTIONS AND RECORD LAYOUT FOR SECTOR 2 OF FORM W-2G

.01 This section contains the general payment information for Sector 2 of Form W-2G. For detailed explanations of the W-2G fields see the 1990 "Instructions for Forms 1099, 1098, 5498, and W-2G" included in your reporting package.

.02 See Part C, Sec. 5 for field descriptions for Sector 1 of the Payee "B" Record for Form W-2G.

.03 FORM W-2G CANNOT BE FILED UNDER THE COMBINED FEDERAL/STATE FILING PROGRAM.

RECORD NAME: PAYEE "B" RECORD
FORM W-2G—SECTOR 2 ONLY

SECTOR 2

Diskette Position	Field Title	Length	Description and Remarks
1	Record Sequence	1	REQUIRED. Must be a "2". Used to sequence the sectors making up a PAYEE Record.

RECORD NAME: PAYEE "B" RECORD—Continued
FORM W-2G—SECTOR 2 ONLY

SECTOR 2 (Continued)

Diskette Position	Field Title	Length	Description and Remarks
2	Record Type	1	REQUIRED. Enter "B".
3-42	Payee Mailing Address	40	REQUIRED. Enter mailing address of payee. Left-justify and fill unused positions with blanks. The address MUST be present. This field MUST NOT contain any data other than the payee's mailing address. Any format may be used in reporting a foreign mailing address.
			For U.S addresses, the Payee City, Payee State and Payee Zip Code must be reported as a 29, 2 and 9 position field, respectively. For foreign addresses, the Payee City, Payee State (country) and Payee Zip Code may be reported as a continuous 40 position field. When reporting a foreign address, the Foreign Country Indicator must contain a "1".
43-71	Payee City	29	REQUIRED. Enter the city, left-justified, and fill the unused positions with blanks. Do not enter state and ZIP Code information in this field.
72-73	Payee State	2	REQUIRED. Enter the abbreviation for the state as shown in Part A, Sec. 18. You MUST use valid U.S. Postal Service state abbreviations for U.S. addresses.
74-82	Payee ZIP Code	9	REQUIRED. Enter the valid 9 digit ZIP Code assigned by the U.S. Postal Service. If only the first 5 digits are known, left-justify and fill the unused positions with blanks. Use this field for the ZIP Code only. For foreign countries, alpha characters are acceptable as long as you have entered a "1" in the Foreign Country Indicator field, which is located in position 162 of Sector 1 of the "B" Record.
83-112	Blank	30	Enter blanks.
113-118	Date Won	6	REQUIRED FOR FORM W-2G ONLY. Enter the date of the winning event in the format MMDDYY (e.g., 102490). This is not the date the money was paid, if paid after the date of the race (or game). DO NOT ENTER HYPHENS OR SLASHES.
119-133	Transaction	15	REQUIRED FOR FORM W-2G ONLY. If applicable, the ticket number, card number (and color, if applicable), machine serial number or any other information that will help identify the winning transaction. Not applicable for horse and dog racing, jai alai and certain other wagering transactions, sweepstakes, wagering pools and certain lotteries. If no entry, enter blanks.
134-138	Race	5	REQUIRED FOR FORM W-2G ONLY. If applicable, the race (or game) applicable to the winning ticket. If no entry, enter blanks.
139-143	Cashier	5	REQUIRED FOR FORM W-2G ONLY. If applicable, the initials of the cashier making the winning payment. If no entry, enter blanks.
144-148	Window	5	REQUIRED FOR FORM W-2G ONLY. The window number or location of the person paying the winnings. If no entry, enter blanks.
149-163	First ID	15	REQUIRED FOR FORM W-2G ONLY. If applicable, the first identification number of the person receiving the winnings. If no entry, enter blanks.

RECORD NAME: PAYEE "B" RECORD—Continued
FORM W-2G—SECTOR 2 ONLY

SECTOR 2 (Continued)

Diskette Position	Field Title	Length	Description and Remarks
164-178	Second ID	15	REQUIRED FOR FORM W-2G ONLY. If applicable, the second identification number of the person receiving the winnings. If no entry, enter blanks.
179-256	Blank	78	Enter blanks.

RECORD NAME: PAYEE "B" RECORD
FORM W-2G—SECTOR 2 ONLY

PAYEE "B" RECORD—RECORD LAYOUT FOR SECTOR 2 OF FORM W-2G

Sector 2—W-2G ONLY

RECORD SEQUENCE	RECORD TYPE	PAYEE MAILING ADDRESS	PAYEE CITY	PAYEE STATE	PAYEE ZIP CODE	BLANK
1	2	3-42	43-71	72-73	74-82	83-112

Sector 2 (Continued)

DATE WON	TRANSACTION	RACE	CASHIER	WINDOW	FIRST ID
113-118	119-133	134-138	139-143	144-148	149-163

Sector 2 (Continued)

SECOND ID	BLANK
164-178	179-256

SEC. 12. END OF PAYER "C" RECORD

.01 The "C" Record consists of one 256-position sector. The Control Total fields are each 15 positions in length.
.02 The End of Payer "C" Record is a summary record for a type of return for a given payer.
.03 The "C" Record will contain the total number of payees and the totals of the payment amount fields filed by a given payer. The "C" Record MUST be written after the last Payee "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.
.04 In developing the "C" Record, for example, if you 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 27-41, 57-86 and 102-146 would be zero filled.
.05 Payers/Transmitters must verify the accuracy of the totals in the "C" Record and must enter the totals on the Forms 4804, 4802 or computer generated substitute, which will accompany the shipment. The lines used on Forms 4804 and 4802 to record payment amounts correspond with the Amount Codes used in the "A" Record.
.06 Missing or incorrect End of Payer "C" Records will result in the media being returned for correction.

RECORD NAME: END OF PAYER "C" RECORD

SECTOR 1

Diskette Position	Field Title	Length	Description and Remarks
1	Record Sequence	1	REQUIRED. Must be a "1". Used to sequence the sectors making up a PAYER Record.
2	Record Type	1	REQUIRED. Enter "C".

SECTOR 1 (Continued)

Diskette Position	Field Title	Length	Description and Remarks
3-8	Number of Payees	6	REQUIRED. Enter the total number of Payee "B" Records covered by the preceding Payer/ Transmitter "A" Record. Right-justify and zero fill.
9-11	Blank	3	Enter blanks.

REQUIRED. If any corresponding Payment Amount fields are present in the Payee "B" Records, accumulate into the appropriate Control Total field. CONTROL TOTALS MUST BE RIGHT-JUSTIFIED, AND UNUSED CONTROL FIELDS MUST BE ZERO FILLED. Please note that all Control Total fields are 15 positions in length.

12-26	Control Total 1	15
27-41	Control Total 2	15
42-56	Control Total 3	15
57-71	Control Total 4	15
72-86	Control Total 5	15
87-101	Control Total 6	15
102-116	Control Total 7	15
117-131	Control Total 8	15
132-146	Control Total 9	15

147-256	Blank	110	Enter blanks.

END OF PAYER "C" RECORD—RECORD LAYOUT

Sector 1

RECORD SEQUENCE	RECORD TYPE	NUMBER OF PAYEES	BLANK	CONTROL TOTAL 1	CONTROL TOTAL 2
1	2	3-8	9-11	12-26	27-41

Sector 1 (Continued)

CONTROL TOTAL 3	CONTROL TOTAL 4	CONTROL TOTAL 5	CONTROL TOTAL 6	CONTROL TOTAL 7	CONTROL TOTAL 8
42-56	57-71	72-86	87-101	102-116	117-131

Sector 1 (Continued)

CONTROL TOTAL 9	BLANK
132-146	147-256

SEC. 13. STATE TOTALS "K" RECORD

.01 The "K" Record consists of one 256-position sector. The Control Total fields are each 15 positions in length.

.02 The State Totals "K" Record is a summary for a given payer and type of return to a given state in the Combined Federal/State Filing Program. Use 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 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 you 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 on this program.

RECORD NAME: END OF PAYER "K" RECORD

SECTOR 1

Diskette Position	Field Title	Length	Description and Remarks
1	Record Sequence	1	REQUIRED. Must be a "1". Used to sequence the sectors making up a PAYER Record.
2	Record Type	1	REQUIRED. Enter "K".
3-8	Number of Payees	6	REQUIRED. Enter the total number of Payee "B" Records being coded for this state. Right-justify and zero fill.
9-11	Blank	3	Enter blanks.

REQUIRED. If any corresponding Payment Amount fields are present in the Payee "B" Records, accumulate into the appropriate Control Total field. CONTROL TOTALS MUST BE RIGHT-JUSTIFIED, AND UNUSED CONTROL FIELDS MUST BE ZERO FILLED. Please note that all Control Total fields are 15 positions in length.

12-26	Control Total 1	15	
27-41	Control Total 2	15	
42-56	Control Total 3	15	
57-71	Control Total 4	15	
72-86	Control Total 5	15	
87-101	Control Total 6	15	
102-116	Control Total 7	15	
117-131	Control Total 8	15	
132-146	Control Total 9	15	
147-254	Blank	108	Enter blanks.
255-256	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.)

END OF PAYER "K" RECORD—RECORD LAYOUT

Sector 1

RECORD SEQUENCE	RECORD TYPE	NUMBER OF PAYEES	BLANK	CONTROL TOTAL 1	CONTROL TOTAL 2
1	2	3-8	9-11	12-26	27-41

Sector 1 (Continued)

CONTROL TOTAL 3	CONTROL TOTAL 4	CONTROL TOTAL 5	CONTROL TOTAL 6	CONTROL TOTAL 7	CONTROL TOTAL 8
42-56	57-71	72-86	87-101	102-116	117-131

Sector 1 (Continued)

CONTROL TOTAL 9	BLANK	COMBINED FEDERAL/ STATE CODE
132–146	147–254	255–256

SEC. 14. END OF TRANSMISSION "F" RECORD

.01 The "F" Record consists of one 256-position sector. 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

SECTOR 1

Diskette Position	Field Title	Length	Description and Remarks
1	Record Type	1	REQUIRED. Enter "F".
2–5	Number of "A" Records	4	You may enter the total number of Payer/Transmitter "A" Records in the entire file. Right-justify and zero fill or enter all zeros.
6–30	Zero	25	Enter zeros.
31–256	Blank	226	Enter blanks.

END OF TRANSMISSION "F" RECORD—RECORD LAYOUT

Sector 1

RECORD TYPE	NUMBER OF "A" RECORDS	ZERO	BLANK
1	2–5	6–30	31–256

PART D. MISCELLANEOUS INFORMATION

SECTION 1. MAGNETIC MEDIA-RELATED FORMS AND PUBLICATIONS AVAILABLE AT THE IRS MARTINSBURG COMPUTING CENTER

.01 IRS/MCC maintains supplies of magnetic media-related forms and publications including:

-Publication 1220, Specifications for Filing Forms 1098, 1099 Series, 5498, and W-2G Electronically or on Magnetic Tape, Tape Cartridge, 5¼ and 3½ Inch Diskettes
-Publication 1255, Requirements and Conditions for Filing Forms 1098, 1099 Series, 5498, and W-2G on 8 Inch Magnetic Diskette
-Publication 1187, Requirements and Conditions for Filing Form 1042S, Foreign Person's U.S. Source Income Subject to Withholding, on Magnetic Tape
-Publication 1239, Requirements and Conditions for Submitting Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips, on Magnetic Tape
-Publication 1245, Magnetic Tape Reporting for Forms W-4
-Publication 1437, Revenue Procedure and File Specifications for Magnetic Tape Filing of Fiduciary Returns Forms 1041, and Partnership Returns Form 1065, for Tax Year 1989
-Instructions for Forms 1099, 1098, 5498, and W-2G
-Form 8508, Request for Waiver from Filing Information Returns on Magnetic Media
-Form 4419, Application for Filing Information Returns Magnetically/Electronically
-Form 8809, Request for Extension of Time to File Information Returns
-Form 4804, Transmittal of Information Returns Reported on Magnetic Media
-Form 4802, Transmittal for Multiple Magnetic Media Reporting
-Form 5064, Media Label
-Notice 210, Preparation Instructions for Media Label, Form 5064
-Form 6466, Transmittal of Magnetic Tape of Form W-4, Employee's Withholding Allowance Certificate
-Form 6467, Multiple Employer Transmittal for Magnetic Tape Reporting of Form W-4
-Form 6468, How to Prepare Form 6469, Tape Label for Form W-4
-Form 6469, Tape Label for Form W-4

.02 To order any of these forms or publications, you may contact IRS/MCC (see Part A, Sec. 3 for the address, telephone number, and hours of operation). You may also call the IRS toll- free forms and publications order number (1-800-424-FORM, 1-800-829-FORM after September 30, 1990), or contact your local IRS office.

SEC. 2. FEDERAL DOLLAR CRITERIA

.01 For your convenience, the federal requirements for reporting the information returns to IRS is provided in Table 1.

TABLE 1. FEDERAL DOLLAR REQUIREMENTS

FORM	DOLLAR CRITERIA
1098	$600
1099-A	ALL
1099-B	ALL
1099-DIV	$10 ($600 for Liquidations)
1099-G	$10—Unemployment and Tax Refunds
	$600—All others
1099-INT	$10
	$600 (In some cases)
1099-MISC	$600
	ALL (Fishing boat proceeds)
	$10 (Royalties or Substitute Dividend and Tax-exempt Interest Payments Reportable by Brokers)
	$5,000—Direct sales indicator
1099-OID	$10
1099-PATR	$10
1099-R	ALL
1099-S	ALL
5498	ALL
W-2G	$600
	$1200 (Bingo or Slot Machines)
	$1500 (Keno)

For specific information, refer to the 1990 "Instructions for Forms 1099, 1098, 5498, and W-2G."

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26 CFR 601.602: Forms and instructions. (Also Part I, Sections 408(i), 6041, 6041A, 6042, 6043, 6044, 6045, 6047, 6049, 6050A, 6050B, 6050D, 6050E, 6050H, 6050J, 6050N; 1.408-5, 1.408-7, 1.6041-1, 7.6041-1, 1.6042-2, 1.6044—2, 1.6044-5, 1.6045-1, 5f.6045-1, 1.6045-2, 1.6045-3T, 1.6047-1, 1.6049-4, 1.6049-6, 1.6049-5T, 1.6049-7T, 1.6050A-1, 1.6050B-1, 1.6050D-1, 1.6050E-1, 1.6050H-1, 1.6050H-2, 1.6050J-1T.)

Rev. Proc. 90-44

PART A. GENERAL

SECTION. 1. PURPOSE

.01 The purpose of this revenue procedure is to state the requirements for: (1) reproducing paper substitutes of the forms shown below, covering payments made during the 1990 calendar year (for Forms 5498, contributions made for 1990), that are required to be filed with the Internal Revenue Service (IRS), and (2) furnishing substitute statements to form recipients (see Section 4.01 for definition) and paper document reporting. This revenue procedure contains specifications for the following:

(a) Form 1098, Mortgage Interest Statement.
(b) Form 1099-A, Information Return for Acquisition or Abandonment of Secured Property.
(c) Form 1099-B, Statement for Recipients of Proceeds From Broker and Barter Exchange Transactions.
(d) Form 1099-DIV, Statement for Recipients of Dividends and Distributions.
(e) Form 1099-G, Statement for Recipients of Certain Government Payments.
(f) Form 1099-INT, Statement for Recipients of Interest Income.
(g) Form 1099-MISC, Statement for Recipients of Miscellaneous Income.
(h) Form 1099-OID, Statement for Recipients of Original Issue Discount.
(i) Form 1099-PATR, Statement for Recipients (Patrons) of Taxable Distributions Received From Cooperatives.
(j) Form 1099-R, Statement for Recipients of Total Distributions From Profit-Sharing, Retirement Plans, Individual Retirement Arrangements, Insurance Contracts, Etc.
(k) Form 1099-S, Statement for Recipients of Proceeds From Real Estate Transactions.
(l) Form W-2G, Statement for Recipients of Certain Gambling Winnings.
(m) Form 5498, Individual Retirement Arrangement Information.
(n) Form 1096, Annual Summary and Transmittal of U.S. Information Returns.

.02 For the purpose of this revenue procedure, a substitute form is one that is not printed by IRS. For a substitute form 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 substitutes to IRS for APPROVAL. Only those forms that conform to the official form or comply with the specifications set forth herein are acceptable. See Part A, Section 8 for the specifications that apply to form recipient statements (Copy B).

SEC. 2. NATURE OF CHANGES

.01 Numerous editorial changes have been made to the publication.

.02 New legislation changed the penalty provisions and some of the magnetic media requirements for information returns.

.03 Two new boxes, Box 11, State income tax withheld; and Box 12, State/Payer's state number; have been added to the Form 1099-MISC. As a result of this change, other boxes on the form have been repositioned. In addition, two new copies have been added-Copy 1, for filing with a state and Copy 2, for the recipient to attach to the state tax return, when required.

.04 An IRA/SEP checkbox has been added to Box 7 of Form 1099-R.

SEC. 3. REQUIREMENTS FOR ACCEPTABLE SUBSTITUTE FORMS 1096, 1098, 1099, 5498, AND W-2G TO BE FILED WITH IRS (COPY A)

.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 procedure may be privately printed and filed as returns with the IRS.

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 with your understanding of the specification to:

Internal Revenue Service
ATTN: R:R:T (IRP Coordinator)
1111 Constitution Avenue, N.W.
Washington, DC 20224

.02 Proposed substitutes for Copy A that do not conform to these specifications are not acceptable.

.03 No IRS office is authorized to allow deviations from this revenue procedure.

.04 IRS approval for the use of chemical transfer paper on Copy A is not required.

.05 Copy B (Form 1098 For Payer, Form 1099-A For Borrower, other Forms 1099 For Recipient, (Form 1099-S For Transferor, Form 5498 For Participant), and Copy C (Form W-2G For Winner's Records) must contain the information specified in section 8 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 composite Form 1099 statement specified in section 8.04.

.06 Forms 1096, 1098, 1099, 5498, and W-2G are subject to annual review and possible change. Filers are cautioned, therefore, against overstocking supplies of privately printed substitutes. THE SPECIFICATIONS CONTAINED IN THIS REVENUE PROCEDURE APPLY TO 1990 FORMS ONLY.

.07 Copies of the official forms for the reporting year may be obtained from most Internal Revenue offices. The IRS provides only cut sheets (no carbon interleaves) of these forms. If they are not available at your local IRS district office, ask that office to order copies for you. You should receive your order within 10 days. If you prefer, you may order them by calling our toll-free telephone number 1-800-424-FORM(3676) through September 30, 1990. Beginning October 1,1990 the number will be 1-800-829-3676 (TAX-FORM)

.08 Only original or ribbon copies having information typed or machine printed with *black carbon-based ink* should be filed with IRS. Dot Matrix Print must be letter quality 7 x 9 per character minimum. Carbon copies and photocopies are not acceptable.

.09 If you submit forms to IRS that do not meet the specifications in this revenue procedure, you may be subject to a penalty under section 6721 of the Internal Revenue Code. The maximum penalty is $50 for each form (up to $250,000) that the IRS cannot accept as a return because it does not meet the provisions set out in this revenue procedure.

SEC. 4. DEFINITIONS

.01 For individual-form recipients the term "taxpayer identification number" (TIN) means the individual's social security number (SSN). The SSN consists of nine digits separated by hyphens as follows: 000-00-0000. For all other form recipients, the term "taxpayer identification number" means the employer identification number (EIN). The EIN consists of nine digits separated by one hyphen as follows: 00-0000000. For a sole proprietor, use the sole proprietor's SSN and name (not their business name).

.02 In the past the terms payee and recipient were usually synonymous. The addition of new forms to the information returns family requires different terminology to identify the recipient of a copy of the form filed with IRS: i.e., for Form 1098 the recipient is "payer/borrower;" Form 1099-A, "the borrower;" Form 1099-S, "the transferor;" and Form 5498, "the participant." Therefore, to prevent any confusion, the person to whom you are required by law to furnish a copy of the official form or information statement will be referred to as the "form recipient."

.03 The term "filer" means the person or organization required by law to file a form listed in section 1.01 with IRS. Thus, a filer may be a payer, 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.

.04 A corrected and/or amended return is one that corrects previously reported information. (A voided return will not correct previously reported information.)

.05 The term "substitute form" means a paper substitute of Copy A of an official form listed in section 1.01 that totally conforms to the provisions in this revenue procedure.

.06 The term "form recipient statement" means a paper statement of the information reported on a form listed in 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.

.07 A composite statement is one form (although the form itself may comprise more than one page) that contains all the requisite Form 1099 information. A composite Form 1099 CANNOT be filed with IRS. If the filer does not use a composite statement, the filer must provide the necessary information to the form recipient separately on each respective form or substitute statement as the case may be. See sections 8.04 and 8.07 for more information on composite statements.

SEC. 5. INSTRUCTIONS FOR PREPARING PAPER FORMS THAT WILL BE FILED WITH THE IRS

.01 The form recipient's name, street address, city, state, and ZIP code information must be TYPED OR MACHINE PRINTED IN BLACK INK on separate lines. 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. (See section 6, Taxpayer Identification Number, for guidelines on the preferred methods for the form recipient's name and TIN). No descriptive information or other name should precede the form recipient's name. ONLY one form recipient's name should appear on the first line of the form. If more than one form recipient(s) name must be entered, place the responsible form recipient (person or organization whose TIN is provided) on the first line. Place the other form recipient's name on the succeeding name line (up to 2 name lines are allowable). We recognize that certain states require that the entities on trust accounts be provided in a different format. Filers should provide information returns reflecting payments to trust accounts with (1) the trust's TIN in the recipient's TIN area, (2) the trust's name as the recipient's first name line and (3) the trustee as the recipient's second name line.

.03 The box below the form recipient's name and address may be used for the account number. This information is not required; however, special caution must be taken if an account number is being entered. This number must be unique and MUST NOT appear anywhere on the form other than in the box specified for this use. If window envelopes are used, this number must not show through the window because the Postal Service may not accept them if you are using metered mail.

.04 Filers should TYPE OR MACHINE PRINT data entries on the forms, 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).

.07 On corrected returns, an "X" must be placed within the check box located at the top of the form to the left of the word "CORRECTED." The accompanying Form 1096 for a submission of corrected returns should also contain an "X" within the "CORRECTED" box at the top of the form. DO NOT type the words CORRECTED RETURN on the Form 1096, 1098, 1099, 5498 or W-2G. All required data blocks must be completed on a corrected return because it replaces and supersedes the information return previously filed. DO NOT intermix corrected and original returns in a submission. Corrected returns should be filed separately. 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.

.08 For corrected or voided documents, enter an "X" within the appropriate box using only computer print, typewriter or #2 pencil, or a ball-point pen. DO NOT use a felt tip marker. The machine used to "read" paper forms generally cannot "read" this ink type.

.09 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 IRS.

.10 Use decimal points to indicate dollars and cents. DO NOT use dollar signs ($), ampersands (&), asterisks (*), commas (,), or other special characters.

.11 DO NOT FOLD Forms 1096, 1098, 1099, or 5498 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.

.12 *DO NOT STAPLE* Forms 1096 to the returns being transmitted. Staple holes in the vicinity of the return code number reduce our ability to machine scan the type of document being processed.

.13 MAIL completed paper forms to the IRS service center specified in the *1990 Instructions for Forms 1099, 1098, 5498 and W-2G.*

SEC. 6. TAXPAYER IDENTIFICATION NUMBER

.01 Under section 6109 of the Internal Revenue Code, a person with respect to whom a return, statement, or other document is required to be made by another person must furnish his taxpayer identification number (TIN) to such other person. The number must be furnished to the filer whether or not the form recipient is required to file a tax return or is covered by Social Security. Section 6109 also requires filers to request the TINs and place them on returns required to be filed with IRS.

.02 Filers must provide correct TINs on all forms submitted. It is particularly important that correct social security and employer identification numbers for form recipients be provided on magnetic media or paper forms submitted to IRS.

.03 Section 6721 of the Internal Revenue Code imposes a tiered penalty on filers for each return filed with an incorrect or a missing TIN for Forms 1099, 1098 and W-2G.

.04 The TIN required to be furnished to the IRS depends primarily on the manner in which the account is maintained in the filer's records. Usually, the TIN provided must be that of the owner of the account. If an account is recorded as a joint account, i.e., more than one person is listed on the account, furnish the TIN and name of the first person listed on the record. For individuals, including sole proprietors, the TIN is the social security number. For other entities, furnish an employer identification number (EIN).

.05 Sole proprietors filing information returns should show their EIN as the filer's TIN on the return if required to have an EIN. If not, they should show their SSN.

.06 The charts below will help you determine the TIN to be furnished to IRS.

Chart 1. Guidelines for Social Security Numbers

Type of Account	For Form Recipient's TIN Enter the Social Security Number of	On the 1st Name Line of the Form Recipient's Portion of the Return Enter the Name of
1. Individual account.	The individual	The individual
2. Joint account (two or more individuals, husband and wife, adult and minor).	The actual owner of account. (If more than one owner, the TIN of the first individual on the account)	The individual whose SSN is entered
3. Account in the name of a guardian or committee for a designated ward, minor, or incompetent person.	The ward, minor, or incompetent person	The individual whose SSN is entered
4. Custodian account of a minor (Uniform Gift (or Transfers) to Minors Act).	The minor	The minor
5. The usual revocable savings trust account (grantor is also trustee).	The grantor-trustee	The grantor-trustee
6. So-called trust account that is not a legal or valid trust under state law.	The actual owner	The actual owner
7. Sole proprietorship.	The sole proprietor owner	The sole proprietor owner, not the sole proprietor's business name

Chart 2. Guidelines for Employer Identification Numbers

Type of Account	For Form Recipient's TIN Enter the Employer Identification Number of	On the 1st Name Line of the Form Recipient's Portion of the Return Enter the Name of
1. A valid trust, estate, or pension trust.	Legal entity. (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)	The legal trust, estate, or pension trust
2. Corporate	The corporation	The corporation
3. An association, club, religious, charitable, educational, or other tax-exempt organization.	The organization	The organization
4. A 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 the 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

SEC. 7. MAGNETIC MEDIA FILING

.01 IRS encourages all filers including nominees (hereafter collectively referred to as filers) to file information returns on magnetic media instead of paper forms. All forms listed in section 1.01 (except Form 1096) may be filed on magnetic media.

.02 Any person who is required to file 250 or more information returns for one calendar year must file on magnetic media. The 250-or-more requirement applies separately to each type of form. The requirement applies to any person for any period unless such person establishes that

this requirement would result in undue hardship and requests and receives a waiver from the filing requirements. To request a waiver from filing on magnetic media, submit a waiver request on a written statement or Form 8508, Request for Waiver From Filing Information Returns on Magnetic Media, 90 days before the due date of the return and send it to the following address: Internal Revenue Service, Martinsburg Computing Center, P.O. Box 1359, Martinsburg, WV 25401-1359. Requests for undue hardship waivers not received at least 90 days prior to the due date will not be approved. Generally, new brokers and new barter exchanges reporting Form 1099-B data to IRS, may request an undue hardship exception by filing a waiver request by the end of the second month following the month in which they became a broker or barter exchange.

.03 Specifications for filing information returns on magnetic tape, 8 inch, 5¼ inch, and 3½ inch diskette are contained in various revenue procedures relating to requirements and conditions for filing information returns on magnetic media. Copies of these procedures may be obtained from any Internal Revenue district office or by writing to the address in .02 above or calling 1-800-824-FORM though September 30, 1990. Beginning October 1, 1900 the number will be 1-800-829-3676 (TAXFORM). Filers or agents who are required to, or want to, file information returns on magnetic media must file Form 4419, Application for Filing Information Magnetically/Electronically. Forms 4419 must be filed prior to submitting returns magnetically or electronically. IRS will provide a written reply to the applicant and further instructions at the time of approval. The application must be sent to the Martinsburg Computing Center address in .02 above.

.04 Because many states accept information returns filed on magnetic media, savings may be obtained if similar media is used for filing with IRS and state tax agencies. For information regarding state magnetic media filing requirements, filers should contact the respective state tax authority.

SEC. 8. STATEMENTS TO FORM RECIPIENTS AND FORM RECIPIENT COPIES

.01 FURNISHING STATEMENTS TO RECIPIENTS.—Forms 1099-INT, DIV, OID, and PATR. For payments of interest and dividends reportable on Forms 1099-DIV (for dividends reportable under section 6042 of the IRC), 1099-INT (except for interest reportable under section 6041), 1099-OID, or 1099-PATR, an official Form 1099 must be furnished to a form recipient either in a statement mailing by first-class mail or in person. For payments of royalties reportable on Form 1099-MISC, you are also required to furnish the statement in person or in a statement mailing by first-class mail, but the statement need not be the official form. (The statement mailing requirements does not apply to the forms listed in 8.04.) These forms may be mailed or provided to the recipient in one of two ways: (1) in a statement mailing with other Forms 1098, 1099 or 5498 form recipient statements, a check, a letter explaining why no check is enclosed, a statement of the person's account, Forms W-8 and W-9, Forms W-2 and W-2P, and a letter limited to an explanation of the tax consequences of the enclosed form recipient statements. The statement " Important Tax Return Document Enclosed" must appear on the outside of the envelope and on each check, letter, or account statement in a bold and conspicuous manner. A form recipient statement may be perforated to a check with respect to the account reported on the payee statement or to a statement of the payee's specific account if payments on such account are reflected on the form recipient statement. The enclosure to which the form recipient statement is perforated must contain, in a bold and conspicuous type, the legend "Important Tax Return Document Attached." (2) in a separate mailing with other Forms 1098, 1099, or 5498 form recipient statements, Forms W-8 and W-9, Forms W-2 and W-2P, and a letter of the tax consequences of the enclosed form recipient statements. If you make a separate mailing you are not required to include the legend "Important Tax Return Document Enclosed" on the envelope. NOTE: Whether you use method (1) or (2), no other information, such as advertising, promotional material, or a quarterly or annual report, may be mailed with the form recipient statement or provided in person with the form recipient statement without violating these requirements. See Notice 87-17, 1987-1 C.B. 454, and Notice 87-70, 1987-2 C.B. 380, for the rules on how these statements should be provided to form recipients.

.02 SUBSTITUTE STATEMENTS TO RECIPIENTS.—The requirement to furnish form recipients with an official Form 1099-DIV, INT, OID, and 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 the aggregate amount paid to the form recipient, any Federal income tax withheld under IRC section 3406 of the Code, the name, address, and TIN of the person making the return, and any other information required by the official form. Generally, information not required by the official form should not be included on the form because it may violate the mailing requirements (see .01 above). In addition, the form recipient statement for interest, dividends, patronage dividends, and original issue discount must contain the information listed below.

1 Payment boxes, captions and numbers that are applicable must be clearly identified, using the same wording and numbering as on the official form.

2 The form recipient statement must contain all applicable form recipient instructions provided on the front and back of the official IRS form.

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 IRS determines that it has not been reported."

4 The caption "Federal income tax withheld" should 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.

6 The form recipient statement must show the title and number of the official IRS Form 1099 for which it substitutes.

7 If the form recipient statement contains all the information listed in 1 through 6 above, layout and format of the form is at the discretion of the filer.

.03 COMPOSITE SUBSTITUTE STATEMENTS.—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. Do not include any other Forms 1099 (i.e. 1098, 1099-A, 1099-B) on a composite state with the forms listed above. This will violate the official form requirements. Although the composite form recipient statement may be on one form, the format of the composite form recipient statement must satisfy the following requirements in addition to the requirements listed in .02 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.

2 The title of the official IRS form or forms for which this form recipient statement substitutes must be shown at the beginning of each appropriate block of information.

3 Any information required by the official IRS form 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.

.04 SUBSTITUTE STATEMENTS TO RECIPIENTS.—Forms 1098, 1099-A, 1099-B, 1099-G, 1099-MISC, 1099-R, 1099-S, 5498, W-2G (1099-INT and 1099-DIV in certain cases). Statements to form recipients of payments reportable on Forms 1098, 1099-A, 1099-B, 1099-G, 1099-MISC, 1099-R, 1099-S, 5498, 1099-DIV (for section 404(k) dividends reportable under section 6047), and 1099-INT (only for payments reportable under section 6041) should meet the following requirements:

1. The filer and form recipient information required on the official IRS form must be included.
2. All money amounts and information 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.
3. Form recipient statements must contain the following:
   (1) Forms 5498 and Form 1099-R—"This information is being furnished to the Internal Revenue Service."
   (2) Forms 1099-B, 1099-DIV, 1099-G, 1099-INT, 1099-MISC and W-2G— "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."
   (3) Form 1099-A—"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."
   (4) Form 1098—(a) "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 the IRS determines that an underpayment of tax results because you overstated a deduction for this mortgage interest on your return."
   (b) "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."
   (5) Form 1099-S—"This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this item is required to be reported and the IRS determines that it has not been reported." NOTE: You may use a Uniform Settlement Statement (under RESPA) as the written statement if it is conformed by designating on the statement the legend described above and by designating which information is being reported to IRS on Form 1099-S.
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 on the statement furnished to form recipients 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 statements required to be furnished in a calendar year.

.05 Form recipient statements specified in .04 above may contain information other than that required by the official IRS form. However, if other information is included, such statements cannot be mailed with Forms 1099-DIV, INT, OID, PATR, MISC (for royalty payments) or their

substitutes without violating the statement mailing requirements.

.06 COMPOSITE SUBSTITUTE STATEMENT—A composite form recipient statement for forms specified in .05 is permitted when one filer is reporting any or all of these payments during a calendar year to the same form recipient. A composite statement is not allowable for a combination of forms listed in 8.01 above and forms listed in 8.04. For example, a composite statement of Forms 1098 and 1099-INT (for interest reportable under section 6049) is not allowable. Although the composite form recipient statement may be on one form, the format of the composite form recipient statement must satisfy the requirements listed in items (1), (2), and (3) of .03 above.

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 of Forms 1098 (Copy A), 1099 (Copy A), 5498 (Copy A), and 1096.

.02 The form identifying number (e.g., 9191 for Forms 1099-DIV) must be printed in non-reflective black carbon-based ink in print positions 25 through 29 using an OCR A font. The ballot boxes located to the right of the form identifying number must be 10-point boxes.

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. "Spot Carbons" are *not permitted* for Copy A. The Government Printing Office (GPO) symbol must be deleted. Specifications for Copy A are provided in Exhibits A thru N.

.02 Color and quality of paper. 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/m2... 75

A Tolerance of +5 pct. shall be allowed.

3 Stiffness: Average, each direction, not less than—milligrams 50

4 Tearing strength: Average, each direction, not less than—grams 40

5 Opacity: Average, not less than—percent 82

6 Thickness: Average—inch—0.0038

Metric equivalent—mm—0.097

A tolerance of +0.0005 inch (0.0127 mm) shall be allowed.

Paper shall not vary more than 0.0004 inch (0.0102 mm) from one edge to the other.

7 Porosity: Average, not less than—seconds 10

8 Finish (smoothness): Average, each side—seconds.. 20-55

For information only, the Sheffield equivalent—units 170-100

9 Dirt: Average, each side, not to exceed—parts per million 8

.03 All printing will be in red OCR dropout ink Sinclair-Valentine J-6983 or an exact match, except for the 4-digit form identifying numbers appearing in the upper middle margin on the official IRS form, which will be printed in non-reflective carbon-based black ink. The screened area of any substitute form should generally correspond to that present on the official form. Separation between fields must be 0.1 inch. The numbered captions are printed as a solid with no screened background.

OCR Specifications

The contractor must have or initiate a quality control program to assure OCR ink density. In addition he or she must have at, or adjacent to the production area either a MacBeth PCM-II tester or a Kidder 082A tester for testing to be accomplished 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 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, N.W.
Washington, DC 20224

Printing exceeding the maximum screen density will cause the forms to be nonprocessable. If this happens the filer may be subject to a $50 penalty for each form printed or prepared that is submitted in a nonprocessable format. Thus, the filer should resubmit acceptable forms promptly to reduce or avoid the penalty.

.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 official Forms 1098, 1099 or 5498 (Copy A) are contained on a single page, which is 8 inches wide (exclusive of any snap—stubs and/or pinfeed holes) by 11 inches deep. See exhibits A thru N in this publication for the correct form measurements. 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.

.06 The depth of the individual trim size of each form on a page must be the same (3-⅔ inches) as that of the official form.

.07 Perforations are required between forms on all copies except Copy A to enable the separation of individual forms.

.08 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.

.09 The OMB Number *must* be printed on *each* ply in the same location as on the official form.

.10 *Privately printed continuous substitute forms (Copy A) must be perforated at each 11" (3-on) page depth. No perforations are allowed between the 3-⅔" forms on a single copy page of Copy A.*

.11 The words "*Do NOT Cut or Separate Forms on This Page*" must be printed in red dropout ink (as required by form specifications) between the three forms. 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) included in the set.

.12 The back of a substitute Copy A must be free of all printing.

.13 Carbonized. "*Spot carbons*" are *not permitted* for Copy A. Interleaved carbon must be of good quality to assure legibility of information on all parts to preclude smudging and should be black. "Chemical transfer paper" is permitted without IRS approval.

.14 Printer's symbol—The GPO symbol must not be placed on substitute Copy A. *In place of the GPO symbol,* 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, or the bottom margin on the reverse side of each Form 1096.

.15 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; b) no part of the indicia is within 1 print position of the scannable area; c) there is a .33 inch head margin from the corrected box; and d) there is a ¼ inch right margin.

PART C. SPECIFICATION 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 IRS (hereinafter referred to as substitute Copy A). Substitute forms submitted to IRS must be exact replicas of the official forms with respect to layout and contents. The Government Printing Office symbol must be deleted.

SEC. 2. SPECIFICATIONS FOR COPY A FOR FORMS W-2G

.01 Color and Quality of Paper—Paper for Copy A must be white chemical wood bond, or equivalent, 20 pound (basis 17 X 22-500), plus or minus 5 percent. The paper must consist of principally bleached chemical woodpulp and be free from unbleached or ground woodpulp 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—Type must be substantially identical in size and shape with corresponding type 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, parallel to the top edge.

.04 Dimensions—The official form is 8 inches wide x 3-⅔ inches deep, exclusive of a ⅔ inch snap stub on the left side of the form. The snap feature is not required on substitutes. The top and right margins must be ¼ inch plus or minus .0313. If the top and right margins are properly aligned, the left margin for all forms will be correct. All margins must be free of all 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 before they are filed with IRS.

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 Clear Area—The back of Copy A must be free of all printing.

.06 Carbonized forms or "spot carbons"— Carbonized forms and "spot carbons" are not permitted. Interleaved carbons, if used, should be black and good quality to preclude smudging.

.07 Printer's Symbol—The Government Printing Office symbol must not be printed on substitute Forms W-2G. In place thereof, the printer's employer identification number should appear in the same place on such substitute forms.

PART D. ADDITIONAL INSTRUCTIONS FOR FORMS 1098, 1099, 5498, AND W-2G

SEC. 1. OTHER COPIES

.01 Copies 1 and 2, B, C and D are included in the official assembly for the convenience of the filer. Although there is no requirement that privately printed substitute forms include these copies, Copies B and C will satisfy the requirement of law and regulations concerning the statement of information that is required to be furnished to the form recipient. Copies C and D may be desired as a filer record copy. Only Copy A should be filed with IRS.

.02 Arrangement of Assembly The parts of the assembly shall be arranged, from top to bottom, as follows: Form 1098 Copy A, "For Internal Revenue Service Center"; Copy B "For Payer"; Copy C "For Recipient." Forms 1099 (except 1099-A, 1099-R, 1099-MISC, 1099-S, 5498, and W-2G) Copy A, "For Internal Revenue Service Center"; Copy B "For Recipient"; Copy C "For Payer." Form 1099-A Copy A, "For Internal Revenue Service Center"; Copy B "For Borrower"; Copy C

"For Lender." Form 1099-R and 1099-MISC Copy A, "For Internal Revenue Service"; 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." Form 1099-S Copy A,"For Internal Revenue Service Center"; Copy B, "For Transferor"; Copy C, "For Filer." Form 5498 Copy A, "For Internal Revenue Service Center"; Copy B "For Participant"; Copy C "For Trustee or Issuer." Form W-2G Copy A, "For Internal Revenue Service Center"; Copy 1, "For State Tax Department"; Copy B and Copy C "For Winner's Records"; Copy 2 "To be filed with winner's state income tax return, if required."; Copy D "For Payer."

SEC. 2. REPRODUCTION PROOFS

.01 Reproduction Proofs—IRS Publication 1192 containing order blanks and a list of items available for reproduction proofs are mailed annually to requesters of record and to other users upon request. Printers and others wishing to obtain reproduction proofs may send their requests to:

Internal Revenue Service
Attn: Repro Coordinator
4300 Carolina Ave
Richmond, VA 23222

.02 Pub. 1192 indicates the appropriate charge for each form, instruction, and publication. Order blanks must be filled out and submitted along with a total payment for all items ordered. Orders will be filled as the reproduction proofs become available. Orders without the correct payment will be returned.

SEC. 3. OMB REQUIREMENTS

.01 Office of Management and Budget (OMB) Requirements for Substitute Forms—Public Law 96-511 requires: (1) OMB approval of Internal Revenue Service tax forms, (2) that 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 will contain this information.

.02 As it applies to substitute IRS forms this means:

1 All substitute forms 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

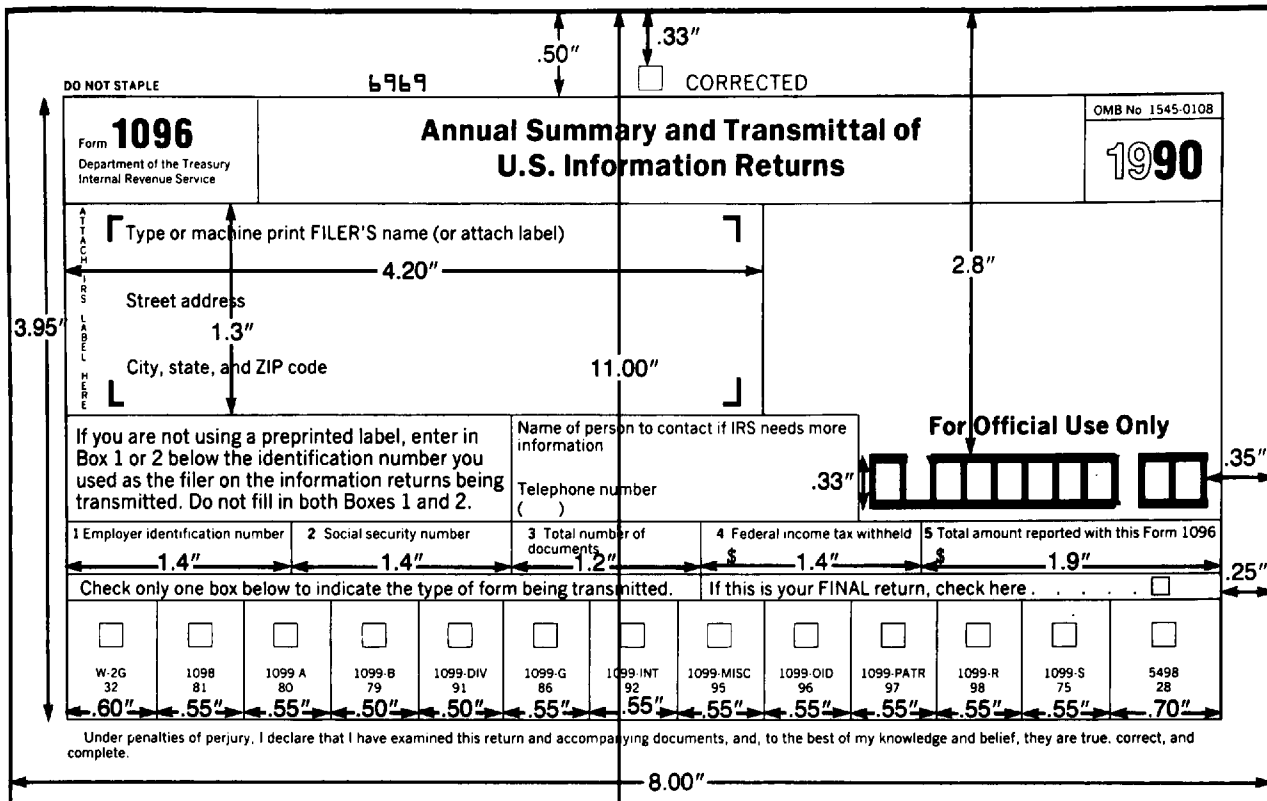
4 You must inform the users of your substitute forms of the reasons for IRS collection, use, and requirements, as stated in the instructions for the IRS form.

5 The official OMB approval numbers may be obtained from reproduction proofs or official IRS printed forms.

SEC. 4. EFFECT ON OTHER REVENUE PROCEDURES

Revenue Procedure 89-42 is superseded.

Exhibit A



Please return this entire page to the Internal Revenue Service. Photocopies are NOT acceptable.

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 on Magnetic Media.

Use of Preprinted Label.—If you received a preprinted label from 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, 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, 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), and a lender who acquires an interest in secured property or who has reason to know that the property has been abandoned.

Transmitting to IRS.—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 Forms 1099-A, complete one Form 1096 to transmit your Forms 1098 and another Form 1096 to transmit your Forms 1099-A.

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 are not required to 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 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	Box 1
Form 1099-B	Boxes 2 and 3
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 Paperwork Reduction Act Notice, see the separate Instructions for Forms 1099, 1098, 5498, and W-2G. Form **1096** (1990)

Exhibit B

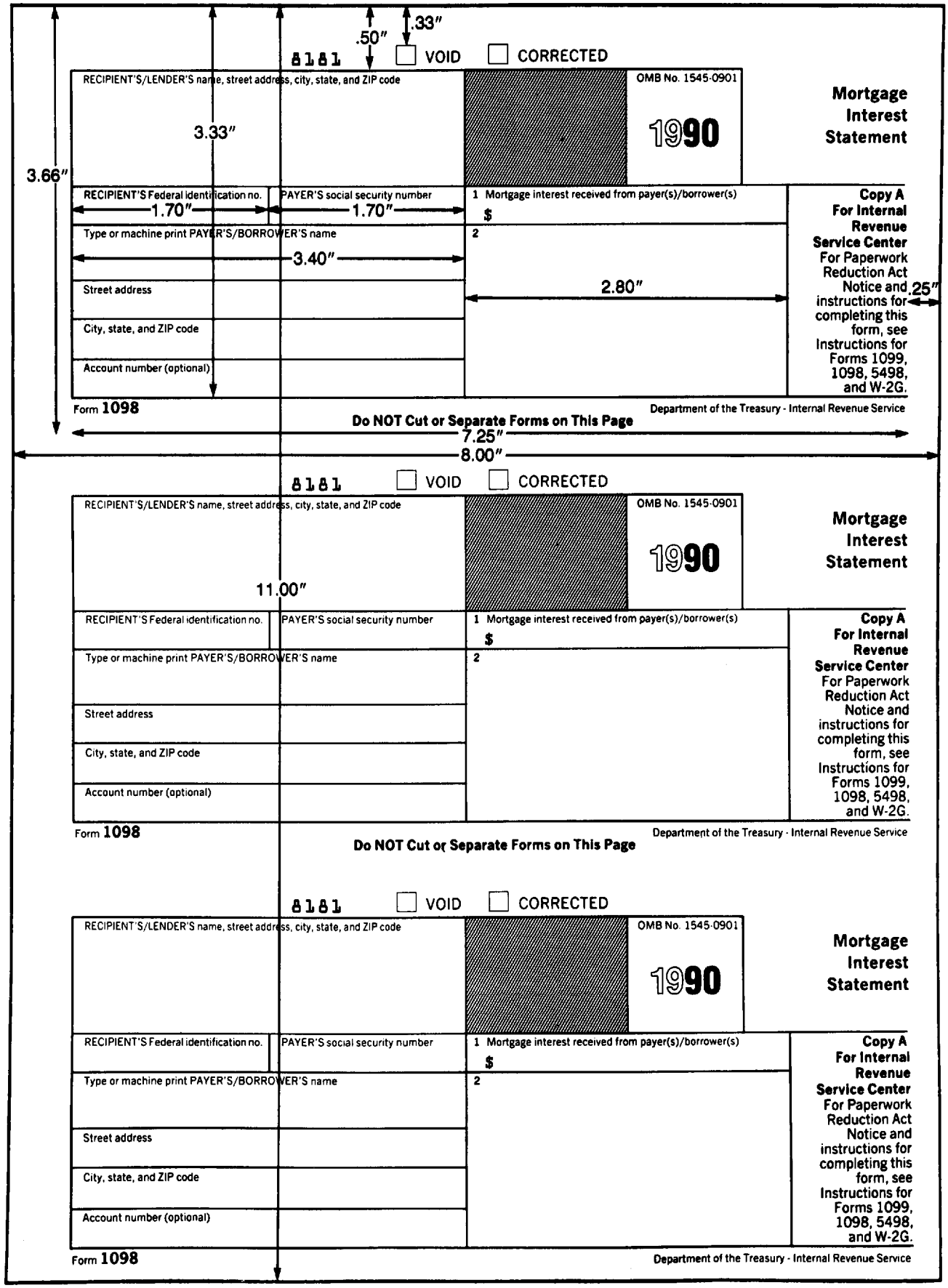

.50"
.33"
8181
VOID
CORRECTED
RECIPIENT'S/LENDER'S name, street address, city, state, and ZIP code
OMB No. 1545-0901
1990
Mortgage Interest Statement
3.33"
3.66"
RECIPIENT'S Federal identification no.
PAYER'S social security number
1.70"
1.70"
1 Mortgage interest received from payer(s)/borrower(s)
$
Type or machine print PAYER'S/BORROWER'S name
2
3.40"
2.80"
Street address
City, state, and ZIP code
Account number (optional)
.25"
Copy A For Internal Revenue Service Center For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Form 1098
Department of the Treasury - Internal Revenue Service
Do NOT Cut or Separate Forms on This Page
7.25"
8.00"
11.00"

Exhibit C

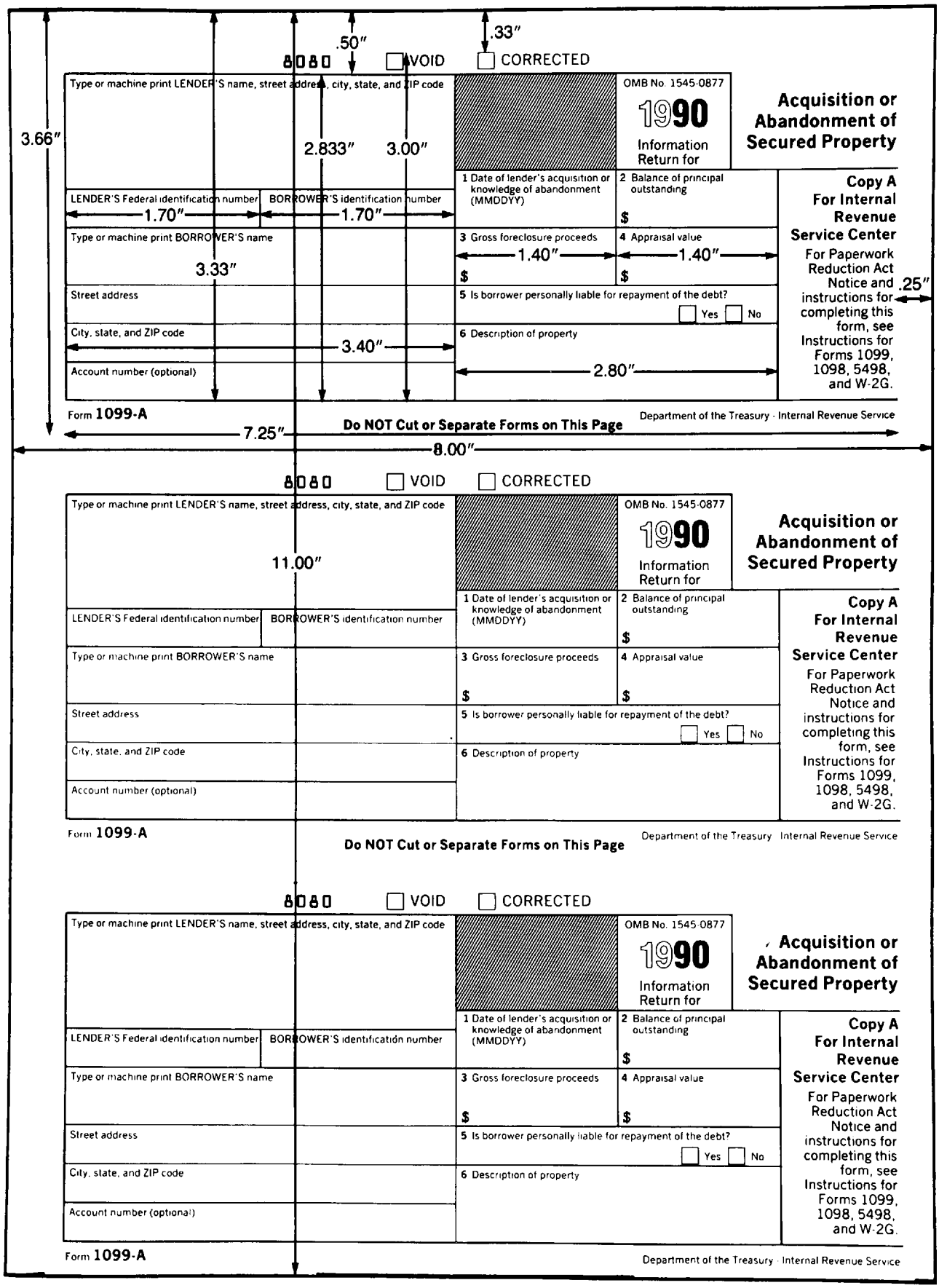

.50"
.33"
8080
VOID
CORRECTED
Type or machine print LENDER'S name, street address, city, state, and ZIP code
OMB No. 1545-0877
1990
Information Return for
Acquisition or Abandonment of Secured Property
3.66"
2.833"
3.00"
1 Date of lender's acquisition or knowledge of abandonment (MMDDYY)
2 Balance of principal outstanding
$
LENDER'S Federal identification number
BORROWER'S identification number
1.70"
1.70"
Type or machine print BORROWER'S name
3.33"
3 Gross foreclosure proceeds
1.40"
4 Appraisal value
1.40"
$
$
Street address
5 Is borrower personally liable for repayment of the debt?
Yes
No
City, state, and ZIP code
3.40"
6 Description of property
Account number (optional)
2.80"
Copy A For Internal Revenue Service Center
For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
.25"
Form 1099-A
Department of the Treasury - Internal Revenue Service
7.25"
Do NOT Cut or Separate Forms on This Page
8.00"
8080
VOID
CORRECTED
Type or machine print LENDER'S name, street address, city, state, and ZIP code
OMB No. 1545-0877
1990
Information Return for
Acquisition or Abandonment of Secured Property
11.00"
1 Date of lender's acquisition or knowledge of abandonment (MMDDYY)
2 Balance of principal outstanding
$
LENDER'S Federal identification number
BORROWER'S identification number
Type or machine print BORROWER'S name
3 Gross foreclosure proceeds
4 Appraisal value
$
$
Street address
5 Is 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
For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Form 1099-A
Department of the Treasury - Internal Revenue Service
Do NOT Cut or Separate Forms on This Page
8080
VOID
CORRECTED
Type or machine print LENDER'S name, street address, city, state, and ZIP code
OMB No. 1545-0877
1990
Information Return for
Acquisition or Abandonment of Secured Property
1 Date of lender's acquisition or knowledge of abandonment (MMDDYY)
2 Balance of principal outstanding
$
LENDER'S Federal identification number
BORROWER'S identification number
Type or machine print BORROWER'S name
3 Gross foreclosure proceeds
4 Appraisal value
$
$
Street address
5 Is 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
For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Form 1099-A
Department of the Treasury - Internal Revenue Service

Exhibit D

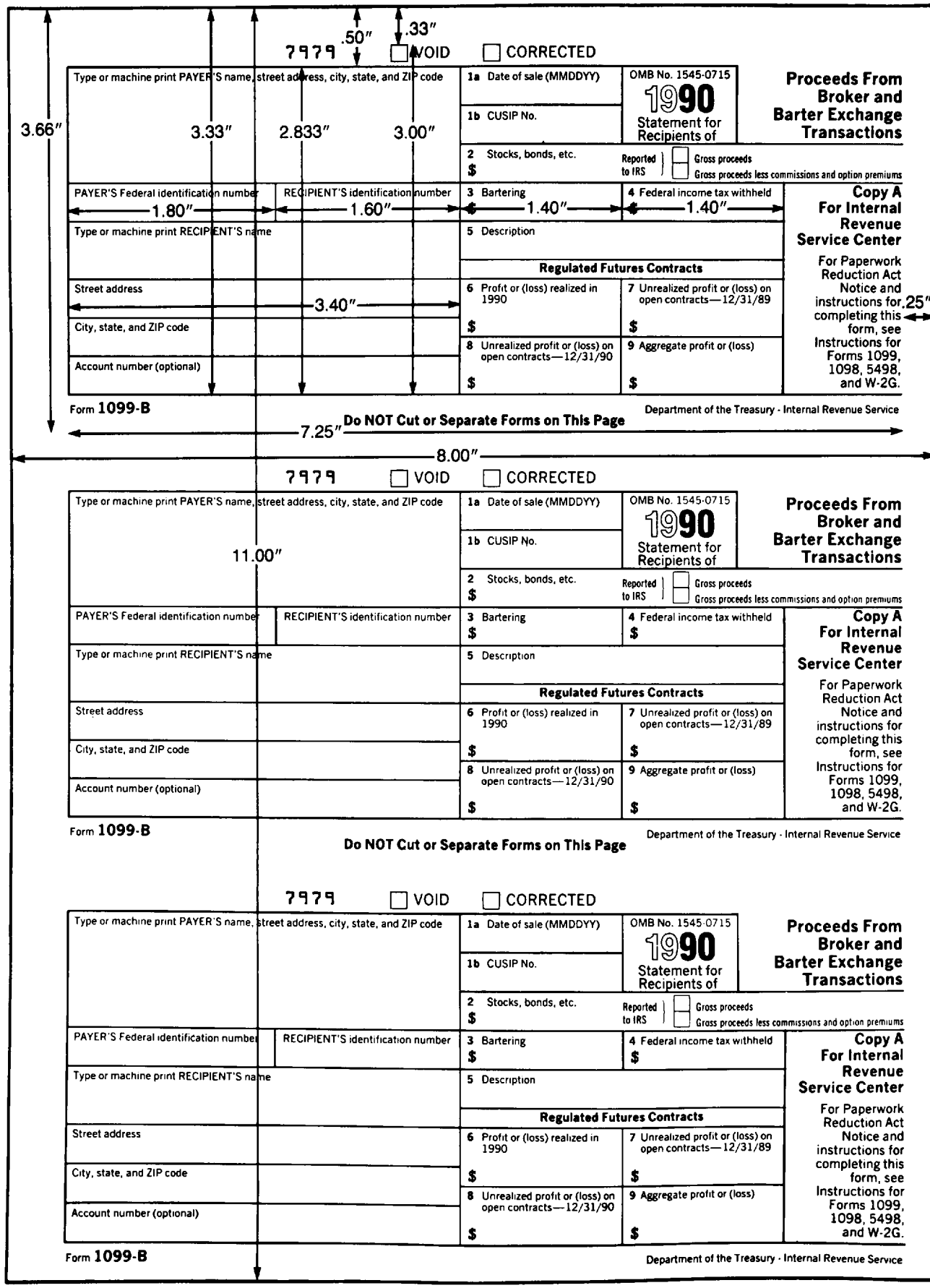

3.66″
3.33″
2.833″
3.00″
.50″
.33″
7979
VOID
CORRECTED
Type or machine print PAYER'S name, street address, city, state, and ZIP code
1a Date of sale (MMDDYY)
1b CUSIP No.
OMB No. 1545-0715
1990
Statement for Recipients of
Proceeds From Broker and Barter Exchange Transactions
2 Stocks, bonds, etc.
$
Reported to IRS
Gross proceeds
Gross proceeds less commissions and option premiums
PAYER'S Federal identification number
RECIPIENT'S identification number
1.80″
1.60″
3 Bartering
4 Federal income tax withheld
1.40″
1.40″
Type or machine print RECIPIENT'S name
5 Description
Regulated Futures Contracts
Street address
3.40″
6 Profit or (loss) realized in 1990
7 Unrealized profit or (loss) on open contracts—12/31/89
City, state, and ZIP code
8 Unrealized profit or (loss) on open contracts—12/31/90
9 Aggregate profit or (loss)
Account number (optional)
Copy A For Internal Revenue Service Center
For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
.25″
Form 1099-B
Department of the Treasury - Internal Revenue Service
Do NOT Cut or Separate Forms on This Page
7.25″
8.00″
11.00″

Exhibit E

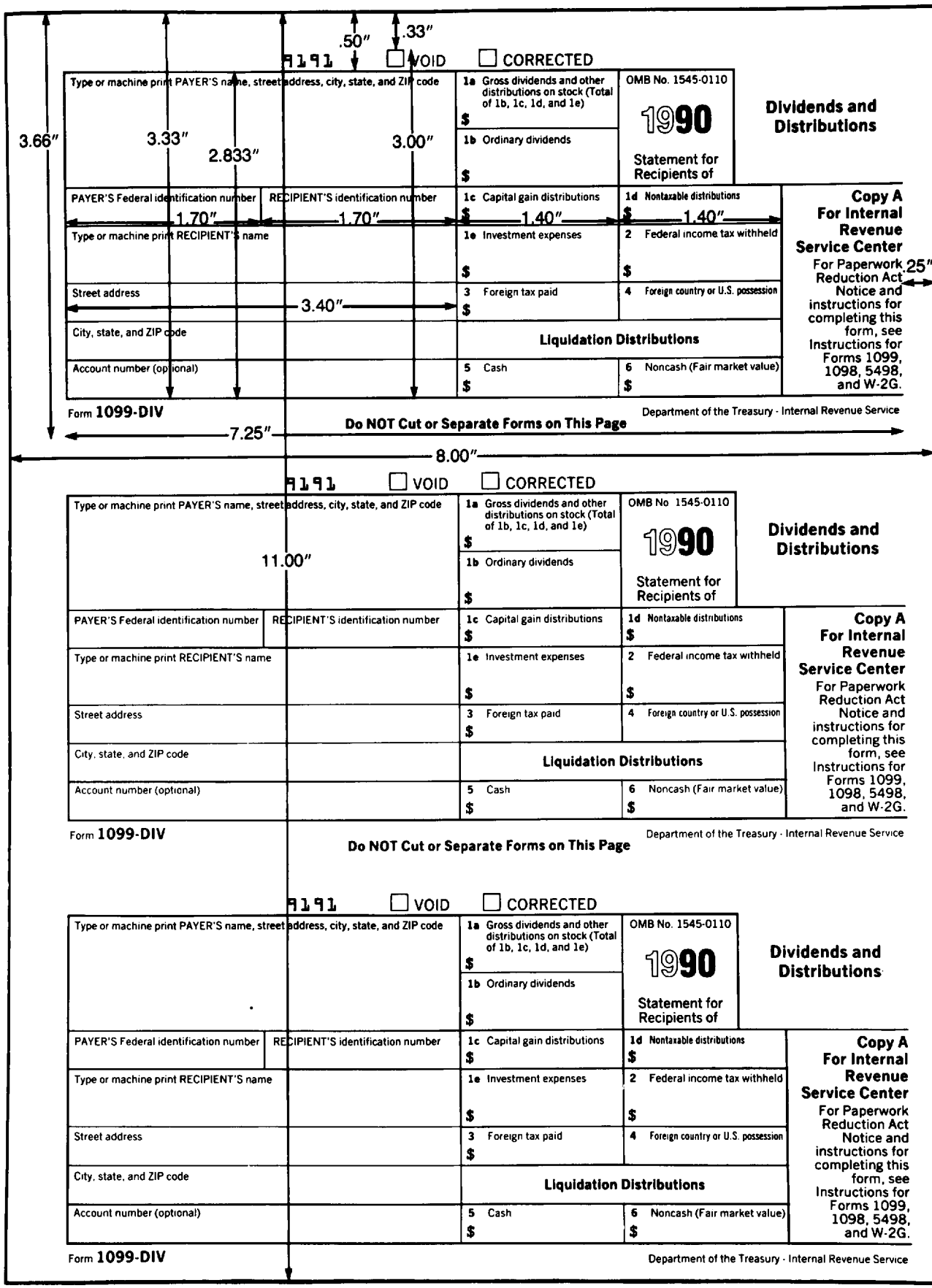

.50"
.33"
9191
VOID
CORRECTED
Type or machine print PAYER'S name, street address, city, state, and ZIP code
1a Gross dividends and other distributions on stock (Total of 1b, 1c, 1d, and 1e)
$
1b Ordinary dividends
$
OMB No. 1545-0110
1990
Statement for Recipients of
Dividends and Distributions
3.66"
3.33"
2.833"
3.00"
PAYER'S Federal identification number
RECIPIENT'S identification number
1.70"
1.70"
1c Capital gain distributions
$
1.40"
1d Nontaxable distributions
$
1.40"
Type or machine print RECIPIENT'S name
1e Investment expenses
$
2 Federal income tax withheld
$
Street address
3.40"
3 Foreign tax paid
$
4 Foreign country or U.S. possession
City, state, and ZIP code
Liquidation Distributions
Account number (optional)
5 Cash
$
6 Noncash (Fair market value)
$
Copy A For Internal Revenue Service Center
For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
.25"
Form 1099-DIV
Department of the Treasury - Internal Revenue Service
7.25"
Do NOT Cut or Separate Forms on This Page
8.00"
9191
VOID
CORRECTED
Type or machine print PAYER'S name, street address, city, state, and ZIP code
11.00"
1a Gross dividends and other distributions on stock (Total of 1b, 1c, 1d, and 1e)
$
1b Ordinary dividends
$
OMB No 1545-0110
1990
Statement for Recipients of
Dividends and Distributions
PAYER'S Federal identification number
RECIPIENT'S identification number
1c Capital gain distributions
$
1d Nontaxable distributions
$
Type or machine print RECIPIENT'S name
1e Investment expenses
$
2 Federal income tax withheld
$
Street address
3 Foreign tax paid
$
4 Foreign country or U.S. possession
City, state, and ZIP code
Liquidation Distributions
Account number (optional)
5 Cash
$
6 Noncash (Fair market value)
$
Copy A For Internal Revenue Service Center
For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Form 1099-DIV
Department of the Treasury - Internal Revenue Service
Do NOT Cut or Separate Forms on This Page
9191
VOID
CORRECTED
Type or machine print 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)
$
1b Ordinary dividends
$
OMB No. 1545-0110
1990
Statement for Recipients of
Dividends and Distributions
PAYER'S Federal identification number
RECIPIENT'S identification number
1c Capital gain distributions
$
1d Nontaxable distributions
$
Type or machine print RECIPIENT'S name
1e Investment expenses
$
2 Federal income tax withheld
$
Street address
3 Foreign tax paid
$
4 Foreign country or U.S. possession
City, state, and ZIP code
Liquidation Distributions
Account number (optional)
5 Cash
$
6 Noncash (Fair market value)
$
Copy A For Internal Revenue Service Center
For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Form 1099-DIV
Department of the Treasury - Internal Revenue Service

Exhibit F

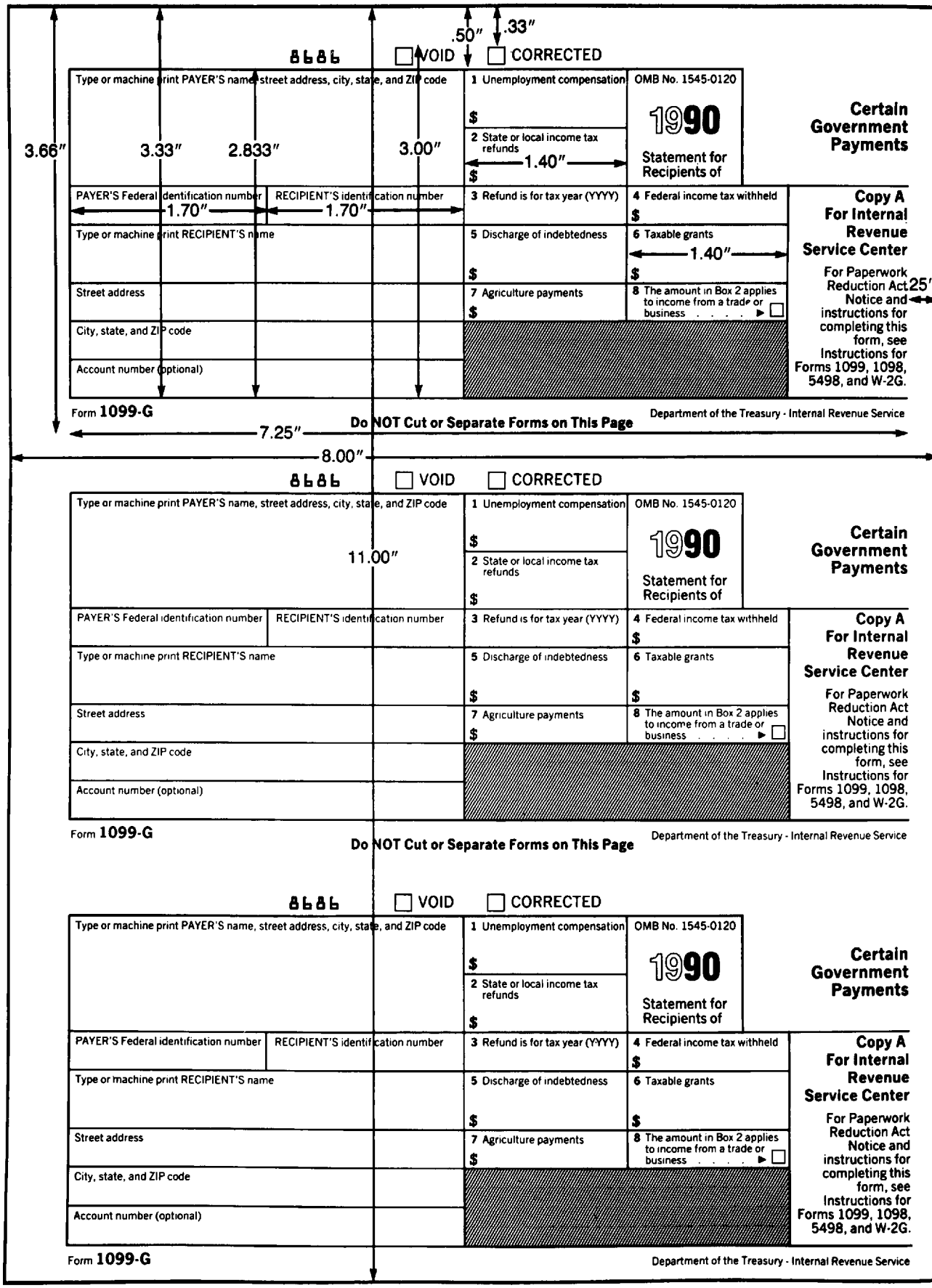

8686
VOID
CORRECTED
Type or machine print PAYER'S name, street address, city, state, and ZIP code
1 Unemployment compensation
$
2 State or local income tax refunds
$
OMB No. 1545-0120
1990
Statement for Recipients of
Certain Government Payments
PAYER'S Federal identification number
RECIPIENT'S identification number
3 Refund is for tax year (YYYY)
4 Federal income tax withheld
$
Type or machine print RECIPIENT'S name
5 Discharge of indebtedness
$
6 Taxable grants
$
Street address
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)
Copy A For Internal Revenue Service Center
For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Form 1099-G
Department of the Treasury - Internal Revenue Service
Do NOT Cut or Separate Forms on This Page
3.66"
3.33"
2.833"
3.00"
.50"
.33"
1.40"
1.70"
1.70"
1.40"
25"
7.25"
8.00"
11.00"

Exhibit G

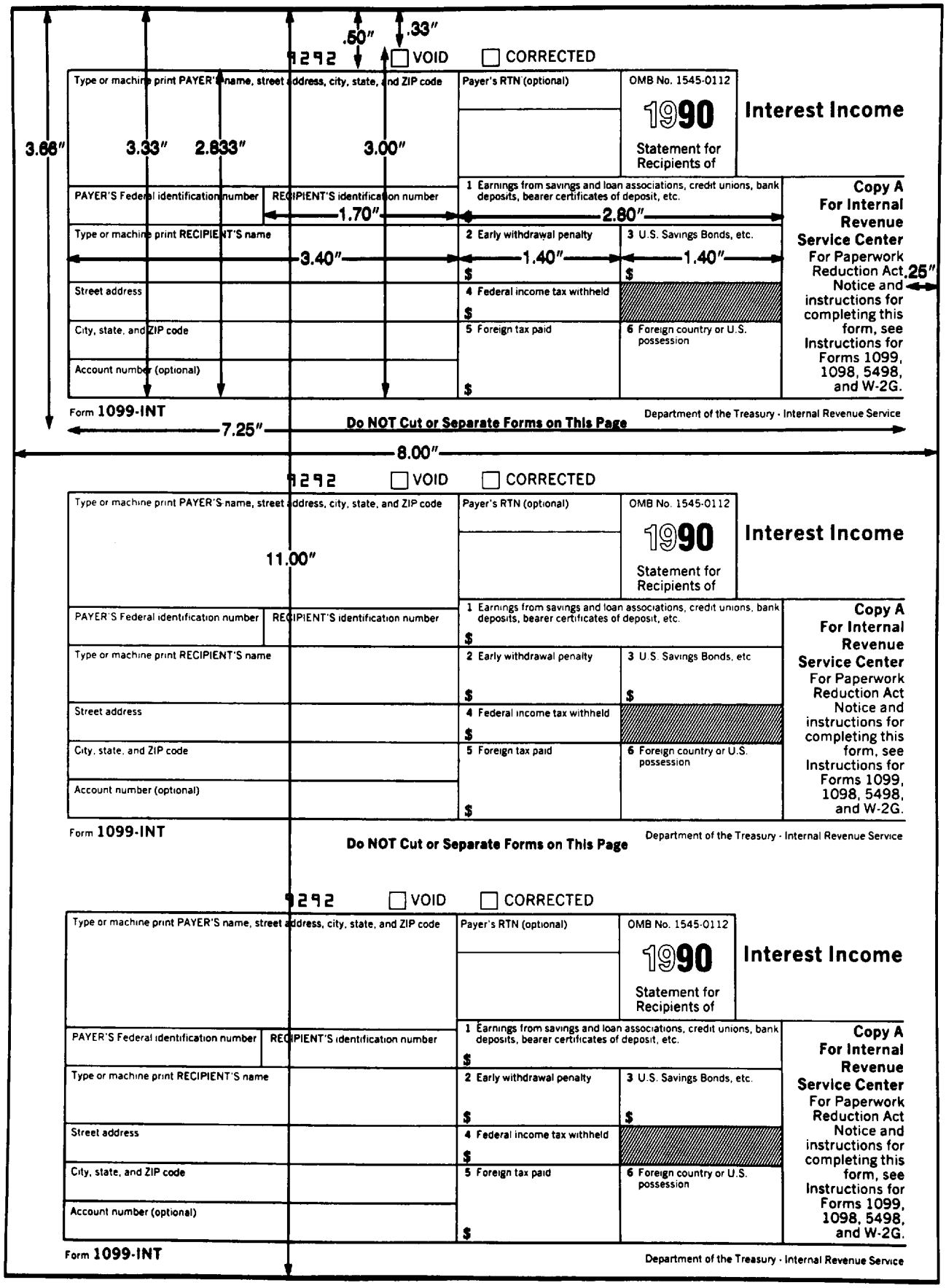

.50"
.33"
9292
VOID
CORRECTED
Type or machine print PAYER'S name, street address, city, state, and ZIP code
Payer's RTN (optional)
OMB No. 1545-0112
1990
Interest Income
Statement for Recipients of
3.66"
3.33"
2.833"
3.00"
PAYER'S Federal identification number
RECIPIENT'S identification number
1.70"
1 Earnings from savings and loan associations, credit unions, bank deposits, bearer certificates of deposit, etc.
2.80"
Type or machine print RECIPIENT'S name
2 Early withdrawal penalty
3 U.S. Savings Bonds, etc.
3.40"
1.40"
1.40"
$
Street address
4 Federal income tax withheld
City, state, and ZIP code
5 Foreign tax paid
6 Foreign country or U.S. possession
Account number (optional)
Copy A For Internal Revenue Service Center
For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
.25"
Form 1099-INT
Department of the Treasury - Internal Revenue Service
7.25"
Do NOT Cut or Separate Forms on This Page
8.00"
11.00"

Exhibit H

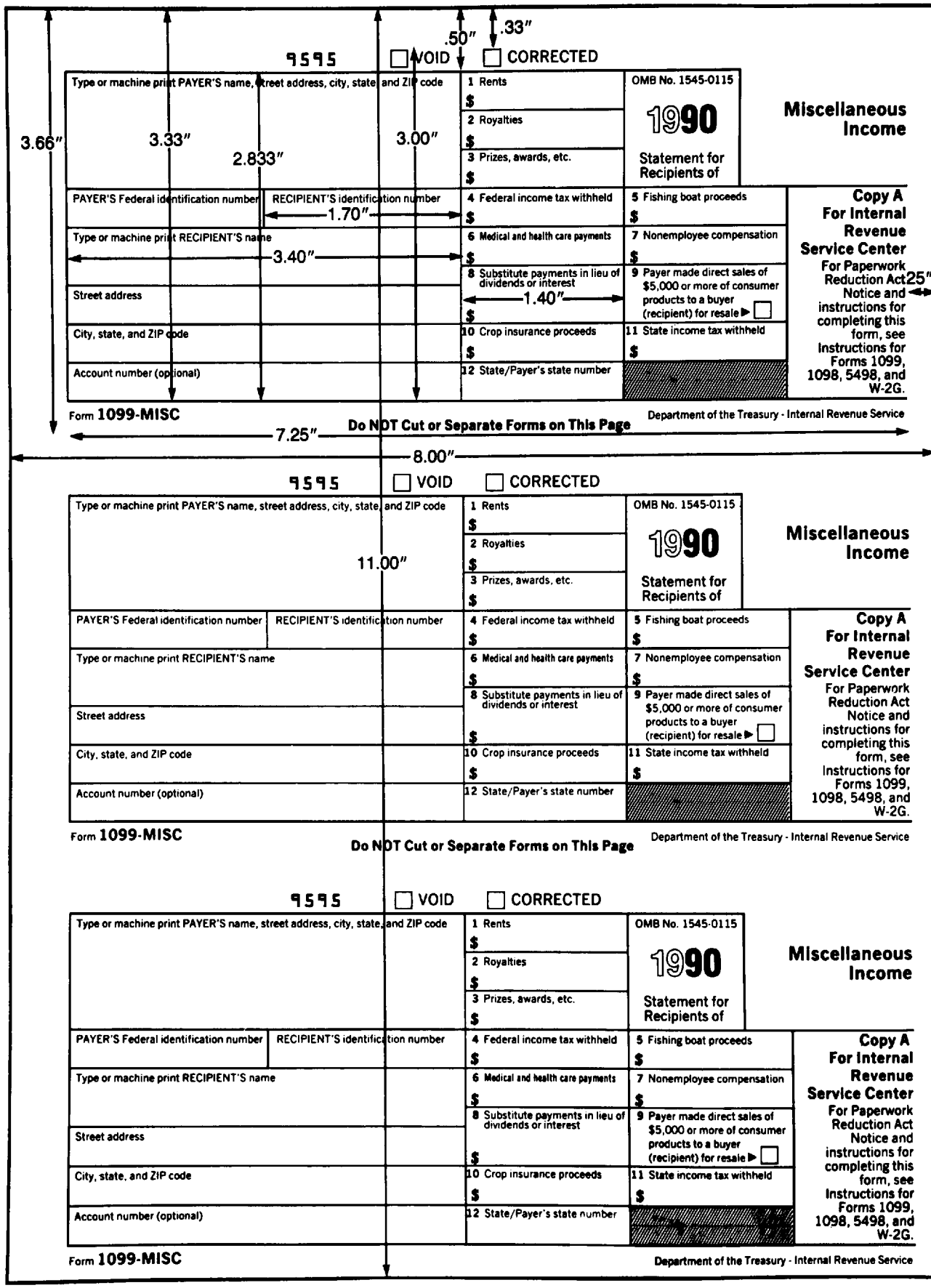

9595
VOID
CORRECTED
.50"
.33"
3.66"
3.33"
2.833"
3.00"
Type or machine print PAYER'S name, street address, city, state, and ZIP code
1 Rents
$
2 Royalties
$
3 Prizes, awards, etc.
$
OMB No. 1545-0115
1990
Statement for Recipients of
Miscellaneous Income
PAYER'S Federal identification number
RECIPIENT'S identification number
1.70"
4 Federal income tax withheld
$
5 Fishing boat proceeds
$
Type or machine print RECIPIENT'S name
3.40"
6 Medical and health care payments
$
7 Nonemployee compensation
$
Street address
8 Substitute payments in lieu of dividends or interest
1.40"
$
9 Payer made direct sales of $5,000 or more of consumer products to a buyer (recipient) for resale ▶
City, state, and ZIP code
10 Crop insurance proceeds
$
11 State income tax withheld
$
Account number (optional)
12 State/Payer's state number
Copy A For Internal Revenue Service Center
For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
.25"
Form 1099-MISC
Department of the Treasury - Internal Revenue Service
7.25"
Do NOT Cut or Separate Forms on This Page
8.00"
9595
VOID
CORRECTED
Type or machine print PAYER'S name, street address, city, state, and ZIP code
11.00"
1 Rents
$
2 Royalties
$
3 Prizes, awards, etc.
$
OMB No. 1545-0115
1990
Statement for Recipients of
Miscellaneous Income
PAYER'S Federal identification number
RECIPIENT'S identification number
4 Federal income tax withheld
$
5 Fishing boat proceeds
$
Type or machine print RECIPIENT'S name
6 Medical and health care payments
$
7 Nonemployee compensation
$
Street address
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 ▶
City, state, and ZIP code
10 Crop insurance proceeds
$
11 State income tax withheld
$
Account number (optional)
12 State/Payer's state number
Copy A For Internal Revenue Service Center
For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Form 1099-MISC
Do NOT Cut or Separate Forms on This Page
Department of the Treasury - Internal Revenue Service
9595
VOID
CORRECTED
Type or machine print PAYER'S name, street address, city, state, and ZIP code
1 Rents
$
2 Royalties
$
3 Prizes, awards, etc.
$
OMB No. 1545-0115
1990
Statement for Recipients of
Miscellaneous Income
PAYER'S Federal identification number
RECIPIENT'S identification number
4 Federal income tax withheld
$
5 Fishing boat proceeds
$
Type or machine print RECIPIENT'S name
6 Medical and health care payments
$
7 Nonemployee compensation
$
Street address
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 ▶
City, state, and ZIP code
10 Crop insurance proceeds
$
11 State income tax withheld
$
Account number (optional)
12 State/Payer's state number
Copy A For Internal Revenue Service Center
For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Form 1099-MISC
Department of the Treasury - Internal Revenue Service

Exhibit I

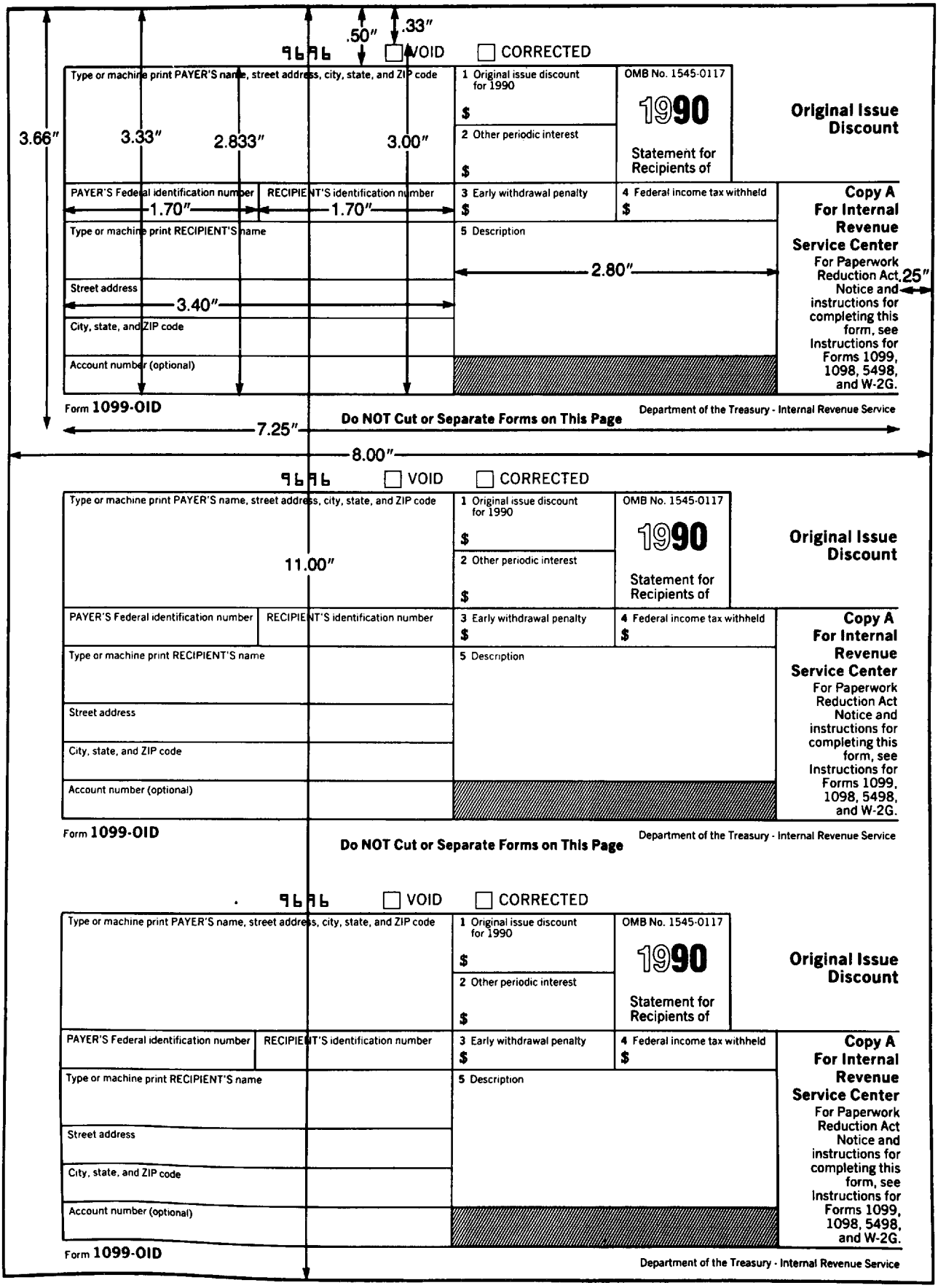

3.66″
3.33″
2.833″
3.00″
.50″
.33″
9696
VOID
CORRECTED
Type or machine print PAYER'S name, street address, city, state, and ZIP code
1 Original issue discount for 1990
$
2 Other periodic interest
$
OMB No. 1545-0117
1990
Statement for Recipients of
Original Issue Discount
PAYER'S Federal identification number
RECIPIENT'S identification number
1.70″
1.70″
3 Early withdrawal penalty
$
4 Federal income tax withheld
$
Type or machine print RECIPIENT'S name
5 Description
2.80″
Street address
3.40″
City, state, and ZIP code
Account number (optional)
Copy A For Internal Revenue Service Center
For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
.25″
Form 1099-OID
Department of the Treasury - Internal Revenue Service
Do NOT Cut or Separate Forms on This Page
7.25″
8.00″
11.00″

Exhibit J

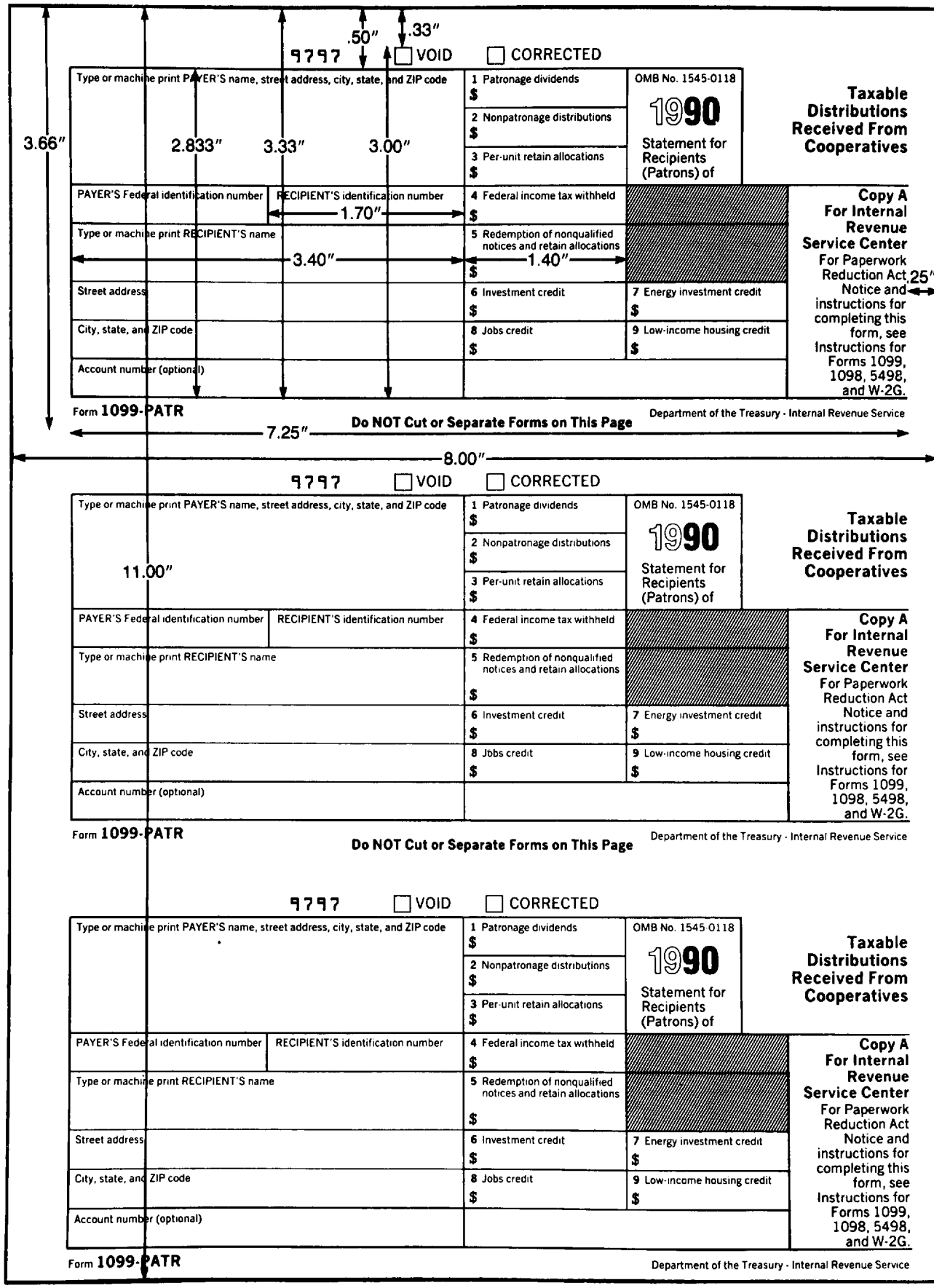

.50"
.33"
9797
VOID
CORRECTED
Type or machine print PAYER'S name, street address, city, state, and ZIP code
1 Patronage dividends
$
2 Nonpatronage distributions
$
3 Per-unit retain allocations
$
OMB No. 1545-0118
1990
Statement for Recipients (Patrons) of
Taxable Distributions Received From Cooperatives
3.66"
2.833"
3.33"
3.00"
PAYER'S Federal identification number
RECIPIENT'S identification number
1.70"
4 Federal income tax withheld
$
Type or machine print RECIPIENT'S name
3.40"
5 Redemption of nonqualified notices and retain allocations
$
1.40"
Copy A For Internal Revenue Service Center
For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
.25"
Street address
6 Investment credit
$
7 Energy investment credit
$
City, state, and ZIP code
8 Jobs credit
$
9 Low-income housing credit
$
Account number (optional)
Form 1099-PATR
Department of the Treasury - Internal Revenue Service
Do NOT Cut or Separate Forms on This Page
7.25"
8.00"
9797
VOID
CORRECTED
Type or machine print PAYER'S name, street address, city, state, and ZIP code
11.00"
1 Patronage dividends
$
2 Nonpatronage distributions
$
3 Per-unit retain allocations
$
OMB No. 1545-0118
1990
Statement for Recipients (Patrons) of
Taxable Distributions Received From Cooperatives
PAYER'S Federal identification number
RECIPIENT'S identification number
4 Federal income tax withheld
$
Type or machine print RECIPIENT'S name
5 Redemption of nonqualified notices and retain allocations
$
Copy A For Internal Revenue Service Center
For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Street address
6 Investment credit
$
7 Energy investment credit
$
City, state, and ZIP code
8 Jobs credit
$
9 Low-income housing credit
$
Account number (optional)
Form 1099-PATR
Department of the Treasury - Internal Revenue Service
Do NOT Cut or Separate Forms on This Page
9797
VOID
CORRECTED
Type or machine print PAYER'S name, street address, city, state, and ZIP code
1 Patronage dividends
$
2 Nonpatronage distributions
$
3 Per-unit retain allocations
$
OMB No. 1545-0118
1990
Statement for Recipients (Patrons) of
Taxable Distributions Received From Cooperatives
PAYER'S Federal identification number
RECIPIENT'S identification number
4 Federal income tax withheld
$
Type or machine print RECIPIENT'S name
5 Redemption of nonqualified notices and retain allocations
$
Copy A For Internal Revenue Service Center
For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Street address
6 Investment credit
$
7 Energy investment credit
$
City, state, and ZIP code
8 Jobs credit
$
9 Low-income housing credit
$
Account number (optional)
Form 1099-PATR
Department of the Treasury - Internal Revenue Service

Exhibit K

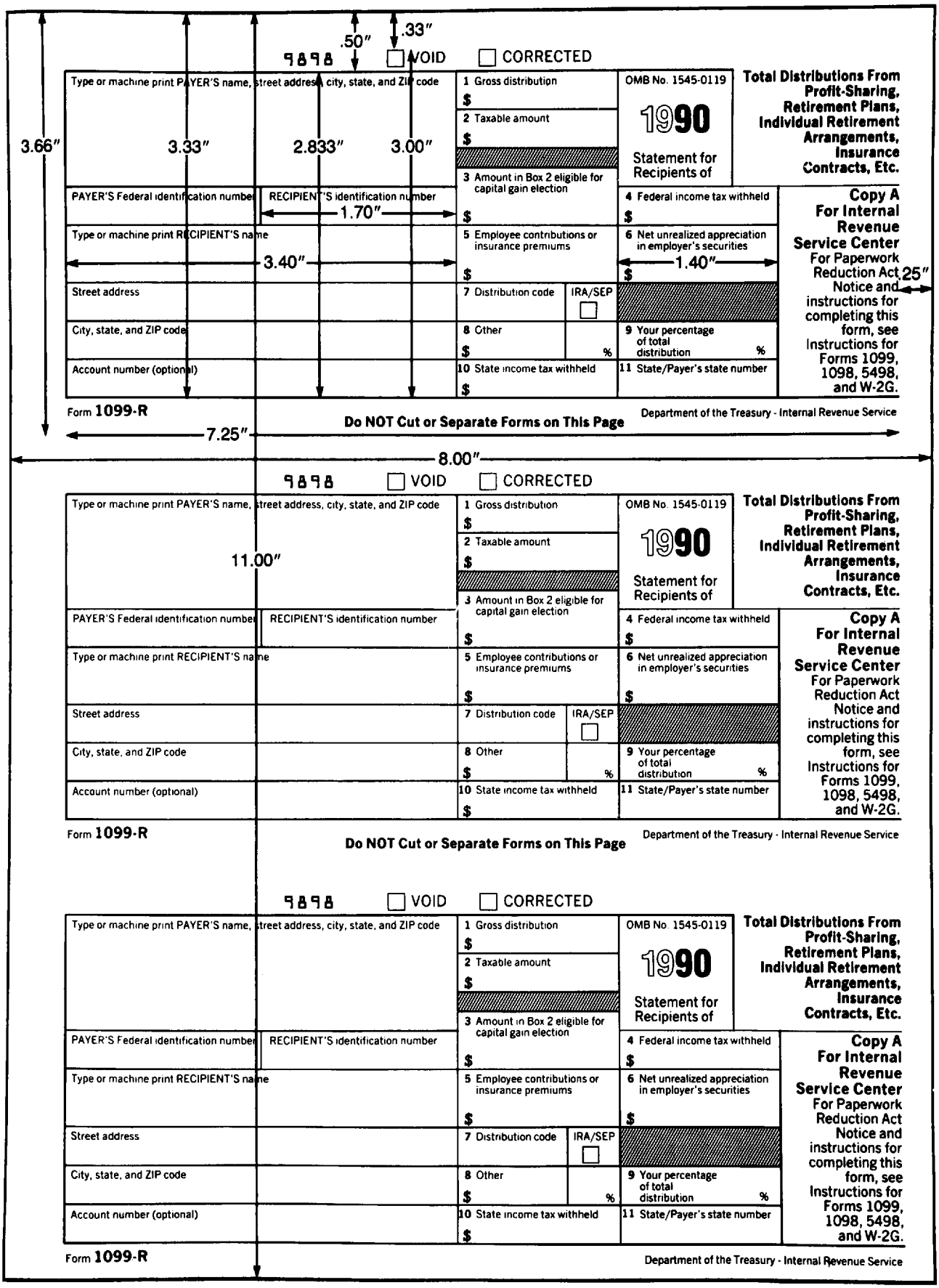
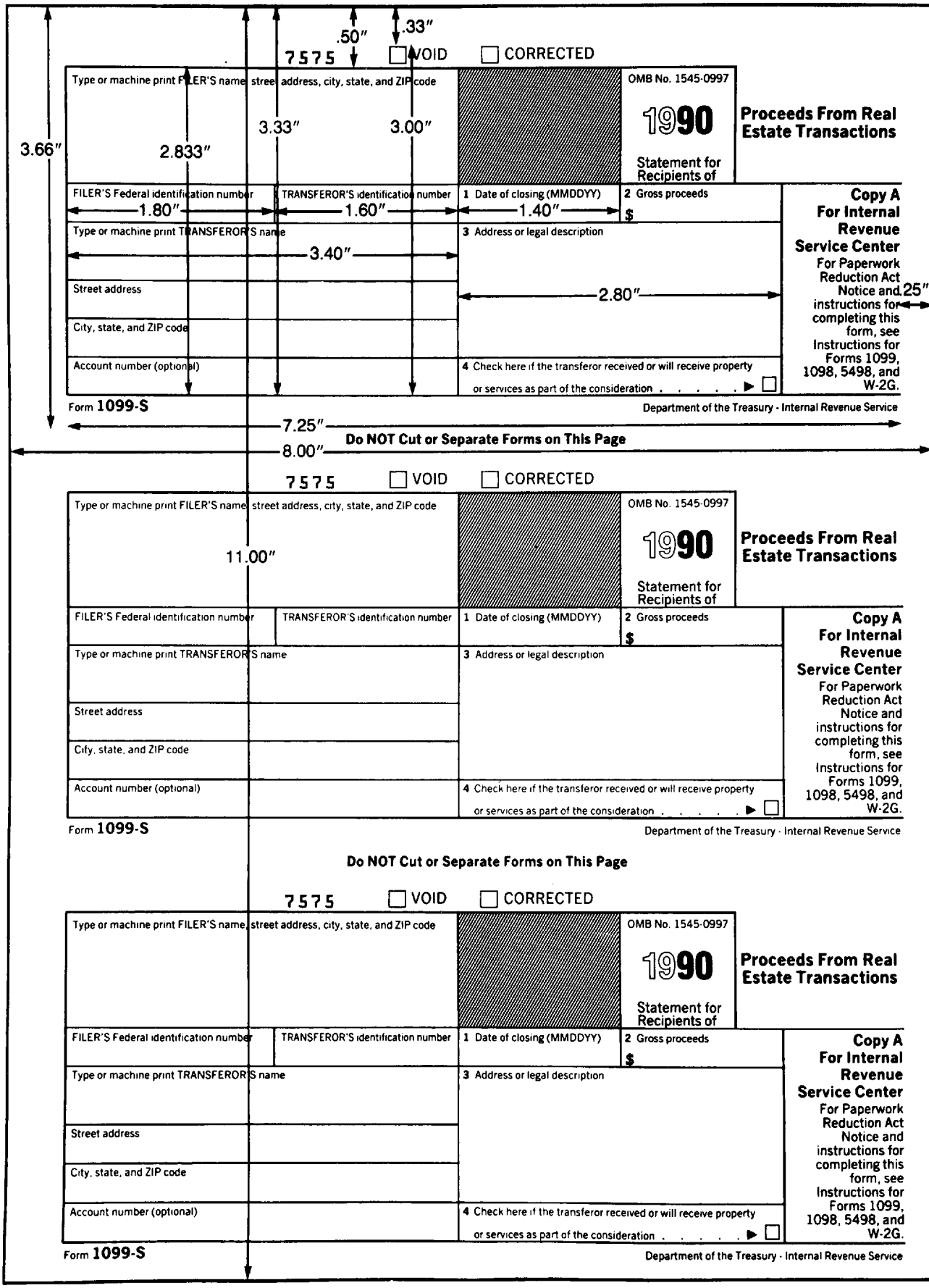

.50"
.33"
9898
VOID
CORRECTED
3.66"
3.33"
2.833"
3.00"
1.70"
3.40"
1.40"
.25"
7.25"
8.00"
11.00"
Type or machine print PAYER'S name, street address, city, state, and ZIP code
PAYER'S Federal identification number
RECIPIENT'S identification number
Type or machine print RECIPIENT'S name
Street address
City, state, and ZIP code
Account number (optional)
1 Gross distribution
2 Taxable amount
3 Amount in Box 2 eligible for capital gain election
4 Federal income tax withheld
5 Employee contributions or insurance premiums
6 Net unrealized appreciation in employer's securities
7 Distribution code
IRA/SEP
8 Other
9 Your percentage of total distribution
10 State income tax withheld
11 State/Payer's state number
OMB No. 1545-0119
1990
Statement for Recipients of
Total Distributions From Profit-Sharing, Retirement Plans, Individual Retirement Arrangements, Insurance Contracts, Etc.
Copy A For Internal Revenue Service Center For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Form 1099-R
Department of the Treasury - Internal Revenue Service
Do NOT Cut or Separate Forms on This Page

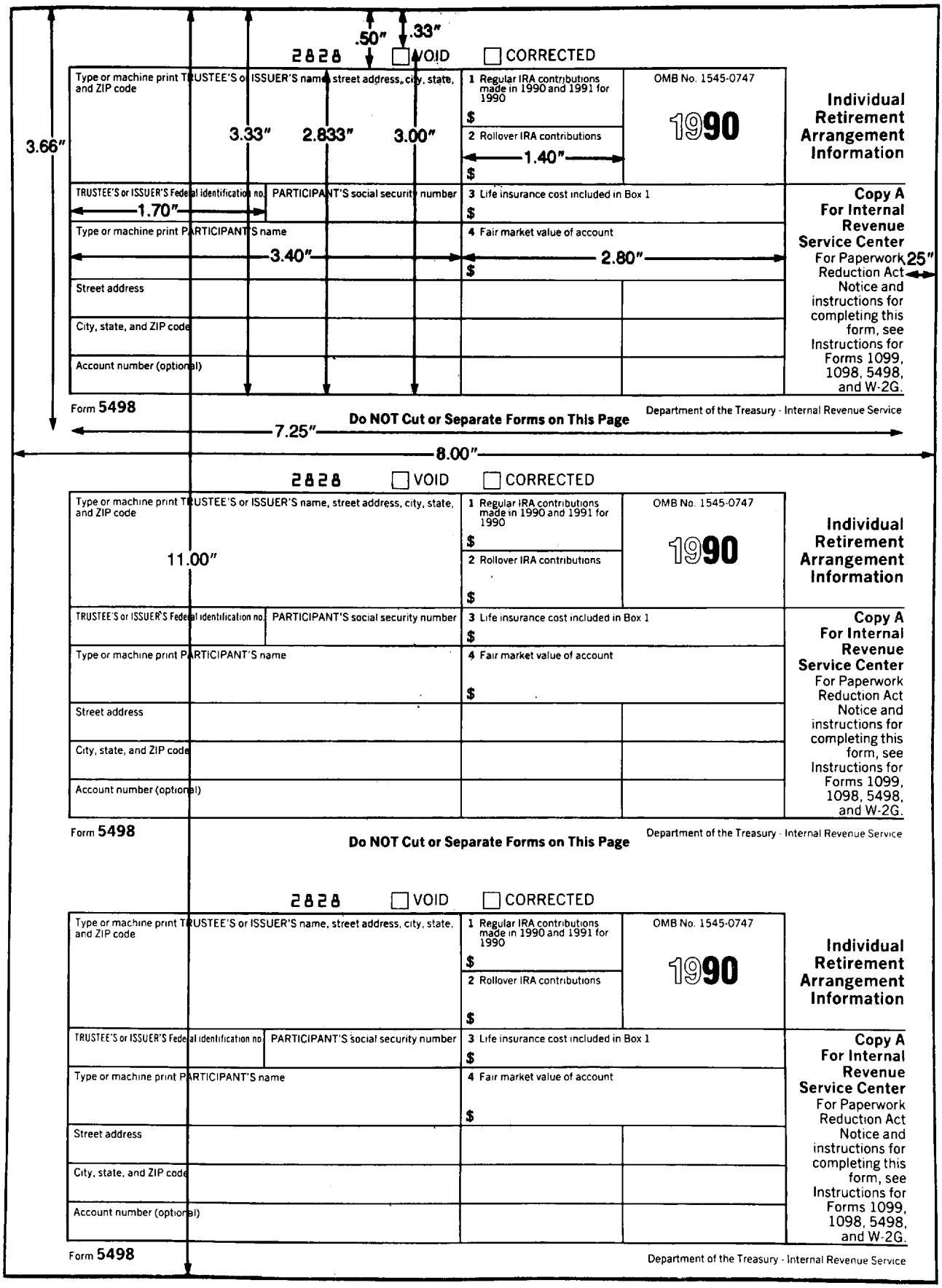
Exhibit L



7575 VOID CORRECTED
Type or machine print FILER'S name, street address, city, state, and ZIP code
OMB No. 1545-0997
1990
Proceeds From Real Estate Transactions
Statement for Recipients of
FILER'S Federal identification number
TRANSFEROR'S identification number
1 Date of closing (MMDDYY)
2 Gross proceeds
$
Type or machine print TRANSFEROR'S name
3 Address or legal description
Street address
City, state, and ZIP code
Account number (optional)
4 Check here if the transferor received or will receive property or services as part of the consideration . . . . . ▶
Copy A For Internal Revenue Service Center
For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Form 1099-S
Department of the Treasury - Internal Revenue Service
Do NOT Cut or Separate Forms on This Page

7575 VOID CORRECTED
Type or machine print FILER'S name, street address, city, state, and ZIP code
OMB No. 1545-0997
1990
Proceeds From Real Estate Transactions
Statement for Recipients of
FILER'S Federal identification number
TRANSFEROR'S identification number
1 Date of closing (MMDDYY)
2 Gross proceeds
$
Type or machine print TRANSFEROR'S name
3 Address or legal description
Street address
City, state, and ZIP code
Account number (optional)
4 Check here if the transferor received or will receive property or services as part of the consideration . . . . . ▶
Copy A For Internal Revenue Service Center
For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Form 1099-S
Department of the Treasury - Internal Revenue Service

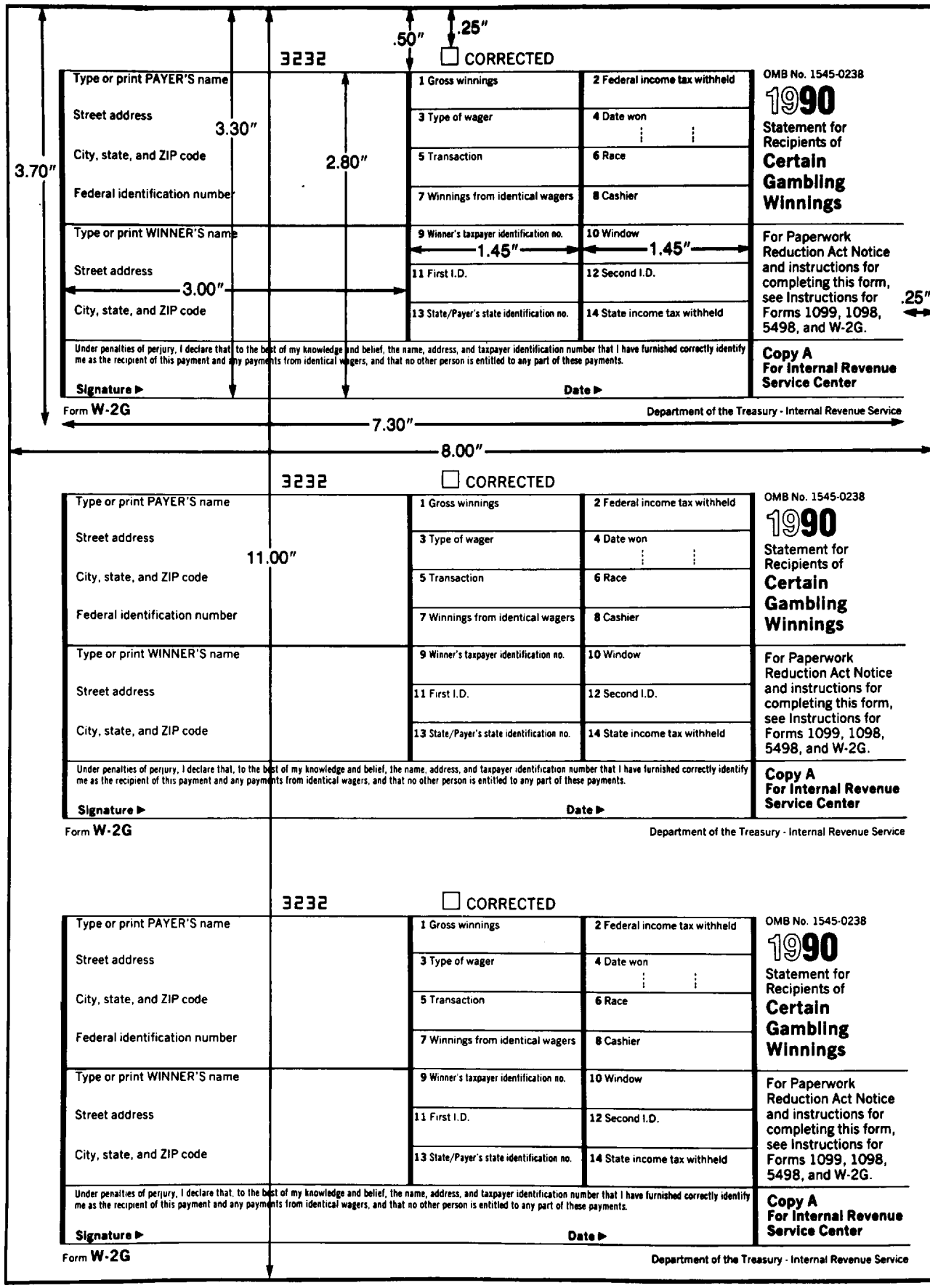
Exhibit M



2828 VOID CORRECTED
Type or machine print TRUSTEE'S or ISSUER'S name, street address, city, state, and ZIP code
1 Regular IRA contributions made in 1990 and 1991 for 1990
$
2 Rollover IRA contributions
$
OMB No. 1545-0747
1990
Individual Retirement Arrangement Information
TRUSTEE'S or ISSUER'S Federal identification no.
PARTICIPANT'S social security number
3 Life insurance cost included in Box 1
$
Type or machine print PARTICIPANT'S name
4 Fair market value of account
$
Street address
City, state, and ZIP code
Account number (optional)
Copy A For Internal Revenue Service Center
For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Form 5498
Department of the Treasury - Internal Revenue Service
Do NOT Cut or Separate Forms on This Page

2828 VOID CORRECTED
Type or machine print TRUSTEE'S or ISSUER'S name, street address, city, state, and ZIP code
1 Regular IRA contributions made in 1990 and 1991 for 1990
$
2 Rollover IRA contributions
$
OMB No. 1545-0747
1990
Individual Retirement Arrangement Information
TRUSTEE'S or ISSUER'S Federal identification no.
PARTICIPANT'S social security number
3 Life insurance cost included in Box 1
$
Type or machine print PARTICIPANT'S name
4 Fair market value of account
$
Street address
City, state, and ZIP code
Account number (optional)
Copy A For Internal Revenue Service Center
For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Form 5498
Department of the Treasury - Internal Revenue Service

Exhibit N



3232
CORRECTED
Type or print PAYER'S name
Street address
City, state, and ZIP code
Federal identification number
1 Gross winnings
2 Federal income tax withheld
3 Type of wager
4 Date won
5 Transaction
6 Race
7 Winnings from identical wagers
8 Cashier
Type or print WINNER'S name
Street address
City, state, and ZIP code
9 Winner's taxpayer identification no.
10 Window
11 First I.D.
12 Second I.D.
13 State/Payer's state identification no.
14 State income tax withheld
Under penalties of perjury, I declare that, to the best of my knowledge and belief, the name, address, and taxpayer identification number that I have furnished correctly identify me as the recipient of this payment and any payments from identical wagers, and that no other person is entitled to any part of these payments.
Signature ▶
Date ▶
OMB No. 1545-0238
1990
Statement for Recipients of
Certain Gambling Winnings
For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Copy A
For Internal Revenue Service Center
Form W-2G
Department of the Treasury - Internal Revenue Service

3232
CORRECTED
Type or print PAYER'S name
Street address
City, state, and ZIP code
Federal identification number
1 Gross winnings
2 Federal income tax withheld
3 Type of wager
4 Date won
5 Transaction
6 Race
7 Winnings from identical wagers
8 Cashier
Type or print WINNER'S name
Street address
City, state, and ZIP code
9 Winner's taxpayer identification no.
10 Window
11 First I.D.
12 Second I.D.
13 State/Payer's state identification no.
14 State income tax withheld
Under penalties of perjury, I declare that, to the best of my knowledge and belief, the name, address, and taxpayer identification number that I have furnished correctly identify me as the recipient of this payment and any payments from identical wagers, and that no other person is entitled to any part of these payments.
Signature ▶
Date ▶
OMB No. 1545-0238
1990
Statement for Recipients of
Certain Gambling Winnings
For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Copy A
For Internal Revenue Service Center
Form W-2G
Department of the Treasury - Internal Revenue Service

26 CFR 601.403: Miscellaneous excise taxes collected by return.
(Also Part 1, Section 4612.)

Rev. Proc. 90-45

SECTION 1. PURPOSE

This revenue procedure provides the interest rates to be used in computing the credit under section 4612(d) of the Internal Revenue Code and the procedures to be followed to claim the credit.

SEC. 2. BACKGROUND

Effective January 1, 1990, section 4612(d) of the Code provides a credit against so much of the tax imposed by section 4611 on crude oil and imported petroleum products as is attributable to the Oil Spill Liability Trust Fund financing rate. The total amount of credit allowable to a taxpayer is equal to the amount paid by the taxpayer before January 1, 1987, into the Offshore Oil Pollution Compensation Fund (Pollution Fund) and the Deepwater Port Liability Trust Fund (Port Fund), plus interest accrued before January 1, 1987, on those amounts.

SEC. 3. PROCEDURE

01. Any person liable under section 4611 of the Code for tax at the Oil Spill Liability Trust Fund financing rate on crude oil (IRS No. 18 on Form 720) or on imported petroleum products (IRS No. 21 on Form 720) may claim a credit against that liability under section 4612(d). The total credit allowable to a taxpayer is equal to the aggregate amount paid by the taxpayer before January 1, 1987, into the Pollution Fund and the Port Fund, plus interest accrued on those amounts before January 1, 1987.

02. The credit is claimed on Form 720, Part II, Line 2, "Adjustments," by following the instructions for Line 2. The statement required by those instructions must include a detailed explanation of how the taxpayer calculated the amount of principal and interest being claimed. The amount of the section 4612(d) credit claimed for any quarter shall not exceed the total amount of tax reportable on IRS No. 18 and IRS No. 21 for that quarter. Any excess credit amount is carried forward until exhausted.

03. For purposes of calculating interest for each calendar year in which an amount was paid into either the Pollution Fund or the Port Fund, the taxpayer shall treat all amounts paid within the calendar year as if paid into the Fund on the mid-point of that year.

04. For purposes of calculating interest accrued, the taxpayer shall assume that payments into the Pollution Fund and the Port Fund accrued interest at the following annual rates:

YEAR	*INTEREST RATE*
1979	5.13%
1980	5.13
1981	9.46
1982	14.13
1983	12.95
1984	11.81
1985	12.51
1986	11.95

05. For purposes of calculating interest accrued, interest may be compounded under any reasonable method consistently applied by the taxpayer.

SEC. 4. EXAMPLE

X, the operator of a United States refinery, is liable for the tax imposed by section 4611 of the Code on crude oil received at the refinery. *X* made payments into the Pollution Fund for liability imposed beginning in January 1985 and ending in March 1989. *X* paid $1,000 in 1985, $1,000 in 1986, $1,000 in 1987, $1,000 in 1988, and $250 in 1989. *X* is eligible to claim $2,000 of the amounts paid into the Pollution Fund (the amounts paid in 1985 and 1986) as a credit against its liability for tax reportable on IRS No. 18 on Form 720. No credit is allowed for amounts paid after December 31, 1986.

X also may claim a credit for the interest accrued before January 1, 1987, on the $2,000 it paid into the Pollution Fund before January 1, 1987. *X* computes the interest accrued as follows. The interest on the payment of $1,000 in 1985 is $1,000 times 12.51 percent times one-half, yielding $62.60 in interest for 1985. The interest rate on the $1,062.60 1985 principal and interest carried over into 1986 is 11.95 percent, yielding $126.98. The interest on the payment of $1,000 in 1986 is $1,000 times 11.95 percent times one-half, yielding $59.80 in interest for 1986. Thus, *X* computes the total interest accrued before January 1, 1987, as $249.38 ($62.60 plus $126.98 plus $59.80).

X is eligible to claim a total credit of $2,249.38 ($249.38 accrued interest plus $2,000 Pollution Fund payments) under section 4612(d) of the Code. *X*'s liability for tax reportable on IRS No. 18 of Form 720 for the quarter ending March 31, 1990, is $1,800. Therefore, *X* may claim only $1,800 on Form 720 for the quarter ending March 31, 1990. All or a portion of the excess amount ($449.38) must be carried over to subsequent Forms 720 on which *X* reports tax liability for IRS No. 18 or IRS No. 21.

SEC. 5. EFFECTIVE DATE

This revenue procedure is effective on January 1, 1990.

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26 CFR 601.602: Tax forms and instructions.

Rev. Proc. 90-46

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TOPIC	
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ATTACHMENTS	37-70

SECTION 1. PURPOSE

.01 This Revenue Procedure sets forth the specifications for the 1990 magnetic tape filing program of tax year 1989 U.S. Partnership Return of Income, Form 1065, and U.S. Fiduciary Income Tax Return, Form 1041. 1990 processing includes the following calendar/fiscal year endings:

Fiscal year filers—Fiscal year ending September 30, 1989 through August 31, 1990 (tax periods 8909, 8910, 8911, 9001, 9002, 9003, 9004, 9005, 9006, 9007 and 9008). If necessary, an extension of time to file covering at least a three month period may be filed for fiscal year tax period endings 8909, 8910 and 8911 only.

Calendar year filers—Calendar year ending December 31, 1989 (8912).

.02 Using this system, qualified return filers will submit tax returns to the Internal Revenue Service via magnetic tape.

.03 To participate in this program, filers who did not participate in the Electronic/Magnetic Tape Filing Program of 1989 (tax filing year 1988 of Forms 1065 and 1041), must complete an application (see Attachment II, Form 9041) and agree to follow all requirements and specifications in this Revenue Procedure. They must also successfully complete testing before being accepted in the program.

.04 Filers who were accepted in the Electronic/Magnetic Tape Filing Program for 1989, do not need to submit a new application unless there are changes or additions to the information provided to IRS previously. Last year's participants who wish to participate in the Magnetic Tape Filing Program for 1990 (tax filing year 1989 of Forms 1041 and 1065), should write or call the Philadelphia Service Center (Form 1041 filers) or the Andover Service Center (Form 1065 filers) to inform them of their intention. (See SEC. 3.01.2 for telephones and addresses).

.05 In any case, acceptance for participation will require applicants to successfully test that the files produced by their software conform with the Service's specifications. (See SEC. 3.02 for additional information on testing requirements.)

.06 The Service reserves the right to revoke the magnetic filing privilege of any filer who varies from these requirements and specifications or does not consistently submit error-free returns.

SEC. 2. COMPOSITION OF A MAGNETIC TAPE RETURN

.01 A magnetic tape return consists primarily of data submitted to the Service on magnetic tape and of paper documents which contain information that cannot be submitted on magnetic tape, such as signatures, documents prepared by third parties, etc. In total, a magnetic tape return must contain the same information as a comparable return filed entirely on paper documents.

.02 For the 1990 filing season, data transmitted on magnetic tape is limited to entries from the forms and schedules listed below.

1. FORM 1041

(a)	Form 1041	- U.S. Fiduciary Income Tax Return
(b)	Schedule D (Form 1041)	- Capital Gains and Losses
(c)	Schedule K-1 (Form 1041)	- Beneficiary's Share of Income Deductions, Credits, etc.
(d)	Form 4952	- Investment Interest Expense Deduction
(e)	Form 8656	- Alternative Minimum Tax Computation
(f)	Form W-2	- Wage and Tax Statement (A paper Form W-2 must also be attached to Form 8453-F)
(g)	Form W-2P	- Statement for Recipients of Annuities, Pensions, Retired Pay, or IRA Payments (A paper Form W-2P must also be attached to the Form 8453-F)

2. FORM 1065

(a)	Form 1065	- U.S. Partnership Return of Income
(b)	Schedule D (Form 1065)	- Capital Gains and Losses
(c)	Schedule K-1	- Partner's Share of Income, Credits, Deductions, etc.
(d)	Form 4562	- Depreciation and Amortization
(e)	Form 4797	- Sales of Business Property
(f)	Form 8271	- Investor Reporting of Tax Shelter Registration
(g)	Form 8308	- Report of a Sale or Exchange of Certain Partnership Interests

.03 The non-magnetic tape portion of the return consists of the following:

1. If submitting Form 1041, U.S. Fiduciary Income Tax Return:

Form 8453-F, U.S. Fiduciary Income Tax Declaration for Magnetic Tape/Electronic Filing, which is required for all returns (see SEC. 6.01 for more information). This signature document may optionally be produced in a consolidated format, when a filer is empowered to sign multiple tax returns. (See Attachment I-A.) In addition, Copy B of paper Forms W-2, W2-P and any other documents containing required signatures or supporting information must be attached.

2. If submitting Form 1065, U.S. Partnership Return of Income:

Form 8453-P, U.S. Partnership Declaration for Magnetic Tape/Electronic Filing, which is required for all returns (see SEC. 3.01 for more information). This signature document may optionally be produced in a consolidated format, when an individual is empowered to sign multiple tax returns. (See Attachment I-B.)

Copies of Forms 8453-F/P may be obtained by writing to the Andover Service Center at the address specified in Sec. 3.02 or by calling the Service Center where the magnetic tape files with the returns were filed. Filers submitting Form 1041 magnetic tape files must call the Philadelphia Service Center at (215) 969-7533. Filers submitting Form 1065 magnetic tape files must call the Andover Service Center at (508) 474-9632. Other documents containing required signatures or supporting information must also be attached.

3. Any other documents that
   (a) are not required by the Service,
   (b) are not IRS forms or schedules, or

(c) are not covered in (a) or (b) above, and are voluntarily included by the partnership/filer as supporting material.

.04 Exclusions

The following types of returns are excluded from the 1990 program.

1. For all returns:
   (a) Amended returns
   (b) Returns containing forms or schedules not listed above
   (c) Returns for any calendar/fiscal year ending prior to September 1, 1989 (8909) or calendar/fiscal year ending after August 31, 1990 (9008)
   (d) Returns submitted by a filer not accepted by the Service for magnetic tape filing
   (e) Delinquent returns (except for those returns covered by the extension provision)
   (f) Returns with dollars and cents entries. (Whole dollars only accepted) Round entries to whole dollars only upon output. Computed percentage distributions on Schedules K-1 may not balance due to this rounding.
   (g) Returns with powers of attorney attached
   (h) Returns with changes of accounting period and short period returns due to changes of accounting period, except those mandated by Tax Reform Act of 1986
   (i) Returns containing more than 1 Schedule D
   (j) Returns with foreign addresses
2. Form 1041 returns only:
   (a) Tentative returns
   (b) Family estate trust returns
   (c) Bankruptcy estate returns
   (d) Returns with more than one of each of the Forms 4952 or 8656
   (e) Grantor trusts created later than 12/31/80 who have requested a simplified filing requirement (Revocable Trusts)
   (f) Returns with more than 20 Forms W-2 or W-2P
   (g) Returns filed under Code Section 642(i) (Trusts)
   (h) Returns with refund amounts equal to or greater than $1,000,000
3. Form 1065 returns only:
   (a) Returns filed under Code Sections 6020(b), 501(d)(3), or 761(a)
   (b) Nominee returns
   (c) Returns with any dollar amount equal to or greater than $9,999,999,999
   (d) Returns with remittance
   (e) Inactive returns with no income on pages 1, 2 and 3
   (f) Returns with more than 1 Form 4797 or 3of Form 4562

SEC. 3. PROCEDURE FOR APPLICATION

.01 How to Apply

1. Filers who express interest in participating in the 1990 magnetic tape filing project will be sent an application Form 9041, Application for Electronic/Magnetic Tape Filing of Forms 1041, 1065, 5500-C/R (see Attachment II), a copy of Publication 1437 (Procedure and File Specifications for Magnetic Tape Filing of Fiduciary Returns Forms 1041 and Partnership Returns Forms 1065) and a copy of Publication 1438 (Record Layouts of Forms 1041 and 1065 Return Records for Tax Year 1989).

2. To be considered for participation in the program, filers must submit a completed application (Form 9041) to the Philadelphia Service Center (Form 1041 magnetic tape filers) or to the Andover Service Center (Form 1065 magnetic tape filers) (see exception in SEC. 1.04). Applications must be received no later than 30 calendar days prior to the return due date or extended due date. Applications will be accepted via FAX telecommunication at the following numbers (not toll-free numbers):

Philadelphia Service Center
FAX Number -(215) 969-2677
Andover Service Center
FAX Number -(508) 474-9425

Form 1041 filers must mail their applications to:

Internal Revenue Service
Philadelphia Service Center
11601 Roosevelt Blvd.
Philadelphia, PA 19155
D. P. 115

Form 1065 filers must mail their applications to:

Internal Revenue Service
Andover Service Center
310 Lowell St.
Andover, MA 05501
Electronic Filing Unit
Stop 983

3. Filers must indicate on the application which returns they intend to file.

.02 Testing Requirements

1. After the Internal Revenue Service receives the application, applicants who are developing software will be notified when and how their systems will be tested for acceptability.

2. When Form 1041 filers are ready to test, they should advise the Philadelphia Service Center Electronic Filing Unit at (215) 969-7533. Form 1065 filers should call the Andover Service Center Electronic Filing Unit at (508) 474-9632. Testing dates will be announced by the corresponding Service Center to each filer individually.

3. When several filers use the same software and communications system, that system needs to pass the acceptance testing once. All of the system's accepted filers may then use it for filing actual returns. Such a system must provide identical software capabilities and, if applicable, data communications capabilities to the accepted filers. An accepted filer must submit actual returns using the same system used for the acceptance test.

.03 Acceptance

1. The Service will review the test submissions of magnetic tape filers and provide feedback to the applicant. If the magnetic tape return file submission is not correctly formatted, or if the applicant's test returns contain errors, the Service will notify the applicant of the errors encountered on each return. The applicant must then correct the software to eliminate the indicated errors and resubmit the test file.

2. When applicants are accepted into the program, the Service will issue a letter to the applicant granting official acceptance to participate in the 1990 program. The letter will contain the filer's official Magnetic Tape Identification Number (MTIN, for Philadelphia Service Center magnetic tape filers) or Electronic Filing Identification Number (EFIN, for Andover Service Center magnetic tape filers). Those filers accepted into the program will be notified when they can begin submitting live returns.

SEC. 4. MAGNETIC TAPE FILER'S REQUIREMENTS AND RESPONSIBILITIES

.01 The entities involved in the magnetic tape filing program are listed below. The Service will accept magnetic tape returns only from filers who have been approved and accepted for magnetic tape filing. The Form 8453-F/8453-P must *always be signed by the person authorized to sign paper returns*, and by the paid preparer, if applicable. The categories of magnetic tape filer listed below are not mutually exclusive.

1. **Originator** The originator of a magnetic tape return is a firm, organization, or individual who deals directly with the taxpayer and performs the following:

(a) prepares a tax return or collects tax return data for purpose of having a magnetic tape return produced; and

(b) obtains the taxpayer's signature on Form 8453-F/P.

2. **Software Firm** Develops the software used to prepare returns for the magnetic tape program.

3. **Magnetic Tape Transmitter** Sends the return to the Internal Revenue Service on magnetic tape, in a format that IRS can process.

.02 Types of Magnetic Tape Filers

1. **Magnetic Tape Filer** Can be one or a combination of the categories described in SEC. 4.01.1 through 4.01.3 above depending on the specific function(s) performed in their relation with the taxpayer or IRS. A magnetic tape filer can fall under one or more of the following classifications:

(a) **The Fiduciary or Partnership** Fiduciaries and partnerships can take part in the program directly. If they want, they can develop their own return preparation software, file the returns on magnetic tape, and send in their Forms 8453-F/8453-P. If they prefer, they can use another firm's return preparation software or magnetic tape submission services. The filer is responsible for obtaining the fiduciary's signature on Form 8453-F or the partner's signature on Form 8453-P and sending the form to IRS.

(b) **Preparer** Falls within the definition of "income tax return preparer" in I.R.C. 7701(a)(36) and Treasury Regulation 301.7701-15. A preparer also submits returns to the IRS. If the preparer submits the return, then the preparer is responsible for obtaining the signed Form 8453-F/8453-P and sending it to the IRS.

(c) **Preparer/Magnetic Tape Transmitter** Fills in the return and computes the tax based on the information the taxpayer provides and submits the return on magnetic tape to the IRS.

(d) **Software Firm/Developer** Develops or designs software is used or sold for the purpose of creating and/or transmitting magnetic tape returns for the IRS.

.03 If a magnetic tape filer accepts returns prepared by others solely for purposes of magnetic tape input, this situation will be considered to come under the "mechanical assistance" exception described in Treasury Regulation 301.7701-15(d)(1), and hence the approved firm will not be considered to be a paid preparer for purposes of IRC7701(a)(36). However, the following requirements must be met:

1 The magnetic tape transmitter must obtain the signature of the person authorized to sign for the partnership/fiduciary (and the paid preparer's signature, if applicable), on the Form 8453-F/8453-P.

2 The return must meet all of the consistency tests required for any other magnetic tape return. The fiduciary, partnership, or paid preparer must correct the source material prior to submission. If the magnetic tape transmitter corrects any material, the magnetic transmitter becomes the return preparer.

.04 After a magnetic tape return is accepted by the IRS, it cannot be recalled or intercepted in process. Hence, if either the filer or the fiduciary or the partnership wishes to change any entries after the return has been accepted, an amended or corrected return must be filed on paper and mailed to the appropriate Service Center.

.06 The filer must promptly satisfy the Service's requests to resolve problems relating to missing or unsigned Forms 8453-F and 8453-P and provide copies of such forms within 3 workdays upon request by the Service.

.07 The filer must provide access to the IRS for all materials that the filer is required to maintain for the purpose of ensuring compliance with the requirements of this Revenue Procedure.

SEC. 5. MAGNETIC TAPE SPECIFICATIONS

.01 In most instances, the Service will be able to process any compatible tape files. Compatible tape files must meet the following criteria:

1.	Type of tape	- 0.5 inch (12.7mm) wide, computer-grade, magnetic tape on reels of up to 2400 feet (731.52m)
2.	Tape thickness	- 1.0 or 1.5 mils
3.	Reel diameter	- 10.5 inch (26.67 cm), 8.5 inch (21.59cm), or 7 inch (17.78cm)
4.	Recording density	- 6250 or 1600 bits per inch density
5.	Parity	- Odd
6.	Interrecord gap	- ¾ inch
7.	Recording mode	- 9 channel EBCDIC (Extended Binary Coded Decimal) or ASCII (American Standard Coded Information Interchange)
8.	Track	- 9 Track *unlabeled tape*
9.	Recording format	- Fixed. (See SEC. 5.04 below)
10.	File Format	- Standard Interchange (Variable blocked format)—Records cannot span reels or volumes (See Attachment VIII)

.02 A physical label should be affixed to the exterior of the tape with the following information:

1. NAME OF TRANSMITTER
2. MAGNETIC TAPE IDENTIFICATION NUMBER (MTIN) (FOR PHILADELPHIA SERVICE CENTER FILERS)
   or
   ELECTRONIC FILING IDENTIFICATION NUMBER (EFIN) (FOR ANDOVER SERVICE CENTER FILERS)
3. CHARACTER CODE (ASCII OR EBCDIC)
4. DENSITY (6250 OR 1600 BPI)
5. NUMBER OF TAPES (If multiple tapes indicate sequence number (e.g. "1 of 3", "1 of 2", etc.))
6. NUMBER OF RETURNS WITH REMITTANCES—Give this information for tape files containing Form 1041 returns only

.03 If a filer is submitting more than one type of return (i.e. Forms 1041 and Forms 1065) the different return records must be on separate tapes as separate files and they must be submitted to the appropriate Service Center. Filers submitting returns for Forms 1041 must send their magnetic tape files to the following address:

Internal Revenue Service
Philadelphia Service Center
11601 Roosevelt Blvd.
Philadelphia, PA 19155
D. P. 115

Filers submitting returns for Forms 1065 must send their magnetic tape files to the following address:

Internal Revenue Service
Andover Service Center
310 Lowell St.
Andover, MA 05501
Electronic Filing Unit
Stop 983

.04 Magnetic tape filers must use the fixed record format (see Appendix A for Form 1041 returns or Appendix B for 1065 returns) to write out the various sized logical records. Each logical record length will be fixed by the byte count specified in Publication 1438 (Record Layouts).

.05 Magnetic tape filers will be responsible for the security of all submitted data. Transmittals of tape returns will not be considered filed returns until they successfully pass through the IRS magnetic tape filing preprocessing system, are acknowledged as accepted and a complete and signed Form 8453-F/P is received by the IRS.

.06 Magnetic tape returns submitted at the end of the filing period:

1. To provide adequate time for acknowledgment of returns submitted prior to the return due date, filers will be allowed up to 7 calendar days to successfully *resubmit those returns which rejected when initially submitted timely* to the appropriate Service Center. Seven days should provide ample time to correct and resubmit any rejected returns.

2. If by 7th day following the due date of the return, an acknowledgment of acceptance has not been received for any previously filed or resubmitted return, the magnetic tape filer must immediately contact the Electronic Filing Unit at the Service Center for further instructions.

SEC. 6. HOW TO USE FORMS 8453-F and 8453-P

.01 Prior to submitting a magnetic tape return, the filer (see Part I, Sec 4.01) must obtain the signature of the fiduciary or the person authorized to sign the partnership's return. The filer must obtain the signature on Form 8453-F/8453-P or consolidated Form 8453-F/8453-P (see Attachments I-A and I-B). Once the signature for the 8453-F/P has been obtained the return may be submitted. After submitting a magnetic tape return (see SEC. 6.11 below), if the Service Center acknowledges the return or returns submitted as accepted, the filer must then attach one of the copies of the Acknowledgment Listing of Transmission sent by the Service Center (see Attachment VII), and any other documents described in SEC. 2.03.3(c) above, to the package containing Forms 8453-F/P, or the consolidated Forms 8453-F/P and mail the entire package to the Service Center. Only those Forms 8453-F/P for returns which have been accepted should be sent to the appropriate Service Center (see Sec. 7.03 below).

.02 If a partner/fiduciary is authorized to sign for more than one return, a consolidated 8453-F/8453-P (see Attachments I-A and I-B) may be used. A consolidated Form 8453-F/8453-P should be produced only for returns that are entered as a continuous series on the input file. The consolidated series on the input file must all be grouped together, with the same specific series number indicated in the consolidation indicator field (see Tax Return Record in Appendices A and B). An indicator of 00 indicates a nonconsolidated return. Consequently, there can be up to 99 groups of consolidated returns (01-99). For example, if the same input file were to contain two consolidated series, the first would have an indicator of 01 and the second would have an indicator of 02.

.03 A consolidated Form 8453-F or 8453-P consists of an official Form 8453-F/8453-P with one signature for the consolidated series and a Consolidated 8453-F/8453-P Control Record (see Attachments I-A and I-B). The following statement should be typewritten on the line for "Name of Estate or Trust" of Form 8453-F: SEE ATTACHED CONSOLIDATED 8453-F CONTROL RECORD. The following statement should be typewritten on line for "Name of Partnership" of Form 8453-P: SEE ATTACHED CONSOLIDATED 8453-P CONTROL RECORD.

.04 The attachment to a consolidated Form 8453-F or 8453-P (Consolidated 8453-F Control Record or Consolidated 8453-P Control Record) should include the Employer Identification Number (EIN), the Name Control, money amounts, and the "Partnership Return Information" or "Tax Return Information" as they would be stated on the Form 8453-P or 8453-F for each return submitted. EINs on the listing must correspond to the EINs as they are specified in the related return and Form 8453-F/8453-P. This listing will be used as an attachment document when sending consolidated Forms 8453-P or consolidated Forms 8453-F to the Service.

.05 Each consolidated listing can contain a minimum of 1 return and no more than 50 returns per page per consolidated Form 8453-F/8453-P (with the same consolidated series number).(See Attachment I-A and I-B for the formats of the Consolidated 8453-F Control Record and the Consolidated 8453-P Control Record.)

.06 The Document Locator Number (DLN) assigned by the IRS to each return, should be taken from the Acknowledgment Listing of Transmission and entered in the upper right-hand corner of the Form 8453-F/P. A range of DLNs should be entered for consolidated Forms 8453-F/P. It is important to remember to attach a copy of the Acknowledgment Listing of Transmission to the package containing Forms 8453-F/P, consolidated Forms 8453-F/P and any other documents as described in SEC. 2.03.3(c).

.07 It is incumbent upon the filer, if other than the entity from whom the return is due, to obtain legal authorization from clients to file their returns and, if applicable, to submit such returns on magnetic tape via a third party. To obtain this authorization, the filer must have the client sign either Form 8453-F or 8453-P, as appropriate.

.08 The Form 8453-F/8453-P serves the following purposes:

- authenticates the return;
- provides a transmittal for any associated paper documents that may be stapled to the declaration;
- authorizes the magnetic tape filer to transmit via a third-party transmitter; and
- authorizes the filer to submit the return on behalf of the fiduciary or partnership.

.09 The magnetic tape filer will be required to file a corrected declaration when:

- On Form 1041:

  the Total Income (Page 1, Line 9) on the declaration differs from the corresponding amount on the return by more than $25; or

  the Total Tax (Page 1, Line 23) on the declaration differs from the corresponding amount on the return by more than $5: or

  the Tax Due (Page 1, Line 26) or Overpayment (Page 1, Line 27) on the declaration differs from the amount shown on the return.

- On Form 1065:

  The Ordinary Income (loss) (Page 1 Line 21), Net Income (loss) from Rental Real Estate (Page 3, Line 2), or Net Income from Other Rentals (Page 3, Line 3c) differs from the corresponding amount on the return by more than $25.

.10 Magnetic tape filers must use the official Form 8453-P/8453-F or an approved substitute form which duplicates the official form in format, language, content, color and size. Magnetic tape filers who wish to develop a substitute form must send a sample of the proposed substitute for approval prior to using it to:

Internal Revenue Service
1111 Constitution Avenue, N. W.
Room 6449 ARFB
Washington, D. C. 20224

Attention: Substitute Forms Program Coordinator, R:E:O

Use of unapproved forms could result in suspension from the program.

.11 After the Form 8453-P/8453-F has been properly executed, including all signatures, the filer will transmit the magnetic portion of the tax return or mail the magnetic tape with the tax return data to the Philadelphia Service Center (Form 1041 filers) or the Andover Service Center (Form 1065 Filers) in accordance with Service specifications. By submitting returns using magnetic means, the filer is stipulating that the declaration has been executed and that the official descriptions of all entries of the magnetic tape return apply, i.e., retained copies do not contain any unauthorized caveats. (See SEC. 4 in this publication for signature requirements.)

SEC. 7. HOW THE MAGNETIC TAPE FILING PROCESS STARTS

.01 The Service will advise magnetic tape filers of the starting date for filing magnetic tape returns. Until this notification has been issued, magnetic tape returns will not be accepted by the Service.

.02 If the magnetic tape filing system breaks down for a potentially lengthy period, the Service will provide contingency instructions to magnetic tape filers.

.03 Where to submit material to be filed with the Service.

Participating filers must send to the Service all magnetic media data, all fiduciary or partnership declarations, and all other materials described in SEC. 2.03.3, of this publication. Magnetic tape files and Forms 8453-F that the Form 1041 filer mails must be submitted to the Philadelphia Service Center at the following address:

Internal Revenue Service
Philadelphia Service Center
11601 Roosevelt Blvd.
Philadelphia, PA 19155
D. P. 115

Magnetic tape files and Forms 8453-P that the Form 1065 filer mails must be submitted to the Andover Service Center at the following address:

Internal Revenue Service
Andover Service Center
P O Box 4050
Woburn, MA 01889-9741
Electronic Filing Unit
Stop 983

Any package shipped to the Andover Service Center via courier service must be shipped to the address below to insure receipt within 2 days:

Internal Revenue Service
Andover Service Center
310 Lowell St.
Andover, MA 05501
Electronic Filing Unit
Stop 983

Forms 8453-F/8453-P must be shipped to the Philadelphia Service Center or the Andover Service Center within 5 days after the filer receives the Acknowledgment Listing of Transmission.

.04 Distribution of Copies

1. The filer will maintain the documents referred to in SEC. 2.03, of this publication, and associate them with the related Acknowledgment Listing of Transmission and the consolidated 8453-F/8453-P control record (if applicable) (see Attachments 1-A and 1-B). IRS will send the filer two copies of the acknowledgment list. The filer is to keep one copy and use the other as a transmittal for the Forms 8453-F/8453-P and attachments, as explained in paragraphs 4 and 6 below.

2. The filer will send this material to the Philadelphia Service Center (Form 1041 filers) or the Andover Service Center (Form 1065 filers) in accordance with shipping instructions described in SEC. 7.04.3 through

7.04.7 below. Do not send Forms 8453-F/8453-P to the Service for returns that the Service have not acknowledged as accepted (see SEC. 8, of this publication).

3. A copy of the Acknowledgment Listing of Transmission must accompany each batch of Forms 8453-F/8453-P or Consolidated Forms 8453-F/8453-P. If the filer is submitting a Consolidated Form 8453-F/8453-P, and a return has been rejected or not acknowledged by the Service, (see SEC. 8, of this publication) line through the EIN and the Name Control on the Consolidated Form 8453-F/8453-P Control Record for each item which has not been accepted.

4. The filer must create the Consolidated Form 8453-F/8453-P Control Record prior to submitting the return file and should review it thoroughly to avoid duplication of EINs.

5. Place one copy of the Acknowledgment Listing of Transmission and the Consolidated Form 8453-F/8453-P Control Record (if applicable) at the front of the batch of Forms 8453-F/8453-P and secure with a rubber band or string. The paper documents in each batch must be in the same order the returns appear on the Acknowledgment Listing of Transmission.

6. Prepare batches of declarations for shipping, using envelopes or cartons, as volume or preference dictates. Send mailed packages to the address specified in SEC. 7.03 above.

7. Method of delivery is optional. However, declarations must be received by the service center within one week of receiving the Acknowledgment Listing of Transmission.

.05 To Be Retained By The Filer:

The filer must retain a copy of the Form 8453-F/8453-P. The filer copy of the magnetic tape return may be retained on computer media. In addition, the filer should retain any acknowledgment lists or files received from the Service for a period of 3 months to facilitate inquiries. If the filer is also the paid preparer, fiduciary, or the partnership, the normal retention periods for tax return information in the Internal Revenue Code will apply.

.06 To Be Provided To The Entity From Which The Return Is Due:

The filer must furnish each client fiduciary or partnership with a copy of all material filed with the Service covered in SEC. 2.02 and SEC 2.03, of this publication. In addition, the filer should advise any client to retain copies of materials which the fiduciary or partnership provided to the filer. The copy of the magnetic return described in SEC. 2.02 can be replicas of official forms or in a format designed by the filer, in which each data item refers to the line entries on the official forms.

SEC. 8. ACKNOWLEDGMENT OF RETURNS

.01 Each transmission of a file of magnetic tape returns will normally be acknowledged within 7 days, by a hardcopy printout specifying which returns have been accepted and which returns have been rejected. Any return not acknowledged as received by the Service will be considered not filed.

.02 If filers do not receive a hardcopy of an Acknowledgment Listing of Transmission within 7 workdays, or if they receive acknowledgments for returns which were *not submitted on the designated magnetic tape file transmission* they should immediately contact the Philadelphia Service Center (Form 1041 filers) or the Andover Service Center (Form 1065 filers).

.03 The acknowledgment file shows which returns have been accepted, rejected or identified as duplicates of earlier accepted returns (see Appendix A, SEC. 12). If the filer receives acknowledgment for returns not submitted, contact the Philadelphia Service Center (Form 1041 filers) or the Andover Service Center (Form 1065 filers) for further instructions (see paragraph .05, below for telephone).

.04 The filer should immediately match the acknowledgment file back to the original file submitted. Any tax return submitted *that is not acknowledged as either accepted (A), rejected (R) or duplicated (D)* will have been bypassed by the Service due to magnetic tape submission or file format problems and must be resubmitted to be considered a filed return. Tax returns that have been acknowledged as rejected (R) or duplicated (D) must be resubmitted until they are acknowledged as accepted (A).

.05 If a return has been rejected after three attempts, contact the Philadelphia Service Center Electronic Filing Unit (Form 1041 filers) at (215) 969-7533 or the Andover Service Center Electronic Filing Unit (Form 1065 filers) at (508) 474-9632.

SEC. 9. SPECIAL INSTRUCTIONS FOR FORM 1041 RETURNS WITH REMITTANCES

When remittances are sent with balance due Form 1041 returns, special instructions must be followed:

.01 All balance due returns that are to be accompanied with or without remittances must be submitted on a separate tape. Remittances may not be split between returns on separate tapes.

.02 Each remittance may cover up to 100 returns and multiple remittances may be received for the same magnetic tape.

.03 For each remittance, a remittance register (Attachment VI) must be prepared. The original remittance register, a duplicate, and an adding machine tape for the total of each remittance register must be sent to the Philadelphia Service Center at the address specified in SEC. 7.03, of this publication.

.04 Remittances and all appropriate backup material must accompany the magnetic tape submission.

SEC. 10. ADVERTISING STANDARDS

.01 Advertising Restrictions

Preparers/transmitters of magnetic tape returns, with respect to their capability to file returns on magnetic tape, shall comply with the advertising and solicitation provisions of 31 C.F.R. Part 10 (Treasury Department Circular No. 230). Such provisions prohibit the use in any way 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. The prohibition includes, but is not limited to, statements pertaining to the quality of services rendered unless subject to factual verification, claims of specialized expertise not authorized by State or Federal agencies having jurisdiction over the preparer/transmitter, and statements or suggestions that the ingenuity and/or prior record of a preparer/transmitter rather than the merit of the matter

are principal factors likely to determine the result of the matter. *In addition, advertising must not imply a special relationship with the Internal Revenue Service.*

.02 Communications

Communications, including fee information, shall be limited to professional lists, telephone directories, print media, permissible mailings, radio, and television. In the case of radio and television broadcasting, the broadcast shall be prerecorded and the practitioner shall retain a recording of the actual audio transmission.

.03 IRS Endorsement Must Not Be Implied

Approval to participate in the program *does not imply* that the Internal Revenue Service endorses the computer software or quality of services provided. Therefore, any public communication in which a participant's magnetic tape filing .pa capability is referenced, whether through publication or broadcast, *must* clearly indicate that IRS acceptance of the participant for magnetic tape filing does not constitute an endorsement or approval of the quality of tax preparation services provided.

SEC. 11. MONITORING

.01 The Service monitors the quality of each participant's submissions to ensure that quality is kept at an acceptable level. IRS will counsel the filer about quality, if necessary.

.02 Participants must conform to the requirements of this revenue procedure.

.03 If a filer does not maintain an acceptable level of quality, the magnetic tape filing authorization may be revoked.

.04 The following conditions can lead to suspension:

1. Deterioration in the format of individual submissions
2. Unacceptable cumulative error rate
3. Violation of advertising standards
4. Unethical practices in return preparation
5. Untimely receipt of Forms 8453-F/8453-P, or illegible, missing or unapproved substitute Forms 8453-F/8453-P

.05 When suspended, IRS will counsel the filer about the requirements for reacceptance to the magnetic tape program.

SEC. 12. ADMINISTRATIVE REVIEW PROCESS

.01 An magnetic tape applicant who has been denied participation, or a filer who has been suspended, has the right to administrative review.

.02 Requests for administrative review of ineligibility or suspension decisions should be directed to the Office of the Director of Practice (HR:DP), 1111 Constitution Ave., NW, Washington, DC 20224.

SEC. 13. EFFECT ON OTHER DOCUMENTS

Publication 1437 (Specifications for Electronic/Magnetic Tape Filing of Fiduciary Returns Forms 1041 for Tax Year 1988) dated April 15, 1989 and Publication 1438 (Specifications for Electronic/Magnetic Tape Filing of Partnership Returns Forms 1065 for Tax Year 1988) dated March 10, 1989 are superseded.

APPENDIX A

Return File Specifications for Form 1041

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Note: A vertical line (|)on the right margin denotes a change. A delete (—|) denotes a deletion of text, field or fields. A "b" in the field description of a record layout denotes a blank space.

SECTION. 1. OVERVIEW

.01 The sequence of record submission is as follows:

1. The original TRANS record (this record identifies the magnetic tape transmitter).
2. Return records including the return (RET), schedule records other than the schedule K-1 (SCH), forms (FRM), statements other than Schedule K-1 statements (STM), Schedule K-1 (K1), statements for Schedule K-1 (STM), and summary records (SUM).
3. RECAP record.

.02 For all filers, a hardcopy acknowledgment report, separately identifying accepted and rejected returns, will be mailed. (See SEC. 12 in this appendix and Attachment VII).

.03 If the entire magnetic tape is rejected, the acknowledgment will

consist of information defining an acceptance code field with a value of "T" and all the reject error related to the magnetic tape submission.(See SEC. 12 in this appendix and Attachment VII).

SEC. 2. GENERAL DESCRIPTION

.01 All the data must be in ASCII or EBCDIC format. No binary fields may be transmitted.

.02 One four-byte, decimal-constant counter must precede each logical record within a block. The byte count must contain the length of the record plus the length of the byte count. Record byte counts are provided in these specifications as the first constant field preceding the Record ID and this byte count (which is not part of the record) is to be used only if the ANSI byte count convention is not used.

NOTE: IBM BYTE COUNT MUST NOT BE USED

.03 All records must be submitted in the fixed format.

.04 The first record on a magnetic tape file (the TRANS record) contains information regarding the filer, the transmission itself and the type of return records in the file. This record should be followed by the records comprising the tax returns being transmitted. The last record on a submitted file (the RECAP record) will provide balancing counts of all returns.

.05 A return file will consist of a variable number of fixed-length records. The size and format of the logical record for each page of each form, schedule etc., are specified herein. Maximum block size is limited to 28,672 characters per block. See Attachment VIII for examples of the variable blocking format.

.06 The logical records described herein may not be broken between physical records (i.e. "blocks"). Files must not be spanned.

.07 Each logical record within a submission must be preceded by a four-byte field (if the ANSI byte count convention is not used), that will be a record byte count containing a count of the number of bytes within the logical record—including the four bytes for the counter itself and the Start of Record Sentinel (****) .

.08 Every logical record must have as its last significant byte the record terminus character ("#"). Note that provisions have been made to allow for non-significant padding following the record terminus character, if the block contains only one logical record (blank padding should never separate logical records within a block). This padding is permitted to accommodate all the different computer systems being used to format the data.

.09 Each logical record should contain all data fields pertaining to one printed page of an official form or schedule. Continuation statements are allowed for certain fields that have been marked with an ampersand ("@") or an asterisk ("*"). The continuation statements are composed of line records corresponding to the print lines of a complete statement. Each line of a continuation statement ("STMbnn") is a logical record (see SEC. 9 for more details).

.10 The complete tax return of Form 1041 must consist of all logical records pertaining to it in the following sequence:

Return records, schedule records other than Schedule K-1 records, form records, statement records not related to Schedule K-1 records, Schedule K-1 records, statements for Schedule K-1 records, and summary records.

The only exception to this rule is that one series of statement line records for a single continuation statement that pertains to a Schedule K-1 must directly follow the applicable Schedule K-1. Schedules must be in alphabetical sequence and forms must be in alpha, then numeric, sequence.

All records must appear in the proper sequence, with the proper control information, and the counts of the schedules and forms must match the accumulators in the Summary Record. Otherwise, the return will be rejected. Return, schedule, form and statement records may contain additional sequential page records if they consist of more than one printed page. (Pages are numbered only within a form, schedule or statement, not across the return.)

.11 *Every return page must have a logical record present. Only the pages of other schedules or forms (in the proper sequence) which contain significant data, need to have a logical record present.* Therefore, a page need not be generated, if there are no entries on the page record of a form (except Form 1041) or schedule (see Sec. 13.02.4 below, for exception rules). Also, if page 2 of a form is generated, page 1 of the form must also be generated.

.12 The Return Type and Tax Period fields are Field Numbers 2 and 5 of the Return Record (see Appendix A, Sec. 6 below) respectively, included in each page of the return.

.13 If the number of data bytes appearing on the same line exceeds the number that can be contained in the space provided on the printed form or schedule, the data must be provided on a separate continuation statement (STM) record. Only fields preceded by an ampersand (@) or and asterisk (*) may contain statement ("STMbnn") references. There is a maximum of 2 pages per statement, 50 lines per page and 98 statement page records per tax return in total. Returns with more than 98 statement page records will be rejected. Schedule K-1 statements are not limited to 98 statement page records. Nevertheless, Schedule K-1 records are limited to two pages per statement and 50 lines per page. If "STMbnn" is used, no data should be entered in the base return. See Appendix A, Sec. 9 for specific details.

.14 Assign a 7-digit number to each Schedule K-1 (Field 010) in ascending order.

.15 A summary record will be the final record for each return. This record will contain magnetic tape filer identification data; counts of the schedules, forms and statements included in the return; and indicators for paper documents retained by the magnetic tape filer for subsequent submission to the IRS.

.16 The end of the logical record submission will be signaled by the recognition of the record terminus character of the RECAP record as the last logical record submitted.

.17 In magnetic tape files, the recognition of the Record Terminus character("#") followed by an End of Volume (EOV) marker (one tape mark), will indicate that there are still more tapes to be read. A return cannot be split between tapes. Otherwise, the recognition of the Record Terminus character followed by End of File (EOF) marker (two tape

marks), will indicate the last record of the tape file.

.18 The file should be unlabeled (no standard header or trailer records), and each file must contain only complete returns.

.19 Returns with the same calendar/fiscal year ending may be submitted on the same magnetic tape.

SEC. 3. FIELD SPECIFICATIONS

.01 Numeric Fields

1. All money fields:
   (a) in Form 1041 are 12 characters, 11 numerics followed by the sign character;
   (b) containing no significant data *must* be filled with zeros.
   (c) The significant numeric characters should be right-justified and zero-filled. Dollar signs, decimal points, or other non-numeric characters are not permitted.
   (d) Money fields must be all whole dollars (no cents).
2. The right-most position of any negative money field must contain the negative sign; for positive fields this position is always blank.

   Note: Fields that can contain either gain (income) or loss amounts, such as Line 4 Net Short-Term Capital Gain or Loss from Schedule D, or Form 1041, Line 6, Capital Gain or Loss, must have the applicable sign character, (i.e., blank for positive amounts and minus for negative amounts).

   Fields that can only contain loss amounts such as Schedule D (Form 1041), Line 5, Short-Term Capital Loss Carryover, must be positive fields.
3. All percentage fields must have five positions, left-justified and zero-filled. Do not enter the decimal point on the record. The decimal point will be assumed to be between the left-most and the second left-most positions. If percentage is less than 100%, precede the figure with a zero. For example, 25.32% would be entered as "02532" and 105% would be entered as "10500". If there is no percentage enter spaces.
4. Other numeric fields must all be numeric, right-justified and zero-filled. If the numeric field has no significant data it must be zero-filled (exceptions are ZIP Code date and Employer Identification Number (EIN) fields).
5. ZIP Codes must be a 5 or 9 character numeric fields, left-justified and blank-filled.
6. All dates must be entered in the MMDDYY, MMYY or YYMM format. If there is no date, enter spaces.

   Examples:

MMDDYY	December 15, 1988	- 121588
YYMM	Calendar/Fiscal Year Ending, December, 1989	- 8912
MMYY	Date placed in Service, December, 1989	- 1289

7. The EIN fields (for other than the Employer Identification Number of the Estate or Trust) and/or the SSN number must be blank filled if there is no entry.

.02 Alphanumeric fields

1. Except where designated, do not enter spaces etc. between data elements.
2. All alphabetic data must be in upper case only.
3. Special characters may be valid for specific fields as noted in the record specifications.
4. Literal fields must contain one of the exact character strings, as specified in the record specifications, or blanks.
5. Data fields without any information must be blank-filled unless otherwise specified.

.03 A "b" in the format description of a record layout denotes a blank space.

SEC. 4. RECORD LENGTH DESCRIPTION

.01 Logical return records must be submitted in a fixed format. All records within a return must be submitted exactly as defined with all the fields present. (See specifications throughout Appendix A and in record layouts in Publication 1438).

Each record must end with a Record Terminus Character ("#").

.02 The fixed ANSI byte count constant or the fixed constant shown as the first field in each record within Publication 1438, must be present always.

SEC. 5. TRANS RECORD

The first record on each file is the TRANS record, which will contain the following information. All participating filers that have been accepted into the Magnetic Tape Filing Program will be assigned an Magnetic Tape Identification Number, or MTIN. Fields 2, 3, and 6 pertain to the entity which has been accepted by the Philadelphia Service Center as a magnetic tape filer.

Field Identification		Length	Format
	Byte Count	4	Value "0168"
	Start of Record Sentinel	4	Alphanumeric Value = "****"
(1)	Record Name	5	Value "TRANS"
(2)	EIN of Filer	9	Numeric
(3)	Filer Name	35	Alphanumeric
(4)	Processing Site	1	Alphanumeric Value = "C"
(5)	Transmission Date	6	Numeric MMDDYY

Field	Identification	Length	Format
(6)	Magnetic Tape Identification Number plus Filer's User Code	8	Numeric Value = NNNNNNnn NNNNNN = MTIN nn = Filer's user code; may be zero-filled
(7)	Julian Date of Transmissin	3	Numeric
(8)	Transmission Sequence Number for Julian Day in (7)	2	Numeric
(9)	Reserved for EF	3	Alphanumeric Values = Blanks
(10)	Paper Check Indicator (for Remittance Returns with paper checks attached, else Blank	1	Value = "1" if Paper Check
(11)	Return Form Type	5	Value = "1041b" left-justified
(12)	Filler	1	Alphanumeric Values = Blank
(13)	Address	35	Alphanumeric
(14)	City	24	Alphanumeric
(15)	State	2	Alphanumeric
(16)	Zip Code	9	Numeric Values for ZIP Code = nnnnnnnnn or nnnnnbbbb n = 0-9
(17)	Area Code, Telephone Number	10	Numeric
(18)	Record Terminus Character	1	Alphanumeric Value = "#"

SEC. 6. RETURN RECORD

Page 01 and 02 for each Form 1041 return will start with the following first 9 fields preceded by a byte count and the Start of Record Sentinel Characters. Each page of the return will have a new page record with the page number incremented.

Field	Identification	Length	Format
	Byte Count, Page 1 and 2	4	"0043" plus length of data fields
	Start of Record Sentinel	4	Alphanumeric Value = "****"
(1)	Record Name	4	Alphanumeric Value = "RETb"
(2)	Return Type	6	Alphanumeric Value = "1041bb"
(3)	Consolidation indicator for Forms 8453-F	2	Numeric (00-99) (00 = nonconsolidated, 01-99 = consolidated)
(4)	Page Number	5	Alphanumeric Value = PGnnb, Valid range for nn = 01 to 02
(5)	Tax Period	4	Numeric, YYMM
(6)	Filler	1	Alphanumeric Value = Blank
(7)	Employer ID Number (EIN)	9	Numeric
(8)	Filler	1	Alphanumeric Value = Blank
(9)	Master File Tax Code	2	Numeric Value = 05
(10)	Data Fields	various	Page data fields
	Record Terminus Character	1	Alphanumeric Value = "#"

SEC. 7. SCHEDULE RECORD

The second record or series of records is the schedule record. Each page of a schedule will have a new schedule record with the page number incremented by 1, preceded by the byte count.

Field	Identification	Length	Format
	Byte Count, Page 1 and 2	4	"0037" plus length of data
	Start of Record Sentinel	4	Alphanumeric Value = "****"
(1)	Record Name	4	Alphanumeric Value = "SCHb"
(2)	Schedule Type	3	Alphanumeric (left-justified) Values = "Dbb" or "K1b"
(3)	Schedule Sequence Number	7	Numeric Range = (0000001-9999999)

Field	Identification	Length	Format
(4)	Page Number	5	Alphanumeric Value = "PGnnb" Valid ranges for nn = 01—02
(5)	Employer Identification Number (EIN)	9	Numeric
(6)	Data Fields	Various	Page data fields
	Record Terminus Character	1	Alphanumeric Value = "#"

SEC. 8. FORM RECORD

The third series of records after returns and schedules are the group of form records. They should appear in the sequence specified in Appendix A, SEC. 13.02.2. Each page of a form will have a new form record, preceded by the byte count, Start of Record Sentinel with the page number incremented.

Field	Identification	Length	Format
	Byte Count, Page 1 and 2 of data	4	"0040" plus length of data
	Start of Record Sentinel	4	Alphanumeric Value = "****"
(1)	Record Name	4	Alphanumeric Value = "FRMb"
(2)	Form Number	6	Alphanumeric (left justified) Values: "4952bb", "8656bb", "W-2bbb" and "W-2Pbb"
(3)	Form Sequence Number	7	Numeric Range = (0000001-0000020)
(4)	Page Number	5	Alphanumeric Value = "PGnnb" Valid range for nn = 01 to 02
(5)	Employer ID Number (EIN)	9	Numeric
(6)	Data fields	various	Page data fields
	Record Terminus Character	1	Alphanumeric Value = "#"

SEC. 9. STATEMENT RECORD

.01 The statement record is the fourth series of records after returns, schedules and forms. Statement records are used to continue a field or related series of fields that *appear on the same print line. (A print line is all the fields that would appear as a single line item on a printed version of the form. An example is Form 1041, line 15(a)).* Each statement is given a sequential number from 01 to 99. References to statements on the tax return must be in ascending numerical sequence and must be referenced in the same sequence as the transmission sequence of the forms.

1. The first line entry for the continued item on the base form or schedule record itself shall read "STMbnn" ("nn" being the applicable statement number). All of the applicable entries must then be on the statement record and cannot be split between the continued item record(s) and the statement.
2. The first statement record may contain a literal description of the item continued.

   Example: (Fixed format for LNO1)

   0116****STM 01 PGO1 LNO1 128888888 (20 blanks) OTHER DEDUCTIONS LINE 15A FORM 1041 (blanks up to 80 characters) #

   Note: Blanks inserted before and after the title of the example statement record listed above, are present for readability and may be determined by the filer.

3. The second statement record for all continuations of tabular data may contain the column headings spaced with the headings as they would appear on the printed form they continue. The tabular column titles will be spaced in the same format as would be printed on a blank continuation page. (This record may be blank or may also be used for non-tabular data if appropriate).

   Example: (Fixed format for LNO2)

   0116****STM 01 PG01 LNO2 128888888 (5 blanks) DESCRIPTION (30 blanks) AMOUNT (blanks up to 80 characters)#

   Note: Blanks between title header columns must be inserted for readability but number of spaces may be determined by filer.

4. The third statement record ("LN03") and beyond, may contain, left justified, the related data fields in the same order as they appear in the base layout.

   Contiguous fields related to tabulated titles from LN02, that would have appeared as a single print line on the basic form or schedule shall also appear on the same statement line record, left-justified, beginning with the third line record ("LN03"). The first data field for a table or a group of related line entries must contain the "STMbnn" for the entire table (i.e., part of the table cannot appear on the form and part in a statement).

   Example: (Fixed format for LN03-LN50)

   0116****STM 01 PG01 LNO3 128888888(6 blanks) LEGAL FEES (30 blanks) 0000002500 (blanks up to 80 characters) #

   0116****STM 01 PG01 LNO4 128888888(6 blanks) AUTO EXPENSES (27 blanks) 0000002500 (blanks up to 80 characters) #

   0116****STM 01 PG01 LNO5 128888888(25 blanks) TOTAL (5

blanks) 0000005000 (blanks up to 80 characters) #

Note: Data should be entered as it would be entered on the form. Alphanumeric fields should be left-justified and blank-filled. Money amount fields (11 numerics followed by a blank if the amount is positive or a (−) if the amount is negative) should be right-justified and zero-filled. Lines 4 through 50 would be entered if needed.

5. If the statement data does not require tabulation, free format is allowed.
6. Statements can only be used by the filer when the open-ended item cannot be contained in the space provided on the printed form or schedule.

.02 The 80 characters of data corresponding to any statement record within the return, containing non tabular data, may begin with line 2. Data should appear left-justified as a continuous print line. The same statement may be continued with additional lines, consecutively numbered, until a maximum of 50 lines have been formatted for the first page or the end of the information needed to be formatted as a statement has been reached, whichever comes first. If additional lines are needed to complete a statement, an additional page with a maximum of 50 lines may be formatted continuing with the numbering sequence from page 1.

.03 Only fields marked with an asterisk (*) in the record layout may contain "STMbnn". Fields marked with an "@" sign in the record layout *must* contain "STMbnn" if corresponding fields contain significant data, (otherwise the fields should contain blanks) and the data fields(s) must appear on a statement record. The length of the data fields in these statements may be up to 80 characters.

.04 An "@" sign will precede any field that *must* contain a statement reference when significant. In the record layout (Publication 1438), an asterisk (*) will precede any field which may contain a statement reference (STMbnn), if necessary. A statement reference indicates that either the first entry of a line or a table of related items is to be continued on a statement record. A plus sign (+) marks the first entry field of a line or table following a field preceded by an asterisk (*) that has been referenced as a statement record (STMbnn). If the field referenced with an asterisk contains "STMbnn", the related field(s) marked with a "+" should be blank; all the information for the table or related items should be entered on the statement.

In some cases, the related statement fields require more than the maximum 80 positions allowed. An asterisk followed by a plus sign (*+) indicates the first field of a separate statement record which continues the required fields from the previous statement record. In other words, fields normally included in one statement record have been divided between two statement records because the maximum of 80 characters per statement record has been surpassed. The statement record containing the additional items relating to the first statement should be referenced by (*+). A "Continuation Statement" should be referenced only when the preceding asterisked field is equal to "STMbnn". See SEC. 9 for the format of the Statement Record.

SEC. 9. STATEMENT RECORD (Continued)

	Field Identification	Length	Format
	Byte Count	4	Value "0116"
	Start of Record Sentinel	4	Alphanumeric Value = "****"
	******* For Schedule K-1 add 8 to Byte Counts *******		
(1)	Record Name	4	Alphanumeric Value = "STMb"
(2)	Statement Number	2	Numeric Range = (01-99) (99 for Schedule K-1 only)
(3)	Reserved for EF	2	Alphanumeric Value = Blanks
(4)	Page Number	5	Alphanumeric Value = "PGnnb" nn = 01-02
(5)	Line Number	5	Alphanumeric Value = LNnnb, nn = 01-50
(6)	EIN	9	Numeric
	*******Fields # 7 and 8 in Schedule K-1 Statements only********		
(7)	K-1 Sequence #	7	Numeric This field must be significant for Schedule K-1 only. Range = (0000001-9999999)
(8)	K-1 Sequence # Filler	1	Alphanumeric Value = Blank
	********** All statements **********		
(9)	Data Record	80	See SEC. 9
	Record Terminus Character	1	Alphanumeric Value = "#"

Note: Refer to Appendix A, SEC. 2, paragraph 13, for restrictions on the use of statement records. Data cannot be split between a return, schedule, or form record and a statement record. If more entries are required than are provided for in Publication 1438 (Record Layouts) enter "STMbnn" in the field or the first of a series of fields on the return, schedule, or form record and put the specific data entries on the statement record (refers to field names marked with "@" or an "*" as specified in Publication 1438, Record Layouts of Forms 1041 and 1065, only).

SEC. 10. SUMMARY RECORD OF FORM 1041

The final record for each tax return (Form 1041) is the summary record. (A "1" in the paper document indicator field shows that the paper document specified is a part of the return and has been attached to the fiduciary/beneficiary declaration, Form 8453-F. Otherwise, enter "0".) The format is as follows:

Field	Identification	Length	Description
	Byte Count	4	Value "0212"
	Start of Record Sentinel	4	Alphanumeric Value = "****"
(1)	Record Name	4	Alphanumeric Value = "SUMb"
(2)	Reserved	13	Alphanumeric Value = Blanks
(3)	Employer Identification Number of the Trust or Estate	9	Numeric (EIN)
(4)	Name of the Magnetic Tape Filer	35	Alphanumeric
(5)	Filer's EIN or SSN	9	Numeric
(6)	Preparer Self-Employment Indicator	1	Alphanumeric Values = "X" or blank "X" = Self-employed
(7)	Preparer Firm EIN	9	Numeric
(8)	Preparer Firm Name	35	Alphanumeric
(9)	Firm/Filer City	20	Alphanumeric
(10)	Firm/Filer State (Abbr.)	2	Alphanumeric
(11)	Firm/Filer ZIP Code	9	Numeric nnnnnnnnn or nnnnnbbbb
(12)	Number of Logical Records in Tax Return (including Summary Record)	7	Numeric Range = 0000003-9999999
(13)	Number of Forms W-2	2	Numeric Range = 00-20
(14)	Number of Forms W-2P	2	Numeric Range = 00-20
(15)	Reserved for EF	8	Blanks
(16)	Number of Schedule Records (excluding Schedule K-1 records)	7	Numeric Range = (0000000-0000002)

SEC. 10. SUMMARY RECORD OF FORM 1041 (Continuation)

Field	Identification	Length	Description
(17)	Number of Form Records (Excluding W-2 and W-2P records)	3	Numeric Range = (000-003)
(18)	Number of Statement Records (excluding Schedule K-1 statement records)	4	Numeric Range = (0000-9999)
(19)	Number of Schedule K-1 Records	7	Numeric Range = (0000000-9999999)
(20)	Number of Statement Records for Schedule K-1 Records	7	Numeric Range = (0000000-9999999)
(21)	Reserved	7	Alphanumeric Value = Blanks
(22)	Paper Document Ind 1	1	Alphanumeric Value = "1" if Form W-2 attached else "0"
(23)	Paper Document Ind 2	1	Alphanumeric Value = "1" if Form W-2P attached else "0"
(24)	Paper Document Ind 3	1	Alphanumeric Value = "1" if other paper attached else "0"
	Record Terminus Character	1	Alphanumeric Value = "#"

SEC. 11. RECAP RECORD

The final record on each file is the RECAP record.

Field	Identification	Length	Format
	Byte Count	4	Value "0072"
	Start of Record Sentinel	4	Alphanumeric Value = "****"
(1)	Record Name	5	Value "RECAP"
(2)	Reserved for IRS only	8	Numeric Value = 00000000
(3)	Reserved	6	Numeric Value = 000000
(4)	Total Return Count	6	Numeric
(5)	Magnetic Tape Identification Number plus Filer's User Code	8	Numeric Value = NNNNNNnn NNNNNN = MTIN nn = Filer's user code; may be zero-filled

Field	Identification	Length	Format
(6)	Julian Date of Transmission	3	Numeric
(7)	Transmission Sequence Number for Julian Day in (6)	2	Numeric
(8)	Reserved	24	Numeric (Zero-filled)
(9)	Filler	1	Alphanumeric Value = Blank
	Record Terminus Character	1	Alphanumeric Value = "#"

SEC. 12. THE ACKNOWLEDGMENT REPORT

.01 The acknowledgment report (Acknowledgment Listing of Transmission, see Attachment VII) is generated by the IRS. It will contain information describing the filer, and the return file as specified in the TRANS record. In addition, the report will include the Document Locator Number (DLN) assigned by the IRS to each accepted return, the Employer Identification Number (EIN) for each return and the acceptance codes. Also, counts for accepted, rejected, and duplicate records will be listed.

Filers who have transmitted processable data will receive by mail, 2 hardcopies of the acknowledgment report within 7 days of submission of the return files.

.02 If the Acceptance Code field for a return on the report contains an "R", the return has been rejected due to a an error involving the return format, internal consistency, or data errors in a key field. Returns that have been rejected must be corrected and resubmitted to the IRS to be considered as filed returns. Additional information about the reasons that will cause the return to be rejected may be found in SEC. 13 below.

.03 If the Acceptance Code field for a return on the report contains a "D", the return has been identified as a duplicate record: i.e., a return record was previously submitted and accepted for that EIN; therefore, the return has been rejected.

.04 If the Acceptance Code field for a return on the report contains a "T", the entire transmission has been rejected.

.05 The error information on the acknowledgment report will contain data defining the form (see Attachment IV), the page number for multipage entries, the error field number, and the error code defining the specific error encountered. This information will be present for up to twelve error records. Each error record contains 8 reject codes for a possible maximum total of 96 reject codes per return.

.06 Any return with an "A" in the Acceptance Code field on the report, has been accepted as a filed return and will be processed from that point in the same manner as paper return documents. Acceptance of a return does not imply that the return will pass all IRS service center validity checks or post to the IRS Master File without delays.

.07 Reject Code Explanation

1. Up to 96 reject codes per return may be furnished to the magnetic tape filer on the acknowledgment report. Filers should use these codes to determine the source of the error causing the return or the entire return file to reject. If more than the maximum number of reject conditions (96) are identified, the 96th reject code will be listed as "999".
2. The reject codes and brief explanations of the conditions that cause the codes to be assigned are listed in Attachment III. Filers should use this information to resolve reject conditions. When a condition cannot be resolved with the information provided, the filer should contact the Magnetic Tape Filing Unit at the Philadelphia Service Center for assistance.

SEC. 13. DATA VALIDATION AND REJECTION CRITERIA

.01 The exclusions listed in Section 2 of the Procedure of this publication must be adhered to or the return shall be rejected.

.02 If the following data controls are not complied with, the entire return file or the return shall be rejected:

1. The following conditions must exist or the entire submission of returns will be rejected:
   (a) the data records of the submission must be in the following sequence: TRANS Record, Return records and the RECAP Record; or
   (b) the format of the TRANS Record and/or RECAP Record must correspond exactly to the record layouts specified above; or
   (c) there should be no duplicate submissions of any record file; or
   (d) there should be no unrecognizable or inconsistent control data in the TRANS and/or RECAP records.
2. The data records must be in the following sequence:
   (a) Return records (Page 1 and 2);
   (b) Schedule records other than Schedule K-1 (optional);
   (c) Form records—in ascending numeric order (optional);
   (d) Form W-2
   (e) Form W-2P
   (f) Statement Records (statements not related to Schedule K-1 optional);
   *(g) Schedule K-1 records (optional);
   *(h) Statement for Schedule K-1 records (optional);
   (i) Summary record (must be final record for each return)
   *Record pairs g and h above are repeated for each Schedule K-1 in the return.
3. Page (Pgnn) records must be consecutive and sequential.
4. Both pages of multiple page schedules or forms must be present with the exception of Page 2 of Schedule D, which need not be transmitted if there are no entries for that page. However, Page 2 of this schedule must not be present without Page 1.

5. All fields must contain the type of data specified under the columnar heading "Format" in the record description. Alphanumeric fields must be left-justified unless otherwise specified. (For further clarification on validation criteria see Appendix A, SEC. 3, Field Specifications of this publication).

6. Significant money fields must be right-justified and zero-filled. Money fields must be all whole dollars (no cents). All other significant numeric fields must entered as specified in SEC. 3.01.4 through 3.01.7. Significant percentage fields must be left-justified and zero-filled. All nonsignificant money fields must be zero-filled. All other nonsignificant fields must be blank unless otherwise specified in the Record Layouts. (See Appendix A, SEC. 3, Field Specifications of this publication).

7. All records must follow the ANSI byte count convention or have a byte count field which must precede the Record ID field for each page record and the count must be equal to the total number of characters contained in the page record. (Reminder: Byte Count includes the Byte Count field, Start of Record Sentinel, Record ID field, all other record fields, and the terminus character (#)).

8. The fields on a statement line (LN) record must be in the same format and sequence as they appear in the record layouts, and only one group of related fields can be entered per statement line (LN) record. Statement references in the tax return must be in ascending numerical sequence. (See Sec. 9, Statement Record, for detailed requirements)

9. The Employer Identification Number (EIN) must be nine numeric characters and must be consistent in all data records for a tax return. The first two digits of the EIN cannot be any one of the following: 00, 07, 08, 09, 10, 12, 15, 17, 18, 19, 20, 21, 24, 26, 27, 28, 29, 30, 32, 40, 44, 49, 50, 53, 60, 67, 69, 70, 78, 79, 80, 89, 90, 96, and 97.

10. The format and content of the Record Identification information (Record ID), which begins each type of record, must always be present and exactly as stated in the input specifications.

11. The Tax Period (Field #5 in the Return Record) must fall within the ranges specified in SEC. 1 of the Procedure in this publication. Fiscal year filers for a fiscal year ending September 30, 1989 (8909), October 31, 1989 (8910), or November 30, 1989 (8911) wishing to participate in the magnetic tape filing of Form 1041 must file for an extension of time (see "Extension of Time to File", Page 2 of instructions attached to official Form 1041) until March 1, 1990. Otherwise, fiscal year filers (Tax Period 8909-8911) for Form 1041 must file a paper document with the appropriate service center. For special instructions about entering the Calendar/Fiscal Year Ending field, see Appendix A, SEC. 15, of this publication.

12. A return will be rejected if program accumulators, maintained while the returns are processed do not match the counters in the SUMMARY record.

13. Foreign address returns are not permitted.

14. The Name Control field must be present.

15. Address data must be present.

16. All "total" fields must have a significant entry when there are amounts leading to the total. Similarly, any "total" field which has a significant entry must have at least one significant entry leading to that amount. Otherwise, the processing of the return will be delayed to resolve the discrepancy.

17. The following checks should be made in relation to Schedule K-1 and statement for Schedule K-1:

(a) Total of count of Schedule K-1 records should match total count found in Summary Record;

(b) The sequence number in the Schedule K-1 statement records should match the sequence numbers of the related Schedule K-1 records.

18. All pages of return Form 1041 must be present. Even if there are no entries on page 2 of Form 1041, the pages must be generated with a significant Return Record ID field.

19. Statement records do not have to be consecutive but must be in ascending sequence. Each statement number reference occurring in a data field ("STMbnn") must have a corresponding statement. Each statement may be referenced only once, except for Schedule K-1 statements (which are always number 99). There may be no more than 98 statement page records, except Schedule K-1 statement records, with any return. For each statement record, at least LN01, LN02, and LN03 must be present, and all line numbers must be in ascending numeric sequence.

Note: The Schedule K-1 Statement record should always contain the statement number (STMb99), and an additional 7 character field containing (0000001-9999999), which is the Schedule Sequence Number (Field #007) assigned to the Schedule K-1 to which it relates.

20. The Form/Schedule Sequence Number in the Record ID of related schedule or form records must be significant and in ascending numerical sequence for all schedule and form records. The sequence number must not be greater than that permitted for the particular form or schedule.

21. There *must be no* significant data present for the following fields from the Form 1041 record:

Form	Title	Field #	Line #
Form 1041	Bankruptcy estate	100	Upper Left
Form 1041	Family estate trust	110	Upper Left
Form 1041	Amended return Box	150	Upper Left
Form 1041	Amended return Stmnt.	160	Upper Left
Form 1041	Nonexempt charitable	260	Upper Right
Form 1041	Split interest trust	270	Upper Right
Form 1041	Box 1, 2, and 3	280	Upper Right

Form	Title	Field #	Line #
Form 1041	Net rent and royalty income or loss	340	4
Form 1041	Net business and farm income	350	5
Form 1041	Ordinary gain or loss	370	7
Form 1041	Treated as credited to trust beneficiaries	600	24b
Form 1041	Taxes paid amount	620	24d
Form 1041	Tax paid with Ext. Form 2758 Box	630	24d
Form 1041	Form 8736 Box	640	24d
Form 1041	Form 8800 Box	650	24d
Form 1041	Form 2439 amount	680	24f
Form 1041	Form 4136 amount	690	24g
Form 1041	Other	700	24h
Form 1041	Total	710	24i
Form 1041	Form penalty amount	780	29
Form 1041	Other tax	1150	G-1b
Form 1041	Description of other tax	1160	G-1b
Form 1041	Foreign tax credit	1180	G-2a
Form 1041	Nonconventional fuel credit	1190	G-2b
Form 1041	Form 3800 Box	1200	G-2c
Form 1041	Form (Specify)—Box	1210	G-2c
Form 1041	Form (Specify)	1215	G-2c
Form 1041	General business credit 1260	G-2c	
Form 1041	Credit for prior minimum tax	1270	G-2d
Form 1041	Total Credits	1280	G-3
Form 1041	Recapture taxes	1300	G-5
Form 1041	Form 4255 Box	1310	G-5
Form 1041	Form 8611 Box	1320	G-5
Form 1041	Name/address change	1350	O/I-1
Form 1041	Passive activity (Yes)	1400	O/I-3

22. Form records of tax return Form 1041 must be in ascending numeric sequence followed by alpha sequence.

(a) Form 4952

(b) Form 8656

(c) W-2

(d) W-2P

23. The capital loss limitation (Field #1750) on Schedule D must not exceed $3000.

24. The following lines and field numbers on the return records for Form 1041 must always be positive amounts:

On Form 1041:

(a) Deduction lines 10-16 and 19-20 (Field #s 420, 430, 440, 450, 460, 480, 485, 486, 490, 530 and 540).

(b) Income Lines 1 and 2, (Field #s 300 and 310).

(c) Total tax line 23 (Field #570), Charitable deductions (Field #950), and Total (Schedule G, Field #1340).

(d) Payment amount (Field #580)

(e) Federal Income Tax Withheld (Field #670)

(f) Total Field (Field #720)

(g) Credited to 1990 (Field #750)

(h) Refunded amount (Field #760)

(i) Alternative minimum tax (Field #1330)

On Schedule D:

(a) Computation of capital loss, from Line 18 above as a positive amount (Field #1770).

(b) Loss shown on Line 6, Line 24 (Field #1794)

(c) Net loss from line 17, Line 18 (Field #1750)

On Form 8656:

(a) Alternative tax net operating loss (Field #350)

(b) Combine lines 4a through 4d (Field #100)—

25. In the return records of Form 1041 there must be no significant entry in the following fields of the following forms and schedules:

Form/Schedule	Title	Line #	Field #
Form 4952	Phase-In Adj.	3	080
Form 8656	Tax shelter farm loss	5i	190
Form 8656	Passive activity loss	5j	200
Form 8656	Foreign Tax Credit	III(9)	590
Form 8656	Sec. 644 tax	III(11c)	620
Schedule D	Short-term gain from Form 6252	2	750
Schedule D	Long-term gain from Form 6252	8	1580
Schedule D	Capital gain distribution	10	1600
Schedule D	Capital gain from Form 4797	11	1610

26. The following fields must be equal:

Field#	Title	Line# =	Sch/Form	Field #	Title	Line #
	Line From 1041 Record					
540	Exemption	20 =	Sched D	1780	Amount from line 20	1041
	Note: this is true only when Field #1780 is significant.					
450	Charitable deduction	13 =	Sched A	950	Total char deductions	6
500	Adjusted	17 =	Sched B	960	Adjusted total income	1
570	Total Tax	23 =	Sched G	1340	Total tax (lines 4-6)	7
980	Net gain	3 =	Sched D	1710	Net gain	17(a)
990	Amount from Schedule A	B(4)=	Sched A	920	Net short-term	4
1330	Alternative minimum Tax Line from Form 8656	G-6 =	Form 8656	640	Alternative minimum Tax	Pt III line 12
400	Fiduciary's share of alternative minimum taxable income	Pt I 12 =	Form 8656	530	Amount from line 12 Part I	III(1)
420	Alternative minimum taxable income	Pt II =1	Form 8656	360	Adjusted alternative minimum taxable income	I(1)

27. The following are the permissible exemption amounts for the fiduciary codes.

(a) If an "X" appears in the following fields, the exemption amount, line 20, Field #540, may be as shown:

(i) Decedent Estate Box (Field #050) - $600

(ii) Simple Trust Box (Field #060) $100 or $300

(iii) Complex Trust Box (Field #070) $100 or $300

(iv) Taxable Grantor Type Trust (Field #080) - $100 or $300

(v) Non-Taxable Grantor Type Trust (Field #080) - Blanks

(vi) Final Return (Field #170) Blanks (Estates or Trust)

Note: If any of Field Numbers 050, 060, 070, 080 is/are significant, then Field #540 can be any amount from zero up to the money amount specified, or blank.

28. The following fields must be present:

(a) Name Control (Field #030) (if Name Control is from a GNMA or FNMA, it must not contain leading zero/zeroes;

(b) Estate/Trust Name line (Field #180);

(c) Fiduciary Name line (Field #200).

29. Fiduciary Code: at least one of Fields 050, 060, 070 or 080 must be present.

30. Address data (Fields 220, 230, 240, 250) must be present.

31. In Fields 050-080:

(a) If Decedent estate Field #050) is "X", Field #060, 070, and 080 must be blank.

(b) If Simple trust (Field #060) is "X", Field #050 and 070 must be blank.

(c) If Complex trust (Field #070) is "X", Field #050 and 060 must be blank.

(d) If Grantor type trust (Field #080) is "X", Field #050 must be blank.

32. Entries for Income distribution (Field #510) on Form 1041 must be supported by Schedules K-1.

33. If Capital gain/loss (Field #360) on Form 1041 is negative, it must equal Net loss (Sch D, Field #1750) which represents a loss of not more than $3000. If Capital gain/loss is positive, it must equal Total net gain (Sch D, Field #1730).

34. Refund Amount (Field #760) cannot be equal or greater than $1,000,000.

35. Preparer's TIN (Field #830 or #810) cannot be equal to EIN (Field #040).

36. If Final Return Box (Field #170) = "X", then Credited to 1990 (Field #750) must be equal to zeros.

37. If Tax due (Field #730) and Overpayment (Field #740) on Form 1041 must not both be equal to zeros.

Note: See Attachment III for explanations of reject codes. Reject codes are assigned to conditions that cause the return or the entire return file to be rejected. They are based on criteria set forth in the above section and elsewhere in this Revenue Procedure.

SEC. 14. SPECIAL INSTRUCTIONS FOR ENTERING THE FIDUCIARY'S NAME AND ADDRESS

These instructions must be followed carefully to avoid delaying returns for error conditions. They must be included in the filer's programs as consistency tests and in the data entry instructions. The return must not contain a foreign address. Foreign addresses are from other than the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, Guam, American Samoa, Caroline Islands, Federated States of Micronesia, Northern Mariana Islands, Marshall Islands, and Palau Islands.

.01 *Name Line 1*

1. Only alphabetic characters, numbers, spaces and the special characters ampersand (&), slash (/), and hyphen (-) may appear in the Estate/Trust name line.

2. Only one intervening space may separate any component of a name line.

3. All apostrophes, and any other punctuation characters except the hyphen, must be omitted from names, and the alphabetic characters must be shifted to the left in their place (e.g., O'Shea = OSHEA).

4. Numeric characters in name components must be replaced by alphabetic Roman numerals (e.g., Charles 3rd = CHARLES III).

.02 *Instructions for Street Address and Name Line 2*

1. Only alphabetic and numeric characters, ampersand (&), slash (/), hyphen (-), percent (%), and spaces appear in the street address and fiduciary/beneficiary name line fields. If no data is available for Name Line 2, enter blanks.
2. Only one intervening space may separate any two components of any name line, the street address lines. Periods should be deleted from these lines.
3. For the street address, enter the house number and street, route number, post office box, or box number.
4. Abbreviate words requiring standard abbreviations unless the word is a proper name.

Examples	Enter As
South Court Street	S COURT ST
Circle Drive	CIRCLE DR
Lane Building	LANE BLDG
Northeast Street	NORTHEAST ST
Third Street	THIRD ST
3 Ave.	3RD AVE

5. Enter college, building, or post office branch as the address if no mailing address is given.
6. If "In Care Of" is the mailing address, use the symbol "%" followed by a space.

Example:	John James Trust In Care of Alice B. Smith 801 Brown St.	
Enter As:	JOHN JAMES TRUST % ALICE SMITH EXEC 801 BROWN ST	(Name of Estate or Trust) (Estate/Trust Name Line) (Street Address)

7. Do not use the "#" symbol, "No.", or "Number" as a prefix to a house, apartment., route, or P.O. Box.
8. Always add st, nd, rd, th, to a numbered street or avenue. Examples: 1 = 1ST; 2 = 2ND; 3 = 3RD, etc.
9. Enter ½ as ½ (no spaces).
10. Plurals for street, road, avenue, apartment, etc., will be entered as STS, RDS, AVES, APTS, etc.
11. Omit the letters "APO" and "FPO" in the address. (Include always as part of the CITY field).
12. The following standard abbreviations are preferred:

WORD	ABBR.
and	&
Air Force Base	AFB
Apartment	APT
Avenue	AVE
Boulevard	BLVD
Building	BLDG
Care of, or In care of	%
Circle	CL
Court	CT
Drive	DR
East	E
General Delivery	GEN DEL
Highway	HWY
Lane	LN
North	N
Northeast, N.E.	NE
Northwest, N.W.	NW
Parkway	PKY
Place	PL
Post Office Box, P.O. Box	PO BOX
Route, Rte.	RT
Road	RD
R.D., Rural Delivery, RFD, R.F.D., R.R. or Rural Route	R D
South	S
Southeast, S.E.	SE
Southwest, S.W.	SW
Street	ST
Terrace	TER
West	W
One-Half	½ (all fractions, space before and after the number, i.e., 1012 ½ ST)

.03 *Instructions for City, State and ZIP Code Fields*

1. The City field may contain alphanumeric characters. The only special character allowed is the blank. If the name of a city contains two words or more, only one intervening space is allowed between consecutive words (e.g., New York)
2. Standard abbreviations for STATE CODE are listed Attachment V.
3. ZIP Code MUST be transcribed as five digits or nine digits. (See Attachment V)

.04 *Special Instructions for Determining the IRS Name Control Field*

1. The Name Control (Field #030) for a trust should be determined from the information specified on the Name of the estate or trust line (Field #180). The Name Control consists of the first four characters of the surname, corporation name, trust name or number.

   The Name Control field for estates should be derived from the first four characters of the last name of the decedent.

Examples:

Trusts/Estates	Name Control
Appletree Trust Co. Trustees U/W OF Kate B. *Crab*apple Dec'd (FBO Edna M. Rose)	CRAB
Treas. of the State of NC in Tr. for *Jas*mine Ins. Co.	JASM
GNMA Pool No. 00*8619* Chicago Bank TTEE	8619
*Welf*are Fund of International/Union of Operating Engineers/Locals 436 & 436B AFL-CIO Locals 436 & 436B TTEE	WELF
Tstmtry. Trust UW Maggie *Plum* for Claudia Ivy & Warren Iris W. Verbena & Charles Plum c/o Willow & Plum	PLUM

2. Disregard blanks between letters in the last name. Omit punctuation marks, titles and suffixes. Exclude the word "the" when followed by more than one word.

3. For Indian tribes, use the name of the tribe.

4. For FNMA or GNMA Mortgage Backed Securities, use the first four digits of the trust number, disregarding any leading zeros. If there are fewer than four numbers, use the letters "GNMA" or "FNMA" for GNMA and FNMA Pools respectively to complete the name control.

Example:

GNMA Pool No. 00100, use 100G as the Name Control.

FNMA Pool No. 00100, use 100F as the Name Control.

5. Before you determine the name control, take the following into consideration.

(a) The first position can only be alpha and numeric characters, A-Z and 0-9.

(b) Positions 2, 3, and 4 can be alpha and numeric characters A-Z and 0-9; the ampersand (&) and the hyphen (-) and blanks are the only special characters allowed.

Example: John A *El-R*ose — Example: Wayne Elm Mary *Al*

(c) Intervening spaces between characters are not allowed.

6. Consider certain foreign suffixes as part of the last name (i.e. Armah-Bey, Paz-Ayala, Allar-Sid). Particular attention must be given to those names which incorporate a mother's maiden name as a suffix to the last name. This practice is common in names of Spanish extraction. Consider the mother's maiden name as part of the surname for Name Control purposes.

Examples

Individual Name	*Name Control*
John Brown	BROW
John Lea-Smith	LEA-
John Di Angelo	DIAN

Examples

Individual Name	*Name Control*
John O'Neil	ONEI
John En, Sr.	EN
Pedro Paz-Ayala	PAZ-
Abdullah Allar-Sid	ALLA
Joe McCarty	MCCA
Juan de la Rosa Y Obregon	DELA

Individual Name	*Name Control*
Jose Alvarado Nogales	ALVA
Donald Vander Neut	VAND
Otto Von Wodtke	VONW
Mary Smith & John Jones	SMIT

SEC. 15. SPECIAL INSTRUCTIONS FOR ENTERING THE TAX PERIOD ENDING

The Tax Period, Field #5 in the Return Record is composed of numeric month and year of the calendar/fiscal year ending for which the return is being filed. The format is YYMM (YY = year and MM = month). For example, a return with a calendar/fiscal year ending of February 15, 1989, will be assigned a Tax Period of 8902. Returns filed under the 52-53 week rule may end not more than 6 days before or more than 3 days after the close of the month. They should be assigned a calendar/fiscal year ending based on that month (i.e. if the ending date is October 3, 1989, the Tax Period field will be 8909 or if the ending date is October 25, 1989, the Tax Period is 8910).

APPENDIX B

Return File Specifications for Form 1065

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SECTION 1. OVERVIEW

.01 The sequence of record submission is as follows:

1. The original TRANS record (this record identifies the magnetic tape transmitter).
2. Return records including the return (RET), and all related schedules other than K-1 (SCH), forms other than Form 8308 (FRM), statements other than Schedule K-1 statements (STM), Schedule K-1 (K1), statements for Schedule K-1 (STM), Form 8308 (FRM), and summary records (SUM).
3. RECAP record.

.02 For all filers, a hardcopy acknowledgment report, separately identifying accepted and rejected returns, will be mailed. (See SEC. 12 in this appendix and Attachment VII).

.03 If the entire magnetic tape is rejected, the acknowledgment will consist of information defining an acceptance code field with a value of "T" and all the reject errors related to the magnetic tape submitted. (SEC. 12 in this appendix and Attachment VII).

SEC. 2. GENERAL DESCRIPTION

.01 All the data must be in ASCII or EBCDIC format. No binary fields may be transmitted.

.02 One four-byte, decimal-constant counter must precede each logical record within a block. The byte count contains the length of the record plus the length of the byte count. Record byte counts are provided in these specifications as the first constant field preceding the Record ID and this byte count (which is not part of the record) is to be used only if the ANSI byte convention is not used.

NOTE: IBM BYTE COUNT MUST NOT BE USED.

.03 All records must be submitted in the fixed format.

.04 The first record on a transmitted file (the TRANS record) contains information regarding the transmitter and the file format. This record should be followed by the records comprising the returns being submitted. The last record on a submitted file (the RECAP record) will provide balancing counts of all returns.

.05 A return file will consist of a variable number of fixed-length records. The size and format of the logical record for each page of each form, schedule etc., are specified herein. Maximum block size is limited to 28,672 characters. See Attachment VIII for examples of variable blocking format.

.06 The logical records described herein may not be broken between physical records (i.e. "blocks"). Files must not be spanned.

.07 Each logical record within a submission must be preceded by a four-byte field (if the ANSI byte count convention is not used), that will be a record byte count containing a count of the number of bytes within the logical record—including the four bytes for the counter itself.

.08 Every logical record must have as its last significant byte the record terminus character ("#"). Note that provisions have been made to allow for non-significant padding to exist following the record terminus character, if the block contains one logical record (blank padding should never separate logical records within a block). This padding is permitted to accommodate all the different computer systems being used to format the data.

.09 Each logical record should contain all data fields pertaining to one printed page of an official form or schedule. Statements are allowed for certain fields that have been marked with an ampersand ("@") or an asterisk ("*"). The continuation statements are composed of line records corresponding to the print lines of a complete statement. Each line of a continuation statement ("STMbnn") is a logical record (see SEC. 9 for more details).

.10 The complete tax return of Form 1065 must consist of all logical records pertaining to it, in the following sequence:

> *Return records, schedule records other than Schedule-K-1, form records other than Form 8308 records, statement records other than statement records for Schedule K-1, Schedule K-1 records, statement records for Schedule K-1, Form 8308 records, and summary records.*

The only exception to this rule is that one series of statement line records for a single continuation statement that pertains to a Schedule K-1 must directly follow the applicable Schedule K-1. Schedules must be in alphabetical sequence and forms must be in alpha, then numeric, sequence.

All records must appear in the proper sequence, with the proper control information, and the counts of the schedules and forms must match the accumulators in the Summary Record. Otherwise, the return will be rejected. Return, schedule, form and statement records may contain additional sequential page records if they consist of more than one printed page. (Pages are numbered only within a form, schedule or statement, not across the return.)

.11 *Every return page must have a logical record present. Only the pages of other schedules or forms (in the proper sequence) which contain significant data, need to have a logical record present.* Therefore, a page need not be generated, if there are no entries on the page record of a form (except Form 1065) or schedule (see Sec. 13.01.4 below, for exception rules). Also, if page 2 of a form is generated, page 1 of the form must be also be generated.

.12 The Return Type and Tax Period fields are Field Numbers 2 and 5 of the Return Record (see Appendix B, SEC. 6 below) respectively, included in each page of the return.

.13 If the number of data bytes appearing on the same line exceeds the number that can be contained in the space provided on the printed form or schedule, the data must be provided on a separate continuation statement (STM) record. Only fields preceded by an ampersand (@) or an asterisk (*) may contain statement ("STMbnn") references. There is a maximum of 2 pages per statement, 50 lines per page and 98 statement page records per tax return in total. Returns with more than 98 statement page records will be rejected. Schedule K-1 statements are not limited to 98 statement page records. Nevertheless, Schedule K-1 records are limited to two pages per statement and 50 lines per page. If "STMbnn" is used, no data should be entered in the base return. See Appendix B, SEC. 9 for specific details.

.14 Assign a 7-digit number to each Schedule K-1 (Field 010) in ascending order (a 7-digit number must be assigned to each Form 8308 also).

.15 A summary record will be the final record for each return. This record will contain magnetic tape filer identification data; counts of the schedules, forms and statements included in the return; and indicators for paper documents retained by the magnetic tape filer for subsequent submission to the IRS.

.16 The end of the logical record submission will be signaled by the recognition of the record terminus character of the RECAP record as the last logical record submitted.

.17 The recognition of the Record Terminus character ("#") followed by an End of Volume (EOV) marker (one tape mark) will indicate that there are still more tapes to be read. A return cannot be split between tapes. Otherwise, the recognition of the Record Terminus character followed by End of File (EOF) marker (two tape marks) will indicate the last record of the tape file.

.18 The file should be unlabeled (no standard header or trailer records), and each file must contain only complete returns.

.19 Returns with different calendar/fiscal year ending may be submitted on the same magnetic tape.

SEC. 3. FIELD SPECIFICATIONS

.01 Numeric Fields

1. All money fields:
   (a) in Form 1065 are 11 characters, 10 numerics followed by the sign character;
   (b) containing no significant data must be filled with zeros.
   (c) The significant numeric characters should be right-justified, and zero-filled. Dollar signs, decimal points, or other non-numeric characters are not permitted.
   (d) Money fields must be all whole dollars (no cents).
2. The right-most position of any negative money field must contain the negative sign; for positive fields this position is always blank.

   Note: Fields that can contain either gain (income) or loss amounts, such as Schedule K (Form 1065), Line 4(d) Net Short-Term Capital Gain or Loss, must have the applicable sign character, (i.e., blank for positive amounts and minus for negative amounts).
3. All percentage fields must have five positions, left-justified and zero-filled. Do not enter the decimal point on the record. The decimal point will be assumed to be between the left-most and the second left-most positions. If percentage is less than 100%, precede the figure with a zero. For example, 25.32% would be entered as "02532" and 105% would be entered as "10500". If there is no percentage enter spaces.

   Exception: Schedule K-1 (Fields #250-300) of Form 1065 require six positions following the decimal point. When these fields are significant, do not enter the leading zero. The decimal point will be assumed to precede the left-most position. For example, if the partner's percentage of loss sharing at the end of the year equals .00038 percent, enter as "000004".
4. Other numeric fields such as in Form 4562, Total miles driven during the year, Part III Sec B 29(a), must all be numeric, right-justified, and zero-filled. If the numeric field has no significant data it must be zero-filled (exceptions are ZIP Code EIN, SSN and date fields).
5. ZIP Codes must be 5 or 9 character numeric fields, left-justified and blank-filled.
6. All dates must be entered in the MMDDYY, MMYY or YYMM format.

Examples:

MMDDYY	February 15, 1988	- 021588
YYMM	Calendar/Fiscal Year Ending December, 1989	- 8912
MMYY	Date placed in service December, 1989	- 1289

If there is no date, enter spaces.

7. EIN (for other than the Partnership's Employer Identification Number) and/or SSN numbers must be blank-filled if there is no entry.

.02 Alphanumeric fields

1. Except where designated, do not enter spaces etc. between data elements.
2. All alphabetic data must be in upper case only.
3. Special characters may be valid for specific fields as noted in the record specifications.
4. Literal fields must contain one of the exact character strings, as specified in the record specifications, or blanks.
5. Data fields without any information must be blank-filled unless otherwise specified.
6. A "b" in the format description of a record layout denotes a blank space.

SEC. 4. RECORD LENGTH DESCRIPTION

.01 Logical return records must be submitted in a fixed format. All records within a return must be submitted exactly as defined with all the fields present. (See specifications throughout Appendix B and in record layouts in Publication 1438).

Each record must end with a Record Terminus Character ("#").

.02 The fixed ANSI byte count constant or the fixed constant shown as the first field in each record within Publication 1438, must be present always.

SEC. 5. TRANS RECORD

The first record on each file is the TRANS record, which will contain the following information. All participating filers that have been accepted into the Electronic Filing Program will be assigned an Electronic Filer Identification Number, or EFIN. Fields 2, 3, and 6 pertain to the entity which has been accepted by the Andover Service Center as a magnetic tape filer.

Field	Identification	Length	Format
	Byte Count	4	Value "0168"
	Start of Record Sentinel	4	Alphanumeric Value = "****"
(1)	Record Name	5	Value "TRANS"
(2)	EIN of Filer	9	Numeric
(3)	Filer Name	35	Alphanumeric
(4)	Processing Site	1	Alphanumeric "C" = Andover
(5)	Transmission Date	6	Numeric MMDDYY
(6)	Electronic Filer Identification Number plus Filer's User Code	8	Numeric Value = NNNNNNnn NNNNNN = EFIN nn = Filer's user code; may be zero-filled
(7)	Julian Date of Transmission	3	Numeric
(8)	Transmission Sequence Number for Julian Day in (7)	2	Numeric
(9)	Reserved for EF	4	Alphanumeric Values = Blanks
(10)	Return Form Type	5	Value = "1065b" left-justified
(11)	Filler	1	Alphanumeric Values = Blank
(12)	Address	35	Alphanumeric
(13)	City, State, Zip Code	35	Alphanumeric Values for ZIP Code = nnnnnnnnn or nnnnnbbbb n = 0-9
(14)	Area Code, Telephone Number	10	Numeric
(15)	Record Terminus Character	1	Alphanumeric Value = "#"

SEC. 6. RETURN RECORD

Page 01, 02, 03 and 04 for each Form 1065 return will start with the following first 9 fields preceded by a byte count and Start of Record Sentinel. Each page of the return will have a new page record with the page number incremented. These records will each begin with Fields 1-9 below.

Field	Identification	Length	Format
	Byte Count, Page 1, 2, 3, and 4	4	"0043" plus length of data fields
	Start of Record Sentinel	4	Alphanumeric Value = "****"
(1)	Record Name	4	Alphanumeric Value = "RETb"
(2)	Return Type	6	Alphanumeric; Valid Values = "1065bb"
(3)	Consolidation indicator for Forms 8453-P	2	Numeric (00-99) (00 = nonconsolidated, 01-99 = consolidated)
(4)	Page Number	5	Alphanumeric Value = PGnnb, Valid range for nn = 01 to 04
(5)	Tax Period	4	Numeric, YYMM
(6)	Filler	1	Alphanumeric Value = Blank
(7)	Employer Identification Number (EIN)	9	Numeric
(8)	Filler	1	Alphanumeric Value = Blank
(9)	Master File Tax Code	2	Numeric Value = 06
(10)	Data Fields	various	Page data fields
	Record Terminus Character	1	Alphanumeric Value = "#"

SEC. 7. SCHEDULE RECORD

The second record or series of records is the schedule record. Each page of a schedule will have a new schedule record with the page number incremented by 1, preceded by the byte count.

Field	Identification	Length	Format
	Byte Count, Page 1 and 2	4	"0037" plus length of data
	Start of Record Sentinel	4	Alphanumeric Value = "****"
(1)	Record Name	4	Alphanumeric Value = "SCHb"
(2)	Schedule Type	3	Alphanumeric (left-justified) Values = "Dbb" or "K1b"
(3)	Schedule Sequence Number	7	Numeric Range = (0000001-9999999)
(4)	Page Number	5	Alphanumeric Value = "PGnnb" Valid ranges for nn = 01-02
(5)	Employer Identification Number (EIN)	9	Numeric
(6)	Data Fields	Various	Page data fields
	Record Terminus Character	1	Alphanumeric Value = "#"

SEC. 8. FORM RECORD

The third series of records after returns and schedules is the group of form records. They should appear in the sequence specified in SEC. 13.02.2 of Appendix B. Each page of a form will have a new form record, preceded by the byte count, the Start of Record Sentinel with the page number incremented.

Field	Identification	Length	Format
	Byte Count, Page 1 and 2	4	"0040" plus length of data
	Start of Record Sentinel	4	Alphanumeric Value = "****"
(1)	Record Name	4	Alphanumeric Value = "FRMb"
(2)	Form Number	6	Alphanumeric (left justified) Values = "4562bb", "4797bb", "8308bb", "8271bb"
(3)	Form Sequence Number	7	Numeric Range = (0000000-9999999)
(4)	Page Number	5	Alphanumeric Value = "PGnnb" Valid range for nn = 01 to 02
(5)	Employer Identification Number (EIN)	9	Numeric
(6)	Data fields	various	Page data fields
	Record Terminus Character	1	Alphanumeric Value = "#"

SEC. 9. STATEMENT RECORD

.01 The statement record is the fourth series of records after returns, schedules and forms. Statement records are used to continue a field or related series of fields that *appear on the same print line. (A print line is all the fields that would appear as a single line item on a printed version of the form. An example is Schedule Form 1065 line 19).* Each statement is given a sequential number from 01 to 99. References to statements on the tax return must be in ascending numerical sequence and must be referenced in the same sequence as the transmission sequence of the forms.

1. The first line entry for the continued item on the base form or schedule record itself shall read "STMbnn" ("nn" being the applicable statement number). All of the applicable entries must then be on the statement record and cannot be split between the continued item record(s) and the statement.

2. The first statement record may contain a literal description of the item continued.

Example: (Fixed format for LNO1)

0116****STM 01 PGO1 LNO1 128888888 (20 blanks) OTHER DEDUCTIONS LINE 19 FORM 1065 (blanks up to 80 characters) #

Note: Blanks inserted before and after the title of the example statement record listed above, are present for readability and may be determined by the filer.

3. The second statement record for all continuations of tabular data may contain the column headings spaced with the headings as they would appear on the printed form they continue. The tabular column titles will be spaced in the same format as would be printed on a blank continuation page. (This record may be blank or may also be used for non-tabular data if appropriate).

Example: (Fixed format for LNO2)

0116****STM 01 PG01 LNO2 128888888 (5 blanks) DESCRIPTION (30 blanks) AMOUNT (blanks up to 80 characters) #

Note: Blanks between title header columns must be inserted for readability but number of spaces may be determined by filer.

4. The third statement record ("LN03") and beyond, may contain, left justified, the related data fields in the same order as they appear in the base layout.

Contiguous fields related to tabulated titles from LN02, that would have appeared as a single print line on the basic form or schedule shall also appear on the same statement line record, left-justified, beginning with the third line record ("LN03"). The first data field for a table or a group of related line entries must contain the "STMbnn" for the entire table (i.e., part of the table

cannot appear on the form and part in a statement).

Example: (Fixed format for LN03–LN50)

0116****STM 01 PG01 LNO3 128888888(6 blanks) LEGAL FEES (30 blanks) 0000002500 (blanks up to 80 characters) #

0116****STM 01 PG01 LNO4 128888888(6 blanks) AUTO EXPENSES (27 blanks) 0000002500 (blanks up to 80 characters) #

0116****STM 01 PG01 LNO5 128888888(25 blanks) TOTAL (5 blanks) 0000005000 (blanks up to 80 characters) #

Note: Data should be entered as it would be entered on the form. Alphanumeric fields should be left-justified and blank-filled. Money amount fields (10 numerics followed by a blank if the amount is positive or a (–) if the amount is negative) should be right-justified and zero-filled. Lines 4 through 50 would be entered if needed.

5. If the statement data does not require tabulation, free format is allowed.
6. Statements can *only* be used by the magnetic filer when the open-ended item *cannot* be contained in the space provided on the printed form or schedule.

.02 The 80 characters of data corresponding to any statement record within the return, containing non tabular data, may begin with line 2. Data should appear left-justified as a continuous print line. The same statement may be continued with additional lines, consecutively numbered, until a maximum of 50 lines have been formatted for the first page or the end of the information needed to be formatted as a statement has been reached, whichever comes first. If additional lines are needed to complete a statement, an additional page with a maximum of 50 lines may be formatted continuing with the numbering sequence from page 1.

.03 Only fields marked with an asterisk (*) in the record layout may contain "STMbnn". Fields marked with an "@" sign in the record layout must contain "STMbnn" if corresponding fields contain significant data, (otherwise the fields should contain blanks) and the data fields(s) must appear on a statement record. The length of the data fields in these statements may be up to 80 characters.

.04 An "@" sign will precede any field that must contain a statement reference when significant. In the record layout (Publication 1438), an asterisk (*) will precede any field which may contain a statement reference (STMbnn), if necessary. A statement reference indicates that either the first entry of a line or a table of related items is to be continued on a statement record. A plus sign (+) marks the first entry field of a line or table following a field preceded by an asterisk (*) that has been referenced as a statement record (STMbnn). If the field referenced with an asterisk contains "STMbnn", the related field(s) marked with a "+" should be blank; the information or related items should be entered on the statement.

In some cases, the related statement fields require more than the maximum 80 positions allowed. An asterisk followed by a plus sign (*+) indicates the first field of a separate statement record which continues the required fields from the previous statement record. In other words, fields normally included in one statement record have been divided between two statement records because the maximum of 80 characters per statement record has been surpassed. The statement record containing the additional items relating to the first statement should be referenced as a "Continuation Statement" and will be preceded by (*+). A "Continuation Statement" should be referenced only when the preceding asterisked field is equal to "STMbnn". See SEC. 9 for the format of the Statement Record.

SEC. 9. STATEMENT RECORD (Continuation)

	Field Identification	Length	Format
	Byte Count if fixed format	4	Value "0116"
	******* For Schedule K-1 add 8 to Byte Counts *******		
	Start of Record Sentinel	4	Alphanumeric Value = "****"
(1)	Record Name	4	Alphanumeric Value = "STMb"
(2)	Statement Number	2	Numeric Range = (01–99) (99 for Schedule K-1 only)
(3)	Reserved for EF	2	Alphanumeric Value = Blanks
(4)	Page Number	5	Alphanumeric Value = "PGnnb" nn = 01–02
(5)	Line Number	5	Alphanumeric Value = LNnnb, nn = 01–50
(6)	EIN	9	Numeric
	*******Fields #7 and 8 in Schedule K-1 Statements only********		
(7)	K-1 Sequence #	7	Numeric This field must be significant for Schedule K-1 only. Range = (0000001–9999999) else bbbbbbb
(8)	K-1 Sequence # Filler	1	Alphanumeric Value = blank
	********** All statements **********		

Field	Identification	Length	Format
(9)	Data Record	80	See SEC. 9
	Record Terminus Character	1	Alphanumeric Value = "#"

Note: Refer to Appendix B, SEC. 2, paragraph 13, for restrictions on the use of statement records. Data cannot be split between a return, schedule, or form record and a statement record. If more entries are required than are provided for in Publication 1438 (Record Layouts) enter "STMbnn" in the field or the first of a series of fields on the return, schedule, or form record and put the specific data entries on the statement record (refers to field names marked with "@" or an "*" as specified in Publication 1438, Record Layouts of Form 1041 and 1065, only).

SEC. 10. SUMMARY RECORD OF FORM 1065

The final record for each tax return is the summary record. (A "1" in the paper document indicator field shows that the paper document specified is a part of the return, and has been attached to the partnership's declaration, Form 8453-P. Otherwise, enter "0".)

The format is as follows:

Field	Identification	Length	Format
	Byte Count	4	Value "0212"
	Start of Record Sentinel	4	Alphanumeric Value = "****"
(1)	Record Name	4	Alphanumeric Value = "SUMb"
(2)	Reserved	13	Alphanumeric Blanks
(3)	Partnership's EIN	9	Numeric
(4)	Name of Magnetic Tape Filer	35	Alphanumeric
(5)	Filer's EIN or SSN	9	Numeric
(6)	Preparer Self-Employment Indicator	1	Alphanumeric Value = "X" if self-employed otherwise blank
(7)	Preparer Firm EIN	9	Numeric
(8)	Preparer Firm Name	35	Alphanumeric
(9)	Firm/Filer's City	20	Alphanumeric
(10)	Firm/Filer's State Abbr.	2	Alphanumeric
(11)	Firm/Filer's ZIP Code	9	Numeric
(12)	Number of Logical Records in Return (including Summary record)	7	Numeric Range = (0000007-9999999)
(13)	Filler	3	Alphanumeric Value = Blanks
(14)	Number of Form 8271 records	3	Numeric Range = 000-999
(15)	Number of Schedule Records (Excluding Schedule K-1 records)	7	Numeric Range = (0000000-0000001)
(16)	Number of Form Records (excluding Forms 8308 and 8271 records)	3	Numeric Range = (000-008)
(17)	Number of Statement Records (Excluding Statement records)	4	Numeric Range = (0000-4900)
(18)	Number of Schedule K-1 records	7	Numeric Range = (0000004-9999999)
(19)	Number of Statement records for Schedule K-1 records	7	Numeric Range = (0000000-9999999)
(20)	Total Number of Form 8308 records	7	Numeric Range = (0000000-9999999)
(21)	Reserved for EF	8	Alphanumeric Value = Blanks
(22)	Paper Document Indicator 1	1	Alphanumeric Value = "1" if other paper is attached, else "0"
	Record Terminus Character	1	Alphanumeric Value = "#"

SEC. 11. RECAP RECORD

The final record on each file is the RECAP record.

Field	Identification	Length	Format
	Byte Count	4	Value "0072"
	Start of Record Sentinel	4	Alphanumeric Value = "****"
(1)	Record Name	5	Value "RECAP"
(2)	Reserved for IRS only	8	Numeric Value = 00000000
(3)	Reserved	6	Numeric Value = 000000
(4)	Total Return Count	6	Numeric
(5)	Electronic Filer's Identification Number plus Filer's User Code	8	Numeric Value = NNNNNNnn NNNNNN = EFIN nn = Filer's user code; may be zero-filled
(6)	Julian Date of Transmission	3	Numeric
(7)	Transmission Sequence Number for Julian Day in (6)	2	Numeric
(8)	Reserved	24	Numeric (Zero-filled)
(9)	Filler	1	Alphanumeric Value = Blank
	Record Terminus Character	1	Alphanumeric Value = "#"

SEC. 12. THE ACKNOWLEDGMENT REPORT

.01 The acknowledgment report (Acknowledgment Listing of Transmission, see Attachment VII) is generated by IRS. It will contain information describing the magnetic tape filer, and the return file as specified in the TRANS record. In addition, the report will include the Document Locator Number (DLN) assigned by the IRS to each accepted return, the Employer Identification Number (EIN) for each return and acceptance codes. Also, counts for accepted, rejected, and duplicate records will be listed.

All magnetic tape filers who have submitted processable data will receive by mail, 2 hardcopies of the acknowledgment report within 7 days of submission of the return files.

.02 If the Acceptance Code field for a return on the report contains an "R", the return has been rejected due to a an error involving the return format, internal consistency, or data errors in a key field. Returns that have been rejected must be corrected and resubmitted to the IRS to be considered as filed returns. Additional information about the reasons that will cause the return to be rejected may be found in SEC. 13 below.

.03 If the Acceptance Code field for a return on the report contains a "D", the return has been identified as a duplicate record: i.e., a return record was previously submitted and accepted for that EIN; therefore, the return has been rejected.

.04 If the Acceptance Code field for a return on the report contains a "T", the entire transmission has been rejected.

.05 The error information on the acknowledgment report will contain data defining the form (see Attachment IV) the page number for multipage entries, the error field number, and the error code defining the specific error encountered. This information will be present for up to twelve error records. Each error record contains 8 reject codes for a possible maximum total of 96 reject codes per return.

.06 Any return with an "A" in the Acceptance Code field on the report, has been accepted as a filed return and will be processed from that point in the same manner as paper return documents. Acceptance of a return does not imply that the return will pass all IRS service center validity checks or post to the IRS Master File without delays.

.07 Reject Code Explanation

1. Up to 96 reject codes per return may be furnished to the magnetic tape filer on the acknowledgment report. Filers should use these codes to determine the source of the error causing the return or the entire return file to reject. If more than the maximum number of reject conditions (96) are identified, the 96th reject code will be listed as "999".
2. The reject codes and brief explanations of the conditions that cause the codes to be assigned are listed in Attachment III. Filers should use this information to resolve reject conditions. When a condition cannot be resoived with the information provided, the filer should contact the Electronic Filing Unit at the Andover Service Center for assistance.

SEC. 13. DATA VALIDATION AND REJECTION CRITERIA

.01 The exclusions listed in SEC. 2.03 of the Procedure in this publication must be adhered to or the return shall be rejected.

.02 If the following data controls are not complied with, the entire return file or the return shall be rejected:

1. The following conditions must exist or the entire submission of returns will be rejected:
   (a) the data records of the submission must be in the following sequence: TRANS Record, Return records and the RECAP Record;
   (b) the format of the TRANS Record and/or RECAP Record must correspond exactly to the record layouts specified above; or
   (c) there should be no duplicate submissions of any record file; or
   (d) There should be no unrecognizable or inconsistent control data in the TRANS and/or RECAP records.
2. The data records must be in the following sequence:
   (a) Return records (Page 1, 2, 3 and 4);
   (b) Schedule records other than Schedule K-1 (optional);
   (c) Form records other than Form 8308 (in ascending numeric order)—optional;

(d) Statement Records (statements not related to Schedule K-1—optional);

* (e) Schedule K-1 records (at least 2 are required);

* (f) Statement for Schedule K-1 records (optional)

(g) Form 8308 Records (Form 1065) (optional).

(h) Summary record (must be final record for each return)

* Record pairs e and f above are repeated for each Schedule K-1 in the return.

3. Page (Pgnn) records must be consecutive and sequential.

4. Both pages of multiple page schedules or forms must be present, with the following exceptions:

(b) Page 2 of Form 4562, and Form 4797 and Schedule K-1 need not be transmitted if there are no entries for that page. However, Page 2 of these schedules/forms must not be present without Page 1.

5. All fields must contain the type of data specified under the columnar heading "Format" in the record description. Alphanumeric fields must be left-justified unless otherwise specified. (For further clarification on validation criteria see Appendix B, SEC. 3, Field Specifications).

6. Significant money fields must be right-justified and zero-filled. Money fields must be all whole dollars (no cents). All other significant numeric fields must be as specified in SEC. 3.01.4 through 3.01.7. Significant percentage fields must be left-justified and zero-filled. All nonsignificant money fields must be zero-filled. All other nonsignificant fields must be blank unless otherwise specified in the Record Layouts. (See Appendix B, SEC. 3, Field Specifications)

7. All records must follow the ANSI byte count convention or have a byte count field which must precede the Record ID field for each page record and the count must be equal to the total number of characters contained in the page record. (Reminder: Byte Count includes the Byte Count field, Start of Record Sentinel, Record ID field, all other record fields, and the terminus character (#)).

8. The fields on a statement line (LN) record must be in the same format and sequence as they appear in the record layouts, and only one group of related fields can be entered per statement line (LN) record. Statement references in the tax return must be in ascending numerical sequence. (See Appendix B, SEC. 9, Statement Record, for detailed requirements)

9. The Employer Identification Number (EIN) must be nine numeric characters and must be consistent in all data records for a partnership return. The first two digits cannot begin with 00, 07, 08, 09, 10, 12, 15, 17, 18, 19, 20, 21, 24 26, 27, 28, 29, 30, 32, 40, 44, 49, 50, 53, 60, 67, 69, 70, 78, 79, 80, 89, 90, 96, and 97.

10. The format and content of the Record Identification information (Record ID) which begins each type of record, must always be present and exactly as stated in the input specifications.

11. The Tax Period (Field #5 of the Return Record) must fall within the ranges specified in SECTION 2.03.2 in the Procedure, of this publication. Fiscal year filers for a fiscal year ending September 30, 1989 (8909). October 31. 1989 (8910), or November 30, 1989 (8911) wishing to participate in magnetic tape filing of Form 1065 must file for an extension of time (see "When to File", Page 1 of instructions attached to official Form 1065) until March 1, 1990. Otherwise, 8909-8911 tax period fiscal year filers of Form 1065 must file a paper document with the appropriate service center. For special instructions about entering the Calendar/Fiscal Year Ending field see Appendix B, Section 15 of this publication.

12. A return will be rejected if program accumulators maintained while the returns are processed, do not match the counters in the SUMMARY record.

13. Foreign address returns are not permitted.

14. The Name Control field must be present.

15. Address data must be present.

16. All "total" fields must have a significant entry when there are amounts leading to the total. Similarly, any "total" field which has a significant entry must have at least one significant entry leading to that amount. Otherwise, the processing of the return will be delayed to resolve the discrepancy.

17. The following checks should be made in relation to Schedule K-1 and statement records for Schedule K-1 Forms 8308 and 8271:

(a) Total of count of Schedule K-1 and Forms 8271 and 8308 records should match total count found in the Summary Record;

(b) The sequence number in the Schedule K-1 statement records should match the sequence numbers of the related Schedule K-1 records.

18. All pages of return Form 1065 must be present. Even if there are no entries on pages 2, 3, and 4 of Form 1065, the pages must be generated with a significant Return Record ID field.

19. Statement records do *not* have to be consecutive but *must* be in ascending sequence. Each statement number reference occurring in a data field ("STMbnn") must have a corresponding statement record. Each statement record may be referenced only once, except for Schedule K-1 statements (which are always number 99). There may be no more than 98 statement page records, except Schedule K-1 statement records, with any return. For each statement record, at least, LN01, LN02, and LN03 must be present, and all line numbers must be in ascending numeric sequence.

Note: The Schedule K-1 statement record should always contain the statement number (STMb99), an additional 7 character field containing (0000001-9999999), which is the sequential Schedule Sequence Number (Field #007) assigned to the Schedule K-1 to which it relates and a blank K-1 Sequence # Filler field.

20. The Form/Schedule Sequence Number of the related schedule or form record must be significant and in ascending numerical sequence. The sequence number must not be greater than that permitted for the particular form or schedule.

21. In the return records of Form 1065 there must be no significant entry in the following fields of the following forms:

Form/Schedule	Title	Line #	Field #
Form 4797	Gain from Form 4684	I3	438
Form 4797	Section 1231 gain	I4	440
Form 4797	Net gain or loss from Form 4684: LOSS	II 14	940
Form 4797	Net gain or loss from Form 4684: GAIN	II 14	950
Form 4797	Ordinary gain from installment sales	II 15	960
Form 4797	Individual return loss	II 18 b(1)	1010
Form 4797	Individual return loss or gain	II 18 b(2)	1020
Form 4797	Section 291 amt. Property A	26f A	1500
Form 4797	Section 291 amt. Property B	26f B	1570
Form 4797	Section 291 amt. Property C	26f C	1640
Form 4797	Section 291 amt. Property D	26f D	1710
Form 4797	Section 1252 soil, water and land expenses Property A	III 27 a A	1730
Form 4797	Section 1252 27a times applicable percentage Property A	III 27 b A	1740
Form 4797	Section 1252 smaller of line 24 or 27b Property A	III 27 c A	1750
Form 4797	Section 1252 Soil, Water and Land Expenses Property B	III 27 a B	1760
Form 4797	Section 1252 27a times applicable percentage Property B	III 27 b B	1770
Form 4797	Section 1252 smaller of line 24 or 27b Property B	III 27 c B	1780
Form 4797	Section 1252 Soil, Water and Land expenses Property C	III 27 a C	1790
Form 4797	Section 1252 27a times applicable percentage Property D	III 27 b C	1800
Form 4797	Section 1252 1810 smaller of 24 or 27b Property C	III 27 c C	1810
Form 4797	Section 1252 Soil, Water and Land expenses Property D	III 27 a D	1820
Form 4797	Section 1252 27a times applicable percentage Property D	III 27 b D	1830
Form 4797	Section 1252 smaller of line 24 or 27b Property D	III 27 c D	1840
Form 4797	Check for election out of install method	33	2040
Form 4797	Face amount of Note	34	2050
Form 4797	% of evaluation	35	2060

22. Form records of return Form 1065 must be in ascending numeric sequence.
23. There *must be no* significant data present for the following fields from the Form 1065 record:

Field #	Title	Line #
180	Change in address	G(3)
190	Amended return	G(4)
500	Net farm profit	5
960	LIFO inventory	A-8b
1940	Low income housing credit	K-12b(1)
1945	Other	K-12b(2)
2040	Gross farming or fishing income	K-14b

24. There must be no significant data present for the following fields from Schedule K-1:

Field #	Title	Line #
380	Amended K-1	J
630	Low income housing credit	12b(1)
640	Low income housing credit (other)	12b(2)
720	Gross farming or fishing income	14(b)
950	Low income housing credit	19(a)
960	Low income housing credit	19(b)

25. There must be no significant entry for the fields of the schedule specified below.

Sch/Form	Title	Line #	Field #
Sch. D	Short-Term Capital Gain from Form 6252	2	390
Sch. D	Long-Term Capital Gain from Form 6252	6	780

26. The following fields must be equal (comparison of bottom line of schedule or form with return carry-forward line):

		Line From Form 1065 Record				
Field	# Title	Line #	Sch/Form	Field #	Title	Line #
460	Cost of goods sold and/or operations	2	Sch A	890	Cost of goods sold	7
510	Net gain (loss)	6	4797	1000	Combine gain/losses	18
1790	Net short-term capital gain/ loss	K(4d)	Sch D	410	Net short-term gain/loss from lines 1-3	4
1800	Net long-term capital gain/ loss	K(4e)	Sched. D	810	Net long-term gain/loss from lines 5-8	9

27. Business Code Number (Field #140) and the Number of Partners (Field #200) must be present.

28. If Tax Period (Field #5 of the Return Record) is significant, the entry must be equal one of the tax periods specified in Part I, Section 1.01.1 of this document.

29. If Question N—no (Field #3226) is "X" or Total Assets (Field #150) is significant, then Sch. L and M must not be blank.

30. If Depreciation (Field #630) is significant, Form 4562 must be attached.

31. Number of Partners (Field #200) must be greater than, or equal to, 2.

32. There may be multiple Schedules K-1, Form 8271, and Forms 8308 (0000001-9999999), but only one Schedule D, Form 4797, and no more than 3 Forms 4562.

Note: With multiple schedules or forms, the page number must be sequential within the Schedule Sequence Number of a schedule or the Form Sequence Number of the form.

33. If any of the following fields are blank, the return will be rejected.

Form/Schedule	Line Title	Field #	Ln Number
1065	Employer Id #	070	D
1065	Name Control	030	
1065	Name Line 1	050	
1065	Street Address	090	
1065	City	110	
1065	State	120	
1065	ZIP Code	130	
1065	Business Code Number	140	C
1065	Number of Partners	200	I

34. If Tax Shelter Registration Number (Field #320) is significant in Schedule K-1, Form 8271, Investor Reporting of Tax Shelter Registration must be submitted.

NOTE: See Attachment III for explanations of reject codes. Reject Codes are assigned to conditions that cause the return or the entire return file to be rejected. They are based on criteria set forth in the above section and elsewhere in this Revenue Procedure.

SEC. 14. SPECIAL INSTRUCTIONS FOR ENTERING PARTNERSHIP'S NAME AND ADDRESS

These instructions must be followed carefully to avoid delaying returns for error conditions. They must be included in magnetic tape filers' programs as consistency tests and in the data entry instructions. The return must not contain a foreign address. Foreign addresses are from other than the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, Guam, American Samoa, Caroline Islands, Federated States of Micronesia, Northern Mariana Islands, Marshall Islands, and Palau Islands.

.01 *Name Line 1*

1. Only alphabetic characters, numbers, spaces and the special characters ampersand (&), slash (/), and hyphen (-) may appear in the Partnership name line.
2. Only one intervening space may separate any component of a name line or street address.
3. All apostrophes, and any other punctuation characters except the hyphen, must be omitted from names and the alphabetic characters must be shifted to the left in their place (e.g., O'Shea = OSHEA).
4. Numeric characters in name components must be replaced by alphabetic Roman numerals (e.g., Charles 3rd = CHARLES III).

.02 *Instructions for Street Address and Name Line 2*

1. Only alphabetic and numeric characters, ampersand (&), slash (/), hyphen (-), percent (%), and spaces appear in the street address and partnership name line fields.
2. Only one intervening space may separate any two components of any name line, the street address lines, or the city lines. Periods should be deleted from these lines.
3. The name and title of the Partnership will be used for the Partnership name line (Field #050).
4. For the street address, enter the house number and street, route number, post office box, or box number.
5. Abbreviate words requiring standard abbreviations unless the word is a proper name.

Examples	Enter As
South Court Street	S COURT ST
Circle Drive	CIRCLE DR
Lane Building	LANE BLDG
Northeast Street	NORTHEAST ST
Third Street	THIRD ST
3 Ave.	3RD AVE

6. Enter college, building, or post office branch as the address if no mailing address is given.
7. If "In Care Of" is the mailing address, use the symbol "%" followed by a space.

Example: J. Lamb & H. Lamb Ptrs
In Care of Alice B. Smith
801 Brown St.

Enter As: J LAMB & H LAMB PTRS (Name of Partnership)
% ALICE B SMITH (Partnership Name Line)
801 BROWN ST (Street Address)

8. Do not use the "#" symbol, "No.", or "Number" as a prefix to a house, apartment., route, or P.O. Box.
9. Always add st, nd, rd, th, to a numbered street or avenue. Examples: 1 = 1ST; 2 = 2ND; 3 = 3RD, etc.
10. Enter ½ as ½ (no spaces).
11. Plurals for street, road, avenue, apartment, etc., will be entered as STS, RDS, AVES, APTS, etc.
12. Omit the letters "APO" and "FPO" in the address. ZIP Code MUST be transcribed as five digits or nine digits.
13. The following standard abbreviations are preferred:

WORD	ABBR.
and	&
Air Force Base	AFB
Apartment	APT
Avenue	AVE
Boulevard	BLVD
Building	BLDG
Care of, or In care of	%
Circle	CL
Court	CT
Drive	DR
East	E
General Delivery	GEN DEL
Highway	HWY
Lane	LN
North	N
Northeast, N.E.	NE
Northwest, N.W.	NW
Parkway	PKY
Place	PL
Post Office Box, P.O. Box	PO BOX
Route, Rte.	RT
Road	RD
R.D., Rural Delivery, RFD, R.F.D., R.R. or Rural Route	R D
South	S
Southeast, S.E.	SE
Southwest, S.W.	SW
Street	ST
Terrace	TER
West	W
One-Half	½ (all fractions, space before and after the number, i.e., 1012½ ST)

14. If there is no information for Name Line 2, enter blanks.

.03 *Instructions for City, State and ZIP Code Fields*

1. The City field may contain alphanumeric characters. The only special character allowed is the blank. If the name of a city

contains two words or more, only one intervening space is allowed between consecutive words (e.g., New York)

2. Standard abbreviations for STATE CODE are listed Attachment V.
3. There cannot be two consecutive blanks within significant data.

.04 *Special Instructions for Determining the IRS Name Control Field*

1. The Name Control consists of the first four significant characters of the first individual's last name if the partnership's name is a series of individuals' names, or the first four significant characters of the name of the partnership if the name is a business name. Disregard blanks between letters in the last name. Omit punctuation marks, titles and suffixes. Exclude the word "the" when followed by more than one word.

Examples (Form 1065)

Partnership Name	Name Control
Shamrock, Shinleaf and Smartweed	SHAM
Bones and Bones Attorneys at Law	BONE
James En & Robert Yee	EN
J. Lamb & H. Lamb Ptrs.	LAMB
En, En Yee & Yee	EN
James, Mary, and John Grey	GREY
Black and White Associates	BLAC
Bernard Black Associates	BERN
Three Stars Legal Services	THRE
J & H Lamb, Attorneys at Law	LAMB
Alley and Avenue Realtors	ALLE

The name control consists of the first four positions. Valid characters are A–Z, 0–9, hyphen (-), ampersand (&), and blank. The first position cannot be blank, nor can there be intervening blanks between characters. Partnership names are reported in several ways. Following are some examples of partnership names and the corresponding name controls.

Type of Name	Name Control
Trade name or or "doing business as" (dba)	*Flow*er Diner
Partnership name	*Green* Brothers Partnership
List of partners	J. *Apple*, T. Banana, et al.
General partnership	D. *Dahl*ia, General Partner, et al.

2. *Before* you determine the name control, take the following into consideration.

(a) The first position can only be alpha and numeric characters, A–Z and 0–9.

(b) Positions 2, 3, and 4 can be alpha and numeric characters A–Z and 0–9; the ampersand (&) and the hyphen (-) and blanks are the only special characters allowed.

Example: John A *El-R*ose

Example: Wayne *Elm* Mary Al

3. Consider certain foreign suffixes as part of the last name (i.e. Armah-Bey, Paz-Ayala, Allar-Sid). Particular attention must be given to those names which incorporate a mother's maiden name as a suffix to the last name. This practice is common in names of Spanish extraction. Consider the mother's maiden name as part of the surname for Name Control purposes.

Examples

Individual Name	*Name Control*
John Brown	BROW
John Lea-Smith	LEA-
John Di Angelo	DIAN
John O'Neil	ONEI
John En, Sr.	EN
Pedro Paz-Ayala	PAZ-
Abdullah Allar-Sid	ALLA
Joe McCarty	MCCA
Juan de la Rosa Y Obregon	DELA
Jose Alvarado Nogales	ALVA
Donald Vander Neut	VAND
Otto Von Wodtke	VONW
Mary Smith & John Jones	SMIT

SEC. 15. SPECIAL INSTRUCTIONS FOR ENTERING CALENDAR/FISCAL YEAR ENDING

The Tax Period (Field #5 in the Return Record) field is composed of numeric month and year of the calendar/fiscal year ending for which the return is being filed. The format is YYMM (YY = year and MM = month). For example, a return with a calendar/fiscal year ending of February 15, 1989, will be assigned a tax period of 8902. Returns filed under the 52–53 week rule may end not more than 6 days before or more than 3 days after the close of the month. They should be assigned a tax period based on that month (i.e. if the ending date is October 3, 1989, the tax period field will be 8909, or if the ending date is October 25, 1989, the tax period is 8910).

Attachments

	Title	Page
I-A	Form 8453-F, U.S. Fiduciary Income Tax Declaration for Magnetic Tape/Filing	38-40
I-B	Form 8453-P, U.S. Partnership Income Tax Declaration for Magnetic Tape/Filing	41-43
II	Form 9041, Application for Electronic/Magnetic Tape Filing of Tax Year 1988	44-45
III	Reject Codes and Explanations	46-62
IV	Return Form Identity Codes	63
V	State Codes and Abbreviations; Postal ZIP Codes	64-65
VI	Remittance Register	66-68
VII	Acknowledgment Listing of Transmission	69
VIII	Examples of Variable Block Files	70

ATTACHMENT I-A

Document Locator Number (DLN) 16244789500010

Form **8453-F**

Department of the Treasury
Internal Revenue Service

U.S. Fiduciary Income Tax Declaration for Magnetic Tape/Electronic Filing

For calendar year 1989, or fiscal year beginning 1/1, 1989, and ending 12/31, 19 89.

OMB No 1545-0967

1989

Name of estate or trust: John James Trust

Employer identification number: 16 : 9999999

Name and title of fiduciary: % Alice B. Smith

Tax Return Information

1 Total income (Form 1041, line 9)	1	15000	
2 Income distribution deduction (Form 1041, line 18)	2		
3 Taxable income of fiduciary (Form 1041, line 22)	3		
4 Total tax (Form 1041, line 23)	4	50	
5 Tax Due or Overpayment (Form 1041, line 26 or 27)	5		

Please Sign Here

Under penalties of perjury, I declare that the above described amounts agree with the amounts shown on the corresponding lines of my 1989 U.S. Fiduciary Income Tax Return. I have also examined a copy of the return being filed on magnetic tape or electronically with the Internal Revenue Service, including accompanying schedules and statements. To the best of my knowledge and belief, the return is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge. If I am not the transmitter, I have consented that the return, including this declaration and accompanying schedules and statements, be sent to the Internal Revenue Service by our return transmitter.

▶ Alice B Smith
Signature of fiduciary or officer representing fiduciary

▶ 4/05/89
Date

Paid Preparer's Use Only

Preparer's signature ▶ John Jones — Date 4/07/89 — Check if self-employed ▶ X — Preparer's social security number 599 : 99 : 9999

Firm's name (or yours if self-employed) and address ▶ John Jones Accounting Service
P.O. Box 9716, New Jersey

E.I. No. ▶ 32 : 8888888

ZIP code ▶ 08991

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.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping	7 min.
Learning about the law or the form	1 min.
Preparing the form	13 min.
Copying, assembling, and sending the form to IRS	20 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form more simple, we would be happy to hear from you. You can write to the Internal Revenue Service, Washington, DC 20224, Attention: IRS Reports Clearance Officer, T:FP; or the Office of Management and Budget, Paperwork Reduction Project (1545-0967), Washington, DC 20503.

Purpose of Form.—Use Form 8453-F to: (1) authenticate the magnetic tape/electronic filing of Form 1041, U.S. Fiduciary Income Tax Return; (2) serve as a transmittal for any associated paper documents that may be stapled to the declaration; and (3) authorize the magnetic tape/electronic filer to transmit via a third party transmitter.

Who Must File.—Every estate or trust wishing to file a 1989 Form 1041 via magnetic tape or electronically must complete Form 8453-F.

Where To File.—The fiduciary of the estate or trust should give Form 8453-F to the third party transmitter. The third party transmitter should send the form to: Internal Revenue Service, Andover Service Center, 310 Lowell Street, Andover, MA ~~01812~~ 05501, Attention: Electronic Filing Unit, Stop 981.

When To File.—The third party transmitter should send Form 8453-F to the Andover Service Center within 5 days of receipt of the Acknowledgment File. Do not send Form 8453-F for a return that has not been acknowledged as accepted by IRS.

Document Locator Number (DLN)

The DLN is a 14-digit number assigned by the IRS to each return. Get the number from the Acknowledgement Listing of Transmission and enter it in the box in the upper right-hand corner of this form. Only returns that have been accepted by IRS will have a DLN.

Note: *For consolidated Forms 8453-F, enter two DLNs to show the range of numbers in the batch being transmitted. See the instructions in* Pub. 1437, *Revenue Procedure and File Specifications for Electronic/Magnetic Tape Filing of Fiduciary Return Forms 1041 and Partnership Return Forms 1065 for Tax Year 1989.*

*U.S. Government Printing Office: 1989-262-151/80152

Attachment I-A (continued)

Document Locator Number (DLN): 16244789500010 - 16244789700900

Form **8453-F**

Department of the Treasury
Internal Revenue Service

U.S. Fiduciary Income Tax Declaration for Magnetic Tape/Electronic Filing

For calendar year 1989, or fiscal year beginning ...1/1..... 1989, and ending ..12/31.....19 .88

OMB No 1545-0967

1989

Name of estate or trust

SEE ATTACHED CONSOLIDATED 8453-F CONTROL RECORD

Employer identification number

Name and title of fiduciary

Tax Return Information

1	Total income (Form 1041, line 9)	1	
2	Income distribution deduction (Form 1041, line 18)	2	
3	Taxable income of fiduciary (Form 1041, line 22)	3	
4	Total tax (Form 1041, line 23)	4	
5	Tax Due or Overpayment (Form 1041, line 26 or 27)	5	

Please Sign Here

Under penalties of perjury, I declare that the above described amounts agree with the amounts shown on the corresponding lines of my 1989 U.S. Fiduciary Income Tax Return. I have also examined a copy of the return being filed on magnetic tape or electronically with the Internal Revenue Service, including accompanying schedules and statements. To the best of my knowledge and belief, the return is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge. If I am not the transmitter, I have consented that the return, including this declaration and accompanying schedules and statements, be sent to the Internal Revenue Service by our return transmitter.

▶ John Trustworthy
Signature of fiduciary or officer representing fiduciary

▶ 4/17/89
Date

Paid Preparer's Use Only

Preparer's signature ▶ Ima Filer — Date 4/05/89 — Check if self-employed ▶ ☐ — Preparer's social security number 666 66 6666

Firm's name (or yours if self-employed) and address ▶ ABC TAX SERVICE
P.O. BOX 5678 , NEW JERSEY — E.I. No. ▶ 13 6849000 — ZIP code ▶ 08101

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.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping	7 min.
Learning about the law or the form	1 min.
Preparing the form	13 min.
Copying, assembling, and sending the form to IRS	20 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form more simple, we would be happy to hear from you. You can write to the Internal Revenue Service, Washington, DC 20224, Attention: IRS Reports Clearance Officer, T:FP; or the Office of Management and Budget, Paperwork Reduction Project (1545-0967), Washington, DC 20503.

Purpose of Form.—Use Form 8453-F to: (1) authenticate the magnetic tape/electronic filing of Form 1041, U.S. Fiduciary Income Tax Return; (2) serve as a transmittal for any associated paper documents that may be stapled to the declaration; and (3) authorize the magnetic tape/electronic filer to transmit via a third-party transmitter.

Who Must File.—Every estate or trust wishing to file a 1989 Form 1041 via magnetic tape or electronically must complete Form 8453-F.

Where To File.—The fiduciary of the estate or trust should give Form 8453-F to the third party transmitter. The third party transmitter should send the form to: Internal Revenue Service, Andover Service Center, 310 Lowell Street, Andover, MA 01812, Attention: Electronic Filing Unit, Stop 981. 05501

When To File.—The third party transmitter should send Form 8453-F to the Andover Service Center within 5 days of receipt of the Acknowledgment File. Do not send Form 8453-F for a return that has not been acknowledged as accepted by IRS.

Document Locator Number (DLN)

The DLN is a 14-digit number assigned by the IRS to each return. Get the number from the Acknowledgement Listing of Transmission and enter it in the box in the upper right-hand corner of this form. Only returns that have been accepted by IRS will have a DLN.

Note: *For consolidated Forms 8453-F, enter two DLNs to show the range of numbers in the batch being transmitted. See the instructions in* Pub. 1437, *Revenue Procedure and File Specifications for Electronic/Magnetic Tape Filing of Fiduciary Return Forms 1041 and Partnership Return Forms 1065 for Tax Year 1989.*

☆U.S. Government Printing Office: 1989-262-151/80152

Attachment I-A (continued)

CONSOLIDATED 8453-F CONTROL RECORD

EFIN: 16100
FILER'S NAME: ABC TAX SERVICE 4-12-90
CONSOLIDATED SERIES NUMBER = 01
CONTACT NAME AND TELEPHONE # = IMA FILER (333) 123-4567 PAGE 1

CONSOLIDATED 8453-F CONTROL RECORD

EIN	NAME CONTROL	TOTAL INCOME	INCOME DIST. DEDUC.	TAXABLE INCOME	TOTAL TAX	TAX DUE/OVERPAYMENT
16-9999999	MACG	132,779.00	132,779.00	0	0	0
16-8999999	DELT	238,908.00	238,908.00	0	0	0
16-7999999	DAVI	126,332.00	126,332.00	0	0	0
16-6999999	MESS	2,887,255.00	2,887,255.00	0	0	0

ATTACHMENT I - B

16265789500010

Form 8453-P

U.S. Partnership Declaration for Magnetic Tape/Electronic Filing

OMB No. 1545-0970

1989

Department of the Treasury
Internal Revenue Service

For calendar year 1989, or fiscal year beginning 1/1, 1989, and ending 12/31, 1989

Name of partnership: Green Brothers Partnership

Employer identification number: 12-4444444

Partnership Return Information

1	Gross receipts or sales minus returns and allowances (Form 1065, line 1c)	1	7000
2	Gross profit (Form 1065, line 3)	2	
3	Ordinary income (loss) from trade or business activities (Form 1065, line 21)	3	
4	Net income (loss) from rental real estate activities (Form 1065, Schedule K, line 2)	4	1000
5	Net income (loss) from other rental activities (Form 1065, Schedule K, line 3c)	5	

Please Sign Here

Under penalties of perjury, I declare that the above described amounts agree with the amounts shown on the corresponding lines of this partnership's 1989 Federal partnership return. I have also examined a copy of the return being filed on magnetic tape or electronically with the Internal Revenue Service, including accompanying schedules and statements. To the best of my knowledge and belief, the return is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge. If I am not the transmitter, I have consented that the return, including this declaration and accompanying schedules and statements, be sent to the Internal Revenue Service by our return transmitter.

Richard Green
Signature of general partner

4/12/89
Date

Paid Preparer's Use Only

Preparer's signature: John Black — Date: 4/2/89 — Check if self-employed ☐ — Preparer's social security number: 555 55 5555

Firm's name (or yours if self-employed) and address: Black and White Associates, P.O. Box 7777, MA — E.I. No. 32 7777777 — ZIP code 05713

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.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping	7 min.
Learning about the law or the form	3 min.
Preparing the form	14 min.
Copying, assembling, and sending the form to IRS	17 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form more simple, we would be happy to hear from you. You can write to the Internal Revenue Service, Washington, DC 20224, Attention: IRS Reports Clearance Officer, T:FP; or the Office of Management and Budget, Paperwork Reduction Project (1545-0970), Washington, DC 20503.

Purpose of Form.—Use Form 8453-P to: (1) authenticate the magnetic tape/electronic filing of Form 1065, U.S. Partnership Return of Income; (2) serve as a transmittal for any associated paper documents that may be stapled to the declaration; and (3) authorize the magnetic tape/electronic filer to transmit via a third-party transmitter.

Who Must File.—Every partnership wishing to file a 1989 Form 1065 via magnetic tape or electronically must complete Form 8453-P.

Where To File.—Send Form 8453-P to: Internal Revenue Service, Andover Service Center, 310 Lowell Street, Andover, MA 01812, Attention: Electronic Filing Unit, Stop 981.

When To File.—Send Form 8453-P to the Andover Service Center within 5 days of receipt of the Acknowledgment File. Do not send Form 8453-P for a return that has not been acknowledged as accepted by IRS.

Document Locator Number (DLN)

The DLN is a 14-digit number assigned by the IRS to each return. Get the number from the Acknowledgement Listing of Transmission and enter it in the box in the upper right-hand corner of this form. Only returns that have been accepted by IRS will have a DLN.

Note: For consolidated Forms 8453-P, enter two DLNs to show the range of numbers in the batch being transmitted. See the instructions in Pub. 1437, Revenue Procedure and File Specifications for Electronic/Magnetic Tape Filing of Fiduciary Return Forms 1041 and Partnership Return Forms 1065 for Tax Year 1989.

☆U.S. Government Printing Office: 1989-242-473/00131

Attachment I-B (continued) 16265789500010 - 16265789700900

Form 8453-P

U.S. Partnership Declaration for Magnetic Tape/Electronic Filing

OMB No 1545-0970

1989

Department of the Treasury
Internal Revenue Service

For calendar year 1989, or fiscal year beginning 01/1 1989, and ending 12/31 1989

Name of partnership: SEE ATTACHED CONSOLIDATED 8453-P CONTROL RECORD

Employer identification number:

Partnership Return Information

1	Gross receipts or sales minus returns and allowances (Form 1065, line 1c)	1	
2	Gross profit (Form 1065, line 3)	2	
3	Ordinary income (loss) from trade or business activities (Form 1065, line 21)	3	
4	Net income (loss) from rental real estate activities (Form 1065, Schedule K, line 2)	4	
5	Net income (loss) from other rental activities (Form 1065, Schedule K, line 3c)	5	

Please Sign Here

Under penalties of perjury, I declare that the above described amounts agree with the amounts shown on the corresponding lines of this partnership's 1989 Federal partnership return. I have also examined a copy of the return being filed on magnetic tape or electronically with the Internal Revenue Service, including accompanying schedules and statements. To the best of my knowledge and belief, the return is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge. If I am not the transmitter, I have consented that the return, including this declaration and accompanying schedules and statements, be sent to the Internal Revenue Service by our return transmitter.

▶ J. Partner — Signature of general partner

▶ 4/12/89 — Date

Paid Preparer's Use Only

Preparer's signature ▶ Don Oakter — Date 4/11/89 — Check if self-employed ▶ ☐ — Preparer's social security number

Firm's name (or yours if self-employed) and address ▶ ABC TAX SERVICE
P.O. BOX 5678, NEW JERSEY

E.I. No. ▶ 13 6849000

ZIP code ▶ 08101

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.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping	7 min.
Learning about the law or the form	3 min.
Preparing the form	14 min.
Copying, assembling, and sending the form to IRS	17 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form more simple, we would be happy to hear from you. You can write to the Internal Revenue Service, Washington, DC 20224, Attention: IRS Reports Clearance Officer, T:FP; or the Office of Management and Budget, Paperwork Reduction Project (1545-0970), Washington, DC 20503.

Purpose of Form.—Use Form 8453-P to: (1) authenticate the magnetic tape/electronic filing of Form 1065, U.S. Partnership Return of Income; (2) serve as a transmittal for any associated paper documents that may be stapled to the declaration; and (3) authorize the magnetic tape/electronic filer to transmit via a third-party transmitter.

Who Must File.—Every partnership wishing to file a 1989 Form 1065 via magnetic tape or electronically must complete Form 8453-P.

Where To File.—Send Form 8453-P to: Internal Revenue Service, Andover Service Center, 310 Lowell Street, Andover, MA 01812, Attention: Electronic Filing Unit, Stop 981.

When To File.—Send Form 8453-P to the Andover Service Center within 5 days of receipt of the Acknowledgment File. Do not send Form 8453-P for a return that has not been acknowledged as accepted by IRS.

Document Locator Number (DLN)

The DLN is a 14-digit number assigned by the IRS to each return. Get the number from the Acknowledgement Listing of Transmission and enter it in the box in the upper right-hand corner of this form. Only returns that have been accepted by IRS will have a DLN.

Note: *For consolidated Forms 8453-P, enter two DLNs to show the range of numbers in the batch being transmitted. See the instructions in Pub. 1437, Revenue Procedure and File Specifications for Electronic/Magnetic Tape Filing of Fiduciary Return Forms 1041 and Partnership Return Forms 1065 for Tax Year 1989.*

*U.S. Government Printing Office: 1989-242-473/80131

ATTACHMENT 1 -B (continued)

CONSOLIDATED 8453-P CONTROL RECORD

EFIN: 31100
FILER'S NAME: ABC TAX SERVICE 4-12-90
CONSOLIDATED SERIES NUMBER = 01
CONTACT NAME AND TELEPHONE #: DON OAKTREE (123) 456-7890 PAGE 1

CONSOLIDATED 8453-P CONTROL RECORD

EIN	NAME CONTROL	GROSS RECEIPTS/SALES	GROSS PROFIT	ORD. INCOME/LOSS	NET INCOME	NET INCOME(OTHER)
12-8888888	OAKE	814,052.00	460,061.00	74,406.00-	0	0
12-8752122	THOM	1,869,732.00	1,138,395.00	250,594.00	0	0
12-7777777	ASHL	1,054,147.00	601,189.00	22,262.00	0	0
12-6666666	BOYE	792,061.00	440,359.00	20,454.00-	0	0

Form 9041 (Rev. October 1989)

Department of the Treasury - Internal Revenue Service

Application for Electronic/Magnetic Tape Filing of Forms 1041, 1065, or 5500-C/R

OMB Number 1545-1079 Expires: 07-31-92

1.

a. Firm name (See instructions.)

b. Employer identification number (EIN must have 9 digits.)

c. P.O. Box and street address

d. Contact person's name

City | State | ZIP Code

e. Daytime telephone number (Include area code)

( ) _____

2. This application is filed by those who desire to participate in the electronic/magnetic tape filing program for the following forms: *(Check each appropriate box.)*

- ☐ Form 1041, U.S. Fiduciary Income Tax Return
- ☐ Form 1065, U.S. Partnership Return of Income
- ☐ Form 5500-C/R, Return/Report of Employee Benefit Plan (with fewer than 100 Participants)

3.

a. Have you ever had an electronic identification number (EFIN)? ☐ Yes ☐ No

b. If yes to 3a, when did you have it? Year ____

c. If yes to 3a, please provide your EFIN.

4.

a. Will you transmit returns directly to the IRS? ☐ Yes ☐ No ☐ Not sure at this time

b. Will you transmit returns electronically? ☐ Yes ☐ No ☐ Not sure at this time

c. Will you transmit or send data to another office, through which the data is transmitted to IRS? ☐ Yes ☐ No ☐ Not sure at this time

d. Will you develop or modify software that prepares returns for electronic/magnetic tape filing? ☐ Yes ☐ No ☐ Not sure at this time

e. Will you file on magnetic tape? ☐ Yes ☐ No ☐ Not sure at this time

f. Will you obtain appropriate signatures for the electronic/magnetic tape returns? ☐ Yes ☐ No, another filer will

5. May we give your name and address to firms that offer services related to electronic/magnetic tape filing? (See instructions) ☐ Yes ☐ No

6.

a. Are you a plan administrator (Form 5500-C/R)? (See instructions) ☐ Yes ☐ No ☐ Not applicable

b. If 6a is yes, please provide:

Name of plan administrator

Plan administrator EIN (must have 9 digits)

Street address

Plan administrator phone number (Include area code)

City | State | ZIP Code

( ) _____

7. Which software and transmission service will you use? Write their names below. (See instructions.)

Software Company	Transmitter

Estimated Volume to be Filed

8. **Returns**	Form 1041...._____	Form 1065...._____
	Returns Form 5500-C/R._____	Don't know at this time._____
9. **Schedules K-1**	K-1 (1041)...._____	K-1 (1065)...._____
	Not applicable._____	Don't know at this time._____
Contractual Statement	**My firm meets the eligibility requirements outlined in the applicable specifications for electronic/magnetic tape filing of Forms 1041, 1065, or 5500-C/R. I will comply with all provisions of the specifications for electronic/magnetic tape filing of Forms 1041, 1065, or 5500-C/R. I understand that my not complying with all of the provisions will result in my not being allowed to participate in the program.**	

10. Name and title of person responsible for filing this application. (Please print)

11. Signature of person responsible for this application	12. Date

Paperwork Reduction Act Notice

We ask for this information to carry out the Internal Revenue laws of the United States. We need it to process your application for electronic or magnetic tape filing of Forms 1041, 1065, or 5500-C/R. You must give us this information if you wish to participate in the electronic/magnetic tape filing program for these forms.

The time needed to complete this form will vary depending upon individual circumstances. The estimated average time is 18 minutes. If you have comments concerning the accuracy of this time estimate or suggestions for making this form more simple, we would be happy to hear from you. You can write to the Internal Revenue Service, Washington, DC 20224, Attention: IRS Reports Clearance Officer T:FP; or write Office of Management and Budget, Paperwork Reduction Project (1545-1079), Washington, DC 20503.

Instructions

Purpose of form.- File Form 9041 if you would like to take part in the electronic/magnetic tape filing program for Forms 1041, 1065, or 5500-C/R. Only filers who did not participate in last year's electronic/magnetic tape filing program need apply.

When to file.- To ensure complete and timely review of your application, file Form 9041 at least 30 calendar days before the end of the accounting period for which the entity files. IRS uses the postmark date on the envelope to determine whether the application was filed timely.

Where to file.- Send the completed Form 9041 to-

Internal Revenue Service Center
310 Lowell Street
Andover, MA 05501
ATTN: EFU-Stop 981

Line 1a.- Enter the name as shown on the return filed for the entity.

Line 1c.- If you have both a post office box and street address, enter both addresses for the firm's main office. We need both addresses in case we need to send information to you by overnight mail.

Line 1d and 1e.- If this information changes, please notify the Andover Service Center.

Line 5.- Complete this section if you would like your name and address given to vendors of services related to electronic/magnetic tape filing. This will give you an opportunity to receive electronic/magnetic tape filing information from vendors who either have applied or have participated in the program.

Line 6.- Complete this section if you file Form 5500-C/R and you are a plan administrator. Please enter the plan administrator information as shown on the Form 5500-C/R.

Line 7.- If this information changes, please notify the Andover Service Center. If you do not know what software company or transmitter you will use, or if you will use you own software or communication equipment, please indicate this in the space provided.

ATTACHMENT III

Reject Codes and Explanations

Note: Reject code explanations marked with an (*) mean that, if such a condition exists, the entire return file is rejected.

001-499 Reserved

500 Employer Identification Number (EIN) on the return record is not consistent on all schedules, forms, or statements.

501 Key numeric data field is not in the prescribed form as follows:

a. In Form 1041, money amount fields must be 12 characters, 11 numerics followed by the sign character; in Form 1065, money amount fields must be 11 characters, 10 numerics followed by the sign character. Negative sign should be used for the negative amounts and a blank space for positive amounts.

b. Money amount fields must be numeric, zero-filled and justified to the right; whole dollars, no cents.

c. All percentage fields must have five positions, left-justified and zero-filled. No decimal points are allowed. There is no entry, blanks must be present.

Exception: Schedule K-1 (for Form 1065) Fields #250-300 require six positions.

d. All dates must be in the MMDDYY, MMYY or YYMM format (see Publication 1438 - Record Layouts for specific date fields.

e. Other numeric fields must not contain any non-numerics, are zero-filled and justified to the right; significant percentage fields must be left-justified and zero-filled (Exceptions, ZIP Codes, dates, SSN, and the EIN fields).

f. ZIP Codes must be 5 or 9 digit numeric fields, left-justified and blank-filled.

g. SSN and/or EIN fields must be blank for no entry.

Reject Codes and Explanations

502 Calendar/Fiscal Year Ending (Field #020) of return record is not valid.

503 Field #800 Capital gain distribution, Schedule D of Form 1065 is negative.

504 Any of following fields have negative money amount entries in the return record for Form 1041:

Form 1041:

(a) Deduction lines 10-16 and 19-20 (Field #s 420-460, 480, 485, 486, 490, 530-540

(b) Income lines 1 and 2, Field #s 300-310

(c) Total Tax line 23, (Field #570), Charitable deductions (Field #950), and Total (Schedule G, Field #1340)

(d) Payments amount (Field #580)

(e) Federal income tax withheld amount (Field #670)

(f) Total (Field #720)

(g) Credited to 1990 (Field #750)

(h) Refunded amount (Field #760)

(i) Alternative minimum tax (Field #1330)

Schedule D:

(a) Computation of capital loss, from Line 18 above as positive amount (Field #1770)

(b) Loss shown on line 6 (Field #1794)

(c) Net loss from line 17 (Field #1750)

Form 8656

(a) Combine lines 4a through 4d (Field #100)

(b) Alternative tax net operating loss (Field #350)

Reject Codes and Explanations

505 Name Control (Field #030) of return record is not present, or is in invalid format.

506 Address Data (Fields #090, 110, 120, 130 in Form 1065 and Fields 220-250 in Form 1041) record is not present, or is in invalid format.

507 The return is duplicated or any page on the return is duplicated.

508 Not all alpha characters are in upper case, or alphanumeric fields are not in proper left-justified format.

509 ZIP Code of the return is not within the valid range of ZIP Codes.

510 Name Line 1 (Field #050) in Form 1065 record is not present, or is in invalid format.

511 Number of Partners (Field #200) is missing from Form 1065.

512 Reserved

513 Total count of Forms W-2, or W-2P (Fields #13 and 14 of the Summary Record) does not match total Form W-2 and W-2P computed by IRS program.

514 Tax Period (Field #5) in the Return Record is invalid.

515 Form 1065, Page(s) 1, 2, 3, or 4 is/are missing or out of sequence from the Tax Return records. Record ID field(s) (Field #000, Field #800, Field #1690 or Field #2470) is/are missing from the return.

516 The return record of Form 1065 is not in sequence of, schedules in ascending alpha sequence, forms other than Form 8308 in numeric sequence, statements (for forms and schedules other than Schedule K-1), schedules K-1 in sequential number order, statements for K-1s, Forms 8308 in sequential number order and summary record; or pages within any of the forms and schedules are not consecutive and sequential.

517-518 Reserved

Reject Codes and Explanations

519 Total Logical Record Count field value on the summary record does not equal the total logical record count computed by the IRS program.

520 Total Statement Line Record Count field value on the summary record does not equal the total statement line record count computed by the IRS program.

521 Number of Schedule Page Records field value on the summary record does not equal the total schedule records count computed by the IRS program.

522 Number of Form Page Records field value on the summary record does not equal the total forms records count computed by the IRS program.

523 Required statement field is significant and does not contain "STMbnn", or there is no corresponding statement record for a given statement reference; or any one of LN01, LN02, or LN03 is missing from a statement record.

524 Statement reference for a given statment record is used more than once or if the number of actual referenced statement records exceeds the number of fields marked with"@" or "*".

525 Number of actual referenced statement records exceeds limitations (these limits do not apply to Schedule K-1 statements):

- the number of fields (fields in which a statement reference is allowed cannot exceed 98 for all forms and schedules except Schedule K-1 and corresponding statements) and/or;
- statement record exceeds 2 pages and/or;
- a page of the statement record contains more than 50 lines and/or;
- line numbers are not in ascending numeric sequence.

526 For return Form 1041 there are more than:

one Schedule D
one Form 4952 or 8656
twenty Forms W-2 or W-2P

Reject Codes and Explanations

527 Return records of Form 1041 contain records other than:

Form 1041, Schedule D, Schedule K-1, Form 4952, 8656, W-2 and W-2P

528 The Filer's SSN field and the Preparer's Firm EIN field are absent from the summary record or either the Paid Preparer's SSN field or Preparer's Firm EIN field is invalid. (SSN is a 9-digit numeric field that cannot be all zeros or all nines).

529 Return submitted is a short period return due to a a change in the accounting period.

530 One of the following fields of Form 1065 return record is significant and should not have an entry:

Form 1065:	Field #
Change in address	180
Amended returns	190
Net farm profit	500
LIFO Inventory	960
Low income housing credit	1940
Other	1945
Gross farming or fishing income	2040
Schedule K-1	
Amended K-1 Low income housing	380
Credit	630-640
Gross farming or fishing income	720
Low income housing Credit	950-960

Reject Codes and Explanations

530 (Continuation)

Schedule D

Short-term capital gain	390
Long-term capital gain	780

531 Number of K-1 Page Records field value on summary record is not equal to computed total Schedule K-1 records count computed by the IRS program.

532 For Return Form 1065 there are more than one Schedule D, one Form 4797, or three Forms 4562

533 Return records of Form 1065 contain records other than :

Form 1065, Schedule D, Schedule K-1, Forms 4562, 4797, 8271 and/or 8308.

534 Employer Identification Number (Field #070 in Form 1065 and Field #040 in Form 1041) is not numeric; or EIN is equal to blanks, all zeros or all nines; or first two digits are:

00, 07, 08, 09, 10, 12, 15, 17, 18, 19, 20, 21, 24, 26, 27, 28, 29, 30, 32, 40, 44, 49, 50, 53, 60, 67, 69, 70, 78, 79, 80, 89, 90, 96 or 97.

535 In Form 1065, Depreciation (Field #630) is significant and Form 4562 is missing.

536 In Form 1065, Question-N (No), (Field #3226), is "X" or Total assets (Field #150) is significant and Schedules L and M are blank.

537 Cost of goods sold and/or operations (Field #460), from Form 1065, is not equal to Cost of goods sold (Field #890) from Schedule A.

538 Net gain/loss, (Field #510), from Form 1065, is not equal to Combine gain/losses (Field #1000), from Form 4797.

Reject Codes and Explanations

539 Net short-term gain/loss (Field #410) from Sched D, is not equal to Net Short-term capital gain/loss (Field #1790) from Form 1065.

540 Net Long-term gain/loss (Field #810) from Schedule D, is not equal to Net Long-term capital gain/loss (Field #1800) from Schedule K.

541 Total K-1 Statement Record field value on the summary record is not equal to total Schedule K-1 statement records count computed by the IRS program.

542 Total Form 8308 and/or Form 8271 record count field value on the summary record is not equal to the total Form 8308 count computed by the IRS program.

543 The following fields on Form 1065 return records have entries other than "X" or blank:

Form 1065
Field Numbers - 160-170, 250, 270, 290
970-1000, 2240, 2250,
3221-3280, 3310-3340

544 One of the following fields of Form 1065 return records is significant:

	Field #
Form 4797	
Gain from Form 4684	438
Section 1231 gain	440
Net gain or loss from Form 4684, Loss:	940
Net gain or loss from Form 4684, Gain:	950
Ordinary gain from installment sales	960
Individual return, loss	1010

Reject Codes and Explanations

544 (Continuation)

Form 4797	Field #
Individual return ,loss or gain	1020
Section 291 Amount Property A	1500
Section 291 Amount Property B	1570
Section 291 Amount Property C	1640
Section 291 Amount Property D	1710
Section 1252 Soil, water and land expenses Property A	1730
Section 1252 27a times applicable percentage Property A	1740
Section 1252 smaller of line 24 or 27b Property A	1750
Section 1252 soil, water and land expenses Property B	1760
Section 1252 27a times applicable percentage Property B	1770

Reject Codes and Explanations

544 (Continuation)

Form 4797	Field #
Section 1252 smaller of line 24 or 27b Property B	1780
Section 1252 soil, water and land expenses Property C	1790
Section 1252 27a times applicable percentage Property C	1800
Section 1252 smaller of 24 or 27b Property C	1810
Section 1252 soil, water and land expenses Property D	1820
Section 1252 27a times applicable percentage Property D	1830
Smaller of line 24 or 27b Property D	1840
Check for election out of install method	2040
Face Amount of Note	2050
% of evaluation	2060

545 Business Code Number (Field #140) on Form 1065 is missing or not within valid range (0120-8999).

Reject Codes and Explanations

546 In Form 1065, Date Business Started (Field #100) or Date entity created in Form 1041 (Field #210) is missing or is in the invalid format.

547 In Form 1065, a money amount field has an entry greater than 9999999999.

548 In Form 1065 one of the following money amount fields is negative:

Cost of goods sold	(Field #460)
Salaries and wages	(Field #540)
Net job credits	(Field #560)
Guaranteed payments to partners	(Field #570)
Rent	(Field #580)
Deductible amount	(Field #590)
Taxes	(Field #600)
Total deductions	(Field #710)
Purchases minus cost	(Field #820)
Gross rents	(Field #1080)

549 In Form 1065, one of the following fields is positive:

Losses not included	(Field #3200)
Withdrawls and dist.	(Field #3210)

550 The Byte Count field is missing.

Note: If the ANSI byte count convention is not used, byte counts must precede the Record ID field for each page record and the count must equal the total number of characters contained in the page record.

551-699 Reserved.

700 The following fields of Form 1041 return records have entries other than "X" or blank:

Form 1041
Field numbers - 050-080, 120, 140, 170, 800, 851, 1320, 1360, 1370, 1410-1450, 1470-1520, 1540

Form W-2
Field Numbers - 080-090

Reject Codes and Explanations

700 (Continued)

Form W-2P
Sequence Numbers - 080.

701 Reserved.

702 The following fields on Form 4562 have values other than "X" or blank.

Form 4562
Field Numbers - 820-845, 1930-2380

703 In Form 1041, Amount Refunded (Field #760), is equal to or greater than $1,000,000.

704 In Form 1041, Preparer's Tin (Field #830 or #810) = EIN (Field #040).

705 In Form 1041, Final Return Box (Field #170) = "X" and Credited to 1990 (Field #750), is significant.

706-714 Reserved.

715 One of the following fields on the Form 1041 return record is significant and should not contain an entry:

Form 1041:	Field Number
Bankruptcy estate	100
Family estate trust	110
Amended return block	150-160
Non-exempt charitable split interest trust box 1,2, & 3	260-280
Net rent and royalty income or loss	340

Reject Codes and Explanations

715 (Continued)

Net business and farm income or loss	350
Ordinary gain or loss	370
Treated as credited to beneficiary	600
Taxes paid amount	620
Tax paid with ext. Form 2758 Box	630
Form 8736 Box	640
Form 8800 Box	650
Form 2439 amount	680
Form 4136 amount	690
Other	700
Total	710
Form penalty amount	780
Other tax	1150
Tax description of other tax	1160
Foreign tax credit	1180
Nonconventional fuel credit	1190
Form 3800 Box	1200
Form Specify (Box)	1210
Form Specify	1215

Reject Codes and Explanations

715 (Continued)

Form 1041:	Field Number
General business credit	1260
Credit for prior miminum tax	1270
Total credits	1280
Recapture taxes	1300
Form 4255 Box	1310
Form 8611 Box	1320
Name/Address change	1350
Passive activity loss (Yes box)	1400
Schedule D:	
Short-term gain from Form 6252	750
Long-term gain from Form 6252	1580
Capital gain distribution	1600
Capital gain from Form 4797	1610
Form 4952:	
Phase-In adj.	080

Reject Codes and Explanations

715 (Continuation)

Form 8656:	Field Number
Tax shelter farm loss	190
Passive activity loss	200
Tax preference	
Alternative min. foreign tax credit	590
Sec 44 tax	620

716 A negative amount has been entered for Capital Loss, line 7 (Field #1020) in Schedule B which is equal to Capital loss from Form 1041, line 6 (Field #360)

OR

a positive amount has been entered for Capital gain, line 8 in Schedule B (Field #1030) which is equal to Capital gain from Form 1041, line 6 (Field #360).

717 Name line 1 (Field #180) or Fiduciary Name Line (Field #200) of Form 1041 record is not present, or is in invalid format.

718 Fiduciary Code field of Form 1041 (at least one of Field #050, 060, 070 or 080) is not present.

719 Reserved.

720 The following lines on the return records for Form 1041 are not equal:

Exemption, line 20 (Field #540) is not equal to Computation of capital loss, line 21 (Field 1780) in Schedule D and Field #1780 is significant.

Charitable deduction, line 13 (Field #450) is not equal to Total Charitable deductions, line 6 (Field #950) in Schedule A.

Adjusted, line 17 (Field 500) is not equal to Adjusted total income, line 1 (Field 960) in Schedule B.

Reject Codes and Explanations

720 (Continuation)

Total Tax, line 23 (Field #570) is not equal to Total tax , line 7 (Field #1340) in Schedule G.

Net gain, line 3 (Field #980) is not equal to Net gain, line 17(a) (Field #1710) in Schedule D.

Amount from Schedule B, line 4 (Field #990) is not equal to Net short-term, line 4 (Field #920) in Schedule A.

Alternative minimum tax, line G-6 (Field #1330) is not equal to Alternative minimum tax, Part III, line 12 (Field #640) in Form 8656.

Fiduciary's share of alternative income from Form 8656, Part II (Field #400), line 12 is not equal to Amount from line 12, Part III(1) (Field 530) in Form 8656.

Alternative minimum taxable income from Form 8656, Part II, line 1 (Field 420), is not equal to adjusted alternative minimum taxable income (Field #360) in Form 8656.

721-723 Reserved

724 "X" is in the following fields on Form 1041 and the exemption amount in Field #540 is other than:

Decedent Estate Box (Field #050) - $600
Simple Trust Box (Field #060) - $100 or $300
Complex Trust Box (Field #070) - $100 or $300
If Taxable Grantor Type Trust (Field #080) - $100 or $300
If Non-taxable Grantor Type Trust (Field #080) - Blanks

NOTE: If any of Field # 050, 060, 070, 080 = "X", then Field #540 can be any amount from zero up to the money amount specified, or blank.

Final (Estate or Trust) Return (Field #170) - blank

Reject Codes and Explanations

725 In Form 1041 if:

(a) (Field #050) Decedent Estate is "X", and Fields #060, 070 and 080 are not blank.
(b) (Field #060) Simple Trust is "X", and Field #070 is not blank.
(c) (Field #070) Complex Trust is "X", and Fields #050 and 060 are not blank.
(d) (Field #080) Grantor Type Trust is "X", and Field # #050 is not blank.

726 There is an entry for Income Distribution (Field #510) on Form 1041 and no Schedules K-1 are attached.

727 A "total field" that should have an entry (there is at least one amount field leading to the total) is blank.

728-729 Reserved

730 In Form 1041

(a) Capital gain/loss (Field #360) is negative, and does not equal to the entry in Net loss (Schedule D, Field #1750) or not more than $3000 loss;
(b) Capital gain/loss is positive and does not equal Total net gain (Schedule D, Field #1730).
(C) Capital gain/loss (Field #360) = 0 and Field # 1750 > 0 .

731 Reserved.

732 Form 1041 Page 1 or 2 is missing or out of sequence from the return record, or the Return Record ID (Field #000 and 860) is missing from either page.

733 The return record of Form 1041 is not in sequence of, schedules in ascending alpha sequence, forms other than W-2 or W-2P in ascending numeric sequence, Form W-2, Form W-2P, statements, schedules K-1 in sequential number order, statements for K-1s, and summary record; or pages within any of the forms and schedules are not consecutive and sequential.

734 If Tax Due (Field #730) and Overpayment (Field #740 are both greater than zeros.

735-799 Reserved

Reject Codes and Explanations

800 Disallowed fiscal year Form 1041 return under the present Tax Law.

801-821 Reserved

* 822 Duplicate submission of return file.

* 823 The entire submission of returns has been rejected due to unrecognizable or inconsistent control data.

824 Reserved

* 825 Submitted data is not in the proper sequence of the TRANS record, Return record(s), and the RECAP record or record format of TRANS or Recap record is incorrect.

ATTACHMENT IV

Return Form Record Numbers

Form/Schedule	Record Number
Form 1041	01
Form 1065	01
Schedule D (Form 1040)	12
Schedule D (Form 1065)	12
Schedule K-1 (Form 1041)	20
Schedule K-1 (Form 1065)	19
Form 4562	67
Form 4797	27
Form 4952	72
Form 8271	71
Form 8308	16
Form 8656	21
Form W-2	22
Form W-2P	23
Statement Record	98
Summary Record	99

ATTACHMENT V

The following standard abbreviations for STATE CODE and corresponding three high order ZIP Code digits must always be used. Enclosed in parentheses are exceptions allowed.

STATE	Abbrev.	ZIP CODE	STATE	Abbrev.	ZIP Code
Alabama	AL	350nn-369nn	Mississippi	MS	386nn-397nn
Alaska	AK	995nn-999nn	Missouri	MO	630nn-658nn
American Samoa	AS	967nn			
Arizona	AZ	850nn-865nn	Montana	MT	590nn-599nn
Arkansas	AR	716nn-729nn (75502)	Nebraska	NE	680nn-693nn
California	CA	900nn-966nn	Nevada	NV	889nn-898nn
Caroline Isls.	TT	969nn			
Colorado	CO	800nn-816nn	New Hampshire	NH	030nn-038nn
			New Jersey	NJ	070nn-089nn
Connecticut	CT	060nn-069nn	New Mexico	NM	870nn-884nn
Delaware	DE	197nn-199nn	New York	NY	(06390) 090nn-149nn
District of Columbia	DC	200nn-205nn	North Carolina	NC	270nn-289nn
			North Dakota	ND	580nn-588nn
Florida	FL	320nn-342nn	Ohio	OH	430nn-458nn
		346nn-349nn	Oklahoma	OK	730nn-749nn
Georgia	GA	300nn-319nn	Oregon	OR	970nn-979nn
Guam	GU	969nn	Puerto Rico	PR	006nn,007nn 009nn
Hawaii	HI	967nn-968nn	Pennsylvania	PA	150nn-196nn
Idaho	ID	832nn-838nn	Rhode Island	RI	(06379) 028nn-029nn
Illinois	IL	600nn-629nn	South Carolina	SC	290nn-299nn
Indiana	IN	460nn-479nn	South Dakota	SD	570nn-577nn
Iowa	IA	500nn-528nn	Tennessee	TN	370nn-385nn
Kansas	KS	660nn-679nn	Texas	TX	(73949) 750nn-799nn
Kentucky	KY	(45275) 400nn-427nn	Utah	UT	840nn-847nn
Louisiana	LA	(71749) 700nn-714nn	Vermont	VT	050nn-059nn
Maine	ME	(03801) 039nn-049nn	Virginia	VA	(20041 20301, 20370) 220nn-246nn
Mariana Isls.	TT	969nn	Virgin Islands	VI	008nn
Maryland	MD	(20331) 206nn-219nn	Washington	WA	980nn-994nn

STATE	Abbrev.	ZIP Code	STATE	Abbrev.	ZIP Code
Marshall Isls.	TT	969nn			
Massachusetts	MA	010nn-027nn	West Virginia	WV	247nn-268nn
Michigan	MI	480nn-499nn	Wisconsin	WI	(49936) 530nn-549nn
Minnesota	MN	550nn-567nn	Wyoming	WY	820nn-831nn

APO/FPO CITY/STATE/ZIP CODES FOR MILITARY ADDRESSES OVERSEAS

CITY	STATE		ZIP CODE
APO	Miami	FL	34nnn
FPO	Miami	FL	34nnn
APO	New York	NY	09nnn
FPO	New York	NY	09nnn
APO	San Francisco	CA	97nnn
FPO	San Francisco	CA	97nnn
APO	Seattle	WA	98nnn
FPO	Seattle	WA	98nnn

ATTACHMENT VI

REMITTANCE REGISTER

FILER'S EFIN_____ TAPE ID_____ 1 OF 3

	EIN	NAME CONTROL	MFT	TAX PERIOD (YYMM)	AMOUNT
00			05		
01			05		
02			05		
03			05		
04			05		
05			05		
06			05		
07			05		
08			05		
09			05		
10			05		
11			05		
12			05		
13			05		
14			05		
15			05		
16			05		
17			05		
18			05		
19			05		
20			05		
21			05		
22			05		
23			05		
24			05		
25			05		
26			05		
27			05		
28			05		
29			05		
30			05		
31			05		
32			05		
33			05		
34			05		
35			05		
36			05		
37			05		
38			05		
39			05		
40			05		
41			05		

_____ SUBTOTAL PG 1

ATTACHMENT VI (Continuation))

REMITTANCE REGISTER

FILER'S EFIN_____TAPE ID_____ 2 OF 3

	EIN	NAME CONTROL	MFT	TAX PERIOD (YYMM)	AMOUNT
42			05		
43			05		
44			05		
45			05		
46			05		
47			05		
48			05		
49			05		
50			05		
51			05		
52			05		
53			05		
54			05		
55			05		
56			05		
57			05		
58			05		
59			05		
60			05		
61			05		
62			05		
63			05		
64			05		
65			05		
66			05		
67			05		
68			05		
69			05		
70			05		
71			05		
72			05		
73			05		
74			05		
75			05		
76			05		
77			05		
78			05		
79			05		
80			05		
81			05		
82			05		

SUBTOTAL PG 2 _____

TOTAL PGS 1 & 2 _____

ATTACHMENT VI (Continuation))

REMITTANCE REGISTER

FILER'S EFIN_____TAPE ID_____ 3 OF 3

	EIN	NAME CONTROL	MFT	TAX PERIOD (YYMM)	AMOUNT
83			05		
84			05		
85			05		
86			05		
87			05		
88			05		
89			05		
90			05		
91			05		
92			05		
93			05		
94			05		
95			05		
96			05		
97			05		
98			05		
99			05		

SUBTOTAL PG 3 _____

TOTAL PGS 1 & 2 & 3 _____

ATTACHMENT VII

ELECTRONIC FILING 1990 DATE: MM/DD/YY
ACKNOWLEDGMENT LISTING OF TRANSMISSION

TRANSMITTER NAME: XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX TRANSMITTER EIN: 999999999
ADDRESS: XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX ** TRANSMITTER XXXX: 999999
XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX ** XXXX = "EFIN" if Form 1065
TELEPHONE NUMBER: (999)999-9999 "MTIN" if Form 1041

TRANS DATE: MM/DD/YY JULIAN DATE: 999 SEQ NUM FOR JULIAN DATE: 99 TYPE FORM; FORM 1041 ****
****NOTE: Form # can be 1041 or 1065

DOCUMENT LOCATOR #	EMPLOYER ID #	RETURN SEQ #	ACCEPTANCE CODE	
99999999999999	999999999	0001	A	
99999999999999	999999999	0002	A	
99999999999999	999999999	0003	A	
99999999999999	999999999	0004	A	
99999999999999	999999999	0005	A	
99999999999999	999999999	0006	D	EIN
99999999999999	999999999	0007	A	
99999999999999	999999999	0008	A	
99999999999999	999999999	0009	D	EIN
99999999999999	999999999	0010	A	
99999999999999	999999999	0011	R	NUMBER OF ERROR RECORDS THAT FOLLOW: 8

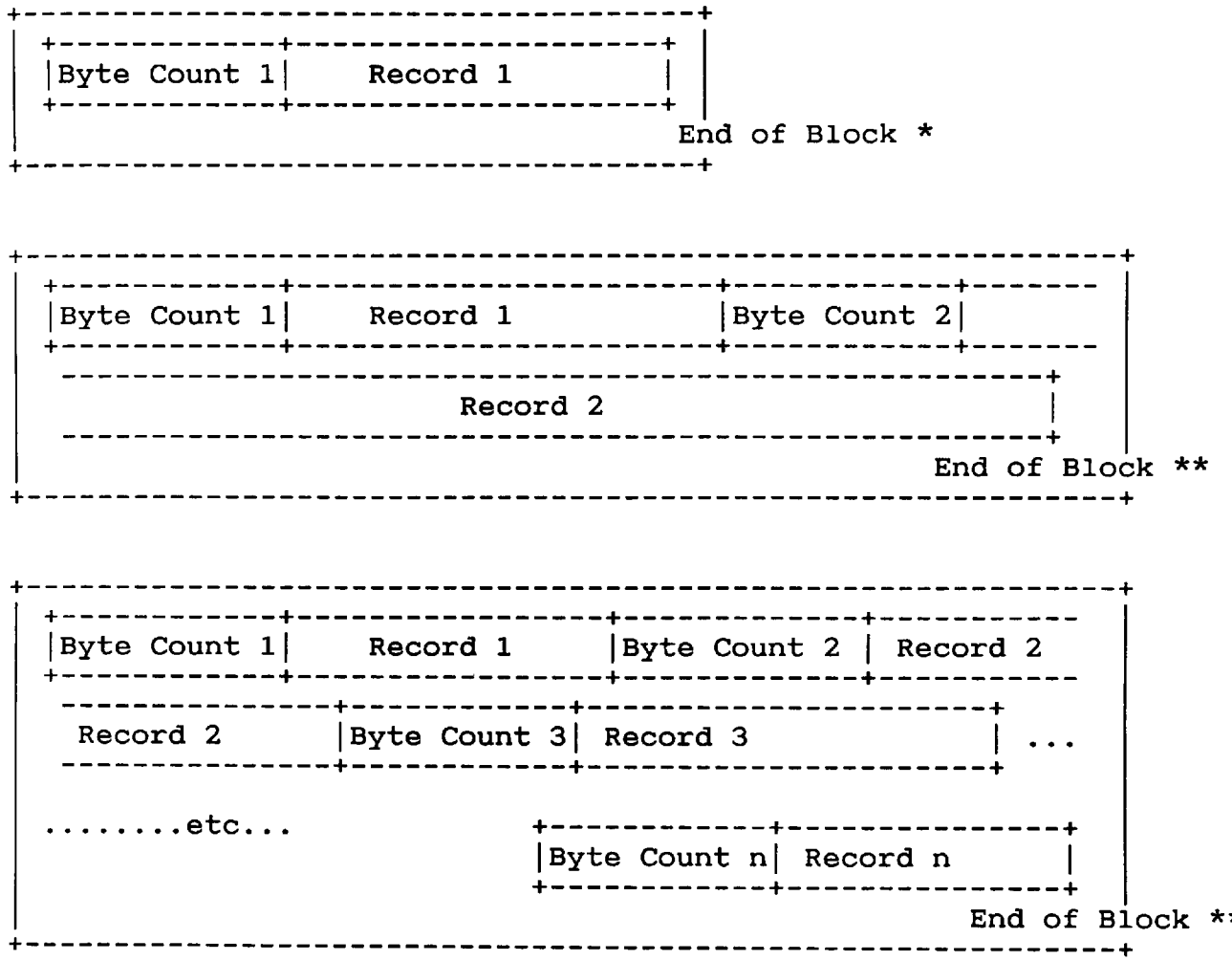
	ERROR RECORD	PG IND	ERROR FIELD	REJ CODE	ERROR RECORD	PG IND	ERROR FIELD	REJ CODE	ERROR RECORD	PG IND	ERROR FIELD	REJ CODE	ERROR RECORD	PG IND	ERROR FIELD	REJ COI
ERROR RECORDS:																
1	XXXXX	99	9999	999	XXXXX	99	9999	999	XXXXX	99	9999	999	XXXXX	99	9999	999
	XXXXX	99	9999	999	XXXXX	99	9999	999	XXXXX	99	9999	999	XXXXX	99	9999	999
2	XXXXX	99	9999	999	XXXXX	99	9999	999	XXXXX	99	9999	999	XXXXX	99	9999	999
	XXXXX	99	9999	999	XXXXX	99	9999	999	XXXXX	99	9999	999	XXXXX	99	9999	999
3	XXXXX	99	9999	999	XXXXX	99	9999	999	XXXXX	99	9999	999	XXXXX	99	9999	999
	XXXXX	99	9999	999	XXXXX	99	9999	999	XXXXX	99	9999	999	XXXXX	99	9999	999
4	XXXXX	99	9999	999	XXXXX	99	9999	999	XXXXX	99	9999	999	XXXXX	99	9999	999
	XXXXX	99	9999	999	XXXXX	99	9999	999	XXXXX	99	9999	999	XXXXX	99	9999	999
5	XXXXX	99	9999	999	XXXXX	99	9999	999	XXXXX	99	9999	999	XXXXX	99	9999	999
	XXXXX	99	9999	999	XXXXX	99	9999	999	XXXXX	99	9999	999	XXXXX	99	9999	999
6	XXXXX	99	9999	999	XXXXX	99	9999	999	XXXXX	99	9999	999	XXXXX	99	9999	999
	XXXXX	99	9999	999	XXXXX	99	9999	999	XXXXX	99	9999	999	XXXXX	99	9999	999
7	XXXXX	99	9999	999	XXXXX	99	9999	999	XXXXX	99	9999	999	XXXXX	99	9999	999
	XXXXX	99	9999	999	XXXXX	99	9999	999	XXXXX	99	9999	999	XXXXX	99	9999	999
* 8	XXXXX	99	9999	999	XXXXX	99	9999	999	XXXXX	99	9999	999	XXXXX	99	9999	999
99999999999999	999999999	0012	A													
99999999999999	999999999	0013	A													

ACKNOWLEDGMENT RECAP
TOTAL RETURN COUNT: ZZZZZ9
TOTAL ACCEPTED RETURNS: ZZZZZ9
TOTAL DUPLICATE RETURNS: ZZZZZ9
TOTAL REJECTED RETURNS: ZZZZZ9

* Note: Error record information could appear for a maximum of 12 error records

ATTACHMENT VIII

EXAMPLES OF VARIABLE BLOCKED FORMAT FILES



* Minimum number of characters per block limited to size of smallest record as specified in record layouts in Appendix A or B

** Maximum number of characters per block - 28,672

26 CFR 601.701: Publicity of information.

Rev. Proc. 90-47

SECTION 1. PURPOSE

The purpose of this revenue procedure is to notify officers and employees of Federal, state, and local agencies administering certain programs under the Social Security Act, the Food Stamp Act of 1977, and State unemployment compensation laws of the manner, time and place by which they may obtain certain return information from the Internal Revenue Service in accordance with Section 6103(l)(7)(B) of the Internal Revenue Code.

SEC. 2. BACKGROUND

01. Section 6103(l)(7) of the Internal Revenue Code was amended by Section 651 of the Deficit Reduction Act of 1984, P.L. 98-369 (1984-3 C.B. (Vol. 1) 1), to enable agencies administering certain programs under the Social Security Act, the Food Stamp Act and State unemployment laws to receive from the Service current return information with respect to unearned income for the purpose of determining eligibility for or the correct amount of benefits under these programs.

02. The return information will be extracted from the Wage and Information Returns (IRP) File—Treas/IRS 22.061, hereafter referred to as the Information Return Master File (IRMF) for the latest processing year. This file contains information returns filed by payers of income such as interest and dividends reported on Forms 1099-INT and 1099-DIV. The information will be extracted on a monthly basis using magnetic tapes submitted by the Coordinating State Agency or the Federal agency with oversight responsibility for the particular program. The information will likewise be on magnetic tape when it is provided to the appropriate agency.

03. The program to extract the information from the IRMF was operational on July 1, 1985.

SEC. 3. AUTHORITY

Section 6103(l)(7)(B) of the Internal Revenue Code requires the Service, upon written request, to disclose unearned income information to Federal, state, and local agencies administering the following programs:

(i) Aid to Families with Dependent Children (AFDC) provided under a State Plan approved under Part A of Title IV of the Social Security Act;

(ii) Medical assistance provided under a State plan approved under Title XIX of the Social Security Act;

(iii) Supplemental Security Income benefits provided under Title XVI of the Social Security Act, and federally administered supplementary payments of the type described in Section 1616(a) of such Act (including payments pursuant to an agreement entered into under Section 212(a) of Public Law 93-66, 87 Stat. 155);

(iv) Any benefits provided under a State plan approved under Titles I, X, XIV, or XVI of the Social Security Act (as those titles apply to Puerto Rico, Guam, and the Virgin Islands);

(v) Unemployment compensation provided under a State law as described in Section 3304 of the Internal Revenue Code;

(vi) Assistance provided under the Food Stamp Act of 1977; and

(vii) State-administered supplementary payments of the type described in Section 1616(a) of the Social Security Act (including payments pursuant to an agreement entered into under Section 212(a) of Public Law 93-66 [1973-2 C.B. 439]).

Information may be disclosed by the Service only for the purposes of, and to the extent necessary in, determining eligibility for or the correct amount of benefits under the aforementioned programs.

SEC. 4. DEFINITIONS

Element	*Description*
DM-1 File	SSA file of all validly issued SSNs and their related names.
EBCDIC	Extended Binary Coded Decimal Interchange
EIN	Employer Identification Number which has been assigned by the Internal Revenue Service to the reporting entity.
File	For the purpose of this Revenue Procedure, a file consists of all magnetic media records submitted by a requesting agency.
IRMF	Wage and Information Returns (IRP), Treas/IRS 22.061, commonly referred to as Information Return Master File.
Payee	Person(s) or organization(s) receiving payments from the reporting entity or for whom an information return must be filed.
Payer	Person or organization, including paying agent, making payments or is otherwise required to issue an information return.
SSA	Social Security Administration.
SSN	Social Security Number assigned by SSA.
TIN	Taxpayer Identification Number which may be either an EIN or SSN.

SEC. 5. APPLICATION FOR INCLUSION IN PROGRAM

01. Disclosures by the Service will be made on a reimbursable basis. This will be a magnetic media project in which the return information is accessed by magnetic tape supplied by the requesting agencies and return information about identified individuals is provided on magnetic tape by the Service. Input by paper will not be accepted and no disclosures will be made on paper.

02. Agencies wishing to receive data under Section 6103(l)(7)(B) of the Code should submit their applications to:

Internal Revenue Service
Director, Office of Disclosure
Room 1603 EX:D
1111 Constitution Ave., NW
Washington, D.C. 20224

03. The application must be made in writing and be signed by the head of the Federal, state, or local agency.

04. The application must contain the following information:

1) an overview of how the information will be used, the programs for which the information will be used, who will conduct the eligibility verification, if any counties will have access to the information, and any other relevant information as to how the receiving agency will use the tax information;
2) the authorizing statute by which the agency qualifies to receive the information;
3) the name(s) and title(s) of the official(s) who is (are) authorized to request return information;
4) the actions which will be taken by the agency to comply with the safeguard and reporting requirements of Section 6103(p)(4) of the Code (see Section 8 of this Revenue Procedure and Internal Revenue Service Publication 1075, *Tax Information Security Guidelines);*
5) a statement certifying that the safeguards to be employed will be in place at the time the agency makes its initial request for return information;
6) the name(s) and title(s) of the official(s) in the agency who has (have) responsibility for safeguarding the return information, and;
7) if appropriate, whether the agency will be acting as the Coordinating State Agency for purposes of requesting information or if it is an agency for whom a Coordinating State Agency will make requests for information (see Sections 10.02-10.04). The agency should identify these other State agencies which are participating in that State's consolidated effort to obtain return information.

SEC. 6. MATCHING AGREEMENTS

01. Upon receipt and approval of an application from an agency, the Service will prepare a matching agreement in accordance with the Computer Matching and Privacy Protection Act of 1988, P.L. 100-503. The agreements will specify in detail the following information:

1) the purpose and legal authority for conducting the match program;
2) justification for the match program and anticipated results;
3) description of the records to be matched;
4) projected starting and completion dates of the match program;
5) procedures for providing notice to individuals that information provided by them may be subject to verification through matching programs;
6) procedures for verifying information produced in matching programs;
7) procedures for the retention and timely destruction of identifiable records created by the recipient agency in the matching program;
8) procedures for ensuring the administrative, technical, and physical security of the records matched and the results of such programs;
9) prohibitions on duplication and redisclosure of records;
10) procedures governing the use by a recipient agency of records provided in the matching program including return or destruction of records;
11) information on assessments made regarding the accuracy of the records used in the matching program, if available; and
12) that the Comptroller General may have access to all records of a recipient agency necessary in order to monitor or verify compliance with the agreement.

02. The requesting agency will be provided two original copies of the prepared matching agreement for signature by the agency head or other delegated official authorized to request data. Both copies of the matching agreement must have an original signature.

03. The Service will receive the signed agreement from the agency. After the signature of the Service's approving official is obtained and copies are forwarded to the appropriate Congressional Committees, a copy of the agreement will be returned to the requesting agency.

04. The agreement will remain in effect for a period not to exceed 12 months, will cover one processing year and shall be effective 30 days after the date copies are provided pursuant to Section 6.03.

05. Matches may not take place until agreements have been signed by both agencies, copies provided to the appropriate Congressional Committees and notice published in the Federal Register. In addition, all matches must be approved by the Department of Treasury Data Integrity Board.

SEC. 7. REIMBURSEMENT

01. All work done by the Service for agencies administering will be performed on a reimbursable basis. Billing will be based on the number of data records processed as work is completed on a quarterly basis. The cost per data record is 1 cent per record submitted. The cost per Service tape, if used, will be $12. These charges are subject to change. Billings will be made directly to each agency that requests return information.

02. In addition to the matching agreement, the Service will prepare Form 5181, Agreement Covering Reimbursable Services upon receipt of and approval of an application from an agency. The requesting agency will be provided an original and copy of the prepared agreement.

03. The requesting agency will complete boxes 5a, 5b, and 5c and 9a, 9b, and 9c of Form 5181. Federal agencies must provide their Agency Location Code (ALC) in block 6b. The person indicated in box 5a will be the person coordinating requests and receipt of data from the Service. The address in 5B will be the address to

which the magnetic tapes will be shipped. The signature in box 9a must be that of the agency head or other delegated official authorized to request data. Both the original and copy of Form 5181 must have an original signature.

04. The Service will receive the signed documents from the agency. After the signature of the Service's approving official is obtained, a copy of the matching agreement and Form 5181 will be returned to the requesting agency. The Service will also provide an agency code to be used when making requests.

05. Upon receipt of the signed matching and reimbursable agreements, the agency may begin requesting return information in accordance with Sections 10, 11 and 12 of this Revenue Procedure.

SEC. 8. SAFEGUARDS AND RECORDKEEPING REQUIREMENTS

01. Return information which is obtained by an agency under Section 6103(l)(7) of the Code is subject to the safeguard, recordkeeping, and reporting requirements of Section 6103(p)(4) of the Code. If the return information becomes a part of the agency case file regarding a specific taxpayer, because physical separation is impractical, the case file must be safeguarded. These files should be clearly labeled to indicate that Federal tax information is included and care should be taken to remove all such Federal tax data to preclude access by unauthorized persons.

02. An agency which receives return information pursuant to Section 6103(l)(7) of the Code must submit a *Safeguard Procedures Report* within 30 days of initial receipt of the return information. The report will detail the security accorded the information, the individuals who may request and have access to the information, the flow of the information once the agency has received it, as well as other information which will give a comprehensive picture of the need for, the use of, and the disposal of the return information. Publication 1075 (Rev. 1-86), *Tax Information Security Guidelines*, gives additional information about the *Safeguard Procedures Report* and may be obtained by writing to the IRS official listed in Section 5.02.

03. The *Safeguard Procedures Report* will be submitted to the Federal agency which has oversight responsibility for the program(s). The address of the specific office the report must be sent to will be provided by the Service upon approval of the agency's application. The report is due within 30 days from the date the agency first receives return information pursuant to Section 6103(l)(7) of the Code.

04. The agency must also submit an annual *Safeguard Activity Report* giving current information on its safeguard procedures. The information required for this report is also detailed in Publication 1075. The report will be submitted annually to the same Federal agency to whom the Safeguard Procedures Report is to be sent.

05. The Federal agency which receives these reports is responsible for insuring that all information required for the reports is included. Problems or concerns which cannot be resolved between the Federal agency and the agency which has the return information will be referred to the Director, Office of Disclosure, for resolution.

06. The oversight Federal agency is responsible for monitoring safeguard procedures employed by requesting agencies and reporting to the Service, on an annual basis, about its oversight of safeguards employed by the requesting agencies.

07. Pursuant to Section 6103(p)(4) of the Code, the Service has the authority to conduct its own safeguard reviews at the Federal, State, and local levels.

SEC. 9. LIMITATIONS

01. Officers and employees who are entitled to access return information generally must not disclose this information to any party outside the agency other than the taxpayer to whom the information relates, the taxpayer's duly appointed representative who has the explicit authority to obtain the return information, or employees of the Federal agency charged with oversight of the particular program the State or local agency is administering. However, to the extent such disclosure is necessary to verify the eligibility for and the correct amount of benefits, including past benefits, under the programs listed in Section 3 of this Revenue Procedure, such disclosures may be made only when there is no other means of verifying the unearned income information and only to the extent necessary to verify the unearned income information.

02. Officers and employees who are entitled to access return information must not disclose this information to any other officer or employee within the agency whose official duties do not require this information to determine eligibility for, or the correct amount of, benefits under these programs.

03. Officers and employees of Federal, state, and local agencies who disclose return information in a manner or for a purpose not authorized by Section 6103(l)(7) are subject to the criminal penalty provisions of Section 7213 of the Code. Federal agencies and officers and employees of State and local agencies who disclose return information in a manner or for a purpose not authorized by Section 6103(l)(7) are also subject to the civil damages provisions of Section 7431 of the Code.

04. Any unauthorized disclosure of return information must be reported to the nearest Internal Revenue Service Regional Inspector. The name, address, and telephone number of this individual may be obtained from the Disclosure Officer at the Internal Revenue Service district in which the agency is located.

05. Return information may be disclosed by the Service only for the purpose of, and to the extent necessary in, determining eligibility for, or the correct amount of, benefits for the programs listed in Section 3 of this Revenue Procedure.

06. Agencies which receive return information pursuant to Section 6103(l)(7) may not reduce, suspend, terminate or deny aid or benefits until the agency has taken steps to independently verify the information, as provided for by the Deficit Reduction Act of 1984.

SEC. 10. TAPE SUBMISSIONS

01. Tape submissions must be received by specific dates in order for the Service to run an agency's tape in the corresponding month. The processing schedule is listed in Exhibit 1. If the tape shipment is received after the deadline for the monthly extract, the Service will run the tape the following month.

02. The Service will only accept magnetic tapes from coordinating State agencies, the Social Security Administration (which will administer the Supplemental Security Income program) and those Federal agencies charged with oversight responsibility for the eligible programs who must use the information to review those programs to insure that State and local agencies are paying out the correct amount of benefits.

03. If there is more than one agency administering the programs listed in Section 3 of this Revenue Procedure, the Coordinating State Agency will consolidate the requests from the requesting agencies within the State and submit a single tape file, on a monthly basis, to the Service.

04. The Coordinating State Agency is the single State agency responsible for tape submissions requesting return information to be used in any of the programs covered by Section 6103(l)(7) of the Code. If there is more than one agency in the State that wishes return information, one of the agencies must be designated as the Coordinating State Agency. However, each agency must sign the matching agreement to receive information.

05. Each magnetic tape submitted in accordance with this revenue procedure must have an external label that contains the following information:

a) Tape Identification or Volume Serial Number;
b) Agency Name;
c) Assigned Agency Code Number;
d) Project Identification of "DIFSLA"; and
e) Reel Sequence (e.g., 1/2, 2/2); and
f) Number of records on entire file.

Note: Files submitted without a record count of the file will be returned to agency unprocessed.

06. Agencies submitting requests for return information under IRC Section 6103(l)(7)(B) must ship magnetic tape submissions to:

Internal Revenue Service
Martinsburg Computing Center
Route 9 and Needy Road
Martinsburg, WV 25401
ATTN: Chief, Tape Library

07. Each tape submission must have an accompanying transmittal letter from the requesting agency, prepared in the format detailed in Exhibit 2, that contains the following information:

a) Project Name;
b) Requesting Agency;
c) Assigned Agency Code;
d) Number of tapes in each shipment;
e) Identification Number of each tape;
f) Exact number of records on the entire file; and
g) Name and Telephone Number of an individual within the requesting agency who can aid in reconciling shipping problems.

NOTE: Do not ship the transmittal letter and tapes separately.

08. The tape shipment must follow the specifications and format in Sections 11 and 12 of this Revenue Procedure. Tapes which do not meet these specifications will be returned to the submitting agency unprocessed.

09. If more than one State agency is to receive return information, the output tape will be sent to the Coordinating State Agency and the Coordinating State Agency will send the individual agencies their own particular data.

10. An agency should provide at least six magnetic tapes, to be maintained as blank stock, for the initial output when making the initial input shipment and at regular intervals. Each shipment of blank tapes must have an accompanying transmittal letter specifying the project name, the requesting agency, the assigned agency code, and the number of tapes in the shipment. See Exhibit 3 for the format for the transmittal letter. If agency tapes are not supplied and Service tapes must be used to provide output, new tapes will be used. The cost of these tapes will be reflected in the agency billing.

11. An agency's input tape will be retained for approximately 90 days. After that time, the input tape will be scratched (electro-magnetically erased) and the tape will be used for the agency's next output. Note: When the input file is scratched the agency's file identification number will be replaced with a new identification number assigned by the Service.

SEC. 11. INPUT MAGNETIC TAPE SPECIFICATIONS

01. The magnetic tape specifications contained in this section of the Revenue Procedure define the required characteristics of the magnetic tape file. These specifications must be adhered to unless deviations have been specifically granted by the Service in writing. In most instances, the Service will be able to process any compatible tape files.

02. Tape File Format:

1) 9 channel;
2) Standard Label, EBCDIC;
3) A file name of "DIFSLA";
4) ODD parity; and
5) A density of 6250 BPI.

03. Tape File Characteristics:

1) Type of tape: 0.5 inch (12.7 mm) wide, computer grade magnetic tape on reels of up to 2400 feet (731.52 m);
2) Tape thickness: 1.0 or 1.5 mils;
3) Reel diameter: 10.5 inches (26.67 cm), 8.5 inches (21.59 cm), or 7 inches (17.78 cm); and
4) Interrecord Gap: 3/4 inch.

04. Input Record Length - The tape records may be blocked or unblocked, subject to the following:

1) A FIXED RECORD OF 92 POSITIONS IS REQUIRED.
2) All records except the Header and Trailer Labels may be blocked.
3) If records are blocked, we recommend a block size of 100. The maximum block size must be 9,200 tape positions in length.
4) When the block results in a short block (less than 20 records), all remaining positions of the block may be filled with 9's. Do not pad a block with blanks.

05. Options for Filing. For the purposes of this Revenue Procedure the following conventions must be used:

1) Header Label:
   a) Agencies may use standard headers provided they begin with 1HDR, HDR1, VOL1, or VOL2; and
   b) Consist of a maximum of 80 positions.
   c) Data Set Name: DIFSLA
2) Trailer Label:
   a) Standard trailer labels may be used provided that they begin with 1EOR, 1EOF, EOR1, EOV1, or EOV2; and
   b) Consist of a maximum of 80 positions.
3) Tape Mark:
   a) Used to signify the physical end of the recording on tape.

b) May follow the header label and precede and/or follow the trailer label.

06. External File Label

1) Tape Identification or Volume Serial Number;
2) Agency Name;
3) Assigned Agency Code Number;
4) Project Identification of "DIFSLA";
5) Reel Sequence (e.g., 1/2, 2/2); and
6) Number of Records

SEC. 12. AGENCY REQUESTS - INPUT RECORD LAYOUT

01. Agency Request Record

Tape Position	*Field Title*	*Field Length*	*Field Description*
1-3	Agency Code	3	REQUIRED. This identifies the agency which originated the request. The number is supplied by the Service when a formal application is made to the Office of Disclosure.
4	Constant	1	REQUIRED. Insert a "0" (numeric) into this position.
5-13	Primary SSN	9	REQUIRED. Enter the SSN of the requested individual. This field must be ALL NUMERICS.
14-22	Secondary SSN	9	OPTIONAL. Enter the SSN of individual's spouse. This field must be ALL NUMERICS if present. Otherwise zero fill.
23	Constant	1	REQUIRED. Enter a "1" (numeric) into this position.
24-25	Constant	2	REQUIRED. Enter "99" into these positions.
26-32	Welfare Codes	7	REQUIRED. Enter the code(s) for the welfare program(s) requesting information. Left justify and blank fill.

Code	*Welfare Program*
1	AFDC
2	Medicaid
3	SSI Benefits
4	Cash Assistance
5	Unemployment Compensation
6	Food Stamps
7	State Supplementary Payments
8	Veterans' Benefits
9	Federal Quality Control

NOTE: Federal agencies requesting information for quality control purposes should use code 9 and the code representing the assistance program being monitored.

33-36	Name Control 1	4	REQUIRED. Enter the first four letters of the last name. Left justify and blank fill if the name is less than four letters.
37-40	Name Control 2	4	OPTIONAL. If the Secondary SSN is present in positions 14-22, Name Control 2 is REQUIRED. Enter the first four letters of the spouse's last name. Left justify and blank fill if the name is less than four letters. Otherwise, blank fill.
41-61	Agency	21	OPTIONAL. Agency supplied for Requester agency use. It is an optional Information field which will be returned on the IRS tape at the end of each record.
62	Program Code	1	REQUIRED. Enter a "1" (numeric) in this position.
63-92	IRS Use Only	30	Must be blank (alpha) filled.

02. The agency requests must follow this format exactly. The tapes are processed through a diagnostic program to assure that they meet the format requirements. Tapes which do not meet the format requirements will be returned to the submitting agency unprocessed.

03. Each tape file returned to the requesting agency unprocessed will have a machine generated external label (Exhibit 4) that reflects information from processing. The file identification will be 405 D1 01—NN (where "NN" represents the last two digits of the Assigned Agency Code number).

04. Each tape file shipment will be accompanied by Form 3220, Mass Storage Media. This document (Exhibit 5) is used to ensure receipt of tape files. The recipient agency must sign and date the Form 3220 and return one copy to the Service at the address noted to acknowledge receipt of the tape file shipment.

SEC. 13. OUTPUT MAGNETIC TAPE SPECIFICATIONS

01. The magnetic tape specifications contained in this section of the Revenue Procedure define the format and contents of the records to be included in the files which will be returned to the requesting agencies.

02. Tape File Format

1) 9 track;
2) IBM Standard Label, EBCDIC;
3) ODD Parity; and
4) A density of 6250 BPI.

03. Tape File Characteristics

1) Type of tape: 0.5 inch (12.7 mm) wide computer grade magnetic tape of reels of up to 2400 feet (731.52 m);
2) Tape thickness: 1.0 or 1.5 mils;
3) Reel diameter: 10.5 inches (26.67 cm); 8.5 inches (21.50) inches; or 7 inches (17.78 cm); and
4) Interrecord Gap: 3/4 inch.

04. Record Length

1) All records except the Header and Trailer Labels will be blocked; and
2) When the block results in a short block (less than 20 records) all remaining positions of the block will be filled with 9's.

3) INVALID REQUEST Records Format
   a) Blocked 100;
   b) Fixed Record of 92 positions; and
   c) The block will be 9,200 tape positions.
4) DOCUMENT INFORMATION Records Format
   a) Blocked 20;
   b) Fixed Record of 1011 positions; and
   c) The block will be 20,220 tape positions.

p1 05. Tape File Labels - Reel labels will be as follows: ("NN" represents the last two digits of the Assigned Agency Code number and "NNN" represents the full three digits of the Assigned Agency Code number.)

1) Invalid Requests File
   a) External Label = 405 D3 11—NN b) Internal File Name = 405D311- -NNN
2) Document Information Records
   a) External Label = 405 D7 11—NN
   b) Internal File Name = 405D711- -NNN

3) Project Identification: DIFSLA

06. The Service will initially validate all SSNs and Name Controls provided by the requesting agency, against the DM-1 file prior to running the agency's requests against the IRMF. All records that do not pass the diagnostic or validation processes will be returned on one file (Invalid Requests) while names of individuals matched against the IRMF will be returned on another tape file (Document Information Records). See Sections 14 and 15, respectively, for output record formats.

07. Each tape file will be accompanied by Form 3220, Mass Storage Media. This document (Exhibit 5) is used to ensure receipt of tape files.

08. The recipient agency must sign and date the Form 3220 and return one copy to the Service at the address noted to acknowledge receipt of the tape file(s).

SEC. 14. INVALID REQUESTS - RECORD LAYOUT

01. Invalid Requests - These records are not processed against the IRMF. All information except position 66 is duplicated from the agency request record.

Tape Position	*Field Title*	*Field Length*	*Field Description*
1-3	Agency Code	3	The agency which originated the request.
4	Constant	1	"0" (numeric).
5-13	Primary SSN	9	SSN of the requested individual.
14-22	Secondary SSN	9	SSN of spouse if present.
23	Constant	1	"1" (numeric).
24-25	Constant	2	"99"
26-32	Welfare Codes	7	The welfare program(s) for which the request is being made. Duplicated from positions 26-32 of the request record.
33-36	Name Control 1	4	The first four letters of the last name associated with the primary SSN.
37-40	Name Control 2	4	First four (4) letters of spouse's last name if Secondary SSN present.
41-61	Agency Requester Information	21	Agency supplied information for agency use. Duplicated from the request record.
62	Program Code	1	"1" (numeric).
63-65	Agency Code	3	Agency which originated the request. Duplicated from positions 1-3 for sorting purposes.
66	Error Code	1	Code explaining the type of error that was encountered during the diagnostic or SSN validation process.

Tape Position	*Field Title*	*Field Length*	*Field Description*
	Code	*Explanation*	
	1	Invalid Agency Code	
	2	Primary SSN not all numeric	
	3	RESERVED FOR FUTURE USE	
	4	Primary Name Control missing or in error	
	5	Invalid Program Code	
	6	Invalid Primary SSN	
	7	Primary Name Control does not match Primary SSN	
67-92	Reserved	26	IRS Use Only

SEC. 15. INFORMATION DOCUMENT - RECORD LAYOUT

01. Information Records - These records were matched against the IRMF. These records represent return information reported by the payers.

Tape Position	*Field Title*	*Field Length*	*Field Description*
1-9	Payee TIN	9	Primary SSN from request record.
10-13	Payee Name	4	Name Control from information document for identified individual.
14-16	Agency Code	3	Assigned Agency Code.
17-18	Tax Year	2	The year in which the income was paid. For requests received July 1990 through June 1991, the Tax Year is "89".
19-20	Document Type	2	The document on which the income was reported.
		Document Type	*Document Name*
		32	Form W-2G
		65	Form 1065 Schedule K-1
		66	Form 1041 Schedule K-1
		67	Form 1120S Schedule K-1
		75	Form 1099-S
		79	Form 1099-B
		80	Form 1099-A
		86	Form 1099-G
		91	Form 1099-DIV
		92	Form 1099-INT
		95	Form 1099-MISC
		96	Form 1099-OID
		97	Form 1099-PATR
		98	Form 1099-R
		**	No matched record on IRMF
21-40	Account Number Payee	20	The number assigned by the payer to the payee's account.
41-80	Payee Name Line 1	40	The name of the payee whose TIN is contained in positions 962-970 as reported on the information document. If less than 40 characters, left justified and blank filled.
81-120	Payee Name Line 2	40	If the payee name required more than 40 characters or if there are other payees, this field will contain these names, left justified and blank filled.
121-160	Payee Mailing Address	40	The mailing address of the payee, left justified and blank filled.
161-200	Payee City	40	The payee's city, left justified and blank filled.
201-202	Payee State	2	The payee's state as abbreviated by the U. S. Postal Service.

Tape Position	*Field Title*	*Field Length*	*Field Description*
203-211	Payee ZIP Code	9	The payee's ZIP Code, left justified and blank filled if it is only 5 digits.
212-220	Payer TIN	9	The Payer's EIN or SSN.
221-260	Payer Name Line 1	40	The payer's name, left justified and blank filled.
261-300	Payer Name Line 2	40	Any additional payer name(s) information, left justified and blank filled.
301-340	Payer Address	40	The payer's address, left justified and blank filled.
341-380	Payer City/ State/Zip Code	40	The payer's city, state and zip code. Left justified and blank filled.
381-382	Reserved	2	Blank (alpha) filled.
(Money fields - all amounts are in dollars only, however, a "-" may appear in the first position of the field to indicate a negative amount.)			
383-394	Other Taxable Income	12	Other taxable income reported on Schedule K-1 of Forms 1065 and 1120S.
395-406	Interest	12	Interest reported on Forms 1099-INT, 1099-OID and Schedule K-1 of Forms 1041, 1065 and 1120S.
407-418	Dividends	12	Dividends reported on Forms 1099-DIV and Schedule K-1 of Forms 1041, 1065 and 1120S.
419-430	Patronage Dividends	12	Patronage dividends reported on Form 1099-PATR.
431-442	Non-Patronage Dividends	12	Non-patronage dividends reported on Form 1099-PATR.
443-454	Per-Unit Retain Allocations	12	Allocations reported on Form 1099-PATR.
455-466	Redemption of Non-Qualified and Retain Allocations	12	Redemption amounts reported on Form 1099-PATR.
467-478	Reserved	12	0 (numeric) filled.
479-490	Reserved	12	0 (numeric) filled.
491-502	Reserved	12	0 (numeric) filled.
503-514	Unemployment Compensation	12	Unemployment compensation reported on Form 1099-G.
515-526	State/Local Tax Refund	12	State and local tax refunds reported on Form 1099-G.
527-538	Discharge of Indebtedness	12	Discharge amounts reported on Form 1099-G.
539-550	Reserved	12	0 (numeric) filled.
551-562	Agricultural Subsidies	12	Agricultural subsidy payments reported on Form 1099-G.
563-574	Reserved	12	0 (numeric) filled.
575-586	Reserved	12	0 (numeric) filled.
587-598	Cash Liquidation Distribution	12	Cash liquidations reported on Form 1099-DIV.
599-610	Non-Cash Liquidation Distribution	12	Non-cash liquidations reported on Form 1099-DIV.
611-622	Reserved	12	0 (numeric) filled.
623-634	Gross Winnings	12	Gambling winnings reported on Form W-2G.

Tape Position	*Field Title*	*Field Length*	*Field Description*
635-646	Additional Winnings	12	Additional winnings from identical wager reported on Form W-2G.
647-658	Savings Bonds	12	U.S. savings bond and Treasury bills, bonds, and notes as reported on Form 1099-INT.
659-670	Interest Forfeiture	12	Interest forfeiture reported on Forms 1099-INT and 1099-OID.
671-682	Substitute Payments	12	Substitute payments reported on Form 1099-MISC.
683-694	Stocks and Bonds	12	Sales of securities reported on Form 1099-B.
695-706	Reserved	12	0 (numeric) filled.
707-718	Aggregate Profit & Loss	12	Total profit/loss from regulated futures or foreign currency contracts as reported on Form 1099-B.
719-730	Profit and Loss Realized	12	Profit/loss reported on Form 1099-B.
731-742	Reserved	12	0 (numeric) filled.
743-754	Reserved	12	0 (numeric) filled.
755-766	Rents	12	Rental income reported on Form 1099-MISC.
767-778	Royalties	12	Royalty income reported on Form 1099-MISC.
779-790	Prizes and Awards	12	Prizes and awards reported on Form 1099-MISC.
791-802	Reserved	12	0 (numeric) filled.
803-814	Reserved	12	0 (numeric) filled.
815-826	Reserved	12	0 (numeric) filled.
827-838	Original Issue Discount	12	Original issue discount reported on Form 1099-OID.
839-850	Total Pension Distribution	12	Lump sum distribution from a retirement plan as reported on Form 1099-R.
851-862	Other Pension Distribution	12	Actuarial value of annuity contract or retirement bond; retirement account exchange or death benefit payment as reported on Form 1099-R.
863-874	Reserved	12	0 (numeric) filled.
875-886	Reserved	12	0 (numeric) filled.
887-898	Reserved	12	0 (numeric) filled.
899-910	Real Estate Sales	12	Proceeds from real estate sales reported on Form 1099-S.
911-922	Reserved	12	0 (numeric) filled.
923-934	Debt Outstanding	12	Balance of principal of debt reported on Form 1099-A.
935-946	Debt Satisfied	12	Gross foreclosure proceeds from sale of property to satisfy debt reported on Form 1099-A.
947-958	Fair Market Value	12	Appraised value of real property that supported loan amount reported on Form 1099-A.
959-960	Blanks	2	Blank filled.
961	Amended Return	1	1 (numeric) if the information return was amended, otherwise Indicator blank.
962-970	Select SSN	9	SSN used to obtain unearned income information.
971-977	Welfare Codes	7	Same as Request Welfare Codes.

Tape Position	*Field Title*	*Field Length*	*Field Description*
978-981	Name Control 1	4	Name Control #1 from information document.
982-985	Name Control 2	4	Same as the Request Name Control #2.
986-1006	Agency Requester Information	21	Requesting Agency Information as forwarded in positions 41-61 of the input record.
1007-1010	Blanks	4	Blank filled.
1011	Error Code	1	Code explaining the type of error that was encountered when the Secondary SSN was validated.

Code	*Explanation*
A	Secondary SSN not all numeric
B	Name Control #2 missing or in error
C	Secondary SSN invalid
D	Name Control #2 does not match SSN #2
E	Welfare Code Invalid

Note: An error code of A, B, C or D may appear in this field although income information is provided.

SEC. 16. INQUIRIES

01. Any questions regarding the material in this Revenue Procedure may be addressed to the Director, Office of Disclosure, at the address listed in Section 5.02 of this Revenue Procedure.

02. Questions concerning tape receipt and shipping can be addressed to:

Internal Revenue Service
Production Control Officer
Systems Operations Division
Martinsburg Computing Center
P.O. Box 1208
Martinsburg, WV 25401

SEC. 17. EFFECTIVE DATE

This Revenue Procedure is effective July 1990 through June 1991.

SEC. 18. DRAFTING INFORMATION

The principal author of this Revenue Procedure is Gwen Collins of the Office of Disclosure. For further information regarding the specifications in this Revenue Procedure contact Ms. Collins on (202) 535-9749 (not a toll-free call).

Exhibit 1

DIFSLA Processing Schedule

July 1990 - June 1991

Tax Year 1989

	PROCESSING CYCLE	*REQUEST DUE DATE*	*RUN DATE*	*SHIPPING DATE*
JUL	8929	07/13/90	07/15/90	07/29/90
AUG	8933	08/10/90	08/12/90	08/26/90
SEP	8937	09/07/90	09/09/90	09/23/90
OCT	8941	10/05/90	10/07/90	10/21/90
NOV	8945	11/02/90	11/04/90	11/18/90
DEC	8952	12/21/90	12/23/90	01/07/91
FEB	8907	02/09/91	02/11/91	02/25/91
MAR	8911	03/09/91	03/11/91	03/25/91
APR	8915	04/06/91	04/08/91	04/22/91
MAY	8919	05/04/91	05/06/91	05/20/91
JUN	8926	06/22/91	06/24/91	07/08/91

There will be no January run of the IRMF. Tapes received after the cutoff date will be processed in the next monthly run. Tapes with matching data will be shipped approximately two weeks after the Run Date.

Tapes will not be processed until all requirements of the Computer Matching and Privacy Protection Act of 1988 are satisfied.

NOTE: If output magnetic tapes are not received within 2 weeks of the Shipping Date, please contact the IRS Program Coordinator immediately.

EXHIBIT 2

Tape Transmittal Letter

Submitting Agency
Agency Address
Assigned Agency Code
Date

Internal Revenue Service
Martinsburg Computing Center
P.O. Box 1208
Martinsburg, WV 25401

Attn: Chief, Tape Library

Enclosed is (are) _____ tape(s) for the DIFSLA project for submission to the _____ run of this project.
(month)

File Name: DIFSLA
Number of Records: N,NNN,NNN

Tape ID #(s)	*Sequence #*
GEC0807	1/2
DCC0725	2/2

Please direct all inquiries to:

_____
(Name of Contact)

_____
(Telephone Number)

Sincerely,

_____
(signature)

_____
(name)

_____
(title)

EXHIBIT 3

Tape Transmittal Letter

Submitting Agency
Agency Address
Assigned Agency Code
Date

Internal Revenue Service
Martinsburg Computing Center
P.O. Box 1208
Martinsburg, WV 25401

Attn: Chief, Tape Library

Enclosed is (are) _____ tape(s) for the DIFSLA project for maintenance as blank stock and use as output tapes for this agency.

Tape ID#(s)	*Sequence*
GEC0807	Scratch
DCC0725	Scratch

Please direct all inquiries to:

_____
(Name of Contact)

_____
(Telephone Number)

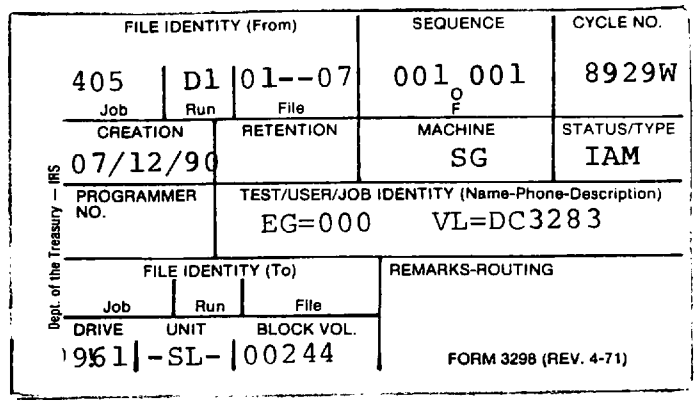
Sincerely,

_____
(signature)

_____
(name)

_____
(title)

TAPE FILE RETURNED UNPROCESSED

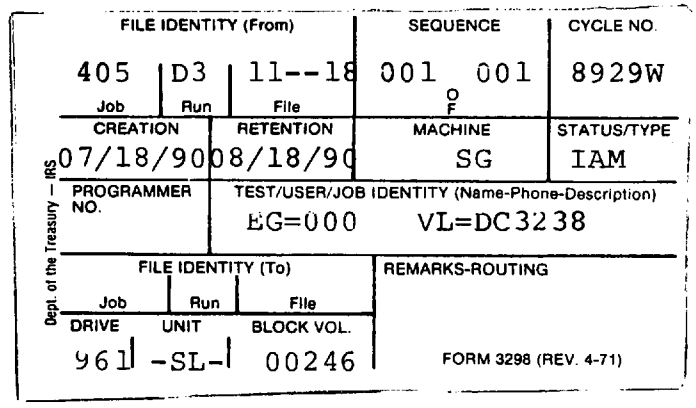


FILE IDENTITY (From)			SEQUENCE	CYCLE NO.
405 (Job)	D1 (Run)	01--07 (File)	001 OF 001	8929W
CREATION	RETENTION		MACHINE	STATUS/TYPE
07/12/90			SG	IAM
PROGRAMMER NO.	TEST/USER/JOB IDENTITY (Name-Phone-Description)			
	EG=000 VL=DC3283			
FILE IDENTITY (To)			REMARKS-ROUTING	
Job	Run	File		
DRIVE	UNIT	BLOCK VOL.		
961	-SL-	00244		

Dept. of the Treasury — IRS

FORM 3298 (REV. 4-71)

INVALID REQUESTS

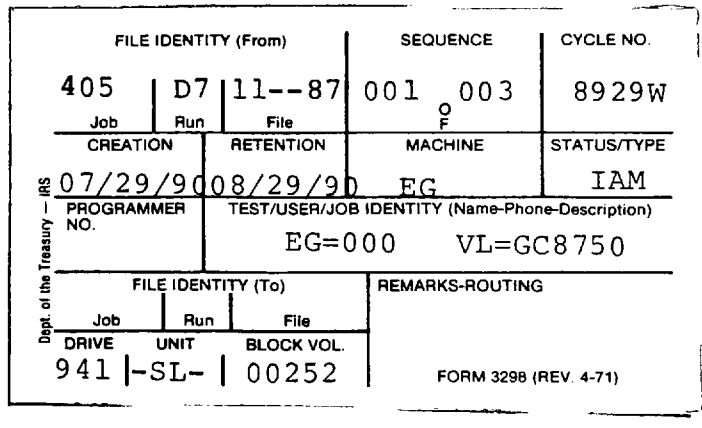


FILE IDENTITY (From)			SEQUENCE	CYCLE NO.
405 (Job)	D3 (Run)	11--18 (File)	001 OF 001	8929W
CREATION	RETENTION		MACHINE	STATUS/TYPE
07/18/90	08/18/90		SG	IAM
PROGRAMMER NO.	TEST/USER/JOB IDENTITY (Name-Phone-Description)			
	EG=000 VL=DC3238			
FILE IDENTITY (To)			REMARKS-ROUTING	
Job	Run	File		
DRIVE	UNIT	BLOCK VOL.		
961	-SL-	00246		

Dept. of the Treasury — IRS

FORM 3298 (REV. 4-71)

DOCUMENT INFORMATION RECORDS



FILE IDENTITY (From)			SEQUENCE	CYCLE NO.
405 (Job)	D7 (Run)	11--87 (File)	001 OF 003	8929W
CREATION	RETENTION		MACHINE	STATUS/TYPE
07/29/90	08/29/90		EG	IAM
PROGRAMMER NO.	TEST/USER/JOB IDENTITY (Name-Phone-Description)			
	EG=000 VL=GC8750			
FILE IDENTITY (To)			REMARKS-ROUTING	
Job	Run	File		
DRIVE	UNIT	BLOCK VOL.		
941	-SL-	00252		

Dept. of the Treasury — IRS

FORM 3298 (REV. 4-71)

MASS STORAGE MEDIA

☐ CHARGE-OUT | DATE 072790 | JOB RUN NUMBER

☐ REMOTE LOG | MACHINE | OP CODE | CYCLE NUMBER | Batch IAM (a) | Cycle 8929 (b) | Group W (c)

☒ TRANSMITTAL | TYPE | CONTROL | TRANSMITTAL NUMBER | From NC2 | Number 003625 | To WA6

I/O	TC	SERIAL NO	JOB-RUN-FILE-ID (FROM)	MEDIA SEQUENCE	CREATION DATE	RETENTION (DAYS)	STATUS	PROG NO	BLOCK COUNT	ERRORS	DR
	5	EV2832	405-D3-11-644	001001	071990	0030					
		EV8600	405-D7-11-644	001001	072290						
			DIAGNOSTIC REPORT ATTACHED								
			IRMF DISCLOSURE TO STATE AND FEDERAL AGENCIES								
		XXXX

26 CFR 601.602: Forms and instructions. (Also Part I, Sections 6011, 6041, 6047, 6051, 6071, 6081, 6091; 1.6041-1, 1.6041-2, 1.6047-1, 31.6051-1, 31.6051-2, 31.6071(a)-1, 31.6081(a)-1.)

Rev. Proc. 90-48

PART A. GENERAL

SEC. 1. PURPOSE

.01 The purpose of this revenue procedure is to provide general rules for filing and to state the requirements of the Internal Revenue Service (IRS) and the Social Security Administration (SSA) relating to reproducing paper substitutes for Form W-2, Wage and Tax Statement; Form W-2P, Statement for Recipients of Annuities, Pensions, Retired Pay, or IRA Payments; and Form W-3, Transmittal of Income and Tax Statements, for amounts paid during the 1990 calendar year.

.02 For the purpose of this revenue procedure, a substitute form is one that is not printed by the IRS. A substitute Form W-2, W-2P, or W-3 must conform to the specifications in this revenue procedure to be acceptable to the IRS. Preparers should also refer to the instructions for preparing and filing Forms W-2, W-2P, and Form W-3 for additional guidelines on how to complete these forms. See Part B, Sec. 1.03, below, for information on ordering the official IRS forms and instructions.

.03 NOTE: For Tax Year 1991, Form W-2P will be combined with Form 1099-R, Statement for Recipients of Total Distributions From Profit-Sharing, Retirement Plans, Individual Retirement Arrangements, Insurance Contracts, Etc. The new combined form will be filed with IRS. The layout of the new combined form will be 2 forms per page.

.04 This revenue procedure supersedes Rev. Proc. 89-41, 1989-2 C.B. 454 (Reprinted as Publication 1141, Revised 7-89).

SEC. 2. NATURE OF CHANGES

.01 Various editorial changes were made. Several requirements received added emphasis to help payers avoid errors.

.02 The exhibits were updated for tax year 1990. The layout and content of Form W-2 was revised for tax year 1990 (see Exhibit A), reflecting the increase to a half-page format for Copy A.

.03 Minimum size requirements are set forth for the substitute Form W-2, Employee's copy (Copy B, etc.). The maximum allowable size was expanded. These new size requirements apply for tax year 1990 only and are subject to change for future years. See Part B, Sec 2., below.

.04 The Revenue Procedure is clarified to state that both magnetic media filers and paper filers (of Form W-2, Copy A) may use substitute employee copies (Copy B, etc.) that meet the requirements set forth in this document.

.05 Instructions similar to those contained on the back of Copy C of the official form are now required to be provided to each employee (recipient). These instructions must include the exact language concerning the Earned Income Credit (EIC) as contained on the official form. The requirement for instructions on the back of Copy D has been eliminated.

.06 The new penalty provisions that apply to Forms W-2 and other information returns are provided. See Sec. 3.07, below.

SEC. 3. GENERAL RULES FOR FILING FORMS W-2 AND W-2P

.01 Employers and payers (hereafter and where applicable collectively referred to as payers) MUST use magnetic media for filing if the payer will file 250 or more 1990 Forms W-2 (Copy A) or W-2P (Copy A) with SSA. This requirement applies unless:

1 The payer can establish that filing on magnetic media will result in undue hardship, AND

2 The payor is granted a waiver of the requirement by the IRS.

To request a *one year* waiver of the magnetic media filing requirement, submit Form 8508, Request for Waiver From Filing Information Returns on Magnetic Media, to:

Internal Revenue Service
Martinsburg Computing Center
P.O. Box 1359
Martinsburg, WV 25401-1359

Please use this address (with the P.O. Box number) whenever possible. However, for requests sent by a courier who will not deliver to a P.O. Box number, the street address is: Route 9 and Needy Road, Martinsburg, WV 25401. Form 8508 may be obtained by calling 1-800-424-FORM (3676) until October 1, 1990. On October 1, 1990, the number will change to 1-800-829-3676. Form 8508 also may be obtained directly from the IRS Martinsburg Computing Center (IRS/MCC) at the above address or by calling (304) 263-8700 (not a toll-free call). Completed requests for waivers (Form 8508) must be submitted at least 90 days before the due date of the return (see Sec. 3.06, below). The requestor will receive an approval or denial letter from IRS, but must allow at least 30 days for IRS to respond. If you have any questions concerning Form 8508, contact IRS/MCC at the address or phone number shown above. Payers who do not comply with the magnetic media filing requirement and who are not granted a waiver will be subject to certain penalties. See Sec. 3.07, below, for an explanation of the new penalties that apply if Forms W-2 are not filed on magnetic media when required. PAYERS WHO FILE FORMS W-2 AND W-2P INFORMATION ON MAGNETIC MEDIA WITH SSA MUST NOT SEND THE SAME DATA TO SSA ON PAPER FORMS W-2 AND W-2P. This would result in duplicate reporting and may subject the filer to penalties imposed by the IRS. Since many states and local governments accept Forms W-2 and W-2P data on magnetic media, savings may be obtained if magnetic media is used for filing with both SSA and state or local governments. You must contact each individual state or local taxing agency to receive approval and make arrangements to file on magnetic media.

.02 Payers can design their own statements to give to employees, pensioners, annuitants, recipients of retired pay, recipients of IRA (Individual Retirement Arrangement) payments, and recipients of disability income (hereafter and where applicable collectively referred to as payees). This applies to both payers who file with SSA on magnetic media or submit paper Forms W-2, Copy A. Payers who file paper Copy A, Form W-2, with SSA continue to be required to use the official IRS printed form or a substitute that exactly meets the specifications set forth in this Revenue Procedure for submission to SSA. Payee statements de-

signed by payers must comply with the requirements shown in Parts B and C, below, of this Revenue Procedure. NOTE: Magnetic media users who use the official IRS printed form or any other pre-printed form are advised not to print Copy A or, if printed, to discard it to prevent duplicate information from being submitted in error, as stated in .01, above. Copy A is not needed by SSA when documents are filed on magnetic media.

.03 TIB-4, "Magnetic Media Reporting, Submitting Annual W-2 and W-2P Copy A Information to the Social Security Administration," contains the specifications and procedures for filing Forms W-2 (Copy A) and W-2P (Copy A) on magnetic media with SSA. Specifications for both tape and diskette reporting for Forms W-2 and W-2P are included in this Technical Instructions Bulletin (TIB-4).

.04 TIB-4 may be obtained by writing to the Social Security Administration, Reports Preparation Section, P.O. Box 2317, Baltimore, MD 21235. Payers using magnetic media are cautioned to obtain the most recent revision of the TIB-4 and supplements due to possible changes in the specifications and procedures. TIB-4 will be revised in the fall of 1990.

.05 Payers not using magnetic media must file Copy A of Form W-2 or Copy A of Form W-2P with SSA on either an official form or a privately printed substitute paper form that exactly meets the specifications shown in Parts B and C, below, of this Revenue Procedure.

.06 1990 Forms W-2 and W-2P, whether filed on magnetic media or paper, must be submitted to SSA on or before February 28, 1991. In addition, the payee copies must be provided to the taxpayer on or before January 31, 1991. Failure to timely file with SSA or to timely provide the taxpayer copies may subject the payer to penalties. See Sec. 3.07, below, concerning which penalties apply if correct Forms W-2 are not filed with SSA or provided to the payee by the due date. Payers needing additional time to file Copy A of Form W-2 or Copy A of Form W-2P with SSA may request an extension of time to file by submitting Form 8809, Request for Extension of Time To File Information Returns, to the IRS/MCC, at the address (or alternative address) listed in Sec. 3.01, above. The extension request should be filed as early as possible, but must be postmarked no later than the due date of the forms (February 28, 1991).

NOTE: APPROVAL OF THE EXTENSION IS NOT AUTOMATIC. Approval or denial is based on administrative criteria and guidelines. The requestor will receive an approval or denial letter from IRS and must allow at least 30 days for IRS to respond. Form 8809 may be obtained by calling 1-800-424-FORM (3676) (1-800-829-3676 after September 30, 1990), or by contacting IRS/MCC (See the address and phone number in Sec. 3.01, above).

.07 New penalty provisions apply to Forms W-2 (and certain other information returns), effective with tax year 1989 returns filed in 1990. Generally, penalties will be assessed for payers who fail to file correct information returns by the due date. The penalties will apply if information returns:

1 Are not filed by the due date (as stated in Sec. 3.06, above);

2 Are filed with incorrect information;

3 Do not include all of the required information;

4 Are submitted on paper when they are required to be filed on magnetic media (as stated in Sec. 3.01, above);

5 Are filed with incorrect or missing Taxpayer Identification Numbers (TINs); or

6 Are filed in a manner that does not allow them to be processed or read by machine.

The amount of the penalty is graduated, based on when the correct Form W-2 (or other information return) is filed, as follows:

— $15 per return if the forms are filed correctly within 30 days of the due date (March 30 for returns due February 28). The maximum penalty is $75,000 per year ($25,000 for small businesses, as defined later);

— $30 per return if the forms are filed correctly more than 30 days after the due date, but on or before August 1. The maximum penalty is $150,000 per year ($50,000 for small businesses);

— $50 per return if the forms are filed after August 1 or if the returns are not filed as required. The maximum penalty is $250,000 per year ($100,000 for small businesses).

The lower maximum penalties for small businesses (as shown above) apply if a business had average annual gross receipts for the 3 most recent tax years (or years in existence, if shorter), ending before the calendar year in which the information returns were due, of $5,000,000 or less.

A penalty also applies to payee statements (or statements for recipients) if:

1 The payee statement is not provided by January 31 (as stated in Sec. 3.06, above);

2 If a statement furnished to payees includes incorrect information; or

3 If a statement is furnished to payees that does not include all the required information. The penalty is $50 per return with a maximum of $100,000 per year. There is no reduction in the penalty for providing a correct information return to the payee after the due date.

The penalties as stated here will not apply if the payer can show that the failure was due to reasonable cause and not to willful neglect.

NOTE: For tax year 1989 returns only, penalties will be waived if incorrect returns, which were filed timely, are corrected by October 1, 1990.

SEC. 4. GENERAL RULES FOR FILING FORM W-3

.01 Employers and payers (hereafter and where applicable collectively referred to as payers) submitting Forms W-2 or W-2P (Copy A) on paper to SSA must transmit Form W-2 or W-2P with Form W-3.

.02 Form W-3 must be the same width (i.e. 7 inches, 7.5 inches, or 8 inches) as the Forms W-2 or W-2P filed.

.03 Form W-3 should only be used to transmit paper Forms W-2 (Copy A) or Forms W-2P (Copy A). Magnetic media filers do not file Form W-3. Payers using magnetic media must transmit Form W-2 or W-2P data with Form 6559, Transmitter Report of Magnetic Media Filing, along with either Form 6560, Employer Summary of Form W-2 Magnetic Media Wage Information, or Form 6561, Payer Summary of Form

W-2P Magnetic Media Pension Information. A set of these forms (Form 6559, 6560, and 6561) are provided by SSA to all approved magnetic media filers in the TIB-4 instructions. The forms may also be obtained by calling IRS at 1-800-424-FORM (3676) (1-800-829-3676 after September 30, 1990).

PART B. REQUIREMENTS FOR FILING PAPER SUBSTITUTES

SEC. 1. GENERAL RULES FOR FILING "PAPER SUBSTITUTES" FOR FORMS W-2, W-2P, AND W-3

.01 Paper substitutes that conform totally to the specifications contained in this revenue procedure may be privately printed without the prior approval of the IRS. SUBSTITUTE FORMS THAT DO NOT CONFORM TOTALLY TO THESE SPECIFICATIONS ARE NOT ACCEPTABLE. This applies to both paper substitutes that are filed with SSA and those that are given to employees. Forms should *not* be submitted to IRS or SSA for general approval. However, 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, your interpretation of that specification, and an example of the how the form would appear if produced using your understanding of the specification to:

Internal Revenue Service
ATTN: Substitute Form W-2 Coordinator
R:R:T, Room 7300
1111 Constitution Avenue, N.W.
Washington, DC 20224

NOTE: You should allow at least 45 days for the IRS to respond.

.02 Forms W-2, W-2P, and W-3 are subject to annual review and possible change. Payers are cautioned against overstocking supplies of privately printed substitutes.

.03 Copies of the current year, official Forms W-2, W-2P, and W-3 and the instructions for these forms may be obtained from most IRS offices or by calling 1-800-424-FORM (3676) (1-800-829- 3676 after September 30, 1990). The IRS provides only cut sheet sets with no carbon interleaves for Forms W-2, W-2P, and W-3. Reproduction proofs of the official Forms W-2, W-2P, and W-3 are also available. See Part C, Sec. 4, below, for information on ordering reproduction proofs.

.04 Substitute Forms W-2, W-2P, and W-3 transmitted to SSA should generally contain only data provided to payees and summary data as requested by the instructions for the form.

.05 If it is necessary to report more than three items in Box 17 of Form W-2, filers of paper forms (Copy A) should use a second Form W-2 to report the additional items. Box 17 may be enlarged on employee copies (Copy B, etc.), so long as the substitute used is in compliance with the specifications contained herein (see Secs. 2 and 3, below). If a second Form W-2 is provided to report additional items in Box 17, other wage and tax data must not be duplicated on the second form.

.06 Substitute Forms W-2, W-2P, and W-3 may be redesigned as to the spacing for state and local tax data as long as the vertical and horizontal spacing for all federal payment and data boxes are in compliance with the specifications contained herein.

.07 All ballot boxes on Forms W-2 (Copy A), W-2P (Copy A), and W-3 must be 8-point boxes. NOTE: If a box is marked, more than 50% of the applicable ballot box must be covered by an "X".

SEC. 2. REQUIREMENTS FOR SUBSTITUTE FORMS FURNISHED TO PAYEES (COPIES B, C, AND 2 OF FORMS W-2 AND W-2P)

.01 All payers (including payers who file on magnetic media and do not file a paper Copy A) must furnish payees with at least two statements (three statements are appropriate for payees required to file a state, city, or local income tax return). The dimensions of these copies may be expanded from the dimensions of the official form to allow space for conveying additional information such as additional entries required for Boxes 17 or 18, withholding from pay for health insurance, union dues, bonds, charity, etc. This may permit the payer to eliminate other statements or notices which would otherwise be furnished to payees.

1 The MAXIMUM allowable dimensions are:

(a) depth should be no more than 6.5 inches;

(b) width should be no more than 8.0 inches.

2 The MINIMUM allowable dimensions are:

(a) 2.67 inches by 5.0 inches.

(b) horizontal or vertical format is permitted.

NOTE: These minimum and maximum size specifications are for 1990 only and are subject to change.

.02 The paper for all copies should be white. The substitute Copy B (or its equal), that payees are instructed to attach to their Federal income tax return, must be at least 12-pound paper (basis 17 x 22-500), while the other copies furnished the payee should be at least 9-pound paper (basis 17 x 22-500).

.03 Interleaved carbon and chemical transfer paper for payee copies must meet the following standards:

1 All copies must be CLEARLY LEGIBLE;

2 All copies must have the capability to be photocopied; and

3 Fading must not be of such a degree as to preclude legibility and the ability to photocopy.

The Service prefers that forms not be printed with iron based inks used for magnetic character reading (MICR) or any other specialty inks having magnetic properties. Similarly, forms should not be imaged by any process that employs magnetic toners.

In general, black chemical transfer inks are preferred; other colors are permitted only if the above standards are met. "Spot carbons" are NOT permitted (See Sec. 3.15, below for standards for chemical transfer paper for Copy A.)

.04 Substitute forms for payees need contain only the payment boxes and captions that are applicable. Certain other boxes contained on the official form may be omitted. In all *cases*, the following boxes must be present:

1 The payee name, address, Social Security Number (SSN);

2 The payer name, address, and Employer Identification Number (EIN);

3 The tax year;

4 Federal income tax withheld; and

5 Wage, tips, other compensation.

Payment boxes and captions that are applicable must be clearly identified, using, where possible, the same wording as on the official form. On Form W-2, Copy B, payers are required to identify the amount of Federal income tax withheld as "Box 9" and the amount of wages, tips, other compensation as "Box 10." On Form W-2P, Copy B, payers are required to identify the taxable amount as "Box 10" and the amount of Federal income tax withheld as "Box 11". These same payment boxes on Copy B are required to be outlined in bold 2-point rule (see Exhibit M) or identified in some manner to distinguish these boxes from the rest of the form. If Form W-2 contains additional data (e.g., saving bonds withholding, retirement withholding, or payroll savings.), there should be a special highlighting of the areas pertaining to (1) Federal income tax withheld, (2) Wages, tips, and other compensation, and (3) Advance EIC (Earned Income Credit) payment.

.05 Substitute forms for payees (Copies B, C, and 2 of Forms W-2 and W-2P) must meet the following requirements:

1 All copies of Forms W-2 and W-2P must clearly show the form number, the form title, and the tax year. The title of Form W-2 is "Wage and Tax Statement." The title of Form W-2P is "Statement for Recipients of Annuities, Pensions, Retired Pay, or IRA Payments."

2 If the substitute forms are not labeled as to the disposition of the copies, then written notification must be provided to each payee as specified below:

(a) The first copy of the form (Copy B) should be filed with the employee's (or recipient's) Federal tax return.

(b) The second copy of the form (Copy C) is for the employee's (or recipient's) records.

(c) If applicable, the third copy (Copy 1) of the form should be filed with the employee's state, city, or local income tax return.

3 If the substitute forms are labeled, then the forms must contain the applicable description:

(a) "Copy B, to be filed with employee's Federal tax return", "Copy C, for employee's records", and the designation "Form W-2, Department of the Treasury - Internal Revenue Service", OR

(b) "Copy B, file with recipient's Federal tax return," "Copy C, for recipient's records," and the designation "Form W-2P Department of the Treasury - Internal Revenue Service."

(c) For this purpose, the word "Department" may be abbreviated as "Dept." as on the official, IRS printed forms. The reference to the Department of the Treasury - Internal Revenue Service should be omitted from other copies provided in the set.

4 Instructions similar to those contained on the back of Copy C of the official form MUST be provided to each employee (recipient). These instructions must include the exact language concerning the Earned Income Credit (EIC) as is contained on the official form. For Form W-2, the Social Security (FICA) rates applicable for the current tax year must appear either on the front or the back of the copy (Copy C) retained by the employee; or be communicated to the employee via a separate statement. NOTE: IF you are a Federal employer or a state or local government employer with employees covered only under Medicare, you must provide the current rate for hospital insurance benefits (Medicare) for those employees.

5 Payees should be advised that substitute wage and tax statements are acceptable for filing with their Federal income tax returns.

SEC. 3. REQUIREMENTS FOR SUBSTITUTE "PRIVATELY PRINTED" FORMS SUBMITTED TO SSA (FORMS W-2 (COPY A), FORMS W-2P (COPY A), AND FORMS W-3)

.01 Payers may file privately printed substitute Forms W-2, W-2P, and W-3 with SSA. The substitute form must be an exact replica of the official reproduction proof with respect to layout and contents because it will be read by machine. The dimensions of a substitute form may differ as far as width (see Sec. 3.05, below). The printing of the Government Printing Office (GPO) symbol must be deleted (see Sec. 3.16, below). The specifications and allowable tolerances for the Copy A of substitute Forms W-2 and W-2P are provided later in this Revenue Procedure. See Exhibits A, D, and E for Form W-2 specifications and Exhibits B, F, and G for Form W-2P specifications. The specifications and allowable tolerances for Forms W-3 are provided in Exhibits C, H, and I.

NOTE: *Printers of Forms W-2 or W-2P that are wider than 7 inches must provide Forms W-3 that are the same width as the Forms W-2 or W-2P (i.e., 7 1/2" Forms W-3 with 7 1/2" width Forms W-2 or W-2P; 8" width Forms W-3 with 8" width Forms W-2 or W-2P).*

.02 Paper for substitute Copy A (of Forms W-2 and W-2P) and Form W-3, (cut sheets and continuous pinfeed forms), that are to be filed with SSA must be white 100% bleached chemical wood, optical character recognition (OCR) bond produced in accordance with the specifications shown as follows:

1 Acidity: pH value, average, not less than 4.5

2 Basis Weight 17 x 22
500 cut sheets 18-20
Metric equivalent grams
per. sq. meter 60-75
A tolerance of ±5 pct. shall be allowed.

3 Stiffness: Average, each direction, not less than Gurley milligrams..cross direction 50
...machine direction..... 80

4 Tearing Strength: Average, each direction, not less than—grams 40

5 Opacity: Average, not less than—percent 82
Reflectivity average not less than 68 percent.

6 Thickness: Average.....inch 0.0038
Metric equivalent ...mm 0.097
A tolerance of +0.0005 inch (0.0127mm) shall be allowed. Paper shall not vary more than 0.0004 inch (0.012mm) from one edge to the other.

7 Porosity: Average, not less than..seconds..... 10

8 Finish (smoothness): Average, each side—seconds 20-55
For information only, the Sheffield equivalent—unit.....170-d100

9 Dirt: Average, each side, not to exceed—parts per million ... 8

NOTE: Reclaimed fiber in any percentage is permitted, provided the

requirements of this standard are met.

.03 All printing for Copy A (of Forms W-2 and W-2P) and Form W-3 will be in red OCR dropout ink, as specified, except for the form identifying numbers '22222,' '55555,' or '33333' at the top of the form and the descriptive information at the bottom (see Exhibits J, K, and L) that will be printed in nonreflective black ink. All other printing will be in red OCR dropout ink meeting, or comparable to, the specifications in this paragraph. The screened area of any substitute form (Copy A of Form W-2 and W-2P, and the Form W-3 that is sent to SSA) should generally correspond to that present on the official form. Vertical rules require screening of .05 inches on each side of an inside rule. Horizontal screening should follow the standard format and allow for typewriter spacing. All screened areas are to be printed in red OCR dropout ink. The numbered captions are printed as a solid with no screened background (see Exhibits). Sinclair and Valentine (U.S.) red OCR dropout ink number J-25083 is the preferred ink because it is easier for the forms preparer to read.

NOTE: Printing in any other red OCR dropout ink must be cleared by contacting Manager of Sales Support, Recognition Equipment, Inc., P.O. Box 660204, Dallas, TX 75266, telephone number (214) 579-6927.

.04 Type must be substantially identical in size and shape with corresponding type on the official form. NOTE: The form identifying number must be in OCR A font.

1 On Copy A of Forms W-2 and W-2P and for Form W-3, all the perimeter rules must be 1-point (0.014 inch), while all other rules must be one-half point (0.007 inch).

2 Vertical rules must be parallel to the left edge of the form; horizontal rules parallel to the top edge.

.05 Two official Forms W-2 (Copy A), three official Forms W-2P (Copy A), or one official Form W-3 are contained on a single page that is 7 inches wide (exclusive of any snap-stubs) by 11 inches deep. The form identifying number for the official forms (7 inches wide) is '22222' for Form W-2; '55555' for Form W-2P; and '33333' for Form W-3. Although adherence to the size of the official page is preferred, the width of privately printed substitute pages may be 7 inches, 7 1/2 inches, or 8 inches exclusive of any left or right snap-stubs, or pin-feed holes. If a 7 inch form is produced, the image must be an exact copy of the official reproduction proof. If the width of the substitute page is increased, the width of specified fields on the substitute page must be increased in accordance with Exhibits D, E, F, G, H, and I. The top margin for all forms must be .25 inch, the right margin must be .15 inch, and the left margin .35 inch, plus or minus .0313 inch. Margins must be free of all printing. For Forms W-2 (Copy A), W-2P (Copy A), and W-3 the combination width of Box 1, "Control number", and the box containing the form identifying number must always be 2.2 inches.

1 When the width of Copy A is increased to 8 inches, exclusive of any left or right snap-stubs or pin-feed holes, the form identifying number must be shown as 222 for Form W-2, 555 for Form W-2P, or 333 for Form W-3. This number tells the scan equipment used by SSA which information document it is reading, the width size and the position of individual data fields (see Exhibits D, F, and H).

2 When the width of Copy A is increased to 7 1/2 inches, exclusive of any left or right snap-stubs or pin-feed holes, the form identifying must be shown as 2222 for Form W-2, 5555 for Form W-2P, or 3333 for Form W-3. This number tells the scan equipment used by SSA which information document it is reading, the width size and the position of individual data fields (see Exhibits E, G, and I).

.06 The depth of the individual image on a page must be the same as that of the official reproduction proof. For Form W-2, the depth is 5.5 inches (see Exhibit A). For Form W-2P the depth is 3 2/3 inches (see Exhibit B). The depths of the Form W-3 on a page must be 3.37 inches (see Exhibit C). The depths are the same for the 7 inch, 7 1/2 inch, and 8 inch wide forms.

.07 The words *"Do Not Cut or Separate Forms on This Page"* must be printed in red OCR dropout ink between the two Forms W-2 (Copy A) or the three Forms W-2P (Copy A) (see Exhibits A and B) and must also be present on 7 1/2 inch and 8 inch wide substitute Forms W-2 or W-2P. Perforations are required on all copies (except Copy A) to enable the separation of individual forms.

.08 The words "For Paperwork Reduction Act Notice, see separate instructions." *must* be printed on Forms W-2 (Copy A) and W-2P (Copy A) (see Exhibits A and B for format and location) and must also be present on 7 1/2 inch and 8 inch wide substitute Forms W-2 and W-2P.

.09 The Office of Management and Budget (OMB) Number must be printed on *each* ply of Form W-2, W-2P, and W-3 (see Exhibits A, B, and C for format and location) and *must* also be present on 7 1/2 inch and 8 inch wide substitute Forms W-2, W-2P, or W-3.

.10 The statement *"Please return this entire page with the accompanying Forms W-2 or W-2P to the Social Security Administration address for your state, as listed below. Household employers filing Forms W-2 for household employees should send the forms to the Albuquerque Data Operations Center."* and the list of SSA addresses *must* be printed on Forms W-3 (*see* Exhibit C), whether Forms W-3 are 7 inches wide, 7 1/2 inches wide, or 8 inches wide.

.11 The Paperwork Reduction Act Notice must be printed on Form W-3 (see Exhibit C for format and location), whether Forms W-3 are 7 inches wide, 7 1/2 inches wide, or 8 inches wide.

.12 *Privately printed continuous substitute Forms W-2 (Copy A) and W-2P (Copy A) must be perforated at each 11" (3-on Forms W-2P and 2-on Forms W-2) page depth. No perforations are allowed between the individual forms (5 1/2 inch Forms W-2 or 3 2/3 inch Forms W-2P) on a single copy page of Copy A.* NOTE: Perforations are required between all the other *individual* copies on a page (Copy 1, B, C, 2, and D) included in the set.

.13 The back of a substitute Copy A and Form W-3 (page 1) must be free of all printing.

.14 Spot carbons are NOT permitted for Copy A of Forms W-2 or W-2P or for Form W-3. Interleaved carbon should be black and must be of good quality to assure legibility of information on all copies and to preclude smudging.

.15 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.

.16 The GPO symbol must not be placed on substitute Copy A of Forms W-2 and W-2P. In the place of the GPO symbol, the Employer Identification Number (EIN) of the forms printer must be printed in the bottom margin on the face of each individual sheet of Copy A. In addition, the EIN of the forms printer must be printed on the face of the substitute Form W-3 that is filed with SSA.

PART C. ADDITIONAL INSTRUCTIONS

SEC. 1. INSTRUCTIONS FOR FORMS PRINTERS

.01 Except as provided below, if magnetic media is not used for filing with SSA, the substitute copies of Forms W-2 and W-2P assembly should be arranged in the same order as the official Forms W-2 and W-2P. Copy A should be first, followed sequentially by perforated sets (Copies 1, B, C, 2, and D). The substitute form to be filed by the payer with SSA must carry the designation "Copy A." NOTE: Magnetic media filers do not need to print Copy A since it is not needed by SSA for processing. (See the caution in Part A, Sec. 3.02, above.)

1 It is not a requirement that privately printed substitute forms contain a copy to be retained by payers (Copy D). However, payers must be prepared to verify or duplicate this information if it is requested by the IRS or SSA. Paper filers that do not keep Copy D should be able to generate a facsimile of Copy A in case of loss. The requirement that instructions be printed on the back of Copy D has been eliminated.

2 Except as provided in the arrangement of the official assemblies, additional copies that may be prepared by payers shall not be placed ahead of the copy "For employee's records," Form W-2 (Copy C) or "For Recipient's Records," Form W-2P (Copy C).

3 Instructions similar to those contained on the back of Copy C of the official form MUST be provided to each employee (recipient). For Form W-2, the social security (FICA) rates applicable for the current tax year must appear either on the front or the back of the copy (Copy C) retained by the employee; or be communicated to the employee via a separate statement.

NOTE: Federal, state and local government employers with employees covered only under Medicare, must provide the current rate for hospital insurance benefits (Medicare) for employees.

.02 All privately printed Forms W-2 (Copy A) and W-2P (Copy A) must have the tax year printed on the bottom face of each form using identical type to that of the official format.

.03 The substitute Copy B (or its equal), which payees are instructed to attach to their Federal income tax return, must be at least 12-pound paper (basis 17 x 22-500), while the other copies furnished to payees should be at least 9-pound paper (basis 17 x 22-500).

.04 The OCR bond Form W-3 that is filed with SSA must have no printing on the reverse side.

.05 Instructions similar to those provided as part of the official form must be provided as part of any substitute Form W-3.

.06 All privately printed Forms W-3 must have the tax year printed on the bottom face of each substitute Form W-3, using identical type to that of the official format.

.07 The copy of the substitute Form W-3 that contains the instructions and is to be retained by the employer should be at least 18-pound paper (basis 17 x 22-500).

SEC. 2. INSTRUCTIONS FOR PAYERS

.01 Only originals or ribbon copies of Copy A (Forms W-2 and W-2P) and Form W-3 may be filed with SSA. *Carbon copies and photocopies are not acceptable.*

.02 Payers should type or machine print entries on forms whenever possible and provide good quality data entries by using black ribbon, inserting data in the middle of blocks, well separated from other printing and guidelines, and taking any other measures that will guarantee clear, sharp images. The payer must provide a machine scannable form for Copy A and payee copies (Copies B, C, and 2) that are legible and capable of being photocopied (by the recipient).

.03 The Employer Identification Number (EIN) may be entered anywhere in Box 2 along with the Payer's name and address on Copy A of Forms W-2 and W-2P. (If this is done, the EIN need not be entered in Box 3 of either Form W-2 or W-2P.) For Forms W-3, the EIN must be entered where prescribed by the Form W-3 instructions.

.04 The payer's name, address, and EIN may be pre-printed.

.05 The optional employer's state number may be pre-printed in the employer's (payer's) name, address, and ZIP code box. If this is done, Box 4 of Forms W-2 and W-2P need not be completed, so long as the applicable state taxing authority does not object.

.06 The preparation and filing instructions for Forms W-2 and W-2P are contained in the 1990 instructions for Forms W-2 and W-2P. The preparation and filing instructions for Form W-3 are contained as part of the 1990 Form W-3 snap set assembly.

.07 To avoid confusion and questions by payees, payers are encouraged to delete the following items from copies for Forms W-2 and W-2P provided to payees:

1 Form identifying number (e.g., 22222, 55555);

2 The words "subtotal" and "void" and their boxes;

3 Any other captions or box number that would not be of any informational use to payees.

.08 Payers are encouraged to use the IRS supplied labels on all Forms W-3 filed with SSA.

SEC. 3. OFFICE OF MANAGEMENT AND BUDGET (OMB) REQUIREMENTS FOR SUBSTITUTE FORMS

.01 Public Law 96-511 requires: (1) OMB approval of IRS tax forms, (2) that each form (all copies) show the OMB approval number and, when appropriate, the form's expiration date, and (3) that the form (or its instructions) state why IRS is collecting the information, how we will use it and whether it must be given to us. The official IRS form (or instructions) will contain this information.

.02 As it applies to substitute IRS forms, this means:

1. All substitute forms (all copies) must show the OMB number and any expiration date as they appear on the official IRS form (see Exhibits A, B, and C).

2. The OMB number must be in one of the following formats:

OMB No. 1545-0008 (preferred),
or
OMB #. 1545-0008

3. You must inform the users of your substitute forms of the reasons for IRS collection, use, and requirements, as stated in the instructions for the official IRS form.

SEC. 4. REPRODUCTION PROOFS

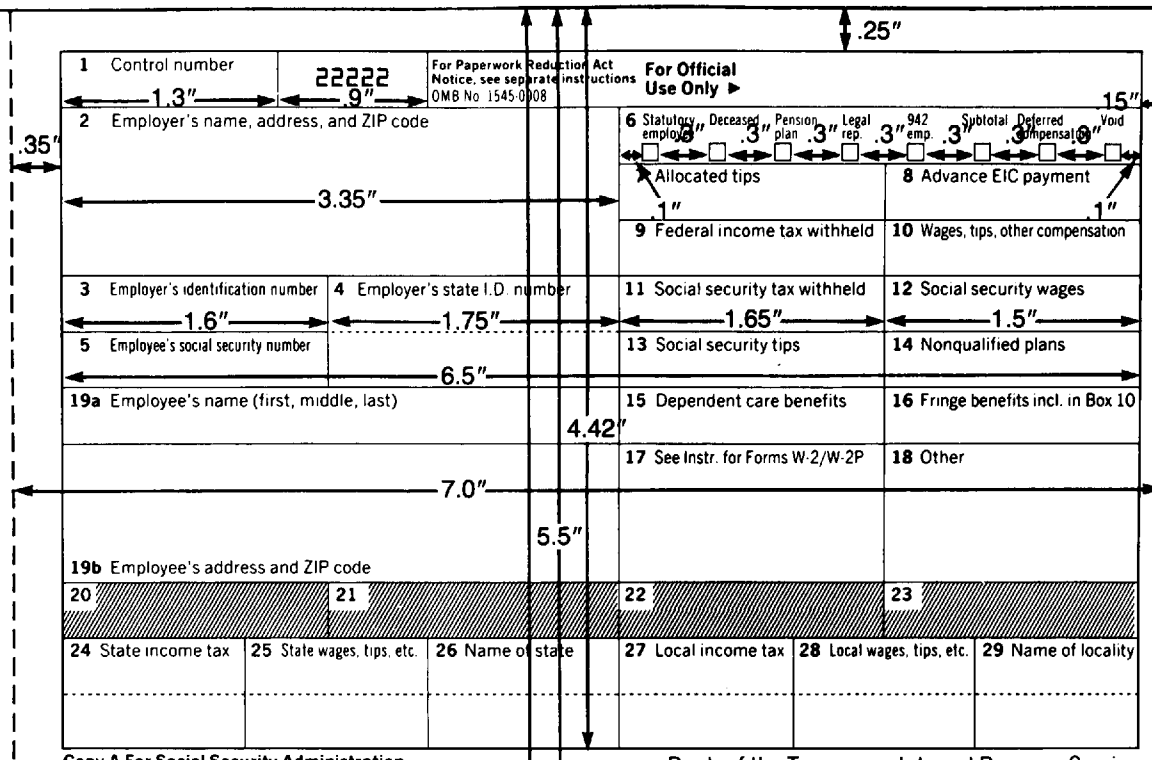
.01 Order blanks for reproductions proofs (repro-proofs) are mailed annually to requestors of record, and on request to other users. Reproduction copies of Forms W-2, W-2P, and W-3 each consist of two parts. Part 1 is line art, i.e., type and rule. Part 2 is a black solid that should be photographically screened by the user to allow a 10%-20% dot pattern when printed in red OCR dropout ink. In some cases, where the production method requires the use of something other than a standard dot pattern, the printed value of part 2 must still be 10%-20%. Printers and others wishing to obtain reproduction proofs should call the toll-free number and ask for Publication 1192, which has order blanks for obtaining reproduction proofs. Written requests for Publication 1192 may be sent to: Internal Revenue Service, Eastern Area Distribution Center, ATTN: Repro Coordinator, 4300 Carolina Ave, Richmond, VA 23222.

.02 Publication 1192 contains information and the individual costs for each reproduction copy. Payment must be submitted with each request.

SEC. 5 EFFECT ON OTHER REVENUE PROCEDURES

.01 Rev. Proc. 89-41, 1989-2 C.B. 454, is superseded.

Exhibit A Form W-2



Do NOT Cut or Separate Forms on This Page

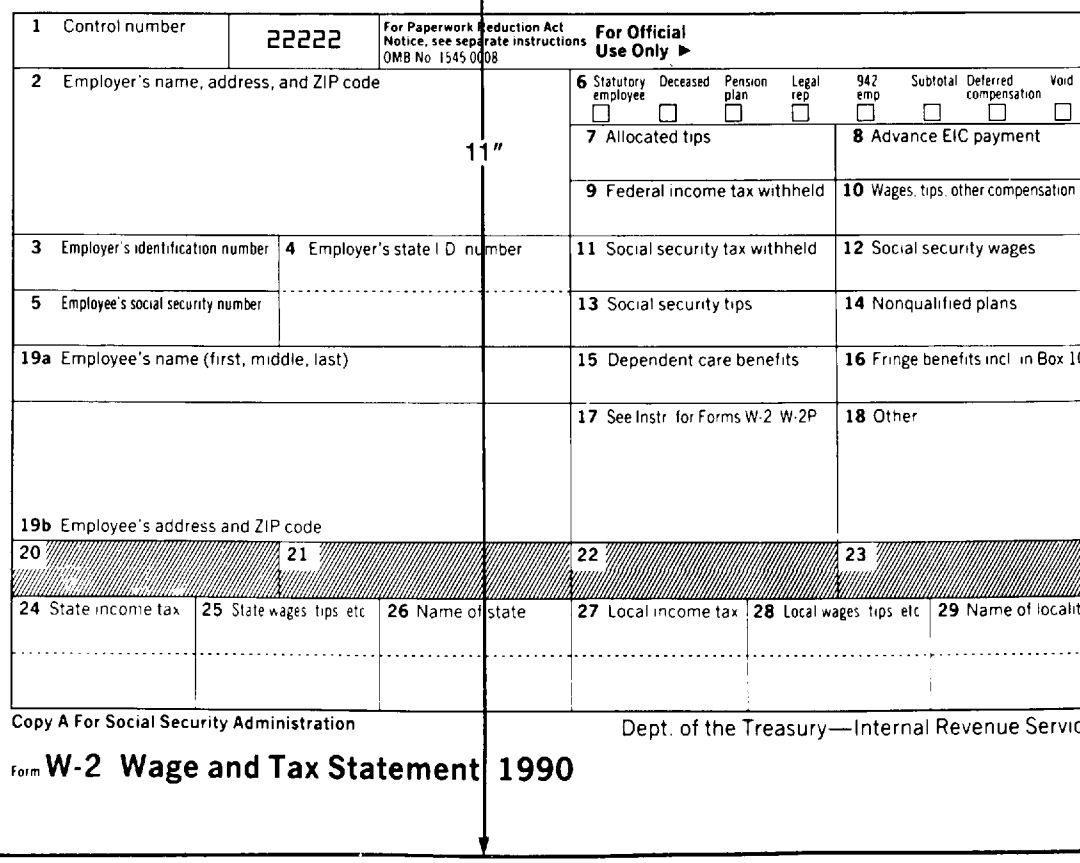
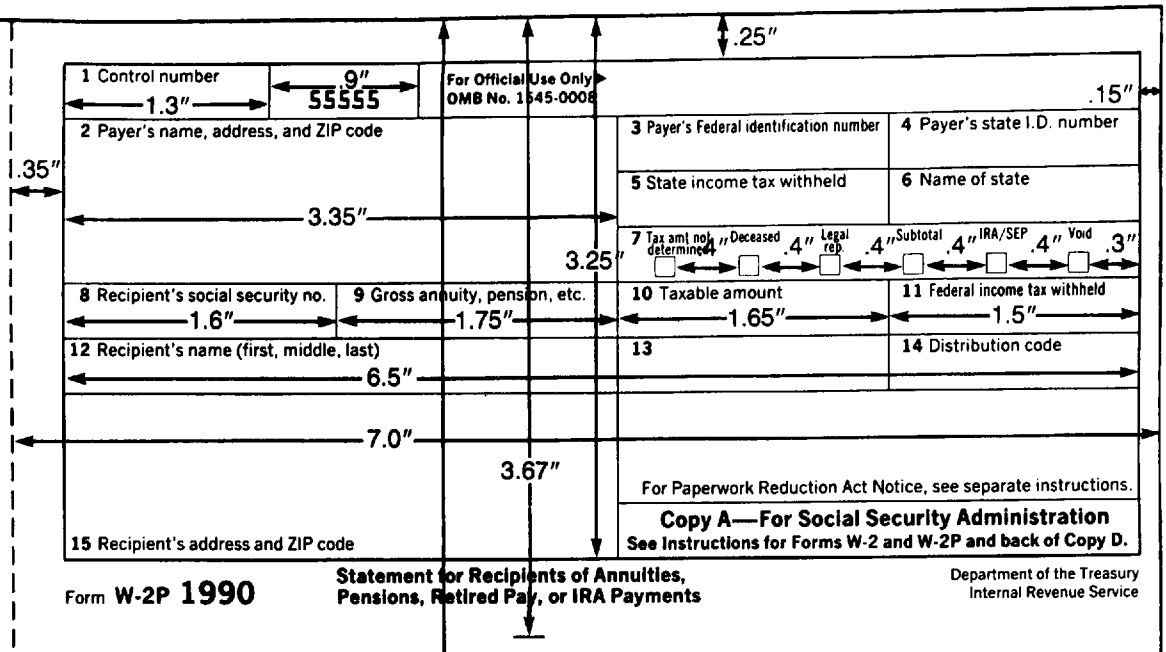
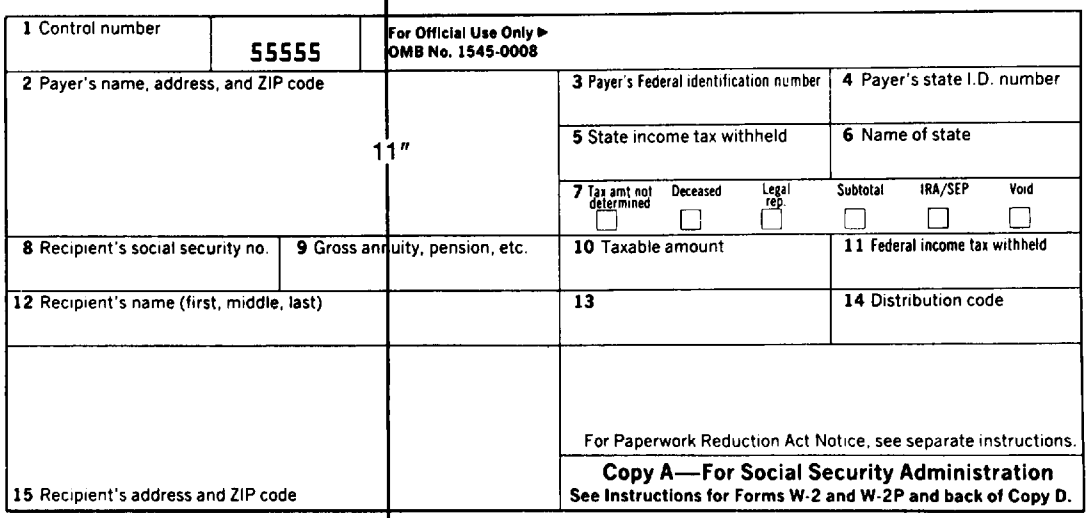


Exhibit B Form W-2P



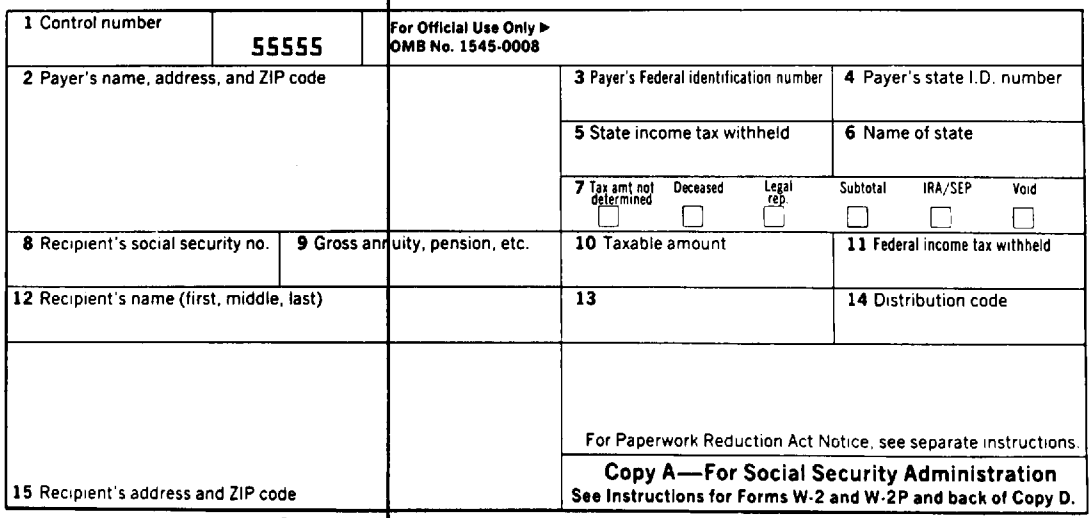
Form **W-2P 1990** **Statement for Recipients of Annuities, Pensions, Retired Pay, or IRA Payments**

Department of the Treasury
Internal Revenue Service



Form **W-2P 1990** **Statement for Recipients of Annuities, Pensions, Retired Pay, or IRA Payments**

Department of the Treasury
Internal Revenue Service



Form **W-2P 1990** **Statement for Recipients of Annuities, Pensions, Retired Pay, or IRA Payments**

Department of the Treasury
Internal Revenue Service

Exhibit C Form W-3

DO NOT STAPLE

~~a Control number~~ 1.3"	.9" 33333	For Official Use Only ▶ OMB No. 1545-0008	.15"
.3" ☐ ~~Kind~~ of Payer 1.7"	2 941/941E .4" Military .4" 943 ☐ CT-1 ☐ 942 ☐ Medicare gov't. emp.	3 Employer's state I.D. number	5 Total number of statements .8"
		4	
.35" 6 Establishment number	7 Allocated tips	8 Advance EIC payments	
9 Federal income tax withheld 1.75"	10 Wages, tips, and other compensation 2.4"	11 Social security tax withheld 2.35"	
12 Social security wages	13 Social security tips	14 Nonqualified plans	
15 Dependent care benefits	16 Adjusted total social security wages and tips	17 Deferred compensation	
18 Employer's identification number		19 Other EIN used this year	
20 Employer's name 4.15"		21 Gross annuity, pension, etc. (Form W-2P)	
6.5"		23 Taxable amount (Form W-2P)	
22 Employer's address and ZIP code (If available, place label over boxes 18 and 20.)		24 Income tax withheld by third-party payer	

.25"

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 ▶

Telephone number (optional) 7.0"

Form **W-3 Transmittal of Income and Tax Statements 1990**

Department of the Treasury Internal Revenue Service

Please return this entire page with the accompanying Forms W-2 or W-2P to the Social Security Administration address for your state as listed below. **Household employers filing Forms W-2 for household employees should send the forms to the Albuquerque Data Operations Center. Note:** Extra postage may be necessary if the report you send contains more than a few pages or if the envelope is larger than letter size. Do NOT order forms from the addresses listed below. You may order forms by calling 1-800-424-3676.

If your legal residence, principal place of business, office or agency is located in ▼	Use this address ▼
Alaska, Arizona, California, Colorado, Hawaii, Idaho, Iowa, Minnesota, Missouri, Montana, Nebraska, Nevada, North Dakota, Oregon, South Dakota, Utah, Washington, Wisconsin, Wyoming	Social Security Administration Salinas Data Operations Center Salinas, CA 93911
Alabama, Arkansas, Florida, Georgia, Illinois, Kansas, Louisiana, Mississippi, New Mexico, Oklahoma, South Carolina, Tennessee, Texas	Social Security Administration Albuquerque Data Operations Center Albuquerque, NM 87180
Connecticut, Delaware, District of Columbia, Indiana, Kentucky, Maine, Maryland, Massachusetts, Michigan, New Hampshire, New Jersey, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, Vermont, Virginia, West Virginia	Social Security Administration Wilkes-Barre Data Operations Center Wilkes-Barre, PA 18769
If you have no legal residence or principal place of business in any state	Social Security Administration Wilkes-Barre Data Operations Center Wilkes-Barre, PA 18769

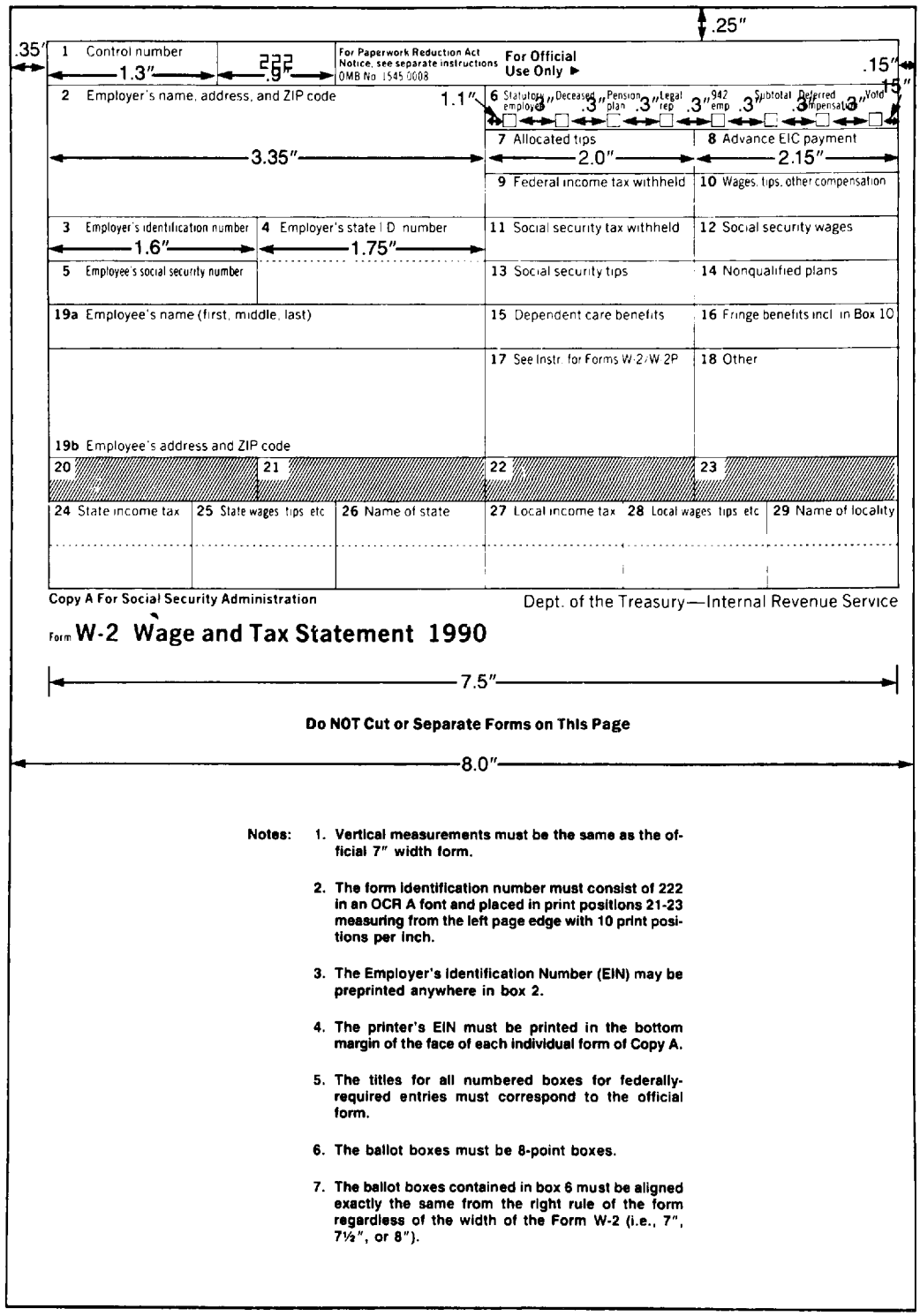
11"

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.

The time needed to complete and file this form will vary depending on individual circumstances.

The estimated average time is 26 minutes. If you have comments concerning the accuracy of this time estimate or suggestions for making this form more simple, we would be happy to hear from you. You can write to the **Internal Revenue Service,** Washington, DC 20224, Attention: IRS Reports Clearance Officer T:FP; or the **Office of Management and Budget,** Paperwork Reduction Project (1545-0008), Washington, DC 20503.

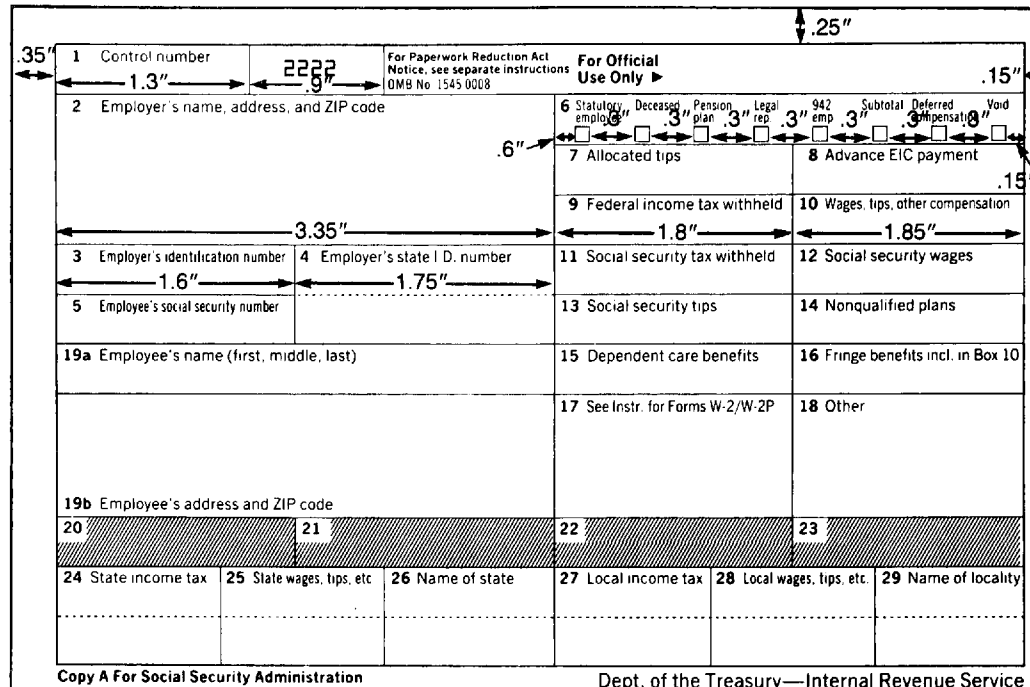
Exhibit D Form W-2 8″ Width



Notes:

1. **Vertical measurements must be the same as the official 7″ width form.**
2. **The form identification number must consist of 222 in an OCR A font and placed in print positions 21-23 measuring from the left page edge with 10 print positions per inch.**
3. **The Employer's Identification Number (EIN) may be preprinted anywhere in box 2.**
4. **The printer's EIN must be printed in the bottom margin of the face of each individual form of Copy A.**
5. **The titles for all numbered boxes for federally-required entries must correspond to the official form.**
6. **The ballot boxes must be 8-point boxes.**
7. **The ballot boxes contained in box 6 must be aligned exactly the same from the right rule of the form regardless of the width of the Form W-2 (i.e., 7″, 7½″, or 8″).**

Exhibit E Form W-2 7½" Width

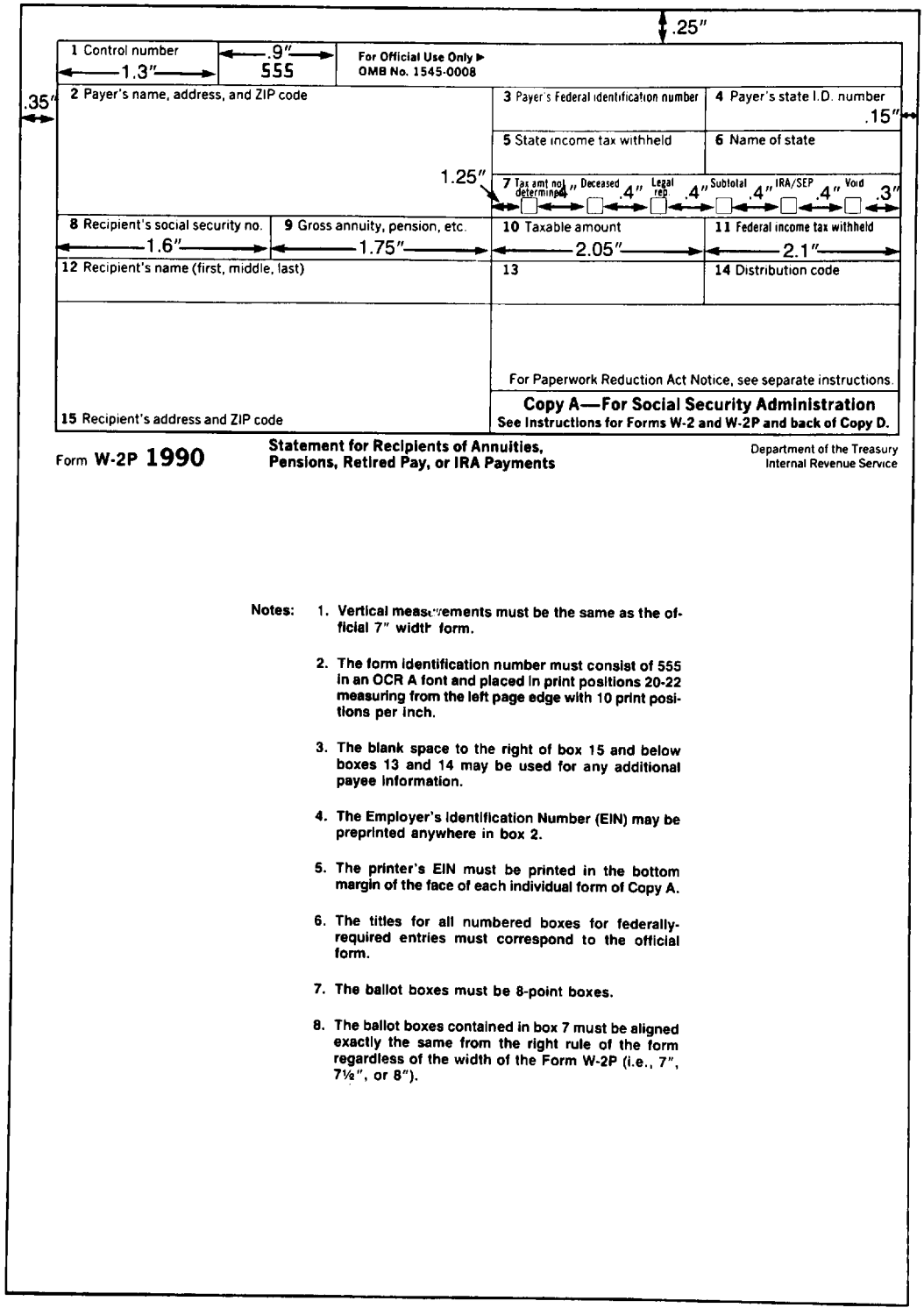


Do NOT Cut or Separate Forms on This Page

Notes:

1. **Vertical measurements must be the same as the official 7" width form.**
2. **The form identification number must consist of 2222 in an OCR A font and placed in print positions 20-23 measuring from the left page edge with 10 print positions per inch.**
3. **The Employer's Identification Number (EIN) may be preprinted anywhere in box 2.**
4. **The printer's EIN must be printed in the bottom margin of the face of each individual form of Copy A.**
5. **The titles for all numbered boxes for federally-required entries must correspond to the official form.**
6. **The ballot boxes must be 8-point boxes.**
7. **The ballot boxes contained in box 6 must be aligned exactly the same from the right rule of the form regardless of the width of the Form W-2 (i.e., 7", 7½", or 8").**

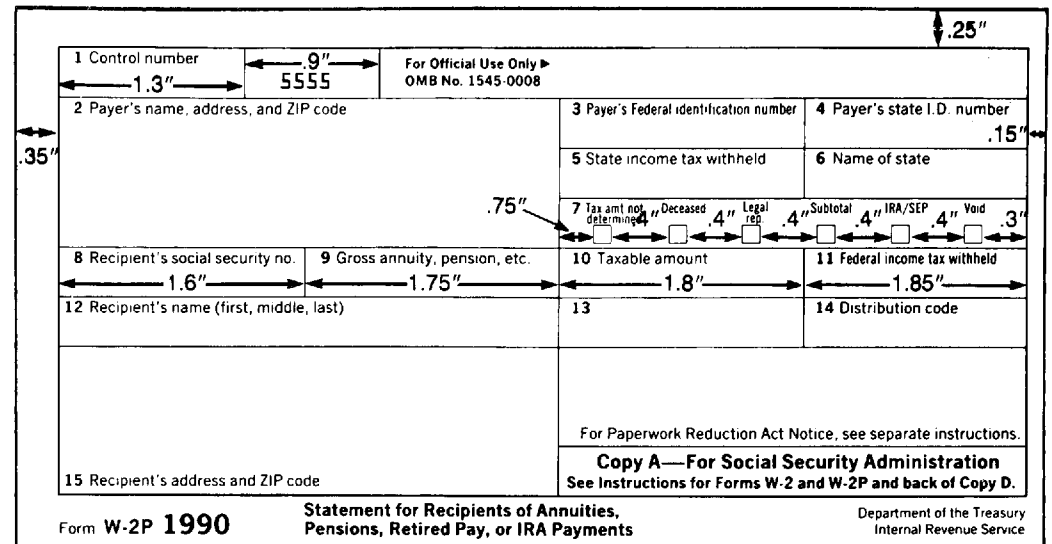
Exhibit F Form W-2P 8″ Width



Notes:

1. Vertical measurements must be the same as the official 7″ width form.
2. The form identification number must consist of 555 in an OCR A font and placed in print positions 20-22 measuring from the left page edge with 10 print positions per inch.
3. The blank space to the right of box 15 and below boxes 13 and 14 may be used for any additional payee information.
4. The Employer's Identification Number (EIN) may be preprinted anywhere in box 2.
5. The printer's EIN must be printed in the bottom margin of the face of each individual form of Copy A.
6. The titles for all numbered boxes for federally-required entries must correspond to the official form.
7. The ballot boxes must be 8-point boxes.
8. The ballot boxes contained in box 7 must be aligned exactly the same from the right rule of the form regardless of the width of the Form W-2P (i.e., 7″, 7½″, or 8″).

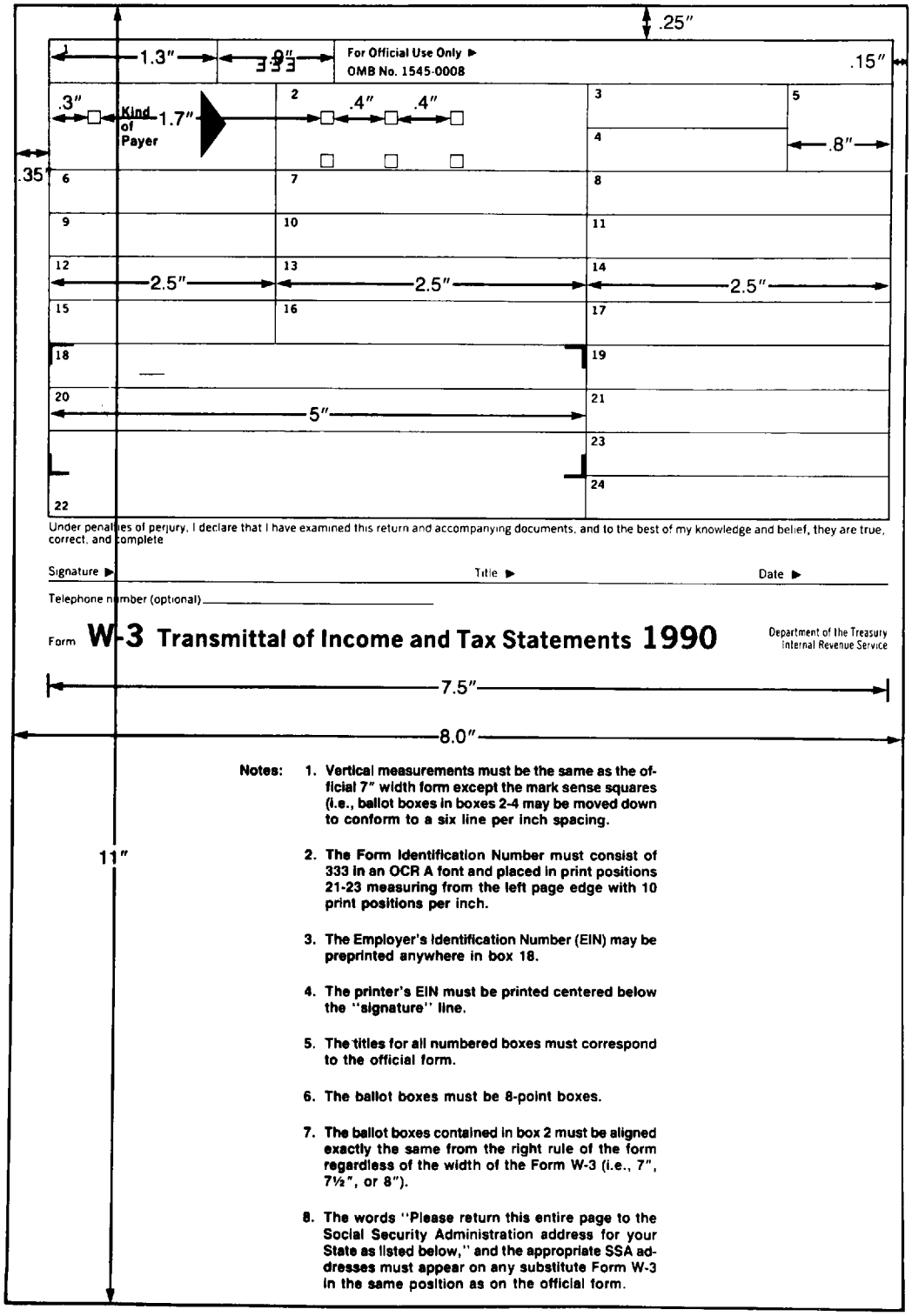
Exhibit G Form W-2P 7½" Width



Notes:

1. **Vertical measurements must be the same as the official 7" width form.**
2. **The form identification number must consist of 5555 in an OCR A font and placed in print positions 19-22 measuring from the left page edge with 10 print positions per inch.**
3. **The blank space to the right of box 15 and below boxes 13 and 14 may be used for any additional payee information.**
4. **The Employer's Identification Number (EIN) may be preprinted anywhere in box 2.**
5. **The printer's EIN must be printed in the bottom margin of the face of each individual form of Copy A.**
6. **The titles for all numbered boxes for federally-required entries must correspond to the official form.**
7. **The ballot boxes must be 8-point boxes.**
8. **The ballot boxes contained in box 7 must be aligned exactly the same from the right rule of the form regardless of the width of the Form W-2P (i.e., 7", 7½", or 8").**

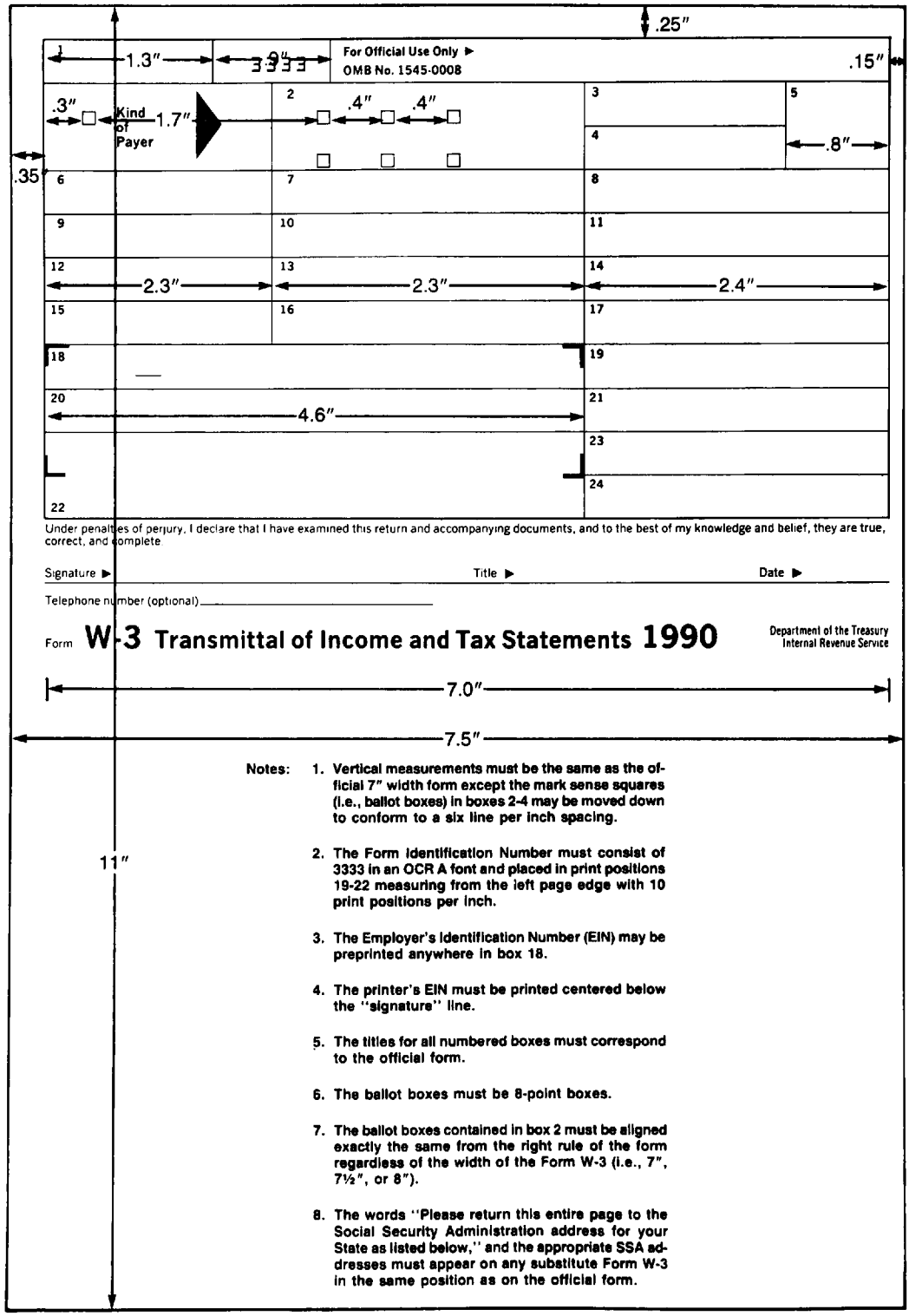
Exhibit H Form W-3 8" Width



Notes:

1. Vertical measurements must be the same as the official 7" width form except the mark sense squares (i.e., ballot boxes in boxes 2-4 may be moved down to conform to a six line per inch spacing.
2. The Form Identification Number must consist of 333 in an OCR A font and placed in print positions 21-23 measuring from the left page edge with 10 print positions per inch.
3. The Employer's Identification Number (EIN) may be preprinted anywhere in box 18.
4. The printer's EIN must be printed centered below the "signature" line.
5. The titles for all numbered boxes must correspond to the official form.
6. The ballot boxes must be 8-point boxes.
7. The ballot boxes contained in box 2 must be aligned exactly the same from the right rule of the form regardless of the width of the Form W-3 (i.e., 7", 7½", or 8").
8. The words "Please return this entire page to the Social Security Administration address for your State as listed below," and the appropriate SSA addresses must appear on any substitute Form W-3 in the same position as on the official form.

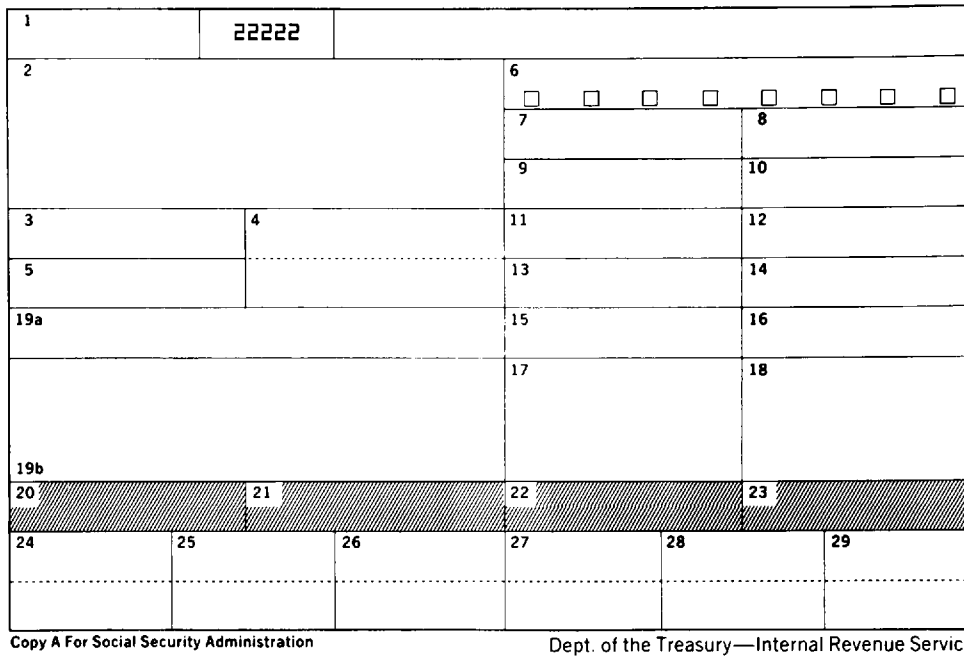
Exhibit I Form W-3 7½" Width



Notes:

1. Vertical measurements must be the same as the official 7" width form except the mark sense squares (i.e., ballot boxes) in boxes 2-4 may be moved down to conform to a six line per inch spacing.
2. The Form Identification Number must consist of 3333 in an OCR A font and placed in print positions 19-22 measuring from the left page edge with 10 print positions per inch.
3. The Employer's Identification Number (EIN) may be preprinted anywhere in box 18.
4. The printer's EIN must be printed centered below the "signature" line.
5. The titles for all numbered boxes must correspond to the official form.
6. The ballot boxes must be 8-point boxes.
7. The ballot boxes contained in box 2 must be aligned exactly the same from the right rule of the form regardless of the width of the Form W-3 (i.e., 7", 7½", or 8").
8. The words "Please return this entire page to the Social Security Administration address for your State as listed below," and the appropriate SSA addresses must appear on any substitute Form W-3 in the same position as on the official form.

Exhibit J Form W-2 Box Layout

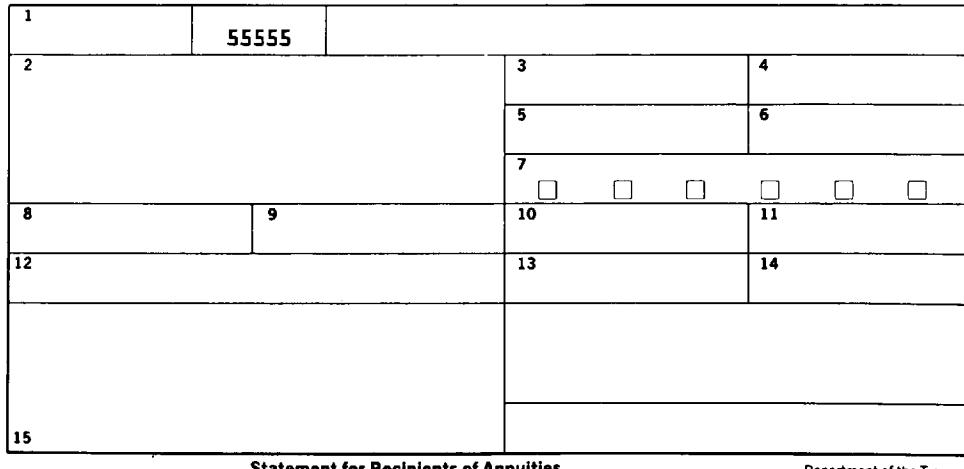


Copy A For Social Security Administration — Dept. of the Treasury—Internal Revenue Service

Form W-2 Wage and Tax Statement 1990

Do NOT Cut or Separate Forms on This Page

Exhibit K Form W-2P Box Layout



Form W-2P 1990 — **Statement for Recipients of Annuities, Pensions, Retired Pay, or IRA Payments** — Department of the Treasury Internal Revenue Service

Exhibit L Form W-3

1	33333		
☐ Kind of Payer	2 ☐ ☐ ☐ ☐ ☐ ☐	3 4	5
6	7	8	
9	10	11	
12	13	14	
15	16	17	
18		19	
20		21	
		23	
22		24	

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 ▶

Telephone number (optional)

Form W-3 Transmittal of Income and Tax Statements 1990

Department of the Treasury
Internal Revenue Service

Please return this entire page with the accompanying Forms W-2 or W-2P to the Social Security Administration address for your state as listed below. **Household employers filing Forms W-2 for household employees should send the forms to the Albuquerque Data Operations Center.** **Note:** Extra postage may be necessary if the report you send contains more than a few pages or if the envelope is larger than letter size. Do NOT order forms from the addresses listed below. You may order forms by calling 1-800-424-3676.

If your legal residence, principal place of business, office or agency is located in ▼	Use this address ▼
Alaska, Arizona, California, Colorado, Hawaii, Idaho, Iowa, Minnesota, Missouri, Montana, Nebraska, Nevada, North Dakota, Oregon, South Dakota, Utah, Washington, Wisconsin, Wyoming	Social Security Administration Salinas Data Operations Center Salinas, CA 93911
Alabama, Arkansas, Florida, Georgia, Illinois, Kansas, Louisiana, Mississippi, New Mexico, Oklahoma, South Carolina, Tennessee, Texas	Social Security Administration Albuquerque Data Operations Center Albuquerque, NM 87180
Connecticut, Delaware, District of Columbia, Indiana, Kentucky, Maine, Maryland, Massachusetts, Michigan, New Hampshire, New Jersey, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, Vermont, Virginia, West Virginia	Social Security Administration Wilkes-Barre Data Operations Center Wilkes-Barre, PA 18769
If you have no legal residence or principal place of business in any state	Social Security Administration Wilkes-Barre Data Operations Center Wilkes-Barre, PA 18769

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.

The time needed to complete and file this form will vary depending on individual circumstances.

The estimated average time is 26 minutes. If you have comments concerning the accuracy of this time estimate or suggestions for making this form more simple, we would be happy to hear from you. You can write to the **Internal Revenue Service,** Washington, DC 20224, Attention: IRS Reports Clearance Officer T:FP; or the **Office of Management and Budget,** Paperwork Reduction Project (1545-0008), Washington, DC 20503.

Exhibit M Forms W-2 and W-2P (Copy B)

1 Control number		OMB No 1545-0008			
2 Employer's name, address, and ZIP code			6 Statutory employee ☐ Deceased ☐ Pension plan ☐ Legal rep ☐ 942 emp. ☐ Subtotal ☐ Deferred compensation ☐ Void ☐		
			7 Allocated tips	8 Advance EIC payment	
			9 Federal income tax withheld	10 Wages, tips, other compensation	
3 Employer's identification number	4 Employer's state I.D. number		11 Social security tax withheld	12 Social security wages	
5 Employee's social security number			13 Social security tips	14 Nonqualified plans	
19 Employee's name, address and ZIP code			15 Dependent care benefits	16 Fringe benefits incl. in Box 10	
			17	18 Other	
20	21		22	23	
24 State income tax	25 State wages, tips, etc.	26 Name of state	27 Local income tax	28 Local wages, tips, etc.	29 Name of locality

Copy B To be filed with employee's FEDERAL tax return

Dept. of the Treasury—Internal Revenue Service

Form **W-2 Wage and Tax Statement 1990**

1 Control number		OMB No. 1545-0008		
2 Payer's name, address, and ZIP code			3 Payer's Federal identification number	4 Payer's state I.D. number
			5 State income tax withheld	6 Name of state
			7 Tax amt not determined ☐ Deceased ☐ Legal rep ☐ Subtotal ☐ IRA/SEP ☐ Void ☐	
8 Recipient's social security no.	9 Gross annuity, pension, etc.		10 Taxable amount	11 Federal income tax withheld
12 Recipient's name, address, and ZIP code			13	14 Distribution code
			Copy B—File with recipient's FEDERAL tax return This information is being furnished to the Internal Revenue Service.	

Form **W-2P 1990** **Statement for Recipients of Annuities, Pensions, Retired Pay, or IRA Payments**

Department of the Treasury
Internal Revenue Service

26 CFR 601.201: Rulings and determination letters.

Rev. Proc. 90-49

SECTION 1. PURPOSE AND SCOPE

.01 The purpose of this revenue procedure is to modify and replace Rev. Proc. 89-35, 1989-1 C.B. 917, in order to extend the effective date to contributions made for plan years beginning after December 31, 1989, to change the deadline for requesting rulings under the revenue procedure, to revise the information requirements for a ruling request made under the revenue procedure, to furnish a worksheet for actuarial computations, and to provide a special rule under which certain *de minimis* nondeductible employer contributions to a qualified defined benefit plan may be returned to the taxpayer without a formal ruling or disallowance from the Service.

.02 This revenue procedure applies to employer contributions to a qualified defined benefit pension plan that are made to satisfy the quarterly contributions requirement of section 412(m) of the Code for the plan years beginning after December 31, 1989 (see section 5).

.03 In general, contributions to which this revenue procedure apply must be effectively disallowed by obtaining a ruling letter, as described in section 3.06 of this revenue procedure, before the nondeductible contributions may be returned to the employer. However, there is an exception for contributions described in section 4.

SEC. 2. BACKGROUND INFORMATION

.01 Section 401(a)(2) of the Internal Revenue Code generally requires a trust forming part of a pension, profit-sharing, or stock bonus plan to prohibit the diversion of corpus or income for purposes other than the exclusive benefit of the employees or their beneficiaries.

.02 Section 412(m) of the Code provides that for plan years beginning after December 31, 1988, quarterly estimated contributions must be made to any plan (other than a multiemployer plan) that is subject to the minimum funding requirements of section 412.

.03 Section 4972 of the Code provides that a 10 percent tax is to be imposed on nondeductible plan contributions. However, the section 4972 tax does not apply to the extent that contributions are returned to the taxpayer no later than the time prescribed by law for filing the tax return for such taxable year (including extensions filed for and granted).

.04 In Rev. Rul. 77-200, 1977-1 C.B. 98, the Service held that plan language providing for the return of employer contributions under certain limited circumstances may be included in a plan intended to qualify under the Internal Revenue Code. One of those circumstances addresses situations in which the employer contribution is conditioned on its deductibility under section 404 of the Code and the deduction is disallowed by the Secretary of the Treasury. Under Rev. Rul. 77-200, the return to the employer must take place within one year from the date of disallowance of the deduction.

.05 Rev. Proc. 90-4, 1990-1 C.B. 410, sets forth the general procedures of the Service relating to the issuance of rulings, determination letters, opinion letters, and notification letters on employee plans and exempt organization matters.

.06 Rev. Proc. 90-17, 1990-1 C.B. 479, sets forth the procedures relating to the payment of user fees for requests to the Service for rulings, opinion letters , determination letters, and similar requests. (The user fee for a request under this revenue procedure is $100 pursuant to section 6.03 of Rev. Proc. 90-17.)

.07 Notice 89-52, 1989-1 C.B. 692, provides guidance with respect to the quarterly estimated payments required by section 412(m).

.08 Rev. Proc. 89-35, 1989-1 C.B. 917, sets forth a procedure by which a plan administrator or plan sponsor of a qualified defined benefit pension plan may under certain circumstances satisfy the requirement that a deduction under section 404 of the Code be disallowed by the Secretary of the Treasury, thereby fulfilling a condition under which nondeductible contributions made for the plan year beginning in 1988 or made to satisfy the quarterly contributions requirement of section 412(m) of the Code for the first plan year beginning after December 31, 1988, may revert to the employer without adversely affecting the plan's qualified status. Rev. Proc. 89-35 did not apply to plan years commencing after December 31, 1989.

SEC. 3. REQUESTS FOR RULING LETTERS TO DISALLOW THE DEDUCTIBILITY OF A CONTRIBUTION

.01 Who May Submit—Only a plan administrator (within the meaning of section 414(g) of the Code), plan sponsor, or the authorized representative of either may make a request for a determination that the employer contribution to which this revenue procedure applies would be nondeductible if claimed as a deduction for purposes of determining whether such contribution may be returned to the employer in accordance with Rev. Rul. 77-200 without adversely affecting the qualified status of the plan.

.02 Where To Submit—Such requests with the appropriate user fee for a ruling pursuant to Rev. Proc. 90-17 shall be submitted to the Internal Revenue Service; Assistant Commissioner (Employee Plans and Exempt Organizations); Attention: E:EP:PA, P.O. Box 14073, Ben Franklin Station; Washington, DC 20044. The request must be made no later than the later of (1) 2 1/2 months after the close of, or (2) 6 months after the valuation date which has or will be reported on the Schedule B of Form 5500 for, the plan year for which the disallowance of the deductibility of the employer contribution is requested.

.03 Procedural Rules—The request must satisfy all of the requirements of Rev. Proc. 90-4, 1990-1 C.B. 410, including deletion instructions in compliance with section 6110 of the Code. Also, attention is called to section 8.02 of Rev. Proc. 90-4 which provides that a request for a ruling must contain a declaration in the following form: "Under the penalties of perjury, I declare that I have examined this request, including accompanying documents, and to the best of my knowledge and belief, the facts presented in support of the request are true, correct, and complete." This declaration must be signed by the taxpayer (e.g., an au-

thorized officer of a corporation). The signature of an individual with a power of attorney will not suffice for the declaration.

.04 Information Required—In addition to any information required by Rev. Proc. 90-4, the following information shall accompany the request:

(1) The location of the office of the District Director of Internal Revenue having jurisdiction over the plan, the employer identification number, the plan name and number, and the name and address of the plan administrator or plan sponsor.

(2) A copy of the last actuarial valuation report, and a copy of the last Schedule B of Form 5500, including attachments thereto, that has been filed with the Internal Revenue Service.

(3) The plan year for which the request is made (e.g., January 1, 1990 - December 31, 1990).

(4) A list of the employer contributions actually paid in each month, from the twelfth month prior to the beginning of the plan year for which the disallowance is requested through the date of the request and the plan year to which the contributions were applied.

(5) A worksheet, signed by the enrolled actuary for the plan, following the format of the worksheet included as Appendix II of this revenue procedure. This worksheet includes the calculation of the full funding limitation, the amount of the reversion due to the employer as a result of the disallowance of the deduction of the employer contribution, and a certification by the enrolled actuary attesting to the accuracy of this information. The maximum amount which may be returned to the employer is the excess of (1) the amount contributed over (2) the amount that would have been contributed had the contribution been limited to the amount that is deductible. Earnings attributable to the excess contribution may not be returned to the employer, but losses attributable thereto must reduce the amount to be so returned.

(6) A copy of the current plan document, and a reference to the appropriate section in the plan document which permits the return of employer contributions.

(7) Documentation must be provided that employer contributions are conditioned on deductibility. A copy of a board resolution will suffice for such documentation as will plan language providing that employer contributions are conditioned on deductibility.

(8) A statement as to whether the contributions for which a disallowance is being requested have been deducted on any tax return of the employer.

.05 Within 90 days from the receipt of a complete request, the National Office will either contact the applicant to obtain more information or will issue a form letter approving the request.

.06 The Service may request additional information as needed.

.07 Approval Letter.

(1) If the request described in section 3.01 is approved, a form letter will be issued. A copy of this approval letter must be attached to the Schedule B of the Form 5500 that is filed for the plan year for which the disallowance is effective (see Appendix I—Form Letter). The form letter will contain the caveat that the Service has considered the disallowance of employer contributions solely for the purpose of applying Rev. Rul. 77-200.

(2) The National Office will send a copy of the form letter to the Key District Director having jurisdiction over the plan.

.08 If the request for the disallowance of a nondeductible employer contribution is approved under this revenue procedure, and if the contribution in question is returned to the employer before the Schedule B for the plan year in which the contribution was made is filed, the contribution is not reported on the Schedule B. If the nondeductible contribution is returned to the employer after the Schedule B for the plan year in question is filed, the contribution must be reported and credited under section 412 of the Code on that Schedule B. However, the nondeductible contribution for which the funding standard account was credited under section 412 creates an offsetting charge to the funding standard account on the Schedule B for the year in which the nondeductible contribution is returned.

SEC. 4. SPECIAL RULES FOR DE MINIMIS NONDEDUCTIBLE CONTRIBUTIONS

.01 Employer contributions to a qualified defined benefit plan that are conditioned on deductibility may be treated as disallowed by the Secretary of the Treasury if they are treated as *de minimis* under section 4.02 and if the conditions on actuarial certification under section 4.03 are satisfied. This treatment is solely for the purpose of applying Rev. Rul. 77-200 to allow the return of the nondeductible contribution to the employer.

.02 A nondeductible contribution is not considered *de minimis* unless the requirements listed below are satisfied.

(1) The amount of the nondeductible contributions is less than $25,000.

(2) The terms of the plan must specifically allow for the return of contributions to the employer if they are determined by the Service to be nondeductible.

(3) Prior to, or concurrent with, the date when the nondeductible contribution is made to the plan, the contribution is specifically conditioned on deductibility in writing either (i) in the plan or (ii) in the plan in combination with a certified corporate board resolution. A contribution is not treated as specifically conditioned on deductibility unless the plan language or board resolution conditioning the contributions explicitly states that the contributions in question *are* conditioned on deductibility. For example, plan language stating that nondeductible contributions *must* or *shall* be returned to the employer meets requirement (3)(i). However, plan language stating that nondeductible contributions *may* be returned to the employer must be combined *with* a board resolution that specifically conditions the contributions on deductibility to meet requirement (3)(ii).

.03 A contribution may not be returned to the taxpayer unless the actuarial certification requirements of this section are satisfied. An actuarial certification that a return of the nondeductible contribution is appropriate must be signed by the enrolled actuary for the plan. This actuarial certification must follow the form of the actuarial worksheet set forth in section 3.04(5) and included in Appendix II of this revenue procedure. The

return of the nondeductible contribution must be made no later than one year from the date of the certification. If not returned by the employer's tax filing date, including extensions filed for and granted, the tax under section 4972 of the Code would apply.

.04 A copy of this actuarial certification, as well as a copy of the applicable plan language or board resolution, must be attached to the Schedule B of the Form 5500 that is filed for the plan year in which the nondeductible contribution was made. The employer who receives the return of contributions must also attach a certification to the Schedule B. The employer must certify that the contributions which are being returned have not been deducted on a tax return of the employer or, if deducted, an amended return has been filed.

.05 Plan sponsors, plan administrators, and plan trustees who make use of this *de minimis* rule are cautioned that the requirement that the contributions have been conditioned (at or prior to the time they were made) on deductibility must be satisfied. Thus, for example, plan contributions must be expressly conditioned on deductibility at the time made, unless the terms of the plan specify that all contributions are conditioned on deductibility. A return of contributions that were not properly conditioned on deductibility will result in the loss of plan qualification under section 401 of the Code.

SEC. 5. EFFECTIVE DATE

This revenue procedure is effective for contributions made to satisfy the quarterly installments requirement for a plan year commencing on or after January 1, 1990.

SEC. 6. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 89-35 is superseded.

APPENDIX I—FORM LETTER

Significant Index No. 0404.00-00

In re: Plan Name
(Plan No. ____)
EIN:

Dear _____ :

This letter is in response to your request with respect to the above-referenced defined benefit pension plan pursuant to Revenue Procedure 90-49 for the plan year commencing _____ .

Rev. Proc. 90-49 sets forth the procedure whereby, under certain circumstances, a disallowance of the deduction of employer contributions to a qualified defined benefit pension plan may be obtained; thereby, fulfilling a condition under which such contributions could revert to the employer.

Based upon the information submitted, we have determined that contributions amounting to $ _____ , which were made for the plan year commencing _____ , may be considered as disallowed solely for the purpose of applying Rev. Rul. 77-200. Therefore, the return of contributions not exceeding $ _____ would not adversely affect the qualified status of the plan, provided this reversion occurs no later than one year from the date of this letter. (However, if it is not returned by your tax filing date, including extensions filed for and granted, the tax under section 4972 would apply.) In granting this approval, we are not expressing any opinion as to the accuracy or acceptability of any calculations or other material submitted with your request.

When filing Form 5500 for the plan year commencing _____ , a copy of this letter must be attached to the Schedule B (Actuarial Information). A copy of this letter should be furnished to the enrolled actuary for the plan. We have sent a copy to the Key District Director in _____ .

Sincerely yours,

James E. Holland, Jr.
Chief, Pension Actuarial Branch

APPENDIX II—ACTUARIAL CERTIFICATION

Section 1. *Full Funding Limitation Calculation*

Valuation Date: _____

I. Full Funding Limitation without regard to current liability

1. Accrued Liability: _____
2. Normal Cost as of _____ : _____
3. Applicable interest on (1) & (2) to end of year at valuation interest rate of ____ %: _____
4. (1) + (2) + (3): _____
5. Plan Assets: _____
6. Applicable interest on (5) to end of year at valuation interest rate of ____ %: _____
7. (5) + (6): _____
8. Full Funding Limitation ((4)-(7)): _____

II. Current Liability Full Funding Limitation

9. Current Liability (including present value of benefit accruing during the current year): _____
10. Applicable interest on (9) to end of year at current liability interest rate of ____%: _____
11. Expected payments during current year: _____
12. Applicable interest on (11) to end of year at current liability interest rate of ____ %: _____
13. (9) + (10)-(11)-(12): _____
14. 150% of (13): _____
15. Applicable interest on (11) to end of year at valuation interest rate of ____ %: _____
16. (7)-(11)-(15): _____
17. Current Liability Full Funding Limitation ((14)-(16)): _____

III. OBRA 1987 Full Funding Limitation: (lesser of (8) or (17), but not less than zero) _____

Section 2. *Amount of Reversion to Employer*

Plan Year Commencing: _____

1. Employer Contributions: _____
2. OBRA 1987 Full Funding Limitation: _____
3. Amount of Reversion due to Employer: _____

Section 3. *Actuarial Certification*

To the best of my knowledge and belief, the information supplied on this worksheet is true, correct and complete.
Signature: _____
Enrollment Number: _____
Date: _____

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26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.
(Also Part I, Section 936; 1.936-7.)

Rev. Proc. 90-50

SECTION 1. PURPOSE

This revenue procedure sets forth procedures under which a taxpayer who has elected the cost sharing method under section 936(h)(5)(C)(i) of the Internal Revenue Code may change to the profit split method permitted under section 936(h)(5)(C)-(ii) of the Code or the method permitted under section 936(h)(1) through (h)(4) for years to which the amendments made to section 936 by section 1231(a)(1) of the Tax Reform Act of 1986 (Act), 1986-3 C.B. (Vol. 1) 478, apply.

SEC. 2. BACKGROUND

Section 1231(a)(1) of the Act amended section 936(h)(5)(C)(i)(I) of the Code to increase the amount of the cost sharing payment to the greater of (1) 110 percent of the cost of product area research multiplied by the amount which possession sales of the product bears to the total sales of the affiliated group of all products in the product area; or (2) the inclusion or payment which would be required under section 367(d)(2)(A)(ii) or section 482 if the section 936 corporation were a foreign corporation. In view of the changes made by section 1231(a)(1) of the Act, Notice 87-27, 1987-1 C.B. 471, Notice 88-97, 1988-2 C.B. 421, and Notice 89-82, 1989-2 C.B. 402, permitted taxpayers who had elected cost sharing for a taxable year beginning before January 1, 1987, to change to the profit split method or the method permitted under section 936(h)(1) through (h)(4) for years to which the changes made to section 936 by the Act apply. Rev. Proc. 89-61, 1989-2 C.B. 782, amplified Notices 87-27, 88-97, and 89-82, by permitting not only taxpayers who have made a cost sharing election for taxable years beginning prior to January 1, 1987, to change their cost sharing election, but also taxpayers who have made a cost sharing election for a taxable year beginning after December 31, 1986.

SEC. 3. PROCEDURE FOR CHANGING METHOD OF ELECTION UNDER SECTION 936(h)

A taxpayer who has elected the cost sharing method under section 936(h)(5)(C)(i) of the Code for taxable years beginning before January 1, 1987, may elect to change to the profit split method under section 936(h)(5)(C)(ii) or to the method under section 936(h)(1) through (h)(4) on an amended return for the possessions corporation's first taxable year beginning after December 31, 1986, if such amended return is filed not later than the due date (including extensions) for the possessions corporation's tax return for its fourth taxable year beginning after December 31, 1986. In the case of cost sharing elections made for a taxable year beginning on or after January 1, 1987, the amended return must be filed no later than the due date (including extensions) for the possessions corporation's tax return for its last taxable year beginning before January 1, 1991. The change will apply to the first applicable taxable year beginning after December 31, 1986, and all subsequent taxable years. The change can only be made if the provisions of section 4 of this revenue procedure relating to the waiver of the statute of limitations are satisfied. Except as amended by this revenue procedure, the conditions prescribed by Notice 87-27 for changing the election continue to apply.

SEC. 4. WAIVER OF STATUTE OF LIMITATIONS

.01 No change of method of election described in section 3 of this revenue procedure may be made unless, at the time the change of method of election is made, the statute of limitations on assessment for the taxable years subject to such change of the persons described in section 4.02 of this revenue procedure will expire no earlier than two years from the time such change of method of election is made. Any extension of the statute of limitations necessary under section 6501(c)(4) of the Code must cover all issues arising under section 936 and related or correlative items. If the requirements of this section are not satisfied, then no change of method of election can be made for any taxable year beginning after December 31, 1986, without the consent of the Commissioner. Any subsequent action by the taxpayer to shorten the statute of limitations specified in this section may, in the discretion of the Commissioner, result in the invalidation of the change of method of election for all applicable years.

.02 The persons described in this section are (a) the possessions corporation(s); (b) the appropriate affiliate(s) determined under section 1.936-6(a)(5), Q&A 1, of the Income Tax Regulations; (c) in the case of a change to the profit split method under section 936(h)(5)(C)(ii) of the Code, the appropriate affiliate(s) determined under section 1.936-6(b)(1), Q&A 13, of the regulations; and (d) in the case of a change to the method under sections 936(h)(1) through (h)(4), the U.S. shareholders described in section 1.936-4, Q&A 1. Where the appropriate affiliate(s) or U.S. shareholder is a member of an affiliated group that files a consolidated return, see section 1.1502-77.

SEC. 5. COMMENTS OR INQUIRIES

Comments or inquiries regarding this revenue procedure should be addressed to the Associate Chief Counsel (International), Attention CC:INTL:Br2, Internal Revenue Service, 1111 Constitution Ave., N.W., Washington, D.C. 20224

SEC. 6. EFFECT ON OTHER DOCUMENTS

This revenue procedure modifies Notices 87-27, 88-97, 89-82, and Rev. Proc. 89-61.

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26 CFR 601.201: Rulings and determination letters.
(Also Part I, Sections 25, 103, 143; 1.25-3T, 1.103-1, 6a.103A-2.)

Rev. Proc. 90-51

SECTION 1. PURPOSE

This revenue procedure adds average area purchase price safe harbor limitations for Guam and Puerto Rico to Rev. Proc. 89-59, 1989-2 C.B. 771, as modified by Rev. Proc. 90-24, 1990-1 C.B. 510.

SEC. 2. BACKGROUND

.01 Issuers of qualified mortgage bonds, as defined in section 143(a) of the Internal Revenue Code, and mortgage credit certificates, as defined in section 25(c), must satisfy several requirements if the interest on the bonds is to be excludable from gross income under section 103(a) or the credit attributable to the certificates is to be allowable against federal income tax. One of the requirements is that the cost of each residence financed must not exceed a certain percentage of the average area purchase price applicable to the residence. The average area purchase price with respect to any residence is the average purchase price of single-family residences in the statistical area in which the residence is located that were purchased during the most recent 12-month period for which sufficient statistical information is available.

.02 Prior to the enactment of the Tax Reform Act of 1986 (1986 Act), section 1301, 1986-3 (Vol. 1) C.B. 519, former section 103A(f) of the Code provided that the acquisition cost of each residence could not exceed 110 percent (120 percent for a targeted area residence) of the average area purchase price. The 1986 Act repealed section 103A(f) and replaced it with section 143(e), which provides that the acquisition cost can not exceed 90 percent (110 percent for a targeted area residence) of the average area purchase price. The 1986 Act generally is effective with respect to bonds issued after August 15, 1986. The Revenue Reconciliation Act of 1989, section 7104(a)-(b), 1990-1 C.B. 210, 216, extended the qualified mortgage bond provisions to bonds issued through September 30, 1990, and extended the mortgage credit certificate provisions for elections made for periods through that date.

.03 Current average area purchase price safe harbor limitations for the states and the District of Columbia are contained in Rev. Proc. 89-59. Safe harbor limitations for the most recent prior periods were set forth in Rev. Proc. 88-48, 1988-2 C.B. 635, *obsoleting* Rev. Proc. 87-20, 1987-1 C.B. 713, *obsoleting* Rev. Proc. 85-42, 1985-2 C.B. 496.

.04 Prior to the present revenue procedure, average area purchase

price safe harbor limitations for Guam and Puerto Rico were set forth in Rev. Proc. 89-27, 1989-1 C.B. 892, which supplemented Rev. Proc. 88-48.

.05 The average area purchase price safe harbor limitations for the Commonwealth of the Northern Mariana Islands were published in Rev. Proc. 87-19, 1987-1 C.B. 712, which supplemented Rev. Proc. 85-42.

SEC. 3. APPLICATION

The average area purchase price safe harbor limitations for Guam and Puerto Rico are set forth in Table 1. These limitations have not been adjusted to reflect either the 90 percent of the average area purchase price described in section 143(e)(1) of the Code or the 110 percent of the average area purchase price described in section 143(e)(5).

Rev. Proc. 90-51, Table 1

STATE AND AREA DESIGNATION	*AVERAGE AREA PURCHASE PRICE SAFE HARBOR LIMITATIONS FOR SINGLE-FAMILY RESIDENCES*	
	NEW	*EXISTING*
Guam		
All Areas	$66,000	$66,000
Puerto Rico		
All Areas	$55,800	$55,800

SEC. 4. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 89-59 is supplemented. The safe harbor limitations for Guam and Puerto Rico, as added to Rev. Proc. 88-48 by Rev. Proc. 89-27, are obsolete except as provided in section 5.02 of this revenue procedure.

SEC. 5. EFFECTIVE DATES

.01 The average area purchase price safe harbor limitations contained in this revenue procedure must be used to compute the housing cost/income ratio under section 143(f)(5) of the Code and to satisfy the purchase price requirement under section 143(e) for commitments to provide financing that are made, or (if the purchase precedes the financing commitment) for residences that are purchased, in the period specified in the following sentence. The period begins on October 9, 1990, the date of publication of this revenue procedure in the Internal Revenue Bulletin, and ends on the date as of which these average area purchase price safe harbor limitations are rendered obsolete by a new revenue procedure. If an issuer computes different average area purchase price limitations for Guam or Puerto Rico based on more accurate and comprehensive data for the purpose of computing the housing cost/income ratio, the issuer must use data from a 12-month period that does not begin earlier than July 1, 1988, or end later than June 30, 1990.

.02 Issuers of qualified mortgage bonds and mortgage credit certificates in Guam and Puerto Rico may continue to rely on the average area purchase price safe harbor limitations added to Rev. Proc. 88-48 by Rev. Proc. 89-27 with respect to bonds sold (and bond authority exchanged for authority to issue mortgage credit certificates) before November 8, 1990, 30 days after publication of this revenue procedure in the Internal Revenue Bulletin, if the commitments to provide financing for mortgages and the commitments to issue the certificates are made before January 7, 1991, 90 days after publication of this revenue procedure in the Internal Revenue Bulletin.

.03 Issuers of qualified mortgage bonds and mortgage credit certificates in the Commonwealth of the Northern Mariana Islands may continue to rely on the average area purchase price safe harbor limitations added to Rev. Proc. 85-42 by Rev. Proc. 87-19.

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26 CFR 601.201: Rulings and determination letters.
(Also Part I, Section 332; 1.332-1.)

Rev. Proc. 90-52

SECTION 332
CHECKLIST QUESTIONNAIRE

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PART I—PROCEDURES

SECTION 1. PURPOSE

The purpose of this revenue procedure is to set forth in a checklist questionnaire the information that must be included in a request for a ruling under section 332 of the Internal Revenue Code relating to complete liquidations of controlled subsidiary corporations. This revenue procedure updates and supersedes Rev. Proc. 81-68, 1981-2 C.B. 723.

SEC. 2. BACKGROUND

Problems from incomplete ruling requests

.01 The Internal Revenue Service receives many requests for rulings in which the information relating to the proposed transaction is not sufficient to permit a determination to be made. In those cases, it is necessary to obtain additional information from the taxpayer before the request for a letter ruling can be considered. Obtaining this additional information is time consuming for both Service personnel and taxpayers, delays issuance of the ruling letter, and may result in the taxpayer being required to pay an additional user fee. See Rev. Proc. 90-1, 1990-1 C.B. 356, section 3.18.

Checklist to facilitate a complete submission

.02 This checklist will facilitate the filing and processing of requests for rulings under section 332 of the Code by specifying information and representations to be included so that the requests will be as complete as possible when initially filed.

Additional information may be required

.03 Because the information and representations necessary to rule on a particular transaction depend upon all the facts and circumstances, information or representations in addition to those set forth in this revenue procedure may be required.

Rev. Proc. 90-1 standard procedures

.04 The authority and general procedures of the National Office of the Internal Revenue Service and of the Office of the District Directors of Internal Revenue with respect to the issuance of letter rulings and determination letters are outlined in Rev. Proc. 90-1, or its successor. Note section 3.04 of Rev. Proc. 90-1, as modified by Rev. Proc. 90-17, 1990-1 C.B. 479, dealing with the payment of user fees by taxpayers requesting certain types of Service advice including private letter rulings. See also Rev. Proc. 90-3, 1990-1 C.B. 402, or its successor, relating to areas in which advance rulings generally will not be issued. These revenue procedures along with this checklist revenue procedure are subject to periodic updating by the Service. Therefore, careful attention should be given to ensure usage of the most current procedures.

Taxpayers to exercise care in preparing ruling requests

.05 Careful attention to all requirements of these revenue procedures will aid in the timely processing of letter ruling requests.

SEC. 3. CHANGES TO REV. PROC. 81-68

.01 Section 1 is modified to indicate that the purpose of the revenue procedure is to update and supersede Rev. Proc. 81-68.

.02 Section 2 is modified to state that representations are now required, and to update references to revenue procedures cited.

.03 Section 4 is substantially altered. Certain sections have been renumbered, and the taxpayer must now submit standard representations using the precise language specified herein, or submit an explanation why the representations cannot be made in the requested form. To properly reflect applicable changes, some citations to Code sections and to revenue rulings and procedures have been added or deleted. Changes include:

1. Section 4.01(6) now requires taxpayers to submit information concerning any prior ruling requests submitted by the taxpayer (or predecessor) that were withdrawn in which the identical or similar issue was present.

2. Section 4.02(2)(b)(2)(C) of Rev. Proc. 81-68, which primarily dealt with issues under former section 334(b)(3)(C) of the Code, has been deleted.

3. Section 4.02(2)(b)(6) has been added to request certain information regarding the applicability of section 338.

4. Section 5 requests certain general information and now includes a cross reference to the information and statements required for all ruling requests pursuant to Rev. Proc. 90-1, and requires taxpayers to list the specific rulings being requested using the precise language desired in the issued ruling and the authorities supporting the rulings.

5. Section 6 is similar to prior section 5 modified to substitute "Associate Chief Counsel (Technical)" for "Assistant Commissioner (Technical)."

6. Section 7 is similar to prior section 6 modified to state that Rev. Proc. 81-68 is superseded.

SEC. 4. SPECIFIC INFORMATION TO BE INCLUDED IN REQUESTS FOR RULINGS UNDER SECTION 332 OF THE CODE

All material facts and relevant representations must be submitted

Each of the items in this section should be specifically dealt with in the letter ruling request. If an item is not applicable, so state and briefly explain why. Standard representations are set forth throughout this section and are highlighted by the word "representation" in boldface type. These representations are of equal importance with the other factual information requested herein. The representations function to ensure that specific statutory and judicial requirements and administrative ruling guidelines are satisfied. Each representation set forth in this section should be submitted in the precise language requested. If a representation cannot be submitted as requested, an explanation must be given. Variations of the language of the representations may delay processing the ruling request and will not be accepted unless reasons satisfactory to the Service are submitted. Submission of the information and representations should follow the format of this revenue procedure as closely as possible, with appropriate descriptive headings. Care must be taken to ensure that all the facts relating to the transaction are submitted.

Information regarding the corporation being liquidated and the corporation receiving the distribution

.01 *Information regarding the corporation being liquidated ("Subsidiary" or "S") and the corporation receiving the liquidating distribution ("Parent" or "P").*

Identification of Parent and Subsidiary

1. Provide names, taxpayer identification numbers, and places and dates of incorporation of Subsidiary and Parent. State whether Parent and Subsidiary are domestic or foreign corporations.

International transactions

2. If a foreign corporation is involved consider whether the issues raised fall primarily within the jurisdiction of the Associate Chief Counsel (International) so that the ruling request should be submitted to the attention of that office (CC:INTL). See, for example, sections 367 and 897 of the Code and the regulations thereunder. See, also, Rev. Proc. 90-19, 1990-1 C.B. 495, and section 2.03 of Rev. Proc. 90-1.

Type of business

3. Provide brief descriptions of the businesses of Subsidiary and Parent.

Applicable District Office

4. Identify the District Office that will have audit jurisdiction over the returns of Subsidiary and Parent.

Identical issue within audit jurisdiction of District Director

5. State whether to the best knowledge of Parent (referred to below as "taxpayer") and the taxpayer's representatives, if any, the identical issue is in a return of the taxpayer (or in a return for any year of a related taxpayer within the meaning of section 267 of the Code, or of a member of an affiliated group of which the taxpayer is also a member within the meaning of section 1504). If so, the statement must specify whether the issue (1) is being examined by a District Director, (2) has been examined and (a) the statutory period of limitation either on assessment or for filing a claim for refund or credit of tax has not expired, or (b) a closing agreement covering the issue or liability has not been entered into by a District Director, (3) is being considered by an Appeals Office in connection with the taxpayer's return for an earlier period, (4) has been considered by an Appeals Office and (a) the statutory period of limitation either on assessment or for filing a claim for refund or credit of tax has not expired, or (b) a closing agreement covering the issue or liability has not been entered into by an Appeals Office, or (5) is pending in litigation in a case involving the taxpayer or a related taxpayer.

Prior ruling request regarding same or similar issue

6. The request also must contain a statement whether, to the best knowledge of the taxpayer and the taxpayer's representatives, if any, the identical or a similar issue has been (i) submitted to the Service by the taxpayer or its predecessors but withdrawn before a ruling was issued, or (ii) ruled on by the Service to the taxpayer or to the taxpayer's predecessor. If so, the statement must specify (i) the date of submission, (ii) the date of withdrawal or issuance, and (iii) details of the Service's consideration of the issue.

Taxpayer to alert IRS National and District Offices to current status

7. If, after the request is filed but before a ruling is issued, the taxpayer knows that an examination of the issue by a District Director has been started, the taxpayer must notify the National Office of this action. If a return is filed before a ruling is received from the National Office concerning the issue, a copy of the pending request for ruling must be attached to the return. This alerts the District Office and avoids premature District action on the issue.

Capital structure and ownership of Subsidiary stock

.02 *Description of, and ownership of, stock and securities of Subsidiary.*

Capital structure of Subsidiary

1. Furnish a complete description of each class of Subsidiary stock outstanding on the date of adoption of the plan of liquidation, setting forth the rights and privileges of each class, including the presence or absence of voting rights, dividend and liquidation preferences or limitations, rights to convert or redeem or acquire additional stock, and whether classified as common or preferred stock. With regard to each class of stock, specifically state whether the stock confers the right to vote for directors, and, also, whether voting rights have been, or will be, suspended, and, if so, under what conditions and for how long. With regard to the voting stock of Subsidiary held by Parent, state whether the right to vote the stock has been, or will be, held by someone other than Parent. If voting stock has been, or will be, exchanged for nonvoting stock, or vice versa, state when this has, or will have, occurred. Also, describe all other outstanding interests (bonds, debentures, notes, warrants, options, etc.) and, taking into account all relevant factors (including those listed in section 385(b) of the Code), briefly explain why each of these items should or should not be considered a stock interest other than preferred stock described in section 1504(a)(4).

Ownership of Subsidiary stock

2. Ownership of stock prior to distribution.

Stock held by minority shareholders

(a) Set forth the number of shares and the percentage of each class of outstanding stock owned by each minority shareholder of Subsidiary (or, if the minority interest is widely held, describe the minority holding in general terms).

Stock held by Parent, type and acquisition date

(b) Describe each block of each class of Subsidiary stock held by Parent and provide the date Parent acquired such stock.

Subsidiary stock acquired by option

(1) If the Subsidiary stock was acquired by exercise of an option, provide full particulars as to the date the option was acquired, the party from whom the option was acquired, and the date the option was exercised.

Transaction in which Subsidiary was acquired

(2) Describe the transaction (purchase, exchange, etc.) in which the Subsidiary stock was acquired, and the amount and kind of consideration given.

Subsidiary stock with carryover basis

(3) State whether the basis of the stock in the hands of Parent is the same, in whole or in part, as the basis in the hands of the party from whom Parent acquired the stock.

Anticipated change in ownership of Subsidiary stock

(4) State whether there is any plan or intent to sell or otherwise dispose of any Subsidiary stock prior to the liquidation, or for Subsidiary to issue any additional shares of Subsidiary stock.

Section 332(b)(1) control

(5) Submit one of the following two representations. (i) If Subsidiary has outstanding only a single class of stock, submit the following REPRESENTATION: *P, on the date of adoption of the plan of liquidation, and at all times until the final liquidating distribution is completed, will be the owner of at least 80 percent of the single outstanding class of S stock.* (ii) If Subsidiary has more than one class of stock outstanding, submit the following REPRESENTATION: *P, on the date of adoption of the plan of liquidation, and at all times until the final liquidating distribution is completed, will be the owner of at least 80 percent of the total combined voting power of all classes of stock of S entitled to vote and the owner of at least 80 percent of the total value of all classes of stock (excluding nonvoting stock that is limited and preferred as to dividends and otherwise meets the requirements of section 1504(a)(4) of the Code).*

Applicability of section 338

(6) State whether the acquisition of Subsidiary stock by Parent constituted a "qualified stock purchase" (QSP) within the meaning of section 338(d)(3) of the Code, and, if so, whether any elections under section 338 were made with respect to such acquisition.

QSP of Subsidiary affiliate

(A) State whether Parent made a qualified stock purchase of any Subsidiary target affiliate (as defined in section 338(h)(6) of the Code) during the consistency period defined in section 338(h)(4), and, if so, whether Parent made any elections under section 338 with respect to its acquisition of the affiliate stock. See Rev. Proc. 89-40, 1989-2 C.B. 453.

Deemed section 338 election

(B) State whether Parent acquired any asset of Subsidiary or a Subsidiary target affiliate (as defined in section 338(h)(6) of the Code) during the consistency period defined in section 338(h)(4). See section 338(e).

Prior redemptions

3. Provide information as to prior redemptions.

Redemptions within 3 years

(a) If shares of Subsidiary stock have been redeemed during the 3 years preceding the adoption of the plan of complete liquidation of Subsidiary, state the number of shares of Subsidiary stock redeemed, the dates of the redemptions, the number of shares of stock of both Subsidiary and Parent owned by the redeemed shareholders at the time of the redemptions, and the property distributed in exchange for the stock.

No redemption within 3 years

(b) If no shares of Subsidiary stock will have been redeemed during this 3-year period, submit the following REPRESENTATION: *No shares of S stock will have been redeemed during the 3 years preceding the adoption of the plan of complete liquidation of S.*

Facts showing complete liquidation

.03 *Facts necessary to show complete liquidation.*

Adoption of plan of liquidation

1. Specify all dates relevant to determining the date of adoption of the plan of liquidation, including dates of any of the following actions: (i) adoption by the directors or shareholders of Subsidiary of a resolution authorizing Subsidiary to distribute all (or substantially all) its assets; (ii) formal adoption by Subsidiary's shareholders of a plan of complete liquidation (or a plan of merger of Subsidiary into Parent); (iii) filing with the District Director of Form 966 (and any supplement or amendment thereto) as required by section 1.6043-1(a) of the regulations; and (iv) recordation of relevant actions in Subsidiary's official record books. State whether Parent or Subsidiary took any action (including entering into negotiations or agreements) prior to the formal shareholder adoption of the plan that could be interpreted as indicating a prior informal adoption of a plan of liquidation for Subsidiary. See Rev. Rul. 75-521, 1975-2 C.B. 120; Rev. Rul. 70-106, 1970-1 C.B. 70; Rev. Rul. 65-235, 1965-2 C.B. 88.

Distributions in liquidation.

2. Give the dates of the first and the final liquidating distributions. If all distributions will occur within a single taxable year, submit the following REPRESENTATION: *All distributions from S to P pursuant to the plan of complete liquidation will be made within a single taxable year of S.* Alternatively, if all distributions will not be made within a single taxable year of Subsidiary, submit the following REPRESENTATION: *S has adopted a plan of liquidation specifying that the final liquidating distribution is to be completed within 3 years from the close of the taxable year of S in which the first liquidating distribution is made.* See section 332(b)(3) of the Code and section 1.332-4(a)(1) of the regulations. See section 5.02(2) of this revenue procedure as to submission of a copy of the plan of liquidation.

Status of liquidation

3. Submit the following REPRESENTATION: *As soon as the first liquidating distribution has been made, S will cease to be a going concern and its activities will be limited to winding up its affairs, paying its debts, and distributing its remaining assets to its shareholders.*

Dissolution of Subsidiary

4. Provide facts as to dissolution of Subsidiary.

Redemption and cancellation of Subsidiary stock

(a) State whether all the stock in Subsidiary will be redeemed and cancelled and Subsidiary dissolved. If not, give reasons.

Will Subsidiary retain assets

(b) State whether Subsidiary will retain any assets following the final liquidating distribution.

No assets retained by Subsidiary

(1) If no assets will be retained, submit the following REPRESENTATION: *S will retain no assets following the final liquidating distribution.*

Some assets retained by Subsidiary

(2) If assets are to be retained, state the nature of the assets, their fair market value, the maximum length of time they will be retained, the purpose for retention, and whether this same purpose could have been achieved equally well and with no significant additional cost or difficulty through use of other means such as a liquidating trust. See Rev. Rul. 80-150, 1980-1 C.B. 316, and Rev. Rul. 72-137, 1972-1 C.B. 101.

Charter and minimum capital retained by Subsidiary

(3) State whether Subsidiary will retain minimum assets and remain in existence for the purpose of either retaining its corporate identity and/or selling its corporate charter.

Subsidiary charter, legal existence, etc. to be preserved

(A) If Parent will retain the stock of Subsidary with Subsidiary remaining in existence and retaining a nominal amount of assets solely for the purpose of preserving Subsidiary's legal existence, its corporate identity, and/or its corporate charter, explain why this is necessary and submit the following REPRESENTATION: *S will remain in existence as an inactive subsidiary of P solely for the purpose of enabling P to protect the corporate charter, legal existence, and/or identity of S. S will retain its corporate charter and only those assets required under local law to maintain corporate existence (minimum capital). S will engage in no activity other than action required under local law to preserve its charter, legal existence, and/or identity.* See section 1.332-2(c) of the regulations.

Subsidiary charter to be sold

(B) If Parent will retain the stock of Subsidiary solely for the purpose of selling Subsidiary's corporate charter, comply with these three requirements.

(i) Describe the assets being retained, why it is necessary for Subsidiary to retain them, and submit the following REPRESENTATION: *S will retain its corporate charter and only those assets required under local law to maintain corporate existence (minimum capital).*

(ii) Describe fully the expected sale by Parent of the Subsidiary stock and furnish the name of the acquiring party, and the consideration expected to be received. Submit the following REPRESENTATION: *The sole reason that S will not be dissolved under local law is to isolate the value of S's charter for resale to a purchaser that is not related to S, P, or their shareholders. For purposes of this representation a purchaser that is not related is a purchaser that does not own, actually or constructively pursuant to section 318(a) of the Code as modified by section 304(c)(3), any stock of S or P or their shareholders.*

(iii) Describe whether the sale of the charter will be accompanied by the sale or dissolution of Subsidiary and submit the following REPRESENTATION: *As soon as reasonably possible, and in any event within no more than 12 months from the date of the final liquidating distribution, S will be dissolved under local law or sold to an unrelated purchaser.*

Constructive distribution and reincorporation in New Subsidiary

(C) If Subsidiary will remain in existence and retain its corporate charter and only those assets necessary to maintain its corporate existence for either of the purposes specified in (A) and (B) above, then to comply with the complete-liquidation requirement of section 332(a) of the Code and the distribution-of-all-the-property requirement of section 332(b)(2) and (3), the assets retained by Subsidiary will be treated as having been distributed to Parent in the final liquidating distribution and then transferred by Parent to a new corporation. See Rev. Proc. 89-50, 1989-2 C.B. 631, which indicates that such a deemed distribution and reincorporation is consistent with established law regarding *de facto* dissolutions. Submit the following REPRESENTATION: *S and P will treat the charter and minimum capital as distributed to P in the final liquidating distribution and then contributed by P to the capital of a new corporation (New S). S will be treated for federal tax purposes as New S and will obtain a new employer identification number.*

Transfers of assets

.04 Transfers of assets to and from Subsidiary.

Acquisitions of assets by Subsidiary in nontaxable transactions

1. If Subsidiary will not have acquired any assets in a non-taxable transaction, except for acquisitions occurring more than 3 years prior to adoption of the liquidation plan, submit the following REPRESENTATION: *S will not have acquired assets in any nontaxable transaction at any time, except for acquisitions occurring more than 3 years prior to the date of adoption of the plan of liquidation.* Alternatively, if Subsidiary will have acquired assets in a nontaxable transaction during this 3-year period, provide full details.

Dispositions of Subsidiary assets

2. Submit the following REPRESENTATION: *No assets of S have been, or will be, disposed of by either S or P except for dispositions in the ordinary course of business and dispositions occurring more than 3 years prior to adoption of the plan of liquidation.* Alternatively, if any Subsidiary assets have been or will be disposed of by either Subsidiary or Parent, other than in the ordinary course of business, briefly describe the transaction and furnish the following:

(i) Name of acquiring party;

(ii) Description of the assets;

(iii) Consideration received.

Description of overlapping stock ownership in Subsidiary and another coporation receiving Subsidiary's assets

3. If, in the liquidation or in the 3-year period prior thereto, any assets of Subsidiary will have been acquired by a corporation, other than Parent, except by sales in the normal course of business, set forth the number of shares and the percentage of each class of the acquiring corporation's stock owned actually and constructively (within the meaning of section 318 of the Code as modified by section 304(c)(3)) by Subsidiary, Parent, and Parent's shareholders, and the number of shares and the percentage of each class of Parent stock owned actually and constructively by the acquiring corporation and its shareholders.

No liquidation-reincorporation

4. Submit the following REPRESENTATION: *The liquidation of S will not be preceded or followed by the reincorporation in, or transfer or sale to, a recipient corporation (Recipient) of any of the businesses or assets of S, if persons holding, directly or indirectly, more than 20 percent in value of the S stock also hold, directly or indirectly, more than 20 percent in value of the stock in Recipient. For purposes of this representation, ownership will be determined by application of the constructive ownership rules of section 318(a) of the Code as modified by section 304(c)(3).*

Distributions to Parent prior to adoption of liquidation plan

5. Describe prior distributions to Parent.

Distributions in normal course

(a) If prior distributions were made only in the normal course of business, submit the following REPRESENTATION: *Prior to adoption of the liquidation plan, no assets of S will have been distributed in kind, transferred, or sold to P, except for (i) transactions occuring in the normal course of business and (ii) transactions occuring more than 3 years prior to adoption of the liquidation plan.*

Other distributions

(b) If there will have been asset transfers not meeting the representation in (a) above, describe the assets so transferred, including their bases and fair market value, the transaction in which they were transferred, the date of transfer, and the reason for the transaction.

Unreported income of Subsidiary

6. Provide facts showing that Subsidiary holds no assets representing earned but unreported income, or submit the following REPRESENTATION: *S will report all earned income represented by assets that will be distributed to its shareholders such as receivables being reported on a cash basis, unfinished construction contracts, commissions due, etc.*

Liabilities of Subsidiary

.05 *Liabilities.*

Solvency

1. In order to demonstrate solvency, submit the following REPRESENTATION: *The fair market value of the assets of S will exceed its liabilities both at the date of the adoption of the plan of complete liquidation and immediately prior to the time the first liquidating distribution is made.*

Intercorporate indebtedness

2. State the amount and provide complete details concerning the debt, if any, owed by Subsidiary to Parent or by Parent to Subsidiary, how and when it was created, the cost and tax basis of the creditor, and how debts have been or will be cancelled, forgiven, or discounted during the period commencing 3 years prior to adoption of the plan of liquidation (or since the initial acquisition by Parent of stock of Subsidiary, if that is later) and ending with the final liquidating distribution. If no intercorporate debt exists and none has been cancelled, forgiven, or discounted, submit the following REPRESENTATION: *There is no intercorporate debt existing between P and S and none has been cancelled, forgiven, or discounted, except for transactions that occurred more than 3 years prior to the date of adoption of the liquidation plan (or, alternatively, if such date is later) except for transactions occurring prior to the date P initially acquired S stock.*

Tax-exempt Parent

.06 *State whether or not Parent is tax-exempt.*

Not tax-exempt

1. If Parent is not tax-exempt, submit the following REPRESENTATION: *P is not an organization that is exempt from federal income tax under section 501 or any other provision of the Code.*

Tax-exempt exceptions

2. If Parent is tax-exempt, is an exception to section 337(b)(2)(A) of the Code applicable (i) as a result of Parent being a cooperative described in section 521, or (ii) as a result of the income from the distributed property being subject to tax under section 511(a)?

Distribution to minority shareholders of Subsidiary

.07 *If Subsidiary has minority shareholders, provide additional material as indicated below.*

Pro rata distribution at fair market value

1. If the distribution is pro rata, submit the following REPRESENTATION: *The fair market value of the consideration received by P and by the minority shareholders for each share of S stock will approximately equal the fair market value of that stock.* Alternatively, if the distribution is not pro rata, explain why the Service should not treat the transaction as a pro rata distribution followed by an intershareholder transfer of the non-pro-rata portion. See Rev. Rul. 79-10, 1979-1 C.B. 140.

Statutory merger involving minority shareholders

2. State whether, and explain the reasons why, it is expected that the transaction will constitute a statutory merger with regard to minority shareholders.

Treatment of minority

(a) If rulings are requested as to the tax treatment of minority shareholders, as a result of the transaction constituting a statutory merger, provide a brief description of the assets being distributed to minority shareholders and submit the requisite information and representations (see Rev. Proc. 77-37, 1977-2 C.B. 568, as amplified by Rev. Proc. 86-42, 1986-2 C.B. 722).

Treatment of Subsidiary, section 361(c)(1) applicability

(b) Explain why it is expected that section 361(c)(1) of the Code will, or will not, apply to the distribution by Subsidiary to its minority shareholders. State whether the property distributed to the minority shareholders includes property other than "qualified property" within the meaning of section 361(c)(2)(B).

Distributions taxable to Subsidiary

3. If the distribution to the minority shareholders is taxable (as a liquidation under section 331 of the Code to which section 336 applies or as a reorganization under section 368 to which section 361(c)(1) does not apply), provide information as follows.

Description of assets distributed to minority

(a) Provide relevant details concerning the amount and kind of assets to be distributed to minority shareholders in exchange for their Subsidiary stock. State which of these assets has a fair market value greater than its basis in the hands of Subsidiary. State whether Subsidiary is distributing to its minority shareholders (i) any installment obligations (section 453B of the Code), (ii) any property described in the recapture provisions of the Code, including (but not limited to) sections 47, 291(a), 341(f), 617(d), 897(d), 904(f), 1245(a), 1248(f), 1250(c), 1252(a), 1254, or 1255, (iii) any property for which Subsidiary obtained a deduction (see *Hillsboro National Bank v. Commissioner,* 460 U.S. 370 (1983), 1983-1 C.B. 50; Rev. Rul. 85-186, 1985-2 C.B. 84; Rev. Rul. 74-396, 1974-2 C.B. 106; Rev. Rul. 61-214, 1961-2 C.B. 60); or (iv) any property described in sections 1256 or 1276.

Installment obligations

(b) If installment obligations will be distributed, describe the nature and terms of the obligations. State how the shareholders intend to treat payments received on the installment obligations. State the effect of sections 453(h) and 453B(d) of the Code on Subsidiary's distribution.

Assets-distributed representation

(c) Delete any inapplicable provisions and then submit the applicable portion of the following REPRESENTATION: *None of the assets being distributed by S to the minority shareholders (i) has a fair market value greater than its basis in the hands of S, (ii) is an installment obligation, (iii) is property described in the recapture provisions of the Code, or (iv) is property for which S obtained a deduction.*

PART II—GENERAL

SEC. 5. GENERAL INSTRUCTIONS TO, AND INFORMATION FOR, TAXPAYERS

Related transactions

.01 *Discuss impact of related transactions.* State whether there have been, or will be, any related transactions, and, if so, briefly describe these other transactions and fully explain their relationship to, and impact on, the present transaction. See section 3.07 of Rev. Proc. 90-1. Other than transfers already discussed in the ruling request, have there been, or will there be, any transfers of assets between Parent and Subsidiary? Even if a transaction is thought to be unrelated, a brief description of the transaction should be submitted if (i) it involves Parent, Subsidiary, or a direct or indirect subsidiary of Subsidiary, and (ii) it occurs contemporaneously with, or in conjuction with, the proposed liquidation of Subsidiary. For instance, describe any plan or intent to merge or liquidate Parent. Submit the following REPRESENTATION: *All other transactions undertaken contemporaneously with, in anticipation of, in conjunction with, or in any way related to, the proposed liquidation of S have been fully disclosed.*

Documents to be submitted with request

.02 *Submit copies of all relevant documents.*

Financial information

1. Submit the latest separate balance sheets for both Subsidiary and Parent.

Plan of complete liquidation

2. Submit a copy of the plan of liquidation of Subsidiary, and all amendments thereto. Alternatively, state why a copy is not available. If the plan of liquidation will not be reduced to writing, explain why and the Service should consider the plan to be adopted. See section 1.332-6 of the regulations.

Additional statements required, including penalties of perjury and proposed section 6110 deletions

.03 *See Rev. Proc. 90-1, or its successor, dealing with generally applicable procedural requirements.* In accord with Rev. Proc. 90-1, provide additional information and statements that must be submitted with all ruling requests, including statements required relating to penalties of perjury and relating to deletions under section 6110 of the Code.

Taxpayer to state every ruling in precisely the desired language

.04 *List every ruling being requested.* For each requested ruling state the ruling in exactly the language desired in the issued ruling letter and provide the Code and regulation sections or other authority supporting issuance of the ruling.

Taxpayer to submit legal memorandum

.05 *Submit legal memorandum.* See section 3.14 of Rev. Proc. 90-1, or its successor, requiring the taxpayer to (i) state the taxpayer's view as to the tax result of the transaction, (ii) explain the legal grounds for this result, and (iii) describe the relevant legal authorities. In order to facilitate an early resolution of problems, taxpayers are advised that if they are taking a position that either lacks substantial authority or is contrary to the published position of the Service, they are encouraged to disclose this in the memorandum.

SEC. 6. COMMENTS OR INQUIRIES

Comment or inquiries regarding this revenue procedure should refer to its number and should be addressed to the Associate Chief Counsel (Technical), Attention: CC:CORP:5, Internal Revenue Service, Washington, D.C. 20224.

SEC. 7. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 81-68 is superseded.

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26 CFR 601.201: Rulings and determination letters.
(Also Part I, Section 1504; 1.1504-1.)

Rev. Proc. 90-53

SECTION 1. PURPOSE

.01 This revenue procedure grants certain taxpayers a waiver of the general rule of section 1504(a)(3)(A) of the Internal Revenue Code, which generally provides that a corporation that ceased to be a member of a consolidated group is prohibited from being included in a consolidated return of that group (or of another affiliated group with the same common parent) for five years after the corporation ceased to be a member of the group.

.02 If a corporation qualifies to use this revenue procedure, then this revenue procedure is the exclusive procedure available for obtaining a waiver of the general rule of section 1504(a)(3)(A) of the Code.

SEC. 2. BACKGROUND

.01 Section 60 of the Tax Reform Act of 1984, 1984-3 (Vol. 1) C.B. 1, 85, amended section 1504(a) of the Code by, among other things, adding section 1504(a)(3).

.02 Section 1504(a)(3)(A) of the Code provides that (1) if a corporation is included (or required to be included) in a consolidated return filed by an affiliated group for a taxable year which includes any period after December 31, 1984, and (2) the corporation ceases to be a member of the affiliated group in a taxable year beginning after December 31, 1984, the corporation (and any successor of the corporation) may not be included in any consolidated return filed by the affiliated group (or by another affiliated group with the same common parent or a successor of the common parent) before the 61st month beginning after its first taxable year in which it ceased to be a member of the affiliated group.

.03 Section 1504(a)(3)(B) of the Code provides that the Secretary may waive the application of section 1504(a)(3)(A) to any corporation for any period subject to such conditions as the Secretary may prescribe.

SEC. 3. APPLICATION

In accordance with section 1504(a)(3)(B) of the Code, a waiver is hereby granted to any corporation described in section 4 of this revenue procedure that complies with the requirements set forth in sections 5 and 6 of this revenue procedure so that the corporation may join in the filing of a consolidated return with the affiliated group of which it is a member.

SEC. 4. SCOPE

.01 This revenue procedure applies to any corporation (1) that was a member of a consolidated group, (2) that subsequently ceased to be a member of the group, and (3) that rejoined the *same* group before the 61st month beginning after its first taxable year in which it ceased to be a member of the group. For purposes of this revenue procedure, the *same* group means a group that remains in existence within the meaning of section 1.1502-75(d) of the Income Tax Regulations.

.02 This revenue procedure also applies to any corporation that was a member of a consolidated group (the old group) and that ceased to be a member of the old group solely as a result of a transaction in which

(1) A nonmember corporation acquired the assets of the common parent of the old group in a reorganization described in section 368(a)(1)(A), (C), or (D) of the Code (but only if the requirements of section 354(b)(1)(A) and (B) are met) and, immediately after the acquisition, the acquiring corporation is the common parent of another affiliated group (the new group) or

(2) a member of the old group acquired (a) the assets of a nonmember corporation in a reorganization described in section 368(a)(1)(A), (C), or (D) (but only if the requirements of section 354(b)(1)(A) and (B) are met) or (b) the stock of a nonmember corporation, and the acquisition was a reverse acquisition described in section 1.1502-75(d)(3) of the regulations in which the old group ceased to exist.

This section 4.02 only applies if all the members of the old group (other than the common parent if its assets are acquired) immediately before the acquisition are members of the new group immediately after the acquisition.

.03 Section 1504(a)(3)(A) and this revenue procedure do not apply to any corporation (including the common parent) that was a member of a consolidated group (the old group) and that ceased to be a member of the old group solely because of the acquisition of

(1) the assets of the common parent of the old group by a member other than the common parent of another affiliated group (the new group) or

(2) the stock of the common parent of the old group.

Section 1504(a)(3)(A) does not apply to these situations because the common parent of the new group neither was the common parent of the old group nor is a successor of the common parent of the old group, and therefore a waiver is not required to join in the filing of a consolidated return of the new group. If the new group filed (or was required to file) a consolidated return for the taxable year immediately preceding the year of the acquisition, the new group is required to file a consolidated return for the year of acquisition that includes the members acquired from the old group, unless it has obtained consent to an election to discontinue filing consolidated returns under section 1.1502-75(c) of the regulations. In the case of a corporation described in both section 4.01 and this section 4.03, however, a waiver is necessary. For example, if a corporation (S) was a member of a consolidated group

(Group P) and all the stock of S was purchased by the common parent (X) of another consolidated group (Group X), and subsequently, all the stock of X was purchased by P, a waiver is required in order for S to be permitted to join in the filing of a consolidated return with Group P.

.04 A waiver will be granted pursuant to this revenue procedure only to a corporation which (pursuant to this revenue procedure) joins in the filing of a consolidated return beginning with the taxable year of the affiliated group in which the corporation rejoins (or, in the case of a transaction described in section 4.02, joins) the affiliated group.

SEC. 5. MANNER OF ACQUIRING A WAIVER UNDER SECTION 1504(a)(3)(B) OF THE CODE

.01 The common parent of the affiliated group of which the corporation seeking the waiver is a member must attach a statement to the consolidated return of the group, filed under penalties of perjury, which includes all the information set forth in section 5.02. However, in the case of a corporation described solely in section 4.02 of this revenue procedure, the statement must include only the information set forth in section 5.02(1), (2), (3), (5), and (6).

.02 The information required under section 5.01 of this revenue procedure is as follows:

(1) The following heading typed or legibly printed at the top of the statement: "WAIVER OF THE APPLICATION OF SECTION 1504(a)(3) FILED PURSUANT TO REV. PROC. 90-53";

(2) The name, address, and employer identification number of the corporation for which the waiver is requested;

(3) The year in which the consolidated group of which the corporation is now a member elected to file consolidated returns;

(4) The date on which the corporation ceased to be a member of the consolidated group;

(5) The date on which the corporation rejoined (or, in the case of a corporation described in section 4.02, joined) the affiliated group;

(6) A description of the manner by which the corporation ceased to be a member of the consolidated group and the manner by which the corporation joined the new group or rejoined the same group (redemption of stock, new issuance of stock, *etc.*). This statement should include the business purpose of the transactions that caused the disaffiliation and reaffiliation and whether the transactions were with a related party;

(7) The taxable income of the consolidated group for (a) the taxable year prior to the taxable year in which the corporation left the consolidated group, (b) the taxable year in which the corporation left the consolidated group, (c) all taxable years subsequent to the taxable year in which the corporation left the consolidated group but before the corporation rejoined the consolidated group, and (d) the taxable year in which the corporation rejoined the consolidated group;

(8) The taxable income, or separate taxable income as defined in section 1.1502-12 of the regulations, as the case may be, of the corporation for all periods described in section 5.02(7);

(9) An analysis of the effect of the disaffiliation and reconsolidation on the consolidated group and the corporation for all periods described in section 5.02(7) on the following items:

(a) Taxable income;

(b) Deferred gains and losses;

(c) Excess loss accounts;

(d) Tax liability;

(e) Net operating loss carryovers;

(f) Capital loss carryovers; and

(g) Investment and foreign tax credits; and

(10) A representation that neither the consolidated group, the corporation, nor any other person will secure or has secured the benefit of a reduction in income, increase in loss, or any other deduction, credit, or allowance that it would not otherwise secure or have secured had the disaffiliation and reconsolidation not occurred, including, but not limited to, the use of a net operating loss or credit that would have otherwise expired.

SEC. 6. EFFECT OF WAIVER

.01 A waiver under section 1504(a)(3)(B) of the Code granted pursuant to this revenue procedure is binding on the consolidated group upon the filing of the consolidated return which includes the statement required by section 5.01 and may not be revoked by the taxpayer. The waiver shall be binding for all subsequent taxable years after the granting of the waiver in which the corporation remains a member of the consolidated group, unless permission is granted under section 1.1502-75(c)(3) of the regulations for the entire group to cease filing a consolidated return.

.02 Notwithstanding section 6.01, if it is determined that the information provided pursuant to this revenue procedure is incorrect, the Service may revoke the waiver granted pursuant to this revenue procedure at any time. The revocation will be effective beginning with the first taxable year for which the waiver was granted.

SEC. 7. TIME FOR FILING A REQUEST FOR WAIVER UNDER SECTION 1504(a)(3)(B) OF THE CODE

A request for waiver under section 1504(a)(3)(B) of the Code pursuant to this revenue procedure must be attached to the consolidated return of the affiliated group filed on or before the due date (including extensions of time) of the consolidated return.

SEC. 8. CORPORATIONS OUTSIDE THE SCOPE OF THE REVENUE PROCEDURE OR WHICH CANNOT SATISFY ITS REQUIREMENTS

If a corporation either is outside the scope of this revenue procedure or cannot satisfy its requirements, a waiver under section 1504(a)(3)(B) of the Code must be requested in a ruling request filed in accordance with Rev. Proc. 90-1, 1990-1 C.B. 356, by the common parent of the affiliated group of which the corporation is now a member on or before the due date (including extensions of time) of the consolidated return of the affiliated group for the tax year with respect to which the waiver is requested. The ruling request should include the information set forth in section 5.02 of this revenue procedure. *See* Rev. Proc. 90-17, 1990-1 C.B. 479, for information regarding user fees.

SEC. 9. EFFECTIVE DATE

This revenue procedure is effective for any group for which the due date (including extensions of time) of its consolidated return for the taxable year of the group in which the corporation rejoins (or, in the case of a transaction described in section 4.02, joins) the group is on or after October 15, 1990, the date of publication of this revenue procedure in the Internal Revenue Bulletin.

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26 CFR 601.201: Rulings and determination letters.

Rev. Proc. 90-54

SECTION 1. BACKGROUND

Rev. Proc. 90-3, 1990-1 C.B. 402, sets forth areas under the jurisdiction of the Associate Chief Counsel (Technical) in which advance rulings or determination letters will not be issued by the Service. Section 3 of Rev. Proc. 90-3 is entitled "Areas In Which Rulings or Determination Letters Will Not Be Issued."

SEC. 2. PROCEDURE

Rev. Proc. 90-3 is amended by adding to section 3 the following new paragraphs:

Section 125.—Benefits Under a Cafeteria Plan—Whether amounts used to provide group-term life insurance under section 79, accident and health benefits under sections 105 and 106, and dependent care assistance program under section 129 are includible in the gross income of participants and considered "wages" for purposes of sections 3401, 3121 and 3306 when the benefits are offered through a cafeteria plan.

Section 425.—Substitution or Assumption of Incentive Stock Options—Whether the substitution of a new Incentive Stock Option ("ISO") for an old ISO, or the assumption of an old ISO, by an employer by reason of a corporate transaction constitutes a modification which results in the issuance of a new option by reason of failing to satisfy the spread test requirement of section 425(a)(1) of the Code or the ratio test requirement of section 1.425-1(a)(4) of the regulations. We will continue to rule on the issue of whether the new ISO or the assumption of the old ISO gives the employee additional benefits not present under the old option within the meaning of section 425(a)(2).

SEC. 3. EFFECTIVE DATE

This revenue procedure applies to all ruling requests received by the Service on or after the date of publication of this revenue procedure in the Internal Revenue Bulletin.

SEC. 4. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 90-3 is amplified.

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26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.
(Also Part I, Section 911; 1.911-1.)

Rev. Proc. 90-55

SECTION 1. PURPOSE

.01 This revenue procedure provides information to any individual who fails to meet the foreign residency requirements of section 911(d)(1) of the Internal Revenue Code for eligibility for the exclusion from gross income under section 911(a) of foreign earned income and housing cost amounts because adverse conditions in a foreign country precluded the individual from meeting those requirements.

.02 Rev. Proc. 86-39, 1986-2 C.B. 701, which supplements Rev. Proc. 81-23, 1981-1 C.B. 693, lists countries for which the foreign residency requirements of section 911(d)(1) of the Code are waived under section 911(d)(4) because of adverse conditions in those countries during the time periods stated. This revenue procedure relists countries where the adverse conditions are still in effect, adds countries where periods of adverse conditions occurred after the publication of the list in Revenue Procedure 86-39, and removes countries where the adverse conditions ended before the publication of Rev. Proc. 86-39. Rev. Proc. 86-39 and Rev. Proc. 81-23 remain in full force and effect; the older periods listed therein are omitted from this revenue procedure solely for brevity, because they now apply to few open year returns.

SEC. 2. BACKGROUND

.01 Section 911(a) of the Code allows foreign earned income and housing cost amounts to be excluded from the gross income of a "qualified individual" as defined in section 911(d)(1).

.02 Section 911(d)(1) of the Code defines the term "qualified individual" as an individual whose tax home is in a foreign country and who is (A) a citizen of the United States and establishes to the satisfaction of the Secretary of the Treasury that the individual has been a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire taxable year, or (B) a citizen or resident of the United States who, during any period of 12 consecutive months, is present in a foreign country or countries during at least 330 full days.

.03 Section 911(d)(4) of the Code provides an exception to the residency requirements of section 911(d)(1). An individual who for any period is a bona fide resident of, or is present in, a foreign country, and who leaves that foreign country after August 31, 1978, will be treated as a qualified individual with respect to the period the individual was a bona fide resident of, or was present in, the foreign country if the departure occurred during a period for which the Secretary of the Treasury, after consultation with the Secretary of State, determines that individuals were required to leave the foreign country because of war, civil unrest, or similar adverse conditions in the foreign country that precluded the normal conduct of business by those individuals. An individual must establish that but for those conditions the individual could reasonably have been expected to meet the residency requirements. Further, an individual must have established residency or have been physically present in the foreign country on or prior to the date that the Secretary of Treasury determines that individuals were required to leave the foreign country. Individuals who establish residency or are first physically present in the foreign country after the date that the Secretary prescribes, but during the period for which the Secretary determines that individuals were required to leave the foreign country, shall not be treated as quali-

fied individuals under section 911(d)(4).

.04 For purposes of section 911 of the Code, an individual who left one of the following countries during the specified period shall be treated as a qualified individual with respect to the period during which that individual was a bona fide resident of, or present in, that foreign country if the individual establishes a reasonable expectation of meeting the requirements of section 911(d) but for those conditions.

Country	*On or After*	*On or before*
Afghanistan	April 23, 1979	(still in effect)
Burma	September 9, 1988	October 24, 1988
China	June 7, 1989	August 9, 1989
Colombia	November 13,1984	April 25, 1988
	August 29, 1989	November 22, 1989
El Salvador	September 24, 1979	July 31, 1988
Haiti	April 30, 1987	February 26, 1988
Iran	September 1, 1978	(still in effect)
Iraq	August 31, 1979	January 1, 1987
	August 3, 1990	(still in effect)
Kuwait	August 3, 1990	(still in effect)
Lebanon	August 31, 1979	(still in effect)
Liberia	June 1, 1990	(still in effect)
Libya	August 31, 1979	(still in effect)
Panama	May 12, 1989	November 6, 1989
Peru	July 3, 1986	April 2, 1988
Sudan	October 17, 1985	November 26, 1986
Yemen	August 20, 1990	(still in effect)

SEC. 3. INQUIRIES

A taxpayer who needs assistance on how to claim this exclusion, or on how to file an amended return, should contact a local IRS Office or, for a taxpayer residing or traveling outside the United States, the nearest overseas IRS office.

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26 CFR 601.201: Rulings and determination letters.
(Also Part I, Sections 351, 368; 1.351-1, 1.368-2.)

Rev. Proc. 90-56

SECTION 1. BACKGROUND

Section 3 of Rev. Proc. 90-3, 1990-1 C.B. 402, lists areas of the Internal Revenue Code under the jurisdiction of the Associate Chief Counsel (Technical) in which the Internal Revenue Service will not issue advance rulings or determination letters. To enable the Service to use its resources more efficiently, this revenue procedure adds several no-rule areas to the list, including most holding company formations, acquisitive mergers, and reorganizations under section 368(a)(1)(F).

SEC. 2. PROCEDURE

Rev. Proc. 90-3 is amplified by adding the following to section 3.01:

Section 351. — Transfer to Corporation Controlled By Transferor. — Whether section 351 of the Code applies to an exchange of stock for stock in the formation of a holding company, and whether the taxpayer is subject to the consequences of qualification under that section (such as nonrecognition and basis consequences) that are adequately addressed by a statute, regulation, decision of the Supreme Court, tax treaty, revenue ruling, revenue procedure, notice, or other authority published in the Internal Revenue Bulletin.

For purposes of this provision, if such an exchange qualifies under both section 351 and another corporate restructuring provision and the other provision is not covered by this revenue procedure, the Service will treat any request for a qualification ruling under the other provision as a request for a qualification ruling under section 351. A taxpayer or the taxpayer's representative (as the Service deems appropriate) seeking a qualification ruling for such an exchange under any such other provision must accordingly state that to the best of his/her knowledge and belief the exchange does not qualify under section 351.

The Service will not rule on the qualification of an exchange of stock under section 351, even if it is an integral part of a larger transaction that involves other issues upon which the Service will rule and it is impossible to determine the tax consequences of the larger transaction without making a determination with regard to the exchange of stock. However, in such event, the Service will rule on the tax consequences of the larger transaction, provided the taxpayer or the taxpayer's representative (as the Service deems appropriate) represents that to the best of his/her knowledge and belief the exchange will (or will not) qualify under section 351. If the Service issues a ruling on the larger transaction the ruling will state that no opinion is expressed as to whether or not the exchange qualifies under section 351.

Section 368(a)(1)(A). — Definitions Relating to Corporate Reorganizations. — Whether a transaction constitutes a corporate reorganization within the meaning of section 368(a)(1)(A) of the Code, including a transaction that qualifies under section 368(a)(1)(A) by reason of section 368(a)(2)(D) or section 368(a)(2)(E), and whether the taxpayer is subject to the consequences of qualification under that section (such as nonrecognition and basis consequences) that are adequately addressed by a statute, regulation, decision of the Supreme Court, tax treaty, revenue ruling, rev-

enue procedure, notice, or other authority published in the Internal Revenue Bulletin.

For purposes of this provision, if a transaction qualifies under both section 368(a)(1)(A) and another corporate restructuring provision other than section 368(a)(1)(G), and the other provision is not covered by this revenue procedure, the Service will treat any request for a qualification ruling under the other provision as a request for a qualification ruling under section 368(a)(1)(A). A taxpayer or the taxpayer's representative (as the Service deems appropriate) seeking a qualification ruling under any such other provision must accordingly state that to the best of his/her knowledge and belief the transaction does not qualify under section 368(a)(1)(A). The Service will continue to rule on transactions that qualify under section 368(a)(1)(G), even if they also qualify under section 368(a)(1)(A).

The Service will not rule on the qualification of a reorganization under section 368(a)(1)(A), even if it is an integral part of a larger transaction that involves other issues upon which the Service will rule and it is impossible to determine the tax consequences of the larger transaction without determining the tax consequences of the reorganization. However, in such event, the Service will rule on the tax consequences of the larger transaction, provided the taxpayer or the taxpayer's representative (as the Service deems appropriate) represents that to the best of his/her knowledge and belief the reorganization will (or will not) qualify under section 368(a)(1)(A). If the Service issues a ruling on the larger transaction the ruling will state that no opinion is expressed as to whether or not the reorganization qualifies under section 368(a)(1)(A). For example, the Service will not rule on whether a transaction constitutes a corporate reorganization within the meaning of section 368(a)(1)(A), even if the larger transaction also involves the issue of whether a prior distribution of stock in a subsidiary containing assets unwanted by the acquiring corporation qualifies under section 355. See Rev. Rul. 78-251, 1978-1 C.B. 89. However, in such event, if the taxpayer or the taxpayer's representative (as the Service deems appropriate) represents that the merger qualifies under section 368(a)(1)(A), the Service will rule as to whether the prior stock distribution qualifies under section 355. Such ruling will state that no opinion is expressed as to whether or not the reorganization qualifies under section 368(a)(1)(A).

Additionally, the Service will have the discretion to rule on significant subissues that must be resolved to determine whether the transaction qualifies under section 368(a)(1)(A) (including transactions qualifying by reason of section 368(a)(2)(D) or section 368(a)(2)(E)). However, the Service will only rule on such subissues if in the view of the Service they are significant and not clearly and adequately addressed by a statute, regulation, decision of the Supreme Court, tax treaty, revenue ruling, revenue procedure, notice, or other authority published in the Internal Revenue Bulletin. To obtain a ruling on such a subissue, the taxpayer must explain the significance of the subissue, set forth the authorities most closely related to the subissue, and explain why the subissue is not resolved by these authorities. The taxpayer or the taxpayer's representative (as the Service deems appropriate) will also be required to state that to the best of his/her knowledge and belief the transaction will (or will not) qualify under section 368(a)(1)(A) if the Service rules as the taxpayer proposes on the subissue. Taxpayers may seek a presubmission conference to determine whether a subissue ruling can be obtained under this section. *See* sections 6.08 and 16.01, Rev. Proc. 90-1, 1990-1 C.B. 356, 373, 380. If the Service issues a ruling on a subissue the ruling will state that no opinion is expressed as to whether or not the transaction in question qualifies under section 368(a)(1)(A).

Section 368(a)(1)(B). — Definitions Relating to Corporate Reorganizations. — Whether the acquisition of stock in the formation of a holding company constitutes a corporate reorganization within the meaning of section 368(a)(1)(B) of the Code, and whether the taxpayer is subject to the consequences of qualification under that section (such as nonrecognition and basis consequences) that are adequately addressed by a statute, regulation, decision of the Supreme Court, tax treaty, revenue ruling, revenue procedure, notice, or other authority published in the Internal Revenue Bulletin.

For purposes of this provision, if such an acquisition of stock qualifies under both section 368(a)(1)(B) and another corporate restructuring provision, and the other provision is not covered by this revenue procedure, the Service will treat any request for a qualification ruling under the other provision as a request for a qualification ruling under section 368(a)(1)(B). A taxpayer or the taxpayer's representative (as the Service deems appropriate) seeking a qualification ruling for such an acquisition under any such other provision must accordingly state that to the best of his/her knowledge and belief the acquisition does not qualify under section 368(a)(1)(B).

The Service will not rule on the qualification of an acquisition of stock under section 368(a)(1)(B), even if it is an integral part of a larger transaction that involves other issues upon which the Service will rule and it is impossible to determine the tax consequences of the larger transaction without determining the tax consequences of the acquisition. However, in such event, the Service will rule on the tax consequences of the larger transaction, provided the taxpayer or the taxpayer's representative (as the Service deems appropriate) represents that to the best of his/her knowledge and belief the acquisition will (or will not) qualify under section 368(a)(1)(B). If the Service issues a ruling on the larger transaction the ruling will state that no opinion is expressed as to whether or not the acquisition qualifies under section 368(a)(1)(B).

Section 368(a)(1)(F). — Definitions Relating to Corporate Reorganizations. — Whether a transaction constitutes a reorganization within the meaning of section 368(a)(1)(F) of the Code, and whether the taxpayer is subject to the consequences of qualification under that section (such as nonrecognition and basis consequences) that are adequately addressed by a statute, regulation, decision of the Supreme Court, tax treaty, revenue ruling, revenue procedure, notice, or other authority published in the Internal Revenue Bulletin.

For purposes of this provision, if a transaction qualifies under both sec-

tion 368(a)(1)(F) and another corporate restructuring provision, and the other provision is not covered by this revenue procedure, the Service will treat any request for a qualification ruling under the other provision as a request for a qualification ruling under section 368(a)(1)(F). A taxpayer or the taxpayer's representative (as the Service deems appropriate) seeking a qualification ruling under any such other provision must accordingly state that to the best of his/her knowledge and belief the transaction does not qualify under section 368(a)(1)(F).

The Service will not rule on the qualification of a reorganization under section 368(a)(1)(F), even if it is an integral part of a larger transaction that involves other issues upon which the Service will rule and it is impossible to determine the tax consequences of the larger transaction without determining the tax consequences of the reorganization. However, in such event, the Service will rule on the tax consequences of the larger transaction, provided the taxpayer or the taxpayer's representative (as the Service deems appropriate) represents that to the best of his/her knowledge and belief the reorganization will (or will not) qualify under section 368(a)(1)(F). If the Service issues a ruling on the larger transaction the ruling will state that no opinion is expressed as to whether or not the reorganization qualifies under section 368(a)(1)(F).

SEC. 3. COLLATERAL AND OTHER ISSUES

Although the Service will not rule on the consequences of qualification under the foregoing provisions if the consequences are adequately addressed by a statute, regulation, decision of the Supreme Court, tax treaty, revenue ruling, revenue procedure, notice, or other authority published in the Internal Revenue Bulletin, it will rule where the consequences of qualification are not adequately addressed by such authorities. For example, the Service will issue a section 381(c)(4) ruling in connection with a section 368(a)(1)(A) or section 368(a)(1)(F) reorganization. To obtain a ruling on a collateral issue, the taxpayer or the taxpayer's representative (as the Service deems appropriate) must state that to the best of his/her knowledge and belief the transaction qualifies under the applicable no-rule section, set forth the authorities most closely related to the collateral issue, and explain why the collateral issue is not resolved by these authorities. If the Service issues a ruling on a collateral issue the ruling will state that no opinion is expressed as to whether or not the transaction in question qualifies under the applicable no-rule provision.

The Service will also continue to rule on issues that arise in connection with a no-rule transaction but do not depend upon or affect qualification under the applicable no-rule provision.

SEC. 4. MODIFICATIONS

Six months from the publication date of this revenue procedure, the Service will assess the resource burden of issuing rulings on subissues under sections 368(a)(1)(A), 368(a)(2)(D), and 368(a)(2)(E). Based on such assessment, the Service may revise this revenue procedure, as appropriate, to eliminate the practice of issuing subissue rulings or to expand the practice to the other no-rule areas covered by this revenue procedure.

SEC. 5. EFFECTIVE DATE

This revenue procedure is effective with regard to all ruling requests postmarked more than 30 days after December 3, 1990, the date of publication of this revenue procedure in the Internal Revenue Bulletin.

SEC. 6. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 90-3 is amplified.

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26 CFR 601.602: Tax forms and instructions. (Also Part I, Section 6049; 1.6049-4.)

Rev. Proc. 90-57

SECTION 1. PURPOSE

This revenue procedure explains both the procedure otherwise required by the regulations (the "standard procedure") and an acceptable alternative procedure for preparing and filing Forms 1099-INT, Statement for Recipients of Interest Income, in certain situations where a corporation acquires substantially all the assets and assumes substantially all the liabilities of another corporation. The revenue procedure facilitates information reporting in these situations and assures that amounts are reported once and only once.

SEC. 2. BACKGROUND

.01 Section 6011(a) of the Internal Revenue Code provides that, when required by regulations, any person made liable for any tax imposed by the Code, or for the collection of the tax, must make a return or statement according to the forms and regulations prescribed by the Secretary.

.02 Section 3406 of the Code provides that payors of interest reportable under section 6049(a) must, in certain circumstances, deduct and withhold tax equal to 20 percent of the payments. Section 3406(a) identifies the circumstances that require the withholding of tax.

.03 Section 6049(a) of the Code provides that every person who pays interest, as defined in section 6049(b), aggregating $10 or more to any other person during a calendar year, or who receives interest payments as a nominee and makes payments aggregating $10 or more during a calendar year, to another person with respect to interest so received, must make a return according to forms or regulations prescribed by the Secretary.

.04 Section 1.6049-4(b) of the Income Tax Regulations provides that persons required to make information returns under section 6049(a) of the Code must file Forms 1099 for the calendar year. Those returns must show the aggregate amount of the interest payments; the name, address, and taxpayer identification number of the person to whom paid; and the amount of tax deducted and withheld under the provisions concerning backup withholding.

SEC. 3. SCOPE

.01 This revenue procedure applies only when all of the following conditions are met:

(1) One corporation (the "successor") acquires substantially all the assets and assumes substantially all the liabilities of another corporation (the "predecessor");

(2) During the pre-acquisition portion of the calendar year in which the acquisition occurs, the predecessor

makes payments of interest within the meaning of section 6049(b); and

(3) During the post-acquisition portion of that year, the predecessor does not make any such interest payments.

.02 This revenue procedure does not apply in the circumstances described in Rev. Rul. 69-556, 1969-2 C.B. 242, which relates to the absorption of one corporation by another corporation pursuant to a merger agreement.

SEC. 4. STANDARD PROCEDURE

Pursuant to section 6049(a) of the Code and section 1.6049-4 of the regulations, each person that makes interest payments is responsible for information reporting of those payments. Thus, unless the alternative procedure set forth below is used, both the predecessor and the successor must file Forms 1099-INT with respect to interest payments made in the calendar year in which the acquisition occurs (the "acquisition year"). The predecessor must perform all reporting duties with respect to the interest payments that it made during that year, and the successor must do the same with respect to the interest payments it made during the year.

SEC. 5. ALTERNATIVE PROCEDURE

.01 In order to use the alternative procedure, the predecessor and successor must agree that the successor assumes the predecessor's entire obligation to file Forms 1099-INT with respect to interest payments made in the acquisition year.

.02 If the predecessor and successor so agree, and if the successor satisfies the predecessor's obligation described in section 5.01 of this revenue procedure, the predecessor is relieved of the obligation. The successor then must combine (1) the interest payments made to a person by the predecessor in the acquisition year with (2) the interest payments made to that person by the successor in that year, and must report the aggregate amount on the Form 1099-INT for that person for that year. The successor may include with this form additional information explaining to the recipient the aggregate reporting of interest paid.

.03 The successor also must combine the amount of any tax withheld for a person by the predecessor in the acquisition year pursuant to section 3406(a) with the amount of tax withheld for that person by the successor in that year and must report the aggregate amount on the Form 1099-INT for the year.

.04 If the alternative procedure described in this section is used, the successor must file a statement with the Service indicating that Forms 1099-INT are being filed on a combined basis in accordance with the provisions of this revenue procedure. This statement is needed to assist the Service in processing the forms filed under the alternative procedure. For example, if any tax has been withheld by the predecessor pursuant to section 3406(a) during the acquisition year and reported by the predecessor on Form 941, Employer's Quarterly Federal Tax Return, the total of the withholding amounts shown on the successor's Forms 1099-INT for that year will exceed the total of the withholding amounts shown on the successor's Forms 941.

.05 The statement required by section 5.04 of this revenue procedure must include the name, address, and taxpayer identification numbers of both the successor and predecessor corporations. The statement must be filed separately from the Forms 1099-INT for the acquisition year and must be mailed to the following address on or before the date those forms are due: Internal Revenue Service, Martinsburg Computing Center, P.O. Box 1359, Attention: Chief, Magnetic Media 2, Martinsburg, WV 25401-1359

SEC. 6. EFFECTIVE DATE

This revenue procedure is effective for Forms 1099-INT filed after December 24, 1990. In addition, if a successor filed Forms 1099-INT on or before December 24, 1990, in the circumstances described in section 3 of this revenue procedure, the predecessor's filing obligations are deemed to have been satisfied with respect to amounts shown on those forms if the predecessor and successor have substantially complied with all the requirements of section 5 of this revenue procedure (except for the statement requirement of section 5.04).

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26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.
(Also Part I, Sections 6302, 6656; 1.6302-2, 31.6302(c)-1, 31.6302(c)-2, 31.6302(c)-3, 46.6302(c)-1, 48.6302(c)-1, 49.6302(c)-1, 52.6302(c)-1, 301.6656-1.)

Rev. Proc. 90-58

SECTION I. PURPOSE

The purpose of this revenue procedure is to provide guidance regarding application of the failure-to-deposit penalty under section 6656 of the Internal Revenue Code as a result of changes made to the penalty provisions by the Revenue Reconciliation Act of 1989 ("1989 Act"), Pub. L. No. 101-239, 1990-1 C.B. 210. This revenue procedure describes how federal tax deposits will be credited in the determination of whether a failure-to-deposit penalty should apply. This procedure will apply with respect to all taxes required to be deposited under section 6302 of the Code and underlying regulations that are reported on the following Internal Revenue Service forms:

Form 720, Quarterly Federal Excise Tax Return
Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return
Form 941, Employer's Quarterly Federal Tax Return
Form 943, Employer's Annual Tax Return for Agricultural Employees
Form CT-1, Employer's Annual Railroad Retirement and Unemployment Repayment Tax Return
Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons

SEC. II. BACKGROUND

In subtitle G (section 7742) of the 1989 Act, Congress revised the penalty provisions under section 6656 of the Code, effective with respect to any failure-to-deposit made after December 31, 1989. Under revised section 6656, the penalty rate is 2 percent of the deposit underpayment ("underdeposit") if the failure is for not more than 5 days, 5 percent if the failure is for more than 5 days but not more than 15 days, and 10 percent if the failure is for more than 15

days. The penalty rate increases to 15 percent if the tax is not paid on or before the earlier of (i) the day 10 days after the date of the first delinquency notice to the taxpayer under section 6303, or (ii) the day on which notice and demand for immediate payment is given under section 6861 or 6862 or the last sentence of section 6331(a).

SEC. III. SERVICE METHOD FOR APPLYING DEPOSITS (AND OTHER CREDITS)

.01 *MANNER IN WHICH DEPOSITS WILL BE APPLIED.* Effective for deposit liability periods beginning after March 31, 1991, deposits will be applied in date-made order against deposit liabilities in due-date order. Thus, a deposit will first be applied to satisfy any past due underdeposits within the same return period, with the oldest underdeposit being satisfied first. Other credits to the taxpayer's account, such as an overpayment from the previous quarter, will be similarly applied. Amounts delivered to an Internal Revenue Service Office are not treated as deposits but will be credited to the taxpayer's account.

The following employment tax example illustrates how deposits will be applied in due-date order. This ordering rule is similarly applicable to deposits under section 6302 of the Code of railroad retirement taxes, FUTA taxes, excise taxes, and income tax withheld from nonresident aliens and foreign corporations:

Example 1: On Wednesday, April 3, 1991, the close of an employer's eighth-monthly deposit liability period, Employer *A* has a deposit liability of $10,000. Under section 31.6302(c)-1(a)(1)(i) of the Employment Tax Regulations, the $10,000 must be deposited by Monday, April 8, 1991, three banking days after the close of the April 1-3 eighth-monthly period.* During the next eighth-monthly period running from Thursday, April 4, 1991, through Sunday, April 7, 1991, *A* incurs an additional deposit liability of $15,000. Under section 31.6302(c)-1(a)(1)(i), the $15,000 must be deposited by Wednesday, April 10, 1991, three banking days after the close of the April 4-7 eighth-monthly period. *A* deposits $7,000 on April 8 and $15,000 on April 10. The $7,000 deposit partially satisfies the $10,000 liability due April 8 resulting in a $3,000 underdeposit. The $15,000 deposited on April 10 is first applied to satisfy the $3,000 underdeposit on April 8 and the remainder is applied to the deposit liability due April 10. *A* will incur a 2% penalty on the April 8 underdeposit because the failure-to-deposit was for not more than 5 days. *A* also has a $3,000 underdeposit on April 10, thereby incurring a failure-to-deposit penalty on that amount. The penalty rate will depend on when that liability is satisfied.

.02 *DEPOSITS OF TAXES (OTHER THAN EXCISE TAXES) USING "SAFE-HAVEN" RULES.* Both the deposits of (1) employment taxes by employers and (2) withheld income taxes by agents withholding from nonresident aliens and foreign corporation are subject to certain "safe-haven" rules. In the case of employment taxes, no failure-to-deposit penalty will apply if at least 95% of the required deposit is timely made and the remainder is timely deposited as required by the regulations. The same is true in the case of those who withhold from nonresident aliens and foreign corporations, except that a 90% threshold is used. In each case the make-up deposit must be deposited with the first deposit otherwise required after the 15th day of the following month, unless the safe-haven underdeposit occurs in the last month of the return period in which case the balance is due by the return due date. Section 1.6302-2(a)(1)(ii) of the Income Tax Regulations and section 31.6302(c)-1-(a)(1)(i)(b) of the Employment Tax Regulations. The following employment tax examples illustrate how deposits will be applied in the case of those employers and withholding agents who deposit on a "safe-haven" basis.

Example 2: For the April-June calendar quarter of 1991 Employer *B* makes deposits of employment taxes taking into account the 95% safe-haven rule found in section 31.6302(c)-1(a)(1)(i) of the Employment Tax Regulations. For each eighth-monthly period in April 1991, *B* has an employment tax liability of $5,000. *B* makes timely deposits of $4,750 with respect to each eighth-monthly period. In May 1991, *B* again has a $5,000 liability for each of the first three eighth-monthly periods and makes timely deposits of $4,750 with respect to each such period. For the fourth eighth-monthly period of May 1991, (i.e., May 12-15) *B* not only has a periodic $5,000 liability but also a $2,000 liability for safe-haven underdeposits from April (8 deposit periods × $250 underdeposit). This is so because, under section 31.6302(c)-1(a)(1)(i)(b) of the Employment Tax Regulations, the safe-haven underdeposits must be deposited with the first deposit otherwise required after the 15th day of the month following the month in which the 95% safe-haven deposits were made. On May 20, 1991, three banking days after May 15, *B* deposits $6,500. The Service will apply that deposit to first satisfy the $2,000 in safe-haven underdeposits from April since they were the oldest of the liabilities due May 20, and the remaining amount, $4,500, will be applied against the $5,000 liability incurred in the May 12-15 eighth-monthly period. The $4,500 fails to satisfy the 95% safe-haven rule and the $500 underdeposit is subject to the section 6656 failure-to-deposit penalty. The rate of penalty will depend upon when that underdeposit is satisfied.

Example 3: The facts are the same as in Example 2 except that *B* fails to make any deposit with respect to the May 8-11 eighth-monthly period. That $5,000 amount was required to be deposited by May 15, 1991. The $6,500 deposited by *B* on May 20 will first be applied to satisfy the $5,000 liability that was due by May 15, 1991, since that amount was due first. The remaining $1,500 will be used to partially satisfy the $2,000 in safe-haven underdeposits due May 20. The remaining amounts due May 20 (i.e., $500 in safe-haven underdeposits and the $5,000 underdeposit with respect to the May 12-15 eighth-monthly period) will be subject to penalties. The penalty rates will depend upon when those underdeposits are satisfied.

.03 *DEPOSITS OF EXCISE TAXES USING "SAFE-HAVEN" RULES.* Depositors of excise taxes

*For purposes of the examples in this revenue procedure, banking days are assumed to include all calendar days except Saturdays, Sundays and Federal holidays.

reportable on Form 720 also are subject to certain "safe-haven" rules. However, in the case of these excise taxes, the safe-haven underdeposit due date is not related to the due date of an otherwise required deposit. Underdeposits of excise taxes have their own specific due dates. Accordingly, such safe-haven underdeposits will be credited in due date order.

.04 *APPLICATION OF OTHER CREDITS TO TAXPAYER ACCOUNTS.* As indicated above, other credits to the taxpayer's account will be applied in the same manner as deposits. The following examples illustrate how other credits to the taxpayer's account will be applied:

Example 4: On April 4, 1991, three banking days after the close of the March 26-31 eighth-monthly period and the close of the first quarter employment tax return period, Employer *C* makes a payroll tax deposit of $10,000 to satisfy *C*'s March 26-31 deposit liability. This results in an overdeposit for the quarterly return period of $3,500. For the eighth-monthly period April 1-3, 1991, the beginning of the second quarter return period, *C* incurs a deposit liability of $3,000. Because the $3,500 overdeposit made April 4 was designated as a deposit for the first quarter, it cannot be applied on April 4 to satisfy the $3,000 deposit liability for the April 1-3 eighth-monthly period because, under section 31.6302(c)-1(a)(1)(i)(b)(2) of the Employment Tax Regulations, an overdeposit from one return period cannot be applied forward to satisfy a succeeding deposit liability in the next return period. On April 30, 1991, the due date for *C*'s Form 941 for the first quarter of 1991, *C* files the form and reports an overpayment of $3,500. *C*'s second quarter account will be credited by the amount of the overpayment on the due date of the first quarter return, April 30. On April 30, the Service will use that amount to satisfy any liabilities for the second quarter to date, with the oldest liability being satisfied first.

Example 5: During the eighth-monthly period May 1-3, 1991, Employer *D* incurs an employment tax liability of $5,000, thus requiring a deposit within 3 banking days. On May 8, 1991, the deposit due date, *D* hand-delivers a check in the amount of $5,000 to the local Internal Revenue Service District Office, rather than depositing the check in an authorized depository as required by section 31.6302(c)-1(a)(2) of the regulations. Because the $5,000 amount has not been deposited, *D* incurs a failure-to-deposit penalty under section 6656 of the Code. However, the Service will apply the $5,000 to *D*'s account as of May 8, 1991. Thus, the amount may be used to satisfy any existing underdeposit in that calendar quarter, with the oldest liability being satisfied first. Since the $5,000 was credited to the taxpayer's account and is, thus, not an amount due at the time the quarterly return was required to be filed, the 15 percent penalty under section 6656 cannot apply with respect to that underdeposit, and the highest rate of penalty that can apply to *D* on the failure-to-deposit is 10 percent.

SEC. IV. EFFECTIVE DATE

This revenue procedure is effective with respect to deposit periods beginning after March 31, 1991.

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26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.
(Also Part I, Sections 62, 162, 274, 1016; 1.62-2, 1.162-17, 1.274-5T, 1.1016-3.)

Rev. Proc. 90-59

SECTION 1. PURPOSE

This revenue procedure updates Rev. Proc. 89-66, 1989-2 C.B. 792, as amplified, 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, 1991, 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 section 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 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. 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 section 262, no portion of the operating cost that is attributable to personal use is deductible.

.02 Section 274(d) of the Code provides, in part, that no deduction shall be allowed under section 162 with respect to any listed property (as defined in section 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 1.274-5T(g) of the temporary regulations, 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 section 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 section 1.274-5T(f).

.04 Section 62(a)(2)(A) of the Code allows an employee, in determining adjusted gross income, a deduction for the expenses allowed by Part VI (section 161 and following), sub-

chapter 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) of the Code provides that an arrangement will not be treated as a reimbursement or other expense allowance arrangement for purposes of section 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 section 274(d), the Commissioner has provided that substantiation is not required for such expense.

.06 Under section 1.62-2(c)(1) of the regulations, a reimbursement or other expense allowance arrangement satisfies the requirements of section 62(c) of the Code 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 section 1.274-5T(g) will be treated as substantiation of the amount of such expenses for purposes of section 1.62-2. Under section 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 section 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) of the regulations provides that if a payor pays a mileage allowance under an arrangement that meets the requirements of section 1.62-2(c)(1), the portion, if any, of the allowance that relates to miles of travel substantiated in accordance with section 1.62-2(e), that exceeds the amount of the employee's expenses deemed substantiated for such travel pursuant to rules prescribed under section 274(d) of the Code and 1.274-5T(g), and that the employee is not required to return, is subject to withholding and payment of employment taxes. See sections 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 section 1.62-2(g) (relating to the return of excess amounts) do not apply to this excess portion.

.08 Under section 1.62-2(h)(2)-(i)(B)(4) of the regulations, the Commissioner may, in his discretion, prescribe special rules regarding the timing of withholding and payment of employment taxes on mileage allowances.

SEC. 3. 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 section 1.62-2(c)(1) of the temporary regulations 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) is paid at the applicable standard mileage rate, a flat rate or stated schedule, 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 3.03. 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. 4. BUSINESS STANDARD MILEAGE RATE

.01 *In general.* The standard mileage rate for transportation expenses paid or incurred or after January 1, 1991, is 27.5 cents per mile for all miles of use for business purposes. This business standard mileage rate will be adjusted annually (to the ex-

tent 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 and taxes are allowable deductions under section 163 or 164 of the Code, 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, section 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 after December 31, 1979, 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 7 cents a mile for 1980 and 1981, 7.5 cents a mile for 1982, 8 cents a mile for 1983, 1984, and 1985, 9 cents a mile for 1986, 10 cents a mile for 1987, 10.5 cents a mile for 1988, and 11 cents a mile for 1989, 1990, and 1991 for those years in which the 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 section 1016 of the Code.

.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) additional first-year depreciation has been claimed, or (c) the taxpayer has used the Accelerated Cost Recovery System (ACRS) under section 168 of the Code. By using the business standard mileage rate, the taxpayer has elected to exclude the automobile from ACRS pursuant to section 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 estimated useful life (subject to the applicable depreciation deduction limitations under section 280F for any passenger automobile).

SEC. 5. RURAL MAIL CARRIER SPECIAL MILEAGE RATE

.01 *Special mileage rate.* For taxable years beginning after December 31, 1987, section 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 41.25 cents per mile for transportation expenses paid or incurred on or after January 1, 1991 (150 percent of the business standard mileage rate of 27.5 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 4.05, except as provided in section 5.03.

.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 sections 167, 168, or 179 of the Code (including any such deduction attributable to use in a trade or business that does not involve the performance of qualifying services). The availability of the special 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 4.03 also apply to use of the special mileage rate.

.05 *Parking fees, tolls, interest, and taxes.* The rules provided under section 4.04 also apply to the use of the special mileage rate.

SEC. 6. CHARITABLE, MEDICAL, AND MOVING STANDARD MILEAGE RATE

.01 *Charitable.* Section 170(j) of the Code 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 section 170.

.02 *Medical and moving.* The standard mileage rate is 9 cents per mile for use of a passenger automobile (a) to obtain medical care described in section 213 of the Code, or (b) as part of a move for which the expenses are deductible under section 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 sections 163 or 164 of the Code, respectively.

SEC. 7. 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 8) 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 8.05. 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 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 per-

cent 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 $22,500.

(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 7.03(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 a 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 section 163 of the Code.

.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) additional first-year depreciation, or (c) depreciation using ACRS under section 168 of the Code. 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 estimated useful life (subject to the applicable depreciation deduction limitations under section 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 section 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 section 1016 of the Code. See section 7.07(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 section 1.61-21(f)(5) and (6) of the regulations, 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 7.04(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 7.06.

(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 ACRS pursuant to section 168(f)(1) of the Code.

.08 *Failure to meet section 7 requirements.* If an employee receives a mileage allowance that fails to meet one or more of the requirements of section 7, 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 4, 8.01(1), and 8.02 to the extent the requirements of those sections are met.

SEC. 8. 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 4.01 or 5.01 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 8.01, 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 section 1.274-5T of the temporary regulations, the employee is deemed to satisfy the adequate accounting requirements of section 1.274-5T(f), as well as the requirement to substantiate by adequate records or other sufficient evidence for purposes of section 1.274-5T(c). See section 1.62-2(e)(1) for the rule that an arrangement requires 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 section 1.62-2(f)(2) of the regulations 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 section 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 $60 based on an anticipated 200 business miles at 30 cents per mile (at a time when the applicable business standard mileage rate is 27.5 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 ($24), even though the employee is not required to return the portion of the allowance ($3.00) that exceeds the amount of the employee's expenses deemed substantiated under section 8.01 ($33.00) for the 120 substantiated business miles. However, the $3.00 excess portion of the allowance is treated as paid under a nonaccountable plan as discussed in section 8.05.

(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 section 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 8.01, provided the employee substantiates in accordance with section 8.02. See section 1.274-5T(f)(2)(i) of the temporary regulations. 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 section 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 8.01, provided the employee substantiates in accordance with section 8.02. See section 1.274-5T(f)(2)(ii) of the temporary regulations. 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 section 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 8.01 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 section 1.274-5T(f)(2)(iii) of the temporary regulations. 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 8.01. The itemized deduction is subject to the 2-percent floor on miscellaneous itemized deductions provided in section 67.

.07 An employee may deduct an amount computed pursuant to section 4.01 or 5.01 only as an itemized deduction. This itemized deduction is subject to the 2-percent floor on miscellaneous itemized deductions provided in section 67 of the Code.

.08 A self-employed individual may deduct an amount computed pursuant to section 4.01 or 5.01 in determining adjusted gross income under section 62(a)(1) of the Code.

.09 If a payor's reimbursement or other expense allowance arrangement evidences a pattern of abuse of the rules of section 62(c) of the Code 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 section 1.62- 2(c)(3), (c)(5), and (h)(2).

SEC. 9. 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 8.01(1) is subject to withholding and payment of employment taxes. See section 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 9.01 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 section 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 9.01 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 section 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 section 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 7), the payor must compute the amount, if any, that exceeds the amount deemed substantiated under section 8.01(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 4.01 or 5.01 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 section 1.62-2(h)(2)(i)(B)(*4*).

(4) For example, assume an employer pays its employees a mileage allowance at a rate of 30 cents per mile (when the business standard mileage rate is 27.5 cents per mile). The employer does not require the return of the portion of the allowance

(2.5 cents) that exceeds the business standard mileage rate for the business miles substantiated. In June, the employer advances an employee $150 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 $30 to the employer for the 100 business miles not traveled. The amount deemed substantiated for the 400 miles traveled is $110 and the employee is not required to return the remaining $10. No later than the first payroll period following the payroll period in which the 400 business miles traveled are substantiated, the employer must withhold and pay employment taxes on $10.

.02 The portion of a FAVR allowance, if any, that exceeds the amount deemed substantiated for those miles under section 8.01(2) is subject to withholding and payment of employment taxes. See section 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, and 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 section 1.62-2(h)(2)(i)(A).

(2) Any optional high mileage payments are subject to withholding and payment of employment taxes when paid.

SEC. 10. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 89-66, 1989-2 C.B. 792, as amplified by Rev. Proc. 90-34, 1990-1 C.B. 552, is hereby superseded for mileage allowances paid to an employee on or after January 1, 1991, with respect to transportation expenses paid or incurred on or after January 1, 1991, and, for purposes of computing the amount allowable as a deduction, for transportation expenses paid or incurred on or after January 1, 1991.

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26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.
(Also Part I, Sections 62, 162, 267, 274; 1.62-2, 1.162-17, 1.274-5T.)

Rev. Proc. 90-60

SECTION 1. PURPOSE

This revenue procedure updates Rev. Proc. 89-67, 1989-2 C.B. 797, as amplified, modified, and clarified, by providing rules under which the amount of ordinary and necessary business expenses of an employee for lodging, meal, and/or incidental expenses incurred while traveling away from home will be deemed substantiated under section 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.

SEC. 2. 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 expenses paid or incurred while traveling away from home in pursuit of a trade or business. However, under section 262, no portion of such travel expenses that is attributable to personal, living, or family expenses is deductible.

.02 Section 274(d) of the Code provides, in part, that no deduction shall be allowed under section 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 1.274-5T(g) of the temporary 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 section 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 section 1.274-5T(f).

.04 Section 1.274-5T(j) of the temporary regulations 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, section 62(a)(2)(A) of the Code allows an employee a deduction for expenses allowed by Part VI (section 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) of the Code provides that an arrangement will not be treated as a reimbursement or other expense allowance arrangement for purposes of section 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 section 274(d), the Commissioner has provided that substantiation is not required for such expense.

.07 Under section 1.62-2(c)(1) of the Income Tax Regulations, a reimbursement or other expense allowance arrangement satisfies the requirements of section 62(c) of the Code 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 section 1.274-5T(g) or (j) will be treated as substantiation of the amount of such expenses for purposes of section 1.62-2. Under section 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 section 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) of the regulations provides that if a payor pays a per diem allowance that meets the requirements of section 1.62-2(c)(1), the portion, if any, of the allowance that relates to days of travel substantiated in accordance with section 1.62(e), that exceeds the amount of the employee's expenses deemed substantiated for such travel pursuant to rules prescribed under section 274(d) of the Code and 1.274-5T(g), and that the employee is not required to return, is subject to withholding and payment of employment taxes. See sections 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 section 1.62-2(g) (relating to the return of excess amounts) do not apply to this portion.

.09 Under section 1.62-2(h)-(2)(i)(B)(*4*) of the regulations, the Commissioner may, in his discretion, prescribe special rules regarding the timing of withholding and payment of employment taxes on per diem allowances.

SEC. 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 section 1.62-2(c)(1) of the regulations 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/or 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 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. The Federal per diem rate, the Federal lodging expense rate, and the Federal M&IE rate for a locality in the continental United States ("CONUS") are set forth in Appendix A of 41 C.F.R., Chapter 301. See 41 C.F.R. Part 301-7 (1990) for specific rules regarding these Federal rates. The Federal per diem rates for nonforeign localities outside the continental United States ("OCONUS") (including Alaska, Hawaii, Puerto Rico, the Northern Mariana Islands, and the possessions of the United States) are established by the Secretary of Defense and listed in Civilian Personnel Per Diem Bulletins published periodically in the *Federal Register. See, e.g.*, Civilian Personnel Per Diem Bulletin Number 153, 55 Fed. Reg. 50,864 (December 11, 1990). The Federal per diem rates for foreign OCONUS localities are established by the Secretary of State and published, together with the rates for nonforeign OCONUS localities, 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 319, issued December 1, 1990.

(2) *Outside CONUS.* For OCONUS travel away from home, if a separately identified Federal lodging expense rate or Federal M&IE rate does not exist for the OCONUS locality of travel, 60 percent of the applicable Federal per diem rate for that locality of travel is treated as equivalent to the Federal lodging expense rate for that locality and 40 percent of the applicable Federal per diem rate for that locality of travel is treated as equivalent to the Federal M&IE rate for that locality. If a separately identified Federal lodging expense rate or Federal M&IE rate is adopted for an OCONUS locality of travel for which no such separately identified rate previously existed, that rate shall apply to all travel within such locality beginning 30 days after its publication.

(3) *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.

(4) *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 waiters and baggage handlers. 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 section 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 section 1.62-2(d)(3)(ii) of the regulations.

SEC. 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, (2) the payor provides the lodging in kind, (3) the payor pays the actual expenses for lodging directly to the provider of the lodging, or (4) the payor does not have a reasonable belief that lodging expenses were or will be incurred by the employee.

.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 section 1.274-5T of the temporary regulations, 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 $30 as the Federal M&IE rate for any locality of travel in CONUS, and/or $34 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 these 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 these 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 $510 (17 days at $30 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.

SEC. 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 rate set forth in this section 5.02 is $130 for any "high-cost locality" specified in section 5.03, or $88 for any other locality within CONUS. Whichever 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 $34 for a high-cost locality and $26 for any other locality within CONUS, and the Federal lodging expense rate shall be treated as $96 for a high-cost locality and $62 for any other locality within CONUS.

.03 *High-cost localities.* The following localities with a Federal per diem rate of $109 or more are high-cost localities:

Key City	*County and other defined location*
California	
Death Valley	Inyo
Los Angeles	Los Angeles, Kern, Orange, and Ventura Counties; Edwards Air Force Base; Naval Weapons Center and Ordnance Test Station, China Lake
San Diego	San Diego
San Francisco	San Francisco
Santa Barbara	Santa Barbara
Colorado	
Aspen	Pitkin
Vail	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
Georgia	
Atlanta	Clayton, De Kalb, Fulton, and Cobb
Illinois	
Chicago	Du Page, Cook, and Lake
Maryland	
Annapolis	Anne Arundel
Columbia	Howard
Ocean City	Worcester
Massachusetts	
Andover	Essex
Boston, Lowell, and Quincy	Suffolk, Middlesex, and Norfolk
Martha's Vineyard/Nantucket	Dukes and Nantucket
Plymouth	Plymouth
Michigan	
Detroit	Wayne
New Jersey	
Atlantic City	Atlantic
Newark	Bergen, Essex, Hudson, Passaic, and Union
Ocean City/Cape May	Cape May
Princeton/Trenton	Mercer

Key City	*County and other defined location*
New York	
New York City	The boroughs of Bronx, Brooklyn, Manhattan, Queens, and Staten Island; Nassau and Suffolk Counties
White Plains	Westchester
Pennsylvania	
Philadelphia	Philadelphia; city of Bala Cynwyd in Montgomery County
Rhode Island	
Newport	Newport
South Carolina	
Hilton Head	Beaufort

.04 *Changes to section 5.03 for 1991.* For 1991, San Diego, California, Key West, Florida, and Detroit, Michigan have been added to the list of high-cost localities. Palm Springs, California, Conway, New Hampshire, and Dallas/Fort Worth, Texas are no longer included in the list of high-cost localities for 1991.

.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.

SEC. 6. LIMITATIONS AND SPECIAL RULES

.01 *In general.* The Federal per diem rate, the Federal lodging expense 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 (1990), except as provided in sections 6.02 through 6.04.

.02 *Federal per diem or lodging expense rate.* A receipt for lodging expenses is not required in order to apply the Federal per diem rate or the Federal lodging expense rate for the locality of travel.

.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. In addition, the 6-hour/$6 limitation formerly provided in 41 C.F.R. Part 301-7.6(c)(2)(iii) (1990) of the Federal Travel Regulations has been eliminated, effective December 1, 1990.

.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 per diem rate or the Federal M&IE rate:

(1) Such rate may be prorated using the method prescribed by the Federal Travel Regulations under which one- fourth of the applicable Federal M&IE rate is allowed 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 1 1/2 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 1 1/2 times the Federal M&IE rate will be treated as being in accordance with reasonable business practice (even though only 1 1/4 times the Federal M&IE rate would be allowed under the Federal Travel Regulations).

.05 *Application of the 80-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/or 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/or 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.* The provisions of this revenue procedure will not apply in any case in which a payor and an employee are related within the meaning of section 267(b) of the Code, but for this purpose the percentage of ownership interest referred to in section 267(b)(2) shall be 10 percent.

SEC. 7. APPLICATION

.01 If the amount of an expense 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 section 1.274-5T of the temporary regulations, the employee is deemed to satisfy the adequate accounting requirements of section 1.274-5T(f) as well as the requirement to substantiate by adequate records or other sufficient evidence for purposes of section 1.274-5T(c). See section 1.62-2(e)(1) for the rule that an arrangement 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 section 1.62-2(f)(2) of the regulations 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 section 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 in a reasonable period of time (as defined in section 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 section 1.274-5T(f)(2)(i) of the temporary regulations. 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 section 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 section 1.274-5T(f)(2)(ii) of the temporary regulations. 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 section 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 section 1.274-5T(f)(2)(iii) of the temporary regulations. However, for purposes of claiming this itemized deduc-

tion 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 80-percent limitation on meal and entertainment expenses provided in section 274(n) of the Code and the 2-percent floor on miscellaneous itemized deductions provided in section 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 80-percent limitation on meal and entertainment expenses provided in section 274(n) of the Code and the 2-percent floor on miscellaneous itemized deductions provided in section 67.

.07 A self-employed individual may deduct an amount computed pursuant to section 4.03 in determining adjusted gross income under section 62(a)(1) of the Code. This deduction is subject to the 80-percent limitation on meal and entertainment expenses provided in section 274(n) of the Code.

.08 If a payor's reimbursement or other expense allowance arrangement evidences a pattern of abuse of the rules of section 62(c) of the Code 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 section 1.62-2(c)(3), (c)(5), and (h)(2).

SEC. 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).

(1) In the case of a per diem allowance paid as a reimbursement, the excess described in this 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 section 1.62-2(h)(2)(i)(B)(*2*).

(2) In the case of a per diem allowance paid as an advance, the excess described in this 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 section 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 section 1.62-2(h)(2)(i)(A).

(3) 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 section 1.62-2(h)(2)(i)(B)(*4*).

(4) For example, assume that a payor 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 six 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 x (120% x $100) + 4 x (120% x $125)), and does not require the employee to return the excess payment of $140 ((2 days x $20 ($120-$100) + 4 days x $25 ($150-$125)). For the payroll period in which the employer reimburses the expenses, the employer must withhold and pay employment taxes on $140.

SEC. 9. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 89-67, 1989-2 C.B. 795, as amplified, modified, and clarified by Rev. Proc. 90-15, 1990-1 C.B. 476, and Rev. Proc. 90-38, page 363, this Bulletin, is hereby superseded for per diem allowances paid to an employee on or after January 1, 1991, with respect to lodging, meal, and/or incidental expenses paid or incurred for travel while away from home on or after January 1, 1991, 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, 1991.

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26 CFR 601.701: Publicity of information. (Also Part I, Sections 901, 902, 905; 1.901-1, 1.902-1, 1.905-3T)

Rev. Proc. 90-61

SECTION 1. PURPOSE

The purpose of this revenue procedure is to clarify and amplify section 3.05 of Rev. Proc. 80-18, 1980-1 C.B. 623.

SEC. 2. BACKGROUND

Article 23(1) of the United States-United Kingdom Income Tax Convention, 1980-1 C.B. 394 (the "Convention"), incorporates into the Convention the principles of sections 901 and 902 of the Internal Revenue Code of 1986, and allows United States citizens and residents a credit against their United States tax liability for certain taxes (including Advance Corporation Tax, or "ACT")

that they or corporations whose stock they own pay to the United Kingdom. The amount of the credit allowed under Article 23 and section 902 of the Code for taxes paid by subsidiary corporations depends on the amount of dividends paid by the subsidiaries directly or indirectly to the United States shareholder.

Rev. Proc. 80-18 provides rules under the Convention for computing the amounts of dividends and resulting foreign tax credits in various factual settings. Section 3.05 of Rev. Proc. 80-18 deals with the proper treatment of ACT refunds paid by the United Kingdom to United States shareholders of United Kingdom corporations, including United Kingdom corporations having United Kingdom subsidiaries. The fourth paragraph of section 3.05 provides:

> For purposes of Articles 10 and 23 of the Convention, refunded ACT offset against the United Kingdom subsidiary's mainstream tax is a deemed distribution from such subsidiary to the United Kingdom parent corporation (and from the parent to the U.S. shareholder) only if and to the extent that such refunded ACT was not useable by the parent (inasmuch as the parent owes no mainstream tax) and was imposed with respect to profits distributed by the subsidiary to the parent and which were then immediately redistributed to the U.S. shareholder. In all other cases, refunded ACT is a deemed dividend distribution only from the United Kingdom parent corporation to the U.S. shareholder.

SEC. 3. PROCEDURE

The fourth paragraph of section 3.05 of Rev. Proc. 80-18 is deleted and replaced with the following paragraphs:

> For purposes of determining a U.S. shareholder's indirect foreign tax credit arising under Articles 10 and 23 of the Convention, ACT that is paid by a United Kingdom parent corporation and refunded to the U.S. shareholder but that offset the United Kingdom subsidiary's mainstream tax is a deemed dividend distribution from the subsidiary to the United Kingdom parent (and from the parent to the U.S. shareholder) only if and to the extent that the refunded ACT is attributable to profits distributed by the subsidiary to the parent during the same taxable year as the distribution by the parent to the U.S. shareholder on which the refunded ACT was actually paid. In all other cases, refunded ACT is a deemed dividend distribution only from the United Kingdom parent corporation to the U.S. shareholder. Further, to the extent that the refund of ACT is considered to be a deemed dividend distribution from the United Kingdom subsidiary to the United Kingdom parent, the United Kingdom parent has not contributed to the capital of the United Kingdom subsidiary an amount equal to unrefunded ACT.
>
> To determine the allowable U.S. foreign tax credit in this situation, the shareholder must compute the portion of the dividend that is deemed to originate with the United Kingdom subsidiary in order to apply section 902. The amount (including refunded ACT) deemed originally to have been paid as a dividend by the United Kingdom subsidiary to its United Kingdom parent corporation will be based on (1) the rate at which ACT liability is computed, (2) the amount of ACT transferred by the United Kingdom parent to be offset against the United Kingdom subsidiary's liability, and (3) the amount actually distributed by the United Kingdom subsidiary without incurring ACT liability on the distribution. When a United Kingdom subsidiary distributes a dividend (the "actual dividend") to its United Kingdom parent corporation without paying ACT during the same taxable year in which the parent corporation distributes a dividend to its United States corporate shareholder and pays ACT, and the parent transfers to the subsidiary the right to offset that ACT against the subsidiary's mainstream tax liability, then, for purposes of computing the U.S. foreign tax credit available to the parent's qualifying U.S. shareholder under Articles 10 and 23 of the Convention, the subsidiary will be deemed to have paid a dividend to the parent in an amount computed under the following rules (in which the rate of ACT is a/b). If the amount of ACT transferred by the U.K. parent to the U.K. subsidiary is greater than or equal to $(a/a+b)$ of the amount of the actual dividend paid by the subsidiary, then the subsidiary is deemed to have paid a dividend to the parent equal to the excess of the amount of the actual dividend over $[a/2(a+b)]$ of that amount. If the amount of ACT transferred by the U.K. parent to the U.K. subsidiary is less than $(a/a+b)$ of the amount of the actual dividend, then the subsidiary is deemed to have paid a dividend equal to the excess of the amount of the actual dividend over one-half of the amount of the ACT transferred by the parent to the subsidiary.
>
> For example, assume that the rate of ACT is 1/3. The subsidiary distributes a dividend of 60 to the parent but pays no ACT. During the same taxable year, the parent distributes a dividend of 90 to the shareholder and pays ACT of 30 ($1/3 \times 90$), all of which is transferred to the subsidiary. Since 30, the amount of ACT transferred by the U.K. parent, is greater than 15 ($1/(1+3) \times 60$), the subsidiary is deemed to have paid a dividend of 52.50 ($60 - (1/8 \times 60)$). In essence, the 60 dividend paid by the U.K. subsidiary is treated as a dividend of 45 coupled with a payment of 15 of ACT, 7.50 of which will ultimately be refunded to the shareholder and treated as an additional dividend from the subsidiary. If, instead, the subsidiary had distributed a dividend of 125 to the parent without paying ACT, the 30 of ACT transferred by the U.K. parent would be less than 31.25 ($1/(1+3) \times 125$), and the subsidiary would be deemed to have paid a total dividend of 110 ($125 - (30/2)$). In essence, the actual dividend of 125 paid by the U.K. subsidiary would be treated as two dividends: a dividend of 90 on which the subsidiary paid 30 of ACT, and a dividend of 5 on which the subsidiary paid no ACT. Thus 15 of the ACT of 30 ultimately refunded to the shareholder will be treated as an additional dividend from the subsidiary.
>
> After a taxpayer determines the amount of the dividend deemed distributed by the subsidiary, sec-

tion 902 of the Internal Revenue Code will be applied to determine the foreign taxes deemed paid under that section.

SEC. 4. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 80-18 is clarified and amplified.

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26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.
(Also Part I, Sections 6012, 6061; 1.6012-5, 1.6061-1.)

Rev. Proc. 90-62

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SECTION 1. PURPOSE

This revenue procedure informs those who participate in the electronic filing program for Form 1040, U.S. Individual Income Tax Return, of their obligations to the Internal Revenue Service, taxpayers, and other participants.

SEC. 2. BACKGROUND

.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. The composite return shall consist of a form prescribed by the Commissioner and an attachment or attachments of magnetic tape or other approved media.

.02 An electronically filed Form 1040 is a composite return consisting of electronically transmitted data and certain paper documents. The non-electronic 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. An electronically filed return must contain the same information that a return filed completely on paper contains. See section 7 for procedures for completing Form 8453.

.03 The Service will periodically issue a publication that lists the forms and schedules that can be electronically transmitted, as well as the forms, schedules, and other information that cannot be electronically filed.

.04 In general, a tax return with a balance due cannot be electronically filed. However, the Service is conducting a limited test program for filing balance due returns that is fully described in Procedures for Electronic Filing of Individual Income Tax Returns, Publication 1345. Issues unique to balance due returns are not addressed in this revenue procedure.

.05 A tax return cannot be electronically filed after August 15, notwithstanding the fact that the taxpayer has been granted an extension to file. Form 4868, Application for Automatic Extension of Time To File U.S. Individual Income Tax Return, cannot be electronically filed.

.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.

SEC. 3. ELECTRONIC FILING PARTICIPANTS—DEFINITIONS

.01 After acceptance into the Electronic Filing Program, as described in section 4, 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 either: (a) an "electronic return preparer" who prepares tax returns, including Forms 8453, for taxpayers who wish to have their returns electronically filed; or (b) an "electronic return collector" who accepts completed tax returns, including Forms 8453, from taxpayers who wish to have their returns electronically filed.

(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 Soft-

ware Developer may also sell its software.

(3) TRANSMITTER. A "transmitter" transmits electronic returns directly to the IRS Series/1 Communications processor. The transmitter may also accept tax returns from Electronic Filers and directly transmit those tax returns to the Service.

03. The Electronic Filer categories are not mutually exclusive. For example, an ERO can, at the same time, be considered a Transmitter or Software Developer depending on the function(s) performed.

SEC. 4. ACCEPTANCE IN THE ELECTRONIC FILING PROGRAM

To be accepted into the Electronic Filing Program, any potential Electronic Filer must:

(1) file a properly completed Form 8633, Electronic Filer Application to File 19____ Individual Income Tax Returns Electronically with each service center to which the potential Electronic Filer intends to transmit returns.

(2) successfully complete the necessary testing at the appropriate service center(s) if the potential Electronic Filer intends to transmit electronic returns or has developed software for formatting or transmitting electronic returns; and

(3) pass a suitability check.

SEC. 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 Electronic Filing Systems Office. Currently, these publications and notices include:

(1) Procedures for Electronic Filing of Individual Income Tax Returns, Publication 1345;

(2) Electronic Return File Specifications and Record Layouts for Individual Income Tax Returns, Publication 1346; and

(3) Electronic Filing Systems 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 or from another Electronic Filer.

.04 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. An Electronic Filer may not charge a separate fee for Direct Deposit. See section 9 for a discussion of Direct Deposit.

.05 A potential Electronic Filer may not stockpile returns for electronic transmission prior to receiving official acceptance into the Electronic Filing Program. An Electronic Filer may not stockpile returns at any time. Stockpiling means collecting returns from taxpayers or from another Electronic Filer prior to official acceptance into the Electronic Filing Program, or waiting more than a few days to transmit a return after receiving the information necessary for an electronic transmission of a tax return.

.06 A previously accepted Electronic Filer must submit a revised Form 8633 to each service center where the Electronic Filer previously filed a Form 8633 to update information when there is a change to:

(1) the Firm name or Doing Business As (DBA) name:

(2) the organization's ownership structure;

(3) the electronic filing functions performed;

(4) the address, telephone or contact representative at the main office;

(5) the control or branch address-(es), contact person(s) and telephone number(s); or

(6) control or branch office(s).

.07 A previously accepted Electronic Filer must file a revised Form 8633 with the Cincinnati and/or Ogden Service Centers to transmit balance due returns.

.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 as accepted for processing and a signed Form 8453 has been received by the Service. However, if the electronic portion of a return is initially 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.

.09 If an acknowledgement of acceptance for processing has not been received by the Electronic Filer within two work days of transmission or if an Electronic Filer receives an acknowledgement for a return that was not transmitted on the designated transmission, the Electronic Filer must immediately contact the Electronic Filing Unit at the appropriate service center for further instructions.

.10 An Electronic Filer who functions as an ERO must:

(1) comply with the procedures for securing Forms 8453 described in section 7 of this revenue procedure;

(2) furnish copies of the signed Forms 8453 and non-electronic portions of the electronic returns to the taxpayer; and

(3) retain the following material until the end of the calendar year of the electronic filing unless otherwise notified by the Service:

(a) a copy of the signed Form 8453 and the non-electronic portion of the electronic return;

(b) a complete copy of an electronically transmitted return (may be retained on magnetic media);

(c) the acknowledgement file received from the Service or from a third party transmitter.

.11 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 section 1.6107-1(b) of the regulations that are required to be kept by an income tax return preparer.

.12 If the electronic portion of a taxpayer's return is acknowledged as rejected by the Service, the ERO must immediately advise the taxpayer that the taxpayer's return has not been filed. 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 due date of the return. If the due date of the return has passed, the taxpayer must file a paper return as soon as possible with an explanation of why the return is being filed after the due date.

.13 An Electronic Filer who functions as a Transmitter must:

(1) transmit all electronic returns within a few days of receipt, retrieve

the acknowledgement file within two work days of transmission, and forward the file to the ERO within five calendar days;

(2) match the acknowledgement file to the original transmission file and resubmit those returns that are not acknowledged as accepted for processing after corrections are made;

(3) contact the appropriate service center Electronic Filing Unit for assistance if a return has been rejected after three transmission attempts, or if an acknowledgement is received for a return that was not in the original submission;

(4) ensure the security of all transmitted data; and

(5) promptly correct any transmission error that causes an electronic return to be rejected.

.14 A Transmitter who provides transmission services to another Electronic Filer must, in addition to the items covered in 5.13, also:

(1) only accept an electronic return for transmission to the IRS Series/1 Communications processor from an accepted Electronic Filer; and

(2) provide each client with the acknowledgement file for the transmitted return within five days after receipt of the acknowledgement from the Service.

.15 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; and

(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 acount the sorting requirements of the Declaration Control Number (DCN).

SEC. 6. PENALTIES

.01 Penalties for Disclosure or Use of Information.

(1) An Electronic Filer, except a Software Developer, is a tax return preparer under the definition of section 301.7216-1(b) of the Regulations on Procedure and Administration. An Electronic Filer is subject to a criminal penalty for disclosure or use of tax return information, as described in section 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. Section 6713 of the Internal Revenue Code also provides for civil penalties that may be assessed against a preparer who makes an unauthorized disclosure or use of tax return information.

(2) Under section 301.7216-2(h) of the regulations, disclosure 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 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, the Transmitter may be guilty of a misdemeanor as described in paragraph (1) above.

.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 section 7701(a)(36) of the Code and 301.7701-15 of the regulations. Examples of preparer penalties that may be asserted under appropriate circumstances include, but are not limited to, those set forth in sections 6694, 6695, and 6713.

(2) Section 301.7701-15(d) of the regulations provides that Electronic Return Collectors, 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, 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 section 301.7701-15(d)(1) of the regulations. 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 tax return by no more than $5;

(b) the Total Income amount shown on Form 8453 differs from the corresponding amount on the electronic tax return by no more than $25; or

(c) Dropping cents and rounding to whole dollars.

(4) If a Transmitter or an Electronic Return Collector alters the return information in a substantive way, rather than having the taxpayer alter the return, the Transmitter or Electronic Return Collector will be considered to be a paid preparer for purposes of section 7701(a)(36) of the Code.

(5) If it can be determined that the role of an Electronic Return Collector or Transmitter, or that 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.

SEC. 7. FORM 8453, U.S. INDIVIDUAL INCOME TAX DECLARATION FOR ELECTRONIC FILING

.01 Procedures for Completing Form 8453.

(1) An ERO prepares the return for electronic filing, computes the tax based on the information that the taxpayer provides, and accepts the return for the purposes of electronic filing, or collects an already prepared

tax return for the purposes of electronic filing.

(2) After the return has been prepared and before the return is electronically transmitted, the taxpayer must verify the information on the electronic return and on Form 8453 and sign Form 8453. Both spouses' signatures are required on a joint return prior to the electronic transmission of the tax return. A file copy of the prepared return must be provided to the taxpayer at the time of signature.

(3) An Electronic Filer must submit the taxpayer's Form 8453 to the appropriate service center one working day after the Electronic Filer receives acknowledgment that the electronic portion of the taxpayer's return has been accepted for processing.

(4) An Electronic Filer must ensure that the Service receives by April 22 all taxpayers' Forms 8453 for all transmissions the Electronic Filer has made as of April 15, whether or not acknowledged by the Service.

(5) If an Electronic Filer functions as an ERO, the Electronic Filer must sign the ERO's Declaration on Form 8453.

(6) If the Electronic Filer is also the paid preparer, the Electronic Filer must sign the Paid Preparer's Declaration on Form 8453.

.02 Corrections to Form 8453.

(1) If the ERO changes an electronic 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 with the corrections if either of the following applies:

(a) the "Total Income" (Form 8453, line 1) differs from the amount on the electronic tax return by more than $25; or

(b) the "Total Tax" (Form 8453, line 2), the "Refund" (Form 8453, line 4), or the "Amount you owe" (Form 8453, line 5), differs from the amount on the electronic tax return by more than $5.

(2) A new Form 8453 is not required for a nonsubstantive change. A nonsubstantive change is limited to a correction within the above tolerances for arithmetic errors, a transposition error, a misplaced entry, and 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, enter the initials or the name of the person making the correction.

(3) Dropping cents and 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 either a copy of the signed Form 8453 from the ERO's records or obtain a new Form 8453 from the taxpayer within five working days of the Service's request for this form.

.04 If a substitute Form 8453 is used, it must be approved by the Service prior to use. See Rev. Proc. 90-8, 1990-1 C.B. 434.

SEC. 8. INFORMATION AN ELECTRONIC FILER MUST PROVIDE TO THE TAXPAYER

.01 The ERO must furnish the taxpayer with a paper copy of the electronic material that was transmitted to the Service. This information 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 also provide the taxpayer with a paper copy of the paper portion of the taxpayer's return.

.03 The ERO must advise the taxpayer to retain a complete copy of a return and any supporting material.

.04 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.

.05 The ERO must, upon request, provide the taxpayer with the Declaration Control Number (DCN) and the date the electronic portion of the taxpayer's return was acknowledged as accepted for processing by the Service.

SEC. 9. DIRECT DEPOSIT OF REFUNDS

.01 The Service does not guarantee a specific date that a refund will be directly deposited into the taxpayer's financial institution account. Because of disclosure laws, the Service cannot provide information to the Electronic Filer about any delay or denial of a Direct Deposit without proper written authorization.

.02 Neither the Internal Revenue Service nor Financial Management Service (FMS) is responsible for the misapplication of a Direct Deposit that is caused by error or negligence on the part of the taxpayer, Electronic Filer, financial institution, or any of their agents.

.03 An ERO must:

(1) ensure that the taxpayer is aware of all the general information regarding a 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, the Direct Deposit election cannot be rescinded nor can the Routing Transit Number "RTN" of the account number be changed;

(7) notify the taxpayer if the Direct Deposit request will not be honored by the Service;

(8) advise the taxpayer of the procedures to be followed if there is a need to contact the Service about a Direct Deposit request;

(9) inform the taxpayer if the electronic portion of a return was acknowledged as accepted for processing by the Service, but the Direct Deposit request was not honored during initial processing; and

(10) not mislead the taxpayer about why a Direct Deposit was denied.

SEC. 10. REFUND ANTICIPATION LOANS (RALS)

.01 An Electronic Filer may assist a taxpayer in applying for a RAL. The RAL must be made by the financial institution designated to receive the Direct Deposit of the anticipated refund. The Service has no involvement in RALs. This is a contract between the taxpayer and the financial institution.

.02 An Electronic Filer may charge a flat fee to assist a taxpayer in applying for a RAL. The fee must be identical for all taxpayers and must not be related to the amount of the refund or RAL. The Electronic Filer cannot accept a fee from a financial institution for any service connected with an RAL that is contingent upon the amount of the refund or RAL.

.03 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 section 301.7216-3(b) of the regulations.

.04 After an Electronic Filer has been informed that the Direct Deposit request will be granted, the request may be subsequently rejected due to special processing needs of the Service. The RAL must not guarantee the date the refund will be issued or the amount of the refund. An Electronic Filer must advise the taxpayer that if a Direct Deposit is not timely, the taxpayer may be liable for interest on the RAL.

.05 An Electronic Filer that is also the return preparer, and the financial institution making the RAL, or any other entity that makes a loan based on or related to a taxpayer's anticipated refund, may not be related taxpayers within the meaning of section 267 or section 707 of the Code.

.06 An income tax return preparer may not endorse or otherwise negotiate a refund check or Direct Deposit for any other taxpayer. A preparer that is also a financial institution may not 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. In addition, section 6695(f) of the Code states that the preparer shall be subject to a penalty of $500 for each prohibited endorsement or negotiation of a refund check.

SEC. 11. ADVERTISING STANDARDS FOR AN ELECTRONIC FILER AND A FINANCIAL INSTITUTION

.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. The prohibition includes, but is not limited to, statements pertaining to the quality of services rendered unless subject to factual verification, claims of specialized expertise not authorized by state or federal agencies having jurisdiction over the Electronic Filer, and statements or suggestions that the ingenuity and/or prior record of an Electronic Filer rather than the merit of the matter are principal factors likely to determine the result of the matter. In addition, advertising must not imply a special relationship with the Service, FMS, or the Treasury Department. Claims for faster refunds by virtue of electronic filing must be consistent with the language in official Service publications.

.02 The use of the Service's name, "Internal Revenue Service," or "IRS" within a firm's name may result in immediate suspension from the Electronic Filing Program.

.03 The use of improper or misleading advertising in relation to the Electronic Filing Program (including the time frames for refunds and RALS) is grounds for suspension or rejection from the Electronic Filing Program.

.04 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.

.05 Advertising materials may not carry the FMS or Treasury Seals.

.06 Advertising for a cooperative electronic return project (public/private sector) must clearly state the names of all cooperating parties.

.07 In advertising the availability of a RAL, an Electronic Filer and a financial institution must 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.

.08 Media communications, including fee information, shall be limited to professional lists, telephone directories, print media, permissible mailings, radio, and television. In the case of radio and television broadcasting, the broadcast shall be prerecorded and the Electronic Filer shall retain a recording of the actual audio transmission until the end of the calendar year in which the transmission is made.

.09 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.

SEC. 12. MONITORING AND SUSPENSION OF AN ELECTRONIC FILER

.01 The Service will monitor an Electronic Filer for conformity with this revenue procedure. The Service will issue a warning letter that describes specific corrective action for deviations from this revenue procedure.

.02 The Service will monitor the timely receipt of Forms 8453, as well as monitoring their overall legibility (especially the recording of the Declaration Control Number (DCN)).

.03 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.

.04 The Service will monitor branch offices and advise an Electronic Filer of any problems the Service has en-

countered that originate in a branch office. If there are repeated or continuing problems with electronic filing from a particular branch office, the "parent" Electronic Filer will be required to drop that office from the Electronic Filing Program. Failure to take corrective action with the problem branch will lead to the initiation of suspension against the "parent" Electronic Filer. If the Service initiates suspension action, it will apply to all returns filed by the "parent" Electronic Filer, including the branch offices.

.05 The Service will monitor complaints about an Electronic Filer and issue a warning or suspension letter as appropriate.

.06 The Service reserves the right to rescind the electronic filing privilege of any Electronic Filer who violates any provision of this revenue procedure or who does not consistently transmit accurate returns. When suspended, the Electronic Filer will be counseled concerning the requirements for reacceptance into the Electronic Filing Program. The following conditions may lead to warning letters and/or suspension of an Electronic Filer from the 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, both business and personal;

(3) failure to pay personal or business tax liabilities;

(4) assessment of 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) deterioration in the format of individual transmissions;

(9) unacceptable cumulative error rate;

(10) unethical practices in return preparation;

(11) untimely received, illegible, missing, or unapproved substitute Forms 8453;

(12) stockpiling returns prior to official acceptance into the Electronic Filing Program or at any time while participating in the Electronic Filing Program;

(13) a transmitter not providing preparer clients with acknowledgement files within five calendar days after receipt from the Service; or

(14) significant complaints about an Electronic Filer.

SEC. 13. ADMINISTRATIVE REVIEW PROCESS FOR DENIAL OF PARTICIPATION IN, OR SUSPENSION FROM, THE ELECTRONIC FILING PROGRAM

.01 An applicant who has been denied participation in the Electronic Filing Program, or a participant who has been suspended from the program, has the right to administrative review.

.02 An appeal for administrative review must be made to the Director of Practice, Internal Revenue Service, within 60 days from the date of denial or the date of suspension. A copy of the denial or suspension letter and a copy of the firm's Electronic Filing Application, Form 8633, should be attached. Requests for Administrative Review should be faxed to (202)535-6795 or mailed to:

Director of Practice HR:DP
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

SEC. 14. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 89-57, 1989-2 C.B. 644, is superseded.

SEC. 15. EFFECTIVE DATE

This revenue procedure is effective January 1, 1991.

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26 CFR 601.204: Changes in accounting period and in methods of accounting.
(Also Part I, Sections 165, 167, 263, 263A, 446, 481; 1.165-2, 1.167(a)-3, 1.263(a)-2, 1.263A-1T(a)(5), 1.446-1, 1.481-5.)

Rev. Proc. 90-63

SECTION 1. PURPOSE

.01 This revenue procedure provides the exclusive procedure for taxpayers to obtain consent from the Commissioner to change their method of accounting for package design costs. It revokes Rev. Proc. 89-16, 1989-1 C.B. 822, and Rev. Proc. 89-17, 1989-1 C.B. 827. It describes three alternative methods of accounting for package design costs: (1) capitalization (see section 5.01), (2) design-by-design capitalization and 60-month amortization (see section 5.02), and (3) pool-of-cost capitalization and 48-month amortization (see section 5.03). It also provides the procedure for taxpayers to obtain consent from the Commissioner to change to each of the alternative methods, including rules relating to the availability of each of the alternative methods of accounting, and the limitations, terms and conditions the Commissioner deems necessary to change to each of the alternative methods.

.02 In accordance with section 1.446-1(e)(3)(ii) of the regulations, the Commissioner waives the 180-day rule, and, in accordance with section 1.446-1(e)(2)(i), hereby grants consent to any taxpayer not described in section 9.01(2) (concerning certain taxpayers that changed (or received permission to change) their method of accounting for package design costs during the six tax years prior to the year of change) to change its method of accounting for package design costs provided the taxpayer complies with the provisions and conditions of this revenue procedure. This consent is granted for the tax year (year of change) for which the taxpayer requests a change by filing a current Form 3115 (Application for Change in Accounting Method) in the manner described in sections 9.01(1), 9.02 or 9.03. Taxpayers that are not using an acceptable method and do not voluntarily change their method of accounting for package design costs will be required to do so on audit. The Commissioner may require them to change to the capitalization method described in section 5.01 rather than one of the two amortization methods described in sections 5.02 and 5.03. *See* section 6.08. A taxpayer filing its first return may, in accordance with section 1.446-1(e)(1), adopt any one of the three alternative methods of accounting for package design costs provided in section 5.

.03 Because this revenue procedure provides the exclusive procedure for taxpayers to change their method of

accounting for package design costs, a taxpayer may not use Rev. Proc. 84-74, 1984-2 C.B. 736, to change its method of accounting for package design costs. However, this revenue procedure incorporates by reference certain provisions of Rev. Proc. 84-74.

.04 A taxpayer that makes a change in method of accounting for package design costs without complying with the conditions of this revenue procedure has made a change in method of accounting without obtaining the consent of the Commissioner as required under section 446(e) of the Code.

SEC. 2. DEFINITIONS

For purposes of this revenue procedure, the terms "package design" and "package design cost" have the meanings provided in Rev. Rul. 89-23, 1989-1 C.B. 85. If the taxpayer develops the package design, the term includes the cost of materials, labor, and overhead associated with the design, including all design exploration and study (for example, the development of any related design which, although abandoned, advances the development of the design selected), refinement of the basic design selected, testing, and preparation of the final master comprehensive design. If an independent contractor performs the work, the term includes all billings related to the development of the particular package, including all design exploration and study (for example, the development of any related design which, although abandoned, advances the development of the design selected), refinement of the basic design selected, testing, and preparation of the final master comprehensive design. If the taxpayer purchases the package, the term includes the purchase price. The costs associated with coupon inserts, refund offers, and other short-lived promotion-related changes are specifically excepted from the definition of "package design cost."

SEC. 3. BACKGROUND

.01 Section 263(a) of the Code provides that no deduction is allowed for any amount paid for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. Section 1.263(a)-2 of the regulations includes in its examples of capital expenditures the costs of acquiring property having a useful life substantially beyond the tax year.

.02 An expenditure generally must be capitalized under section 263 of the Code if the expenditure creates, enhances, or is part of the cost of acquiring a tangible or intangible asset having a useful life that extends substantially beyond the end of the tax year in which the expenditure is incurred. *See Commissioner v. Lincoln Savings and Loan Association*, 403 U.S. 345 (1971), 1971-2 C.B. 116; *Central Texas Savings and Loan Association v. United States*, 731 F.2d 1181 (5th Cir. 1984); *Ellis Banking Corp. v. Commissioner*, 688 F.2d 1376 (11th Cir. 1982), *cert. denied*, 463 U.S. 1207 (1983); and *Cleveland Electric Illuminating Company v. United States*, 7 Cl. Ct. 220 (1985). Generally, taxpayers must capitalize package design costs incurred prior to January 1, 1987, under section 263 because those costs create intangible assets having useful lives that extend substantially beyond the end of the tax year in which the costs are incurred. *See* Rev. Rul. 89-23.

.03 Section 263A of the Code, enacted by the Tax Reform Act of 1986, provides, in part, for the capitalization of certain direct and indirect costs with respect to real or tangible personal property produced by the taxpayer. All costs that are incurred with respect to real or tangible personal property that the taxpayer produces are to be capitalized with respect to the property. The term "produce" includes construct, build, install, manufacture, develop, improve, create, raise, or grow. For purposes of section 263A, "tangible personal property" includes a film, sound recording, video tape, book, or similar property embodying words, ideas, concepts, images, or sounds (*see* 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-308 (1986), 1986-3 (Vol. 4) C.B. 308) without regard to whether the property is treated as tangible or intangible under other provisions of the Code. *See* section 1.263A-1T(a)(5)(iii) of the regulations. Section 263A and the regulations thereunder require that costs incurred after December 31, 1986, in connection with the development and design of product packages must be capitalized. *See* Rev. Rul. 89-23.

.04 As stated in Rev. Rul. 89-23, package designs generally do not have an ascertainable useful life, and thus no depreciation or amortization is allowed under section 167 of the Code and the regulations thereunder. *See* section 1.167(a)-3 of the regulations. Only when such a package design is abandoned may the capitalized costs be deducted. *See* section 165 of the Code and section 1.165-2(a) of the regulations.

.05 Thus, taxpayers are generally required under the Code and regulations to use the capitalization method of accounting for package design costs described in section 5.01. However, to minimize disputes regarding the accounting for package design costs, the Internal Revenue Service, as a matter of administrative convenience, will allow a taxpayer that complies with the requirements of this revenue procedure to choose one of two alternative methods of accounting for package design costs: (1) the capitalization and 60-month amortization method described in section 5.02, determined on a design-by-design basis for all package designs or; (2) the capitalization and 48-month amortization method described in section 5.03, determined on a pool-of-cost basis for all package design costs.

.06 Section 446(e) of the Code provides that, except as otherwise provided, a taxpayer that changes the method of accounting on the basis of which it regularly computes its income in keeping its books shall, before computing its taxable income under the new method, secure the consent of the Secretary. Section 1.446-1(e)(2)(ii)(*a*) of the regulations provides that a change in method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in the overall plan. Section 1.446-1(e)(2)(ii)(*a*) defines a material item as any item that involves the proper time for the inclusion of the item in income or the taking of a deduction. Section 1.446-1(e)(3)(i) provides generally that in order to obtain the consent of the Commissioner for an accounting method change, a taxpayer must file an application on Form 3115, Application for Change in Accounting Method, within 180 days after the beginning of the

tax year for which the proposed change is to be made. Section 1.446-1(e)(3)(ii) authorizes the Commissioner to prescribe administrative procedures setting forth the limitations, terms, and conditions deemed necessary to permit taxpayers to obtain consent to change their method of accounting in accordance with section 446(e).

.07 Section 481(a) of the Code provides that if a taxpayer's taxable income for any tax year is computed under a method of accounting different from the method used to compute taxable income in the preceding tax year, the taxpayer must take into account those adjustments necessary to prevent amounts from being duplicated or omitted by reason of the change in method. Section 481(a) and section 1.481-5 of the regulations provide that the adjustments required by section 481(a) may be taken into account in determining taxable income in the manner and subject to the conditions agreed to by the Commissioner and the taxpayer.

SEC. 4. SCOPE

This revenue procedure applies to any taxpayer that desires or is required to change its method of accounting for package design costs. A change in method of accounting for package design costs made pursuant to this revenue procedure does not affect the taxpayers method of accounting for intangible property other than package designs described in section 2. This revenue procedure includes special rules for taxpayers:

(i) contacted for examination where the package design issue has not been raised (see section 6.02);

(ii) before an appeals office where the package design issue has not been raised (see section 6.03);

(iii) before a federal court where the package design issue has not been raised (see section 6.04);

(iv) the subject of a criminal investigation or proceeding (see section 6.05);

(v) under examination, before an appeals office, or before a federal court where the package design issue was raised before March 6, 1989 (see section 6.06);

(vi) under examination, before an appeals office, or before a federal court where the package design issue is raised on or after March 6, 1989, but on or before the due date of the taxpayer's tax return for its first tax year ending on or after release of this revenue procedure (see section 6.07); and

(vii) under examination, before an appeals office, or before a federal court where the package design issue is raised after the due date of the taxpayer's tax return for its first tax year ending on or after release of this revenue procedure (see section 6.08).

SEC. 5. ALTERNATIVE METHODS OF ACCOUNTING

.01 *The Capitalization Method.*

(1) *Description of Method.* The treatment of the costs of developing new package designs or modifying existing designs in accordance with the capitalization method constitutes a permissible method of accounting. Under the capitalization method, the taxpayer must capitalize the costs of developing (or modifying) any package design if the asset created by those costs has no ascertainable useful life or an ascertainable useful life that extends substantially beyond the end of the tax year in which the costs are incurred. If the asset created by the costs has an ascertainable useful life, the taxpayer may amortize the costs ratably over the useful life, beginning with the month the package design (or modification to the design) is placed in service. If the asset created by the costs has no ascertainable useful life, the taxpayer may deduct the costs only upon the disposition or abandonment of the package design (or modification to the design). *See* Rev. Rul. 89-23.

(2) *Computation of Basis.* The basis of each package design (or modification to the design) subject to capitalization is determined by applying the provisions of section 263 of the Code and the regulations thereunder to costs incurred prior to January 1, 1987, and section 263A and the regulations thereunder to costs incurred after December 31, 1986 (regardless of the tax year the design (or modification to the design), is placed in service). The costs required to be capitalized are described in section 2.

.02 *The Design-by-Design Capitalization and 60-month Amortization Method.*

(1) *Description of Method.* The treatment of the costs of developing new package designs or modifying existing designs in accordance with the design-by-design capitalization and 60 month amortization method constitutes a permissible method of accounting. Under the design-by-design capitalization and 60-month amortization method, the taxpayer must capitalize the costs of developing (or modifying) any package design if the asset created by those costs has no ascertainable useful life or an ascertainable useful life that extends substantially beyond the end of the tax year in which the costs are incurred. The taxpayer must amortize the basis of any package design (or modification to the design) subject to capitalization over a period of 60 months. Thus, in computing taxable income, the basis of each package design (or modification to the design) subject to capitalization is allowed as a deduction ratably over a 60-month period, beginning with the month the design (or modification to the design) is treated as placed in service. *See* section 5.02(3) below. If the package design (or modification to the design) is disposed of or abandoned within the 60-month period, the taxpayer is permitted to deduct the unamortized portion of the basis of the design (or modification to the design) in the tax year of disposition or abandonment.

(2) *Computation of Basis.* Under the design-by-design capitalization and 60-month amortization method, the basis of each package design (or modification of the design) subject to capitalization must be determined by applying the provisions of section 263 of the Code and the regulations thereunder to costs incurred prior to January 1, 1987, and section 263A and the regulations thereunder to costs incurred after December 31, 1986, (regardless of the tax year the design (or modification to the design) is placed in service). The costs required to be capitalized are described in section 2.

(3) *Half-year Convention.* Under the design-by-design capitalization and 60-month amortization method, the amortization allowance for each package design (or modification to the design) subject to capitalization must be determined by treating a

design (or modification to the design) placed in service during the tax year as placed in service on the mid-point of the tax year. If the tax year in which the package design (or modification to the design) is placed in service is 12 full months, the design (or modification to the design) is treated as placed in service on the first day of the seventh month of the tax year. For guidance in computing the amortization allowance under the design-by-design capitalization and 60-month amortization method when a package design (or modification to the design) is placed in service in a taxable year of less than 12 months (a short taxable year), see Rev. Proc. 89-15, 1989-1 C.B. 816.

(4) *Eligibility.* The design-by-design capitalization and 60-month amortization method is a rule of administrative convenience which may only be adopted on the taxpayer's first return or pursuant to the provisions of this revenue procedure.

.03 *The Pool-of-Cost Capitalization and 48-month Amortization Method.*

(1) *Description of Method.* The treatment of the costs of developing new package designs or modifying existing designs in accordance with the pool-of-cost capitalization and 48-month amortization method constitutes a permissible method of accounting. Under the pool-of-cost capitalization and 48-month amortization method, the taxpayer must capitalize all of its package design costs and amortize the costs over a period of 48 months. Thus, in computing taxable income, package design costs incurred during the tax year are allowed as a deduction ratably over a 48-month period, beginning with the month the costs are treated as incurred. *See* section 5.03(3) below. The taxpayer may not deduct the unamortized portion of the cost of a package design (or modification to the design) if the design (or modification to the design) is never placed in service or is disposed of or abandoned within the 48-month period.

(2) *Costs Subject to Capitalization.* All package design costs are subject to capitalization without regard to whether the costs create a package design (or modification to the design) having an ascertainable useful life that extends substantially beyond the end of the tax year in which the costs are incurred. Thus, all package design costs incurred prior to January 1, 1987, that would be capitalized under section 263 of the Code and the regulations thereunder but for the fact that the costs create a package design (or modification to the design) having an ascertainable useful life that does not extend substantially beyond the end of the tax year in which the costs are incurred must be capitalized. All package design costs incurred after December 31, 1986, that would be capitalized under section 263A of the Code and the regulations thereunder but for the fact that the costs create a package design (or modification to the design) having an ascertainable useful life that does not extend substantially beyond the end of the tax year in which the costs are incurred must be capitalized. The costs required to be capitalized are described in section 2.

(3) *Half-year Convention.* Under the pool-of-cost capitalization and 48-month amortization method, the amortization allowance for package design costs must be determined by treating all package design costs incurred during the tax year as incurred on the mid-point of the tax year. If the tax year in which the package design costs are incurred is 12 full months, the costs are treated as incurred on the first day of the seventh month of the tax year. For guidance in computing the amortization allowance under the pool-of-cost capitalization and 48-month amortization method when package design costs are incurred in a taxable year of less than 12 months (a short taxable year), see Rev. Proc. 89-15.

(4) *Eligibility.* The pool-of-cost capitalization and 48-month amortization method is a rule of administrative convenience which may only be adopted on the taxpayer's first return or pursuant to the provisions of this revenue procedure.

SEC. 6. AVAILABILITY OF ALTERNATIVE METHODS OF ACCOUNTING

.01 *In General.*

(1) *Availability.* Except as provided in sections 6.02 through 6.08 below (relating to special rules for taxpayers who are under examination, are before an appeals office, are before a federal court, or are the subject of a criminal investigation or proceeding), the rules in this section 6.01 apply to a taxpayer that desires to change its method of accounting for package design costs. Provided the requirements of this revenue procedure are satisfied, the taxpayer is permitted to change its method of accounting for package design costs to any one of the three alternative methods of accounting provided in section 5. The year of change is determined under section 6.01(2) below. The rules for computing the section 481(a) adjustment and determining the adjustment period are set forth in section 8.01 for a change to capitalization; section 8.02 for a change to design-by-design capitalization and 60-month amortization; and section 8.03 for a change to pool-of-cost capitalization and 48-month amortization. The procedure for effecting the change is set forth in sections 9.01 (general procedure) and section 9.02(1) (special procedure for taxpayers changing for their first tax year ending on or after the date of release).

(2) *Year of Change.*

(a) If the Form 3115 required by section 9 is filed on or before the date that is 180 days after the beginning of the taxpayer's third tax year ending on or after December 18, 1990, the date of release of this revenue procedure, the year of change is the first tax year ending on or after December 18, 1990. The effect of this rule is to preclude a taxpayer from changing its method of accounting for package design costs for its second or third tax years ending on or after December 18, 1990. If the tax return for its first tax year ending on or after December 18, 1990, has already been filed, the taxpayer must make the change on (and attach the Form 3115 to) an amended return for that year filed on or before the date that is 180 days after the beginning of its third tax year ending on or after December 18, 1990. The taxpayer must also reflect the change in method of accounting on amended returns filed for tax years subsequent to the year of change for which returns have already been filed. *See* section 9.02(1).

(b) If the Form 3115 required by section 9 is filed after the date that is 180 days after the beginning of the taxpayer's third tax year ending on or after December 18, 1990, the date of release of this revenue procedure, the

year of change is the applicable tax year under section 1.446-1(e)(3) of the regulations that would apply at the time the Form 3115 is filed.

.02 *Taxpayer Contacted for Examination but Package Design Issue Not Raised.* Except as provided in sections 6.02(1) through 6.02(4) below, if the taxpayer has been contacted in any manner by a representative of the Service for the purpose of scheduling an examination of its federal income tax return for any year and the package design issue has not been raised by the Service, the taxpayer is not permitted to change its method of accounting for package design costs.

(1) *First Taxable Year Window.* A taxpayer described in section 6.02 above is permitted to change its method of accounting for package design costs to any one of the three alternative methods of accounting provided in section 5 provided the taxpayer is changing for its first tax year ending on or after December 18, 1990, the date of release of this revenue procedure. The rules for computing the section 481(a) adjustment and determining the adjustment period are set forth in section 8.01 for a change to capitalization; section 8.02 for a change to design-by-design capitalization and 60-month amortization; and section 8.03 for a change to pool-of-cost capitalization and 48-month amortization. The procedure for effecting the change is set forth in section 9.02(2).

(2) *Taxpayer Using Permissible Method; Special Consent from Examining Agent.* A taxpayer described in section 6.02 above that is using one of the three alternative methods of accounting provided in section 5 is permitted to change its method of accounting for package design costs to another of the three alternative methods of accounting if the taxpayer obtains an agreement (which must be attached to the Form 3115) from the examining agent that there is no objection to the proposed change in method of accounting. The year of change is the applicable tax year that would apply under section 6.01 of this revenue procedure at the time the Form 3115 is filed if the taxpayer had not been under examination. The rules for computing the section 481(a) adjustment and determining the adjustment period are set forth in section 8.01 for a change to capitalization; section 8.02 for a change to design-by-design capitalization and 60-month amortization; and section 8.03 for a change to pool-of-cost capitalization and 48-month amortization. The procedure for effecting the change is set forth in section 9.01 or section 9.02(1).

(3) *120-Day Window After Receipt of A Basic Report.* A taxpayer described in section 6.02 above is permitted to change its method of accounting for package design costs to any one of the three alternative methods of accounting provided in section 5 during the 120-day period following the date of issuance by the Service of either a letter stating that there is no change in tax liability or a basic report form (a report of Individual Income Tax Examination Changes, a report of Income Tax Examination Changes, a report of Income Tax Audit Changes, or an Unagreed and Excepted Agreed report) giving notice of results of an examination by the Service of the taxpayer's liability for certain tax years. However, this section 6.02(3) does not apply (1) if the package design issue is included as an item of adjustment in a basic report form as a result of the examination by the Service, (2) if the package design issue is placed in suspense by the Service, or (3) if the taxpayer has, before the end of the 120-day period and prior to the filing of the Form 3115, received written notification from the examiner(s) that the package design issue is under consideration for the tax year under examination. The year of change is the applicable tax year that would apply under section 6.01 of this revenue procedure at the time the Form 3115 is filed if the taxpayer had not been under examination. The rules for computing the section 481(a) adjustment and determining the adjustment period are set forth in section 8.01 for a change to capitalization; section 8.02 for a change to design-by-design capitalization and 60-month amortization; and section 8.03 for a change to pool-of-cost capitalization and 48-month amortization. The procedure for effecting the change is set forth in sections 9.01 and 9.02(1).

(4) *30-Day Provision for Continuous Audit.* A taxpayer described in section 6.02 above is permitted to change its method of accounting for package design costs to any one of the three alternative methods of accounting provided in section 5 during the first 30 days of any tax year if (1) the taxpayer has been precluded under section 6.02 from changing its method of accounting for package design costs for at least 18 consecutive months prior to the 30-day period and (2) the taxpayer has not received written notification from the examiner that the package design issue is under consideration prior to the 30-day period. The year of change is the applicable tax year that would apply under section 6.01 of this revenue procedure at the time the Form 3115 is filed if the taxpayer had not been under examination. The rules for computing the section 481(a) adjustment and determining the adjustment period are set forth in section 8.01 for a change to capitalization; section 8.02 for a change to design-by-design capitalization and 60-month amortization; and section 8.03 for a change to pool-of-cost capitalization and 48-month amortization. The procedure for effecting the change is set forth in sections 9.01 and 9.02(1).

.03 *Taxpayer Before an Appeals Office but Package Design Issue Not Raised.* Except as provided in sections 6.03(1) and 6.03(2) below, if the taxpayer is under consideration by an appeals office of the Service with respect to an examination and the package design issue has not been raised by the Service, the taxpayer is not permitted to change its method of accounting for package design costs.

(1) *First Taxable Year Window.* A taxpayer described in section 6.03 above is permitted to change its method of accounting for package design costs to any one of the three alternative methods of accounting provided in section 5 if the taxpayer is changing for its first tax year ending on or after December 18, 1990, the date of release of this revenue procedure. The rules for computing the section 481(a) adjustment and determining the adjustment period are set forth in section 8.01 for a change to capitalization; section 8.02 for a change to design-by-design capitalization and 60-month amortization; and section 8.03 for a change to pool-of-cost capitalization and 48-month amortization. The procedure for effecting the change is set forth in section 9.02(2).

(2) *Special Consent from Appeals Officer.* A taxpayer described in section 6.03 above is permitted to change its method of accounting for package design costs to any one of the three alternative methods of accounting provided in section 5 if the taxpayer obtains an agreement (which must be attached to the Form 3115) from the Appeals Officer that there is no objection to the proposed change in method of accounting. The year of change is the applicable tax year that would apply under section 6.01 of this revenue procedure at the time the Form 3115 is filed if the taxpayer had not been before appeals. The rules for computing the section 481(a) adjustment and determining the adjustment period are set forth in section 8.01 for a change to capitalization; section 8.02 for a change to design-by-design capitalization and 60-month amortization; and section 8.03 for a change to pool-of-cost capitalization and 48-month amortization. The procedure for effecting the change is set forth in sections 9.01 and 9.02(1). The Appeals Officer ordinarily will grant its consent to the proposed change. *See* IRM 8653, MT 8-188 (Jan. 22, 1990).

.04 *Taxpayer Before a Federal Court but Package Design Issue Not Raised.* Except as provided in sections 6.04(1) and 6.04(2) below, if the taxpayer is before any federal court with respect to an income tax issue arising in any tax year and the package design issue has not been raised by the Service, the taxpayer is not permitted to change its method of accounting for package design costs.

(1) *First Taxable Year Window.* A taxpayer described in section 6.04 above is permitted to change its method of accounting for package design costs to any one of the three alternative methods of accounting provided in section 5 if the taxpayer is changing for its first tax year ending on or after December 18, 1990, the date of release of this revenue procedure. The rules for computing the section 481(a) adjustment and determining the adjustment period are set forth in section 8.01 for a change to capitalization; section 8.02 for a change to design-by-design capitalization and 60-month amortization; and section 8.03 for a change to pool-of-cost capitalization and 48-month amortization. The procedure for effecting the change is set forth in sections 9.02(2).

(2) *Special Consent from Counsel.* A taxpayer described in section 6.04 above is permitted to change its method of accounting for package design costs to any one of the three alternative methods of accounting provided in section 5 if the taxpayer obtains an agreement (which must be attached to the Form 3115) from counsel for the government that there is no objection to the proposed change in method of accounting. The year of change is the applicable tax year that would apply under section 6.01 of this revenue procedure at the time the Form 3115 is filed if the taxpayer had not been before a federal court. The rules for computing the section 481(a) adjustment and determining the adjustment period are set forth in section 8.01 for a change to capitalization; section 8.02 for a change to design-by-design capitalization and 60-month amortization; and section 8.03 for a change to pool-of-cost capitalization and 48-month amortization. The procedure for effecting the change is set forth in sections 9.01 and 9.02(1).

.05 *Taxpayer Subject to a Criminal Investigation or Proceeding.* If the taxpayer is the subject of a criminal investigation or proceeding concerning, directly or indirectly, (a) the taxpayer's federal tax liability for any year, or (b) the possibility of false or fraudulent statements made by the taxpayer with respect to any issue relating to its federal tax liability for any year, the taxpayer is not permitted to change its method of accounting for package design costs.

.06 *Taxpayer Under Examination, Before an Appeals Office, or Before a Federal Court; Package Design Issue Raised Before March 6, 1989.*

(1) *Availability.* If the taxpayer is under examination, before an appeals office, or before a federal court with respect to a tax year in which the package design issue has been raised before March 6, 1989, the taxpayer is permitted to change its method of accounting for package design costs to any one of the three alternative methods of accounting provided in section 5. The year of change is determined under section 6.06(2) below. The rules for computing the section 481(a) adjustment and determining the adjustment period are set forth in section 8.01 for a change to capitalization; section 8.02 for a change to design-by-design capitalization and 60-month amortization; and section 8.03 for a change to pool-of-cost capitalization and 48-month amortization. The procedure for effecting the change is set forth in section 9.03.

(2) *Year of Change.*

(a) If the taxpayer is under examination with respect to a tax year in which the package design issue has been raised, the year of change is the most recent tax year that is being examined by the Service during the examination of the taxpayer's returns, but not later than the most recent tax year for which a federal income tax return has been filed as of the date the examination began. However, if the package design issue has been raised for the first year in which the erroneous method of accounting for package design costs was used by the taxpayer (i.e., the issue has been raised for the year in which the erroneous method was initiated by the taxpayer or the year in which the taxpayer changed to the erroneous method without the consent of the Commissioner), the year of change is the year in which the erroneous method was first used by the taxpayer.

(b) If the taxpayer is before an appeals office with respect to a tax year in which the package design issue has been raised, the year of change is the earliest open year before appeals in which the issue has been raised.

(c) If the taxpayer is before a federal court with respect to a tax year in which the package design issue has been raised, the year of change is the earliest year before the court in which the issue has been raised.

(d) Notwithstanding subparagraphs (a), (b), and (c) of this section 6.06(2), if the taxpayer is under examination, before an appeals office, or before a federal court for different tax years in which the package design issue has been raised, the year of change is the earliest of the years provided in subparagraphs (a), (b), and (c) of this section 6.06(2).

.07 *Taxpayer Under Examination, Before an Appeals Office, or Before a Federal Court; Package Design Issue Raised On or After March 6, 1989 but On or Before the Due Date of Taxpayer's Tax Return for Its First Tax Year Ending On or After*

Release. If the taxpayer is under examination, before an appeals office, or before a federal court with respect to a tax year in which the package design issue has been raised on or after March 6, 1989, but on or before the due date (determined with regard to extensions) of the taxpayer's federal income tax return for its first tax year ending on or after December 18, 1990, the date of release of this revenue procedure, the taxpayer is permitted to change its method of accounting for package design costs to any one of the three alternative methods of accounting provided in section 5. The year of change is the first tax year ending on or after December 18, 1990. The rules for computing the section 481(a) adjustment and determining the adjustment period are set forth in section 8.01 for a change to capitalization; section 8.02 for a change to design-by-design capitalization and 60-month amortization; and section 8.03 for a change to pool-of-cost capitalization and 48-month amortization. The procedure for effecting the change is set forth in section 9.03.

.08 *Taxpayer Under Examination, Before an Appeals Office, or Before a Federal Court; Package Design Issue Raised After the Due Date of Taxpayer's Tax Return for Its First Tax Year Ending On or After Release.*

(1) *Availability.* If the taxpayer is under examination, before an appeals office, or before a federal court with respect to a tax year in which the package design issue has been raised after the due date (determined with regard to extensions) of the taxpayer's federal income tax return for its first tax year ending on or after December 18, 1990, the date of release of this revenue procedure, the taxpayer is permitted to change its method of accounting for package design costs only to the capitalization method. The year of change is determined under section 6.08(2) below. The rules for computing the section 481(a) adjustment and determining the adjustment period are set forth in section 8.01. The procedure for effecting the change is set forth in section 9.03.

(2) *Year of Change.*

(a) If the taxpayer is under examination with respect to a tax year in which the package design issue has been raised, the year of change is the earliest open year under examination in which the issue has been raised.

(b) If the taxpayer is before an appeals office with respect to a tax year in which the package design issue has been raised, the year of change is the earliest open year before appeals in which the issue has been raised.

(c) If the taxpayer is before a federal court with respect to a tax year in which the package design issue has been raised, the year of change is the earliest year before the court in which the issue has been raised.

(d) Notwithstanding subparagraphs (a), (b), and (c) of this section 6.08(2), if the taxpayer is under examination, before an appeals office, or before a federal court for different tax years in which the package design issue has been raised, the year of change is the earliest of the years provided in subparagraphs (a), (b), and (c) of this section 6.08(2).

SEC. 7. SPECIAL RULES RELATING TO RAISED ISSUE

For purposes of this revenue procedure, the package design issue is considered raised when the taxpayer receives written notification that the issue is under consideration (*e.g.*, by an examination plan or an information document request). If the package design issue has been raised in more than one audit cycle, the applicability of sections 6.06, 6.07, and 6.08 is determined by reference to when the issue was first raised.

SEC. 8. SECTION 481(a) ADJUSTMENT

.01 *Change to the Capitalization Method.*

(1) *Computation of the Section 481(a) Adjustment.* If the taxpayer is changing its method of accounting for package design costs to the capitalization method, the section 481(a) adjustment (which will be positive) will restore to income the total amounts deducted or amortized in tax years prior to the year of change with respect to all package designs (or modifications to designs) subject to capitalization and not abandoned as of the first day of the tax year of change, less the amounts that would have been amortized during the tax years prior to the year of change with respect to designs (or modifications to designs) which had an ascertainable useful life on the date the designs (or modifications to the designs) were placed in service. The section 481(a) adjustment is the difference at the beginning of the tax year of change between the basis of all such package designs (or modifications to designs) determined under the taxpayer's present method of accounting and the basis redetermined under the capitalization method.

(2) *Section 481(a) Adjustment Period.*

(a) *Change from Impermissible Method.* If the taxpayer is changing to the capitalization method of accounting for package design costs from a method other than the design-by-design capitalization and 60-month amortization method or the pool-of-cost capitalization and 48-month amortization method, the adjustment period is determined in accordance with sections 8.01(2)(a)(i) and 8.01(2)(a)(ii) below.

(i) The portion of the adjustment referred to in section 8.01(1) that is attributable to costs incurred after December 31, 1986, is to be taken into account in full in computing taxable income in the tax year of change.

(ii) Except as provided in sections 8.01(2)(a)(ii)(*a*) and 8.01(2)(a)(ii)(*b*) below, the portion of the adjustment referred to in section 8.01(1) that is attributable to costs incurred before January 1, 1987, is to be taken into account in accordance with the rules set forth in the following sections of Rev. Proc. 84-74: section 5.06(1)(a) (attributable to the immediately preceding tax year rule), section 5.06(1)(b) (67-percent rule), and section 5.06(1)(e) (rule for all other situations).

(*a*) If a taxpayer described in section 6.01 (relating to taxpayers not contacted for examination, not before an appeals office, not before a federal court, and not subject to a criminal investigation or proceeding), 6.02 (relating to taxpayers contacted for examination where the package design issue has not been raised), 6.03 (relating to taxpayers before an ap-

peals office where the package design issue has not been raised), or 6.04 (relating to taxpayers before a federal court where the package design issue has not been raised) files the Form 3115 required by sections 9.01 or 9.02 after the due date (determined with regard to extensions) of the taxpayer's federal income tax return for its first tax year ending on or after December 18, 1990, the date of release of this revenue procedure, then the adjustment period otherwise determined in section 8.01(2)(a)(ii) above cannot exceed 3 tax years.

(*b*) If a taxpayer described in section 6.08 (relating to taxpayers under examination, before an appeals office, or before a federal court where the package design issue is raised after the due date of its tax return for its first tax year ending on or after release) is changing its method of accounting for package design costs, the portion of the adjustment referred to in section 8.01(2)(a)(ii) is also to be taken into account in computing taxable income in the year of change.

(b) *Change from Permissible Method.* If the taxpayer is changing to the capitalization method of accounting for package design costs from the design-by-design capitalization and 60-month amortization method or the pool-of-cost capitalization and 48-month amortization method, the adjustment referred to in section 8.01(1) is to be taken into account in accordance with the rules set forth in the following sections of Rev. Proc. 84-74: section 5.06(1)(a) (attributable to the immediately preceding tax year rule), section 5.06(1)(b) (67-percent rule), and section 5.06(1)(e) (rule for all other situations).

.02 *Change to the Design-by-Design Capitalization and 60-month Amortization Method.*

(1) *Computation of the Section 481(a) Adjustment.* If the taxpayer is changing its method of accounting for package design costs to the design-by-design capitalization and 60-month amortization method, the section 481(a) adjustment is equal to the total amounts deducted or amortized in tax years prior to the year of change with respect to all package designs (or modifications to designs) subject to capitalization and not abandoned as of the first day of the tax year of change, less the amounts that would have been amortized during the tax years prior to the year of change with respect to such designs (or modifications to designs) had the design-by-design capitalization and 60-month amortization method been used.

(2) *Section 481(a) Adjustment Period.*

(a) *Change from Impermissible Method.* If the taxpayer is changing to the design-by-design capitalization and 60-month amortization method of accounting for package design costs from a method other than the pool-of-cost capitalization and 48-month amortization method or the capitalization method, the total amount of the adjustment referred to in section 8.02(1) is to be taken into account in computing taxable income in the year of change.

(b) *Change from Permissible Method.* If the taxpayer is changing to the design-by-design capitalization and 60-month amortization method of accounting for package design costs from the pool-of-cost capitalization and 48-month amortization method or the capitalization method, the adjustment referred to in section 8.02(1) is to be taken into account in accordance with the rules set forth in the following sections of Rev. Proc. 84-74: section 5.06(1)(a) (attributable to the immediately preceding tax year rule), section 5.06(1)(b) (67-percent rule), and section 5.06(1)(e) (rule for all other situations).

.03 *Change to the Pool-of-Cost Capitalization and 48-month Amortization Method.*

(1) *Computation of the Section 481(a) Adjustment.* If the taxpayer is changing its method of accounting for package design costs to the pool-of-cost capitalization and 48-month amortization method, the section 481(a) adjustment is equal to the total amounts deducted or amortized in tax years prior to the year of change with respect to all package design costs treated as incurred during the tax years prior to the year of change, less the amounts that would have been amortized during the tax years prior to the year of change with respect to such costs had the pool-of-cost capitalization and 48-month amortization method been used.

(2) *Section 481(a) Adjustment Period.*

(a) *Change from Impermissible Method.* If the taxpayer is changing to the pool-of-cost capitalization and 48-month amortization method of accounting for package design costs from a method other than the design-by-design capitalization and 60-month amortization method or the capitalization method, the total amount of the adjustment referred to in section 8.03(1) is to be taken into account in computing taxable income in the year of change.

(b) *Change from Permissible Method.* If the taxpayer is changing to the pool-of-cost capitalization and 48-month amortization method of accounting for package design costs from the design-by-design capitalization and 60-month amortization method or the capitalization method, the adjustment referred to in section 8.03(1) is to be taken into account in accordance with the rules set forth in the following sections of Rev. Proc. 84-74: section 5.06(1)(a) (attributable to the immediately preceding tax year rule), section 5.06(1)(b) (67-percent rule), and section 5.06(1)(e) (rule for all other situations).

.04 *Insufficient Information to Compute Section 481(a) Adjustment.* In applying section 8, if a taxpayer's books and records do not contain sufficient information to compute the section 481(a) adjustment that would have been required if the same change had been made at the beginning of the preceding 1-, 2-, or 3-tax-year period, the taxpayer may reasonably estimate these amounts. The taxpayer must attach the computations upon which the estimates are based and the perjury statement provided in section 5.06(2) of Rev. Proc. 84-74 to the Form 3115.

.05 *Ceasing to Engage in the Trade or Business.* If the taxpayer ceases to engage in the trade or business to which the adjustment referred to in section 8 relates at any time prior to the expiration of the adjustment period referred to in section 8, the balance of the adjustment not previously taken into account in computing taxable income is to be taken into account in that year. See section 5.09 of Rev. Proc. 84-74 for rules relating to the acceleration of a section 481(a) adjustment when a corporation, partnership, or sole proprietor is deemed

to cease operation of its trade or business.

.06 *Limiting Terms and Conditions With Respect to Net Operating Losses and Credits.* The limiting terms and conditions relating to net operating losses and credits provided in sections 5.15(1)(a) (net operating loss—negative section 481(a) adjustment), 5.15(1)(b) (net operating loss—positive section 481(a) adjustment), and 5.15(2) (credit carryover—positive section 481(a) adjustment) of Rev. Proc. 84-74 apply to all changes in method of accounting made pursuant to this revenue procedure.

SEC. 9. MANNER OF EFFECTING THE CHANGE

01. *Package Design Issue Not Raised By the Service.*

(1) *In General.* Except as provided in sections 9.01(2) and 9.02 below, if the package design issue has not been raised by the Service, the taxpayer applying for a change in method of accounting pursuant to this revenue procedure must use the following "automatic procedure." The taxpayer must complete a current Form 3115. The original of the Form 3115 must be attached to the taxpayer's timely filed (determined with regard to extensions) federal income tax return for the year of change. A copy of the Form 3115 must be filed with the National Office addressed to the Commissioner of Internal Revenue, P.O. Box 14095, Benjamin Franklin Station, Washington, D.C. 20224, within 180 days after the beginning of the tax year of change. However, if the taxpayer is changing its method of accounting for package design costs pursuant to the 120-day provision described in section 6.02(3), the copy of the Form 3115 must be filed with the National Office within the 120-day period. If the taxpayer is changing its method of accounting for package design costs pursuant to the 30-day provision described in section 6.02(4), the copy of the Form 3115 must be filed with the National Office within the 30-day period. No user fee is required for a filing under this section 9.01(1).

(2) *Change During Prior Six Years.* Except as provided in section 9.02 below, if a taxpayer described in section 9.01(1) above (concerning taxpayers applying for a change in method of accounting where the package design issue has not been raised) changed its method of accounting for package design costs during the six tax years prior to the year of change or received permission from the National Office to change its method of accounting for package design costs for any of its six tax years immediately preceding the year of change but did not effect the requested change, the taxpayer may not use the "automatic procedure" described in section 9.01(1) above. The taxpayer must request permission to change by filing a complete current Form 3115 with the National Office addressed to the Commissioner of Internal Revenue, P.O. Box 7604, Benjamin Franklin Station, Washington, D.C. 20224, within 180 days after the beginning of the tax year of change. Consent to the change will be granted only upon a showing of extraordinary circumstances. A user fee is required for a filing under this section 9.01(2).

02. *Package Design Issue Not Raised By the Service; Special Procedures for Taxpayers Changing for Their First Tax Year Ending On or After Release.*

(1) *In General.* Except as provided in section 9.02(2) below, if the package design issue has not been raised by the Service, a taxpayer changing its method of accounting for its first tax year ending on or after December 18, 1990, the date of release of this revenue procedure, must use the following "automatic procedure." The taxpayer must attach a complete current Form 3115 to the taxpayer's timely filed (determined with regard to extensions) federal income tax return for the year of change. If the tax return for the year of change has already been filed, the taxpayer must attach a complete current Form 3115 to an amended return for the year of change filed on or before 180 days after the beginning of its third tax year ending on or after December 18, 1990. However, if the taxpayer is changing its method of accounting for package design costs pursuant to the 120-day provision described in section 6.02(3), the amended return to which the Form 3115 is attached must be filed within the 120-day period. If the taxpayer is changing its method of accounting for package design costs pursuant to the 30-day provision described in section 6.02(4), the amended return to which the Form 3115 is attached must be filed within the 30-day period. If the taxpayer is changing its method of accounting for package design costs pursuant to one of the special consent provisions described in sections 6.02(2) (special consent from examining agent), 6.03(2) (special consent from appeals officer), or 6.04(2) (special consent from counsel for the government), the amended return to which the Form 3115 is attached must be filed within the time period agreed to by the taxpayer and the examining agent, appeals officer, or counsel for the government. The taxpayer must reflect the change in method of accounting on the amended return for the year of change and on amended returns filed for tax years subsequent to the year of change for which returns have already been filed. No user fee is required for a filing under this section 9.02(1).

(2) *First Taxable Year Window.* If a taxpayer described in sections 6.02, 6.03, or 6.04 (relating to taxpayers contacted for examination, before an appeals office, or before a federal court where the package design issue has not been raised) is changing its method of accounting pursuant to sections 6.02(1), 6.03(1), or 6.04(1) (relating to first taxable year window), the taxpayer must use the following "automatic procedure." The taxpayer must attach a complete current Form 3115 to the taxpayer's timely filed (determined with regard to extensions) federal income tax return for the year of change. The taxpayer is not permitted to make the change in method of accounting on an amended return. No user fee is required for a filing under this section 9.02(2).

.03 *Package Design Issue Raised By the Service.* If the taxpayer is under examination, before an appeals office, or before a federal court with respect to a tax year in which the package design issue has been raised, the taxpayer applying for a change in method of accounting pursuant to this revenue procedure must use the following "automatic procedure." The taxpayer must provide the examining agent, appeals officer, or counsel for the government with the original and one copy of a complete current Form 3115. The examining agent, appeals officer, or counsel for

the government will verify that the amount of the section 481(a) adjustment is correct and that the year of change and the adjustment period have been determined in accordance with sections 6 and 8. The Form 3115 will not be accepted unless the examining agent, appeals officer, or counsel for the government and the taxpayer are in agreement with respect to the year of change, the amount of the section 481(a) adjustment, and the adjustment period. If the examining agent, appeals officer, or counsel for the government and the taxpayer cannot agree as to these items, a technical advice request may be submitted to the National Office in accordance with Rev. Proc. 90-2, 1990-1 C.B. 386. If agreement is reached as to these items, the examining agent, appeals officer, or counsel for the government will associate the original of the Form 3115 with the taxpayer's federal income tax return for the year of change and forward the copy of the Form 3115 and pertinent comments to the National Office addressed to Commissioner of Internal Revenue, P.O. Box 14095, Benjamin Franklin Station, Washington, D.C. 20224. The taxpayer must reflect the change in method of accounting on amended returns filed for tax years subsequent to the year of change for which returns have already been filed. No user fee is required for a filing under this section 9.03.

.04 *Additional Information, Representations and Conditions.*

(1) If the taxpayer is changing its method of accounting for package design costs to the capitalization method or the design-by-design capitalization and 60-month amortization method, the taxpayer must attach a statement to its timely filed Form 3115. The statement must provide a description of each package design, the date on which each was placed in service, and the cost basis of each (as determined under sections 5.01(2) or 5.02(2)).

(2) In addition to including all the information required on the Form 3115 and the additional information required by section 9.04(1) above, the taxpayer must: (1) state that it agrees to all the conditions of Rev. Proc. 90-63 and that it proposes to take the section 481(a) adjustment into account over the appropriate period required by section 8.01(2), 8.02(2) or 8.03(2) (whichever is applicable); and (2) indicate the period over which the section 481(a) adjustment will be taken into account and the basis for that conclusion.

(3) In order to assist in the processing of these changes in method of accounting and to insure proper handling, reference to this revenue procedure must be made a part of the Form 3115. If the taxpayer is described in sections 9.01(1) or 9.02 above (concerning taxpayers applying for a change in method of accounting where the package design issue has not been raised) and except as otherwise provided, the taxpayer must type or legibly print the following statement at the top of page 1 of Form 3115: "AUTOMATIC CHANGE FILED UNDER REV. PROC. 90-63." If a taxpayer described in sections 9.01(1) or 9.02 is changing its method of accounting pursuant to the 120-day provision described in section 6.02(3), the taxpayer must type or legibly print the following statement at the top of page 1 of Form 3115: "AUTOMATIC CHANGE FILED UNDER REV. PROC. 90-63 / 120-DAY PROVISION." If a taxpayer described in sections 9.01(1) or 9.02 is changing its method of accounting pursuant to the 30-day provision described in section 6.02(4), the taxpayer must type or legibly print the following statement at the top of page 1 of Form 3115: "AUTOMATIC CHANGE FILED UNDER REV. PROC. 90-63 / 30-DAY PROVISION." If a taxpayer described in sections 9.01(1) or 9.02 is changing its method of accounting for package design costs pursuant to one of the special consent provisions described in sections 6.02(2) (special consent from examining agent), 6.03(2) (special consent from appeals officer), or 6.04(2) (special consent from counsel for the government), the taxpayer must type or legibly print the following statement at the top of page 1 of Form 3115: "AUTOMATIC CHANGE FILED UNDER REV. PROC. 90-63 / SPECIAL CONSENT PROVISION." If a taxpayer described in sections 9.01(1) or 9.02 is changing its method of accounting pursuant to the early application procedure described in section 9.05, the taxpayer must type or legibly print the following statement at the top of page 1 of Form 3115: "AUTOMATIC CHANGE FILED UNDER REV. PROC. 90-63 / EARLY APPLICATION PROCEDURE." If the taxpayer is described in section 9.01(2) above (concerning taxpayers that changed or received permission to change their method of accounting for package design costs during the six tax years prior to the year of change), the taxpayer must type or legibly print the following statement at the top of page 1 of Form 3115: "NONAUTOMATIC CHANGE FILED UNDER REV. PROC. 90-63." If a taxpayer described in section 9.01(2) is changing its method of accounting pursuant to the early application procedure described in section 9.05, the taxpayer must type or legibly print the following statement at the top of page 1 of Form 3115: "NONAUTOMATIC CHANGE FILED UNDER REV. PROC. 90-63 / EARLY APPLICATION PROCEDURE." If the taxpayer is described in section 9.03 above (concerning taxpayers under examination, before an appeals office, or before a federal court where the package design issue has been raised), the taxpayer must type or legibly print the following statement at the top of page 1 of Form 3115: "AUTOMATIC CHANGE FILED UNDER REV. PROC 90-63 / ISSUE RAISED BY SERVICE."

(4) The signature of the person requesting the change in method of accounting and authorized to sign the Form 3115 must appear in the space provided for it on the Form 3115. For example, an officer must sign on behalf of a corporation, a general partner on behalf of a partnership, a trustee on behalf of a trust, or the individual taxpayer on behalf of a sole proprietorship. See the signature requirements set forth in the General Instructions attached to a current Form 3115 for those who are to sign.

(5) If the taxpayer is a member of an affiliated group that has elected to file a consolidated federal income tax return, a Form 3115 submitted on behalf of the taxpayer must be signed by a duly authorized officer of the common parent. See section 1.1502-77 of the regulations.

(6) If an agent is authorized to represent the taxpayer before the Service, to receive the original or copy of correspondence concerning the re-

quest, or to perform any other act(s) regarding the Form 3115 on behalf of the taxpayer, a power of attorney reflecting that authorization must be attached to the form. A taxpayer's representative without a power of attorney to represent the taxpayer as indicated in this subsection will not be given any information regarding the Form 3115 application.

(7) A taxpayer changing its method of accounting for package design costs pursuant to this revenue procedure must reconcile its books and records at the end of the year of change and at the end of later tax years to show the accounting method granted.

.05 *Early Applications.* To implement a change in method of accounting for package design costs for a tax year subsequent to its third tax year ending on or after December 18, 1990 (see section 6.01(2) which precludes a taxpayer from making the change for its second or third tax years ending on or after December 18, 1990), the date of release of this revenue procedure, a taxpayer must complete a current Form 3115 and file a copy of it with the National Office within the first 180 days after the beginning of the year of change. A qualified application for a change in method of accounting for package design costs filed after the 180th day of a tax year and before the beginning of the next tax year will be considered to be timely filed for the next tax year (year of change) for purposes of this revenue procedure. The taxpayer must file a copy of the perfected Form 3115 with the National Office addressed to the Commissioner of Internal Revenue, P.O. Box 14095, Benjamin Franklin Station, Washington, within the first 180 days after the beginning of the year of change. The original of the perfected Form 3115 must be attached to the taxpayer's timely filed (determined with regard to extensions) federal income tax return for the year of change. Unlike the early application procedure under Rev. Proc. 84-74, the taxpayer will not be notified if the early application has not been perfected.

A taxpayer described in section 9.01(2) (concerning certain taxpayers that changed or received permission to change their method of accounting for package design costs during the six tax years prior to the year of change) must file the original of the perfected Form 3115 with the National Office addressed to the Commissioner of Internal Revenue, P.O. Box 7604, Benjamin Franklin Station, Washington, D.C. 20224, within the first 180 days after the beginning of the year of change. The taxpayer will be notified if the early application has not been perfected.

SEC. 10. ESTIMATED TAXES

For purposes of any required quarterly installments made on or before January 30, 1991, no penalty shall be assessed for underpayment of estimated taxes under sections 6654 or 6655 of the Code to the extent an underpayment results from the treatment of package design costs.

SEC. 11. INQUIRIES

Inquiries regarding this revenue procedure may be addressed to the Commissioner of Internal Revenue, CC:IT&A, 1111 Constitution Avenue, N.W., Washington, D.C. 20224.

SEC. 12. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 89-16 and Rev. Proc. 89-17 are revoked. Any request for change in method of accounting filed under the provisions of Rev. Proc. 89-16 and any election filed under Rev. Proc. 89-17 will be disregarded. Any request for change in method of accounting filed under the provisions of Rev. Proc. 84-74 which is pending as of December 18, 1990, the date of release of this revenue procedure, will be returned. Rev. Rul. 89-23 is modified to delete the identification of the ruling as a designated ruling pursuant to section 5.12(2) of Rev. Proc. 84-74.

SEC. 13. EFFECTIVE DATE

.01 All the provisions of this revenue procedure, except as provided in section 13.02 below, are effective with respect to Forms 3115 filed for tax years ending on or after December 18, 1990, the date of release of this revenue procedure.

.02 With respect to taxpayers described in section 9.03 (concerning taxpayers under examination, before an appeals office, or before a federal court where the package design issue has been raised), the provisions of this revenue procedure are effective for Forms 3115 filed on or after December 18, 1990, the date of release of this revenue procedure.

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26 CFR 601.602: Tax forms and instructions. (Also Part I, Sections 1, 32, 63, 135, 151, 6012, 6013; 1.1-1, 1.43-2, 1.63-1, 1.151-4, 1.6012-1, 1.6013-1)

Rev. Proc. 90-64

SECTION 1. PURPOSE

This revenue procedure sets forth the following inflation adjusted items for taxable years beginning in 1991:

1. the tax rate tables for individuals and for estates and trusts;
2. the basic standard deduction amounts for different filing statuses, the limitation on the standard deduction in the case of certain dependents, and the additional standard deductions for the aged and blind;
3. the personal exemption;
4. the earned income credit;
5. the amounts allowed against unearned income in computing the "kiddie tax," which taxes a minor child's net unearned income at the marginal rate that applies to the income of the child's parent; and
6. the limitations on the exclusion of income from the redemption of United States savings bonds for taxpayers who pay qualified higher education expenses.

SEC. 2. 1991 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 section 1 of the Code with respect to taxable years beginning in 1991.

TABLE 1 - Section 1(a). — MARRIED INDIVIDUALS FILING JOINT RETURNS AND SURVIVING SPOUSES

If Taxable Income Is:	The Tax Is:
Not Over $34,000	15% of the taxable income
Over $34,000, but not over $82,150	$5,100 plus 28% of the excess over $34,000
Over $82,150	$18,582 plus 31% of the excess over $82,150

TABLE 2 - Section 1(b). — HEADS OF HOUSEHOLDS

If Taxable Income Is:	The Tax Is:
Not Over $27,300	15% of the taxable income
Over $27,300 but not over $70,450	$4,095 plus 28% of the excess over $27,300
Over $70,450	$16,177 plus 31% of the excess over $70,450

TABLE 3 - Section 1(c). — UNMARRIED INDIVIDUALS (OTHER THAN SURVIVING SPOUSES AND HEADS OF HOUSEHOLDS)

If Taxable Income Is:	The Tax Is:
Not Over $20,350	15% of the taxable income
Over $20,350 but not over $49,300	$3,052.50 plus 28% of the excess over $20,350
Over $49,300	$11,158.50 plus 31% of the excess over $49,300

TABLE 4 - Section 1(d). — MARRIED INDIVIDUALS FILING SEPARATE RETURNS

If Taxable Income Is:	The Tax Is:
Not Over $17,000	15% of the taxable income
Over $17,000 but not over $41,075	$2,550 plus 28% of the excess over $17,000
Over $41,075	$9,291 plus 31% of the excess over $41,075

TABLE 5 - Section 1(e). — ESTATES AND TRUSTS

If Taxable Income Is:	The Tax Is:
Not Over $3,450	15% of the taxable income
Over $3,450 but not over $10,350	$517.50 plus 28% of the excess over $3,450
Over $10,350	$2,449.50 plus 31% of the excess over $10,350

SEC. 3. 1991 STANDARD DEDUCTION

.01 The following adjusted standard deduction amounts are prescribed in lieu of the amounts set forth in section 63(c)(2) of the Code with respect to taxable years beginning in 1991.

Filing Status	*Standard Deduction*
MARRIED INDIVIDUALS FILING JOINT RETURNS AND SURVIVING SPOUSES	$5,700
HEADS OF HOUSEHOLDS	$5,000
UNMARRIED INDIVIDUALS (OTHER THAN SURVIVING SPOUSES AND HEADS OF HOUSEHOLDS)	$3,400
MARRIED INDIVIDUAL FILING A SEPARATE RETURN	$2,850

.02 Under section 63(c)(5) of the Code, the standard deduction for an individual who may be claimed as a dependent by another taxpayer for a taxable year beginning in the calendar year in which the individual's taxable year begins, cannot exceed the greater of (A) $550 or (B) the amount of the individual's earned income.

.03 The additional standard deduction amount for the aged and blind allowed under section 63(f) of the Code for taxable years beginning in 1991 is $650. That amount is increased to $850 if the individual is also unmarried and not a surviving spouse.

SEC. 4. 1991 PERSONAL EXEMPTION

.01 Section 151(b) of the Code generally allows a taxpayer an exemption for himself or herself. Section 151(c) generally allows a taxpayer additional exemptions for dependents as defined in section 152. The personal exemption for tax years beginning in 1991 is $2,150.

.02 Section 151(d) of the Code provides for the phaseout of the tax benefit of the personal exemptions allowed by section 151. For 1991 the threshold amounts at which that phaseout begins are as follows:

Section 1(a)	$150,000
Section 1(b)	$125,000
Section 1(c)	$100,000
Section 1(d)	$ 75,000
Section 1(e)	- - - -

Under section 151(d)(4) of the Code, these threshold amounts will be adjusted for inflation for taxable years beginning in 1992 and thereafter.

SEC. 5. 1991 EARNED INCOME CREDIT

.01 Section 32 of the Code provides a "basic earned income credit" which for 1991 is allowed at a rate of 16.7 percent for a taxpayer with one qualifying child and 17.3 percent for a taxpayer with two or more qualifying children. This credit may be increased by a "supplemental young child credit" which is allowed at a rate of 5 percent for a taxpayer with a qualifying child who has not attained age 1 as of the close of the calendar year. In addition, a "health insurance credit" is allowed at a rate of 6 percent for certain health insurance expenses.

.02 For calendar years beginning in 1991, these credits will be allowed on the first $7,140 of earned income. These credits will be phased out if the taxpayer's adjusted gross income (or, if greater, earned income) exceeds $11,250.

.03 For calendar years beginning in 1991, the maximum basic earned income credit will be $1,192 [.167 x $7,140] for a taxpayer with one qualifying child and $1,235 [.173 x $7,140] for a taxpayer with two or more qualifying children. The credit phases out at a rate of 11.93 percent for a taxpayer with one qualifying child and 12.36 percent for a taxpayer with two or more qualifying children and will phase out completely at $21,242 of adjusted gross income, or earned income, as the case may be.

.04 For calendar years beginning in 1991, the maximum supplemental young child credit will be $357 [.05 x $7,140]. The credit phases out at a rate of 3.57 percent and will phase out completely at $21,244 of adjusted gross income, or earned income, as the case may be.

.05 For calendar years beginning in 1991, the maximum health insurance credit will be $428 [.06 x $7,140]. The credit phases out at a rate of 4.285 percent and will phase out completely at $21,248 of adjusted gross income, or earned income, as the case may be.

SEC. 6. UNEARNED INCOME OF MINOR CHILDREN TAXED AS IF PARENT'S INCOME (THE "KIDDIE TAX")

.01 Section 1(i) of the Code 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 section 1(i)(4)(A)(ii) net unearned income generally equals unearned income less the sum of (I) the amount in effect for the taxable year under section 63(c)(5)(A), plus (II) the greater of the amount described in (I) or certain itemized deductions.

.02 The amount in effect for 1991 under section 63(c)(5)(A) is $550. See section 3.02. Accordingly, for tax years beginning in 1991 net unearned income will generally equal unearned income less the greater of $1,100 or $550 plus certain itemized deductions.

SEC. 7. INCOME FROM UNITED STATES SAVINGS BONDS FOR TAXPAYERS WHO PAY QUALIFIED HIGHER EDUCATION EXPENSES

.01 Section 135 of the Code provides an exclusion for income from the redemption of United States savings bonds for taxpayers who pay qualified higher education expenses. The exclusion is phased out under section 135(b)(2) if the taxpayer's modified adjusted gross income exceeds $40,000 ($60,000 in the case of a joint return). The amount of a reduction is calculated by multiplying the amount otherwise excludable by a fraction. The numerator of the fraction is the excess of the modified adjusted gross income over the threshold amount and the denominator is $15,000 ($30,000 in the case of a joint return). For tax years beginning in 1991, the exclusion phases out if a taxpayer's modified adjusted gross income exceeds $41,950 ($62,900 in the case of a joint return) and the denominator of the fraction is $15,750 ($31,450 in the case of a joint return).

SEC. 8. COMPUTATION OF INFLATION ADJUSTMENTS

.01 Section 1(f)(1) of the Code 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 section 1 with respect to taxable years beginning in the succeeding calendar year.

Under section 1(f)(3) of the Code, 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 1989. For purposes of computing the inflation adjustment, section 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 section 1(f)(5), the CPI is that for all-urban consumers published by the Department of Labor.

Section 1(f)(2)(A) of the Code provides that the inflation adjustment is reflected in the tax rate tables by increasing the minimum and maximum amounts subject to the 15%, 28%, and 31% tax brackets. Under section 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 Under section 63(c)(4) of the Code, the standard deduction amounts (including the limitation for certain dependents and the additional standard deduction for the aged or blind) are adjusted for inflation under the method described in section 1(f)(3), except that the preceding calendar year's CPI is compared with the CPI for the calendar year 1987. Under section 1(f)(6) an adjusted amount is "rounded down" to the nearest multiple of $50 ($25 in the case of married individuals filing separately).

.03 Section 151(d)(3) of the Code provides that the personal exemption amount is adjusted for inflation under the method described in section 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 section 1(f)(6).

.04 Section 32(i) of the Code provides that the dollar amounts of the limitations applicable to the earned income credit are adjusted for inflation under the method described in section 1(f)(3), except that the preced-

ing calendar year's CPI is compared with the CPI for the calendar year 1984. Under section 32(i)(3), an adjusted amount is rounded to the nearest multiple of $10 (or, if the adjusted amount is a multiple of $5, it is increased to the next highest multiple of $10).

.05 Section 135(b)(2)(B) of the Code provides that the limitation on the exclusion of income from the redemption of United States savings bonds for taxpayers who pay qualified higher education expenses is adjusted for inflation under the method described in section 1(f)(3). The preceding calendar year's CPI is compared with the CPI for the calendar year 1989. The adjusted limitation 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 section 135(b)(2)(C).

SEC. 9. INFLATION ADJUSTMENT FACTORS

.01 Tax rate tables and qualified higher education expense exclusion — The CPI for 1990 is 128.0583333333 and the CPI for 1989 is 122.1500000000. Based on these figures, the inflation adjustment factor for the tax rate tables and the qualified higher education expense exclusion for taxable years beginning in 1991 is 1.0483694911.

.02 Standard deduction — The CPI for 1990 is 128.0583333333 and the CPI for 1987 is 111.9833333333. Based on these figures, the inflation adjustment factor for the standard deductions for taxable years beginning in 1991 is 1.1435481470.

.03 Personal exemption — The CPI for 1990 is 128.0583333333 and the CPI for 1988 is 116.6166666667. Based on these figures, the inflation adjustment for the personal exemption for taxable years beginning in 1991 is 1.0981134772.

.04 Earned income credit — The CPI for 1990 is 128.0583333333 and the CPI for 1984 is 102.4916666667. Based on these figures, the inflation adjustment for the earned income credit for taxable years beginning in 1991 is 1.2494511749.

SEC. 10. EFFECTIVE DATE

This revenue procedure is applicable for all taxable years beginning in 1991.

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26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.
(Also Part I, Section 953.)

Rev. Proc. 90-65

SECTION 1. PURPOSE

This revenue procedure provides additional guidance under section 953(d) of the Internal Revenue Code of 1986 for corporations whose election under section 953(d) for the first taxable year beginning after December 31, 1987, was due before September 15, 1989, and who failed to make a timely election under section 953(d) for that year. This revenue procedure applies only to a corporation that upon making a section 953(d) election becomes a member of an affiliated group that files a consolidated return on the basis of a fiscal year.

SEC. 2. BACKGROUND

Notice 89-79, 1989-2 C.B. 392, provides guidance to certain foreign corporations concerning the election to be treated as a domestic corporation under section 953(d) of the Code. Notice 89-79 provides that, to be effective for a taxable year, an election under section 953(d) must be filed by the due date prescribed in section 6072(b) (with extensions) for the federal income tax return that is filed for the first year the election is in effect. Under Notice 89-79 and section 843, an electing corporation must use a calendar year annual accounting period unless it becomes an includible corporation in an affiliated group that files a consolidated return on the basis of a fiscal year.

Generally, an electing corporation that satisfies the stock ownership requirements of section 1504(a) of the Code will become an includible corporation in an affiliated group when it is first treated as a domestic corporation under section 953(d). See Section 1504(b)(2) and (c)(1) for exceptions applicable to life insurance companies. For any taxable year of the electing corporation beginning after December 31, 1987, for which an election under section 953(d) is filed, the electing corporation will first be treated as a domestic corporation on the day following the close of its prior taxable year. If the electing corporation becomes a member of a consolidated group upon the effective date of the election, the electing corporation must report its income on the consolidated return for the taxable year of the group in which or with which the electing corporation's taxable year begins. The consolidated return should report the income of the electing corporation for the portion of the year for which it was a member of the consolidated group, from the day following the close of its prior taxable year to the close of the group's taxable year. Section 1.1502-76(b) of the Income Tax Regulations.

The extended due date for the return of the calendar year electing corporation, for its first taxable year beginning after December 31, 1987, was September 15, 1989. The extended due date for the consolidated returns of certain fiscal year affiliated groups on which electing corporations would report income for their first taxable year beginning after December 31, 1987, may have been prior to July 24, 1989, the date Notice 89-79 was issued by the Internal Revenue Service.

SEC. 3. PROCEDURE

.01 If a corporation was unable to make a timely election under section 953(d) for its first taxable year beginning after December 31, 1987, and the final date for making its election for such year was prior to September 15, 1989, such corporation may make a section 953(d) election pursuant to the provisions of this revenue procedure, effective as of the first day of the electing corporation's first taxable year beginning after December 31, 1987, as provided herein. A late election, described in the preceding sentence, cannot be made unless the electing corporation has filed an effective election under section 953(d) for the second taxable year for which an election can be made if the date for making an election for such second taxable year precedes the date when an election is made pursuant to this revenue procedure. The final date for making an election pursuant to this revenue procedure is March 15, 1991. The procedure for making such election is described in section 3.02, .03 and .04, below.

.02 A corporation to which this revenue procedure applies can make an election under section 953(d) of the Code, effective for the electing

corporation's first taxable year beginning after December 31, 1987, by mailing an original election statement to: Internal Revenue Service, Assistant Commissioner (International), IN:C:C:51, 950 L'Enfant Plaza South, S.W., Washington D.C. 20024. The election statement must be in the form provided in Notice 89-79 except that it should be entitled "FOREIGN INSURANCE COMPANY ELECTION UNDER SECTION 953(d) PURSUANT TO REV. PROC. 90-65." If the electing corporation has previously made an election for the second taxable year for which a section 953(d) election can be made, such corporation should attach a copy of its previous election statement to the election statement for this retroactive election.

.03 A corporation that makes an election pursuant to this revenue procedure must report its income for its first taxable year beginning after December 31, 1987, on the amended consolidated income tax return of the affiliated group for the taxable year of the affiliated group in which or with which such taxable year of the electing corporation commences. A copy of the election statement filed pursuant to this revenue procedure and any previously filed section 953(d) election statement, as described in section 3.02, above, must be attached to the amended consolidated return. The amended consolidated return of the affiliated group must be filed by March 15, 1991, at the following address: Internal Revenue Service, P.O. Box #245, Ben Salem, PA 19020, D.P. 102C.

.04 The electing corporation should also amend any United States income tax return it previously filed that reported income that should have been reported on the consolidated return and indicate on the amended return the tax identification number of the affiliated group that it is joining. Any return of the electing corporation amended pursuant to this revenue procedure must be filed by March 15, 1991, at the address provided in section 3.03, above.

.05 If an electing corporation amends a United States income tax return that reported income that should have been reported on the consolidated return, as provided in section 3.04, above, any refund of tax paid with respect to the income reported on such amended return may be applied to the tax due on the amended consolidated return. If an electing corporation previously paid the tax due under section 953(d)(6) for a section 953(d) election made for the second taxable year for which an election can be made, the amount paid may be applied to the amount due under section 953(d)(6) for an election made pursuant to this revenue procedure. The amended consolidated return should indicate the name and tax identification number of the electing corporation and the tax year of the return of the electing corporation from which the payment of tax is to be applied.

.06 The extension of time provided by this revenue procedure for making an election under section 953(d) of the Code does not operate to extend the time for payment of the tax due, including the additional tax due under section 953(d)(6). Accordingly, interest will be imposed under section 6601 on any amount of such tax due that is not paid on or before the date prescribed for payment. Additions to tax under section 6651(a)(1) and (2) and section 6653(a) for any tax due with respect to the inclusion of the electing corporation's income on the amended consolidated return, will not be imposed if such tax is paid by March 15, 1991. The penalty for underpayment of estimated tax under section 6655 for installment payments due for the amended consolidated return will not be waived.

SEC. 4. EFFECT ON OTHER DOCUMENTS

Notice 89-79 is amplified.

SEC. 5. EFFECTIVE DATE

This revenue procedure is effective for the first taxable year beginning after December 31, 1987, of a corporation specified in section 953(d)(1) of the Code, if such corporation's due date for making an election under section 953(d) for such first taxable year was prior to September 15, 1989.

Notice of Proposed Rulemaking

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Notice of Proposed Rulemaking

Notice of Proposed Rulemaking

Consolidated Return Regulations—Coordination with Section 833

CO-26-89

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In *** [T.C. 8310, page 205, this Bulletin], the Internal Revenue Service is issuing temporary regulations that add a new §1.1502-75T(d)(5) of the consolidated return regulations by providing rules relating to the removal of the tax-exempt status of organizations described in section 833 of the Internal Revenue Code. The rules are needed because such organizations are, for taxable years beginning after 1986, includible corporations under section 1504(b). The text of the temporary regulations also serves as the comment document for this notice of proposed rulemaking.

DATES: Written comments and requests for a public hearing must be received by November 6, 1990.

ADDRESS: Send comments and requests for a public hearing to: Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Attn: CC:CORP:T:R (CC:CO-26-89), Room 4429, Washington, D.C. 20044.

SUPPLEMENTARY INFORMATION:

Background

The temporary regulations published in *** [T.D. 8310, page 205, this Bulletin] add a new §1.1502-75T(d)(5) to Part 1 of Title 26 of the Code of Federal Regulations. For the text of the new temporary regulations, see T.D. 8310, published in *** [page 205, this Bulletin]. The preamble to the temporary regulations explains the regulations.

Special Analyses

It has been determined that these proposed rules will not be major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis 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 regulations will be submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

Comments And Requests For A Public Hearing

Before these temporary regulations are adopted as final regulations, consideration will be given to any written comments that are submitted (preferably nine copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request by any person who has submitted written comments. If a public hearing is held, notice of the time and place will be published in the Federal Register.

Michael J. Murphy,
Acting Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on August 30, 1990, 11:30 a.m., and published in the issue of the Federal Register for September 5, 1990, 55 F.R. 36290)

Notice of Proposed Rulemaking

Regulations under Section 382 of the Internal Revenue Code of 1986; Limitations on Corporate Net Operating Loss Carryforwards

CO-62-89

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed amendments to §1.382-2T of the temporary Income Tax Regulations and §1.382-3 of the proposed Income Tax Regulations under section 382 of the Internal Revenue Code of 1986. The amendments provide option attribution rules for purposes of determining stock ownership in order to determine whether certain transactions in title 11 or similar cases qualify under section 382(l)(5). The rules are necessary to limit relief under section 382(l)(5) to ownership changes in which pre-change shareholders and qualified creditors maintain a substantial continuing interest in the loss corporation following the title 11 or similar case.

DATES: Written comments and requests for a public hearing must be received by November 6, 1990.

ADDRESS: Send comments and requests for a public hearing to: Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Attention CC:CORP:T:R [CO-62-89], Room 4429, Washington, D.C. 20044.

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to Part 1 of Title 26 of the Code of Federal Regulations (CFR) under section 382 of the Code. The proposed regulations relate to the operation of option attribution rules in determining when an ownership change occurs in a title 11 or similar case and whether the transaction qualifies under section 382(l)(5). Section 382 was amended by section 621 of the Tax Reform Act of 1986 (Pub. L. No. 99-514, 100 Stat. 2085 (1986)) [1986-3 C.B. (Vol. 1) 1, 171] and subsequent acts. Temporary regulations regarding the determination of an ownership change were added to the CFR as §1.382-2T by T.D. 8149, published in the Federal Register on August 5, 1987 (52 FR 29668) [1987-2 C.B. 85]. Proposed regulations were issued under section 382(l)(5) by a notice of proposed rulemaking published in the Federal Register on August 14, 1990 (55 FR 33137) [CO-77-89, page 682, this Bulletin].

Explanation of Provisions

Overview of relevant provisions of the Code and regulations.

Under section 382(a) of the Code, as amended, if an ownership change occurs with respect to a loss corporation (as defined in section 382(k)(1) and §1.382-2T(f)(1) of the temporary Income Tax Regulations), the amount of the loss corporation's taxable income for a post-change year that may be offset by the pre-change net operating losses (and certain built-in losses) of the loss corporation cannot exceed the section 382 limitation. The section 382 limitation for a post-change year is generally equal to the fair market value of the loss corporation's stock immediately before the ownership change multiplied by the applicable long-term tax-exempt rate published in the Internal Revenue Bulletin.

In general, an ownership change involves an increase of more than 50 percentage points in stock ownership by 5-percent shareholders during the testing period (usually the three-year period ending on the date on which a transaction is tested for an ownership change).

Ownership of stock for these purposes is determined by applying option attribution rules set forth in section 382(l)(3)(A) of the Code and §1.382-2T(h) of the temporary regulations. Section 382(l)(3)(A)(iv) provides that, except to the extent provided in regulations, an option to acquire stock is treated as exercised if the exercise results in an ownership change. Under §1.382-2T(h)(4), subject to certain exceptions, the owner of an option (or similar interest) to acquire stock is treated as acquiring the underlying stock on a testing date if that treatment would result in an ownership change.

Section 382(l)(5) of the Code provides that the limitation imposed by section 382(a) does not apply after an ownership change of a loss corporation if (1) the corporation is under the jurisdiction of a court in a title 11 or similar case immediately before the ownership change, and (2) the corporation's pre-change shareholders and qualified creditors (determined immediately before the ownership change) own at least 50 percent of the value and voting power of the loss corporation's stock (or stock of a controlling corporation if also in bankruptcy) immediately after the ownership change and as a result of being pre-change shareholders or qualified creditors immediately before the ownership change. Section 382(l)(5) applies only to a transaction that is ordered by a court or is pursuant to a plan approved by a court. *See* H.R. Rep. 841, 99th Cong., 2d Sess. II-192 (1986), 1986-3 C.B. (Vol. 4) 192. Although the limitation imposed by section 382(a) does not apply, the loss corporation may be required to reduce a portion of its pre-change losses and credits following a transaction qualifying under section 382(l)(5).

The proposed regulations.

Section 382(l)(5) of the Code is intended to provide relief from the application of the section 382 limitation only for bankruptcy reorganizations in which pre-change shareholders and qualified creditors maintain a substantial continuing interest in the loss corporation. Because the continuity requirement contemplated by the statute may be easily circumvented through the issuance of options, the Internal Revenue Service has determined that the application of option attribution rules is necessary to limit relief under section 382(l)(5) to ownership changes in which pre-change shareholders and qualified creditors do, in fact, maintain a substantial continuing interest. Without option attribution rules, a loss corporation could emerge from a bankruptcy reorganization with no limitation on its use of pre-change losses, even though more than 50 percent of the ownership interest in the loss corporation is effectively transferred to new investors as a result of a plan of bankruptcy reorganization.

The proposed regulations therefore provide option attribution rules that apply for purposes of determining whether the stock ownership requirements of section 382(l)(5) of the Code are satisfied. Under these rules, options (and similar interests) are generally deemed exercised if their exercise would cause the pre-change shareholders and qualified creditors to own less than the requisite amount of stock. The rules are proposed to be effective as of [Insert date that the Treasury Decision adopting this notice of proposed rulemaking is filed with the Federal Register] and to be applicable to ownership changes occurring on or after September 5, 1990.

Options created pursuant to the plan of reorganization in a title 11 or similar case are subject to the option attribution rules of §1.382-2T(h)(4)(i) of the temporary regulations upon confirmation of the plan by the court. The proposed regulation, however, adds new §1.382-2T(h)(4)(x)(J) to provide that the option attribution rules of §1.382-2T(h)(4)(i) do not apply to an option created by the confirmation of a plan of reorganization in a title 11 or similar case (including an option created under the plan), but only until the time that the plan of reorganization becomes effective. The amendment to §1.382-2T is proposed to be effective as of [Insert date that the Treasury Decision adopting this notice of proposed rulemaking is filed with the Federal Register] and to be applicable for any testing date occurring on or after September 5, 1990.

No inference should be drawn from the proposed regulations as to the application of option attribution rules for any other purpose or as to future regulations concerning section 1504(a)(5) of the Code.

Special Analyses

It has been determined that these proposed rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. 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 proposed regulations, and therefore, an initial Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, these regulations will be submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

Comments and Requests for a Public Hearing

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably a signed original and seven copies) to the Internal Revenue Service. All comments will be available for public inspection and copying in their entirety. A public hearing will be scheduled and held upon written request by any person who submits written comments on the proposed rules. Notice of the time

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

List of Subjects in 26 CFR 1.301-1 through 1.383-3

Corporate adjustments, Corporate distributions, Corporations, Income taxes, Reorganizations.

Proposed Amendments to the Regulations

The notice of proposed rulemaking (to amend 26 CFR Part 1) that was published on August 14, 1990 (55 FR 33137) is amended and additional amendments to 26 CFR Part 1 are proposed as follows:

PART 1—[AMENDED]

Paragraph 1. The authority for Part 1 is amended by adding the following citations to read in part:

Authority: 26 U.S.C. section 7805; *** §1.382-2T also issued under 26 U.S.C. 382(g)(4)(C), and 26 U.S.C. 382(m), and §1.382-3 also issued under 26 U.S.C. 382(l)(3)(A) and 382(m).

Par. 2. A new §1.382-2T(h)(4)(x)(J) is added to read as set forth below:

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

* * * * *

(h) ***

(4) ***

(x) *Options not subject to attribution.* ***

(J) *Title 11 or similar case.* Any option created by the confirmation of a plan of reorganization in a title 11 or similar case (within the meaning of section 368(a)(3)(A)), but only until the time that the plan becomes effective. This paragraph (h)(4)(x)(J) applies to any testing date occurring on or after September 5, 1990.

Par. 3. Section 1.382-3, as proposed on August 14, 1990 (55 FR 33137), is amended by revising paragraphs (c) and (d) to read as follows:

§1.382-3 Special rules under section 382 for a corporation in a title 11 or similar case.

* * * * *

(c) *Option attribution*—(1) *Determination of stock ownership for purposes of section 382(l)(5)(A)(ii).* Solely for purposes of determining whether the stock ownership requirements of section 382(l)(5)(A)(ii) and §1.382-3(a)(2) are satisfied at the time of an ownership change, stock of the loss corporation (or of a controlling corporation if also in bankruptcy) that is subject to an option is treated as acquired at that time, pursuant to an exercise of the option by its owner, if such deemed exercise would cause the pre-change shareholders and qualified creditors of the loss corporation to own (after such ownership change and as a result of being pre-change shareholders or qualified creditors immediately before such change) less than an amount of such stock sufficient to satisfy the ownership requirements of section 382(l)(5)(A)(ii) and §1.382-3(a)(2). An option that is owned as a result of being a pre-change shareholder or qualified creditor and that, if exercised, would result in the ownership of stock by a pre-change shareholder or qualified creditor will not be treated as exercised under this section. For purposes of this paragraph, rules similar to the rules of paragraphs (iii), (iv), (v), (vii), and (x)(A), (B) (except with respect to a debt instrument that was issued after the filing of the petition of the title 11 or similar case), (D), (E), (G), (H), (J), and (Z) of §1.382-2T(h)(4) (relating to certain rules regarding option attribution rules for purposes of determining whether an ownership change occurs) apply. Rules similar to the rules of §1.382-2T(h)(4)(viii) also apply with respect to an option except to the extent any person owning the option at any time on or after the change date acquires additional stock or an option to acquire additional stock during the period of time on or after the ownership change and on or before the lapse or forfeiture of the option.

(2) *Examples.*

Example 1. L is a loss corporation in a title 11 case. The plan of reorganization of L approved by the bankruptcy court provides for the cancellation of all existing L stock, the issuance of 100 shares of new L common stock to qualified creditors, and the issuance of an option to a new investor to acquire, at any time during the next 3 years, 90 shares of new L common stock from L at its fair market value on the date the plan is effective. Under paragraph (c)(1) of this section, upon the effective date of the plan, the option held by the new investor is deemed exercised if the exercise would cause the qualified creditors of L to own less than 50 percent of the total voting power or value of the L stock after the ownership change. Because the qualified creditors would receive at least 50 percent of the voting power and value of the new L common stock even if the option were deemed exercised, the stock ownership requirements of section 382(l)(5)(A)(ii) are satisfied.

Example 2. The facts are the same as in Example (1), except that L issues an option to the new investor to acquire 110 shares of new L common stock. This option is deemed exercised under paragraph (c)(1) of this section upon the effective date of the plan, because, as a result of the deemed exercise, the qualified creditors would receive only 100 of 210 shares of the new L common stock (approximately 48 percent) after the ownership change. Accordingly, the stock ownership requirements of section 382(l)(5)(A)(ii) are not satisfied and section 382(a) applies to the ownership change.

(3) *Effective date.* This paragraph (c) applies to ownership changes occurring on or after September 5, 1990.

(d) *Coordination with the definitions and nomenclature used in section 382*—(1) *In general.* Terms and nomenclature used in this section, and not otherwise defined herein, have the same respective meaning as in section 382 and the regulations thereunder.

(2) *Pre-change shareholders.* [reserved]

(3) *Qualified creditors.* [reserved]

Fred T. Goldberg, Jr.,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on September 5, 1990, 8:45 a.m., and published in the issue of the Federal Register for September 6, 1990, 55 F.R. 36657)

Notice of Proposed Rulemaking

Acquisitions Made to Evade or Avoid Income Tax; Use of Corporate Tax Attributes Following an Ownership Change

CO-77-89

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed income tax regulations providing guidance relating to acquisitions made to evade or avoid income tax under section 269 of the Internal Revenue Code of 1986 (the "Code"). This document also contains proposed income tax regulations which provide guidance relating to the use

of certain corporate tax attributes following an ownership change within the meaning of section 382(g)(1) to which section 382(l)(5) applies. Section 382 was amended in relevant part by the Tax Reform Act of 1986 (the "1986 Act") and the Revenue Act of 1987 (the "1987 Act").

DATES: Written comments and requests for a public hearing must be received by September 28, 1990. The proposed regulations would apply generally to any ownership change, as defined under section 382 of the Code, occurring after December 31, 1986.

ADDRESS: Send comments and requests for a public hearing to: Internal Revenue Service, Attn: CC: CORP:T:R (CO-77-89), Room 4429, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044.

SUPPLEMENTARY INFORMATION:

Background

This document contains a notice of proposed rulemaking which proposes additions to Part 1 of Title 26 of the Code of Federal Regulations ("CFR") under sections 269 and 382 of the Code. The proposed regulations provide guidance under sections 269, 382, and 383 relating to acquisitions made to evade or avoid income tax and to the use of pre-change corporate tax attributes following an ownership change with respect to which section 382(l)(5) applies. Section 382 was amended in relevant part by section 621 of the 1986 Act (Pub. L. No. 99-514; 100 Stat. 2085 [1986-3 C.B. (Vol. 1) 1, 171]) and by section 10225 of the 1987 Act (Pub. L. No. 100-1203; 101 Stat. 1330-413 [1987-3 C.B. 1, 133]).

Explanation of Provisions

Overview of the relevant statutory provisions.

Under section 382(a) of the Code, as amended, if an ownership change occurs with respect to a loss corporation (as defined in section 382(k)(1) and §1.382-2T(f)(1) of the Income Tax Regulations), the amount of the loss corporation's taxable income for a post-change year that may be offset by the pre-change net operating losses (and certain built-in losses) of the loss corporation cannot exceed the section 382 limitation. The section 382 limitation for a post-change year is generally equal to the fair market value of the loss corporation's stock immediately before the ownership change multiplied by the applicable long-term tax exempt rate as published in the Internal Revenue Bulletin. In general, an ownership change involves an increase of more than 50 percentage points in stock ownership by 5-percent shareholders during the testing period (usually the three-year period ending on the date on which a transaction is tested for an ownership change).

Section 382(c) of the Code reduces the section 382 limitation to the amount of certain recognized built-in gains and any excess limitation carried over from prior years if the loss corporation does not continue its business enterprise at all times during the two-year period following the ownership change. The continuity of business enterprise requirement under section 382(c) is the same continuity of business enterprise requirement that must be satisfied in order for a transaction to qualify as a tax-free reorganization under section 368. H.R. Conf. Rep. No. 841, 99th Cong., 2nd Sess., II-189 (1986), 1986-3 (Vol. 4) C.B. 194 (the "Conference Report"). Thus, a loss corporation or its successor must either continue the loss corporation's historic business or use a significant portion of the loss corporation's historic business assets in a business. *See* §1.368-1(d).

Section 382(l)(5) of the Code provides that section 382(a) does not apply after an ownership change of a loss corporation if (1) the corporation is under the jurisdiction of a court in a title 11 or similar case immediately before the ownership change, and (2) the corporation's pre-change shareholders and qualified creditors (determined immediately before the ownership change) own at least 50 percent of the value and voting power of the loss corporation's stock (or stock of a controlling corporation if also in bankruptcy) immediately after the ownership change and as a result of being pre-change shareholders or qualified creditors immediately before the ownership change. Section 382(l)(5) applies only to a transaction that is ordered by the court or is pursuant to a plan approved by the court. Conference Report at II-192. Although the limitation imposed by section 382(a) does not apply, the loss corporation may be required to reduce a portion of its pre-change losses and credits following a transaction qualifying under section 382(l)(5).

Under section 383 of the Code and §1.383-1T, the section 382 limitation for a post-change year also applies to limit the amount of capital gain or tax liability that may be offset, respectively, by capital losses and excess credits (excess foreign taxes carried over under section 904(c), unused general business credits carried over under section 39, and unused minimum tax credits under section 53) of the loss corporation that are attributable to the pre-change period.

Section 269 of the Code may also affect a corporation's ability to use losses and credits following a change in ownership. Under section 269, if a person acquires control of a corporation, or a corporation acquires property in a carryover basis transaction from another corporation not controlled by the acquiring corporation or its shareholders, and the principal purpose of the acquisition is the evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or allowance which would otherwise be unavailable, the Commissioner may disallow all or a portion of the deduction, credit, or allowance.

Relationship of section 269 to sections 382 and 383 after the Tax Reform Act of 1986—In General.

The amendments to sections 382 and 383 of the Code by the 1986 Act do not alter the continuing application of section 269 to acquisitions made for the principal purpose of evasion or avoidance of Federal income tax. Conference Report at II-194. Accordingly, the proposed regulations address the application of section 269 in situations in which section 382 or 383 also apply.

The proposed regulations provide, in general, that section 269 of the Code may be applied to disallow a deduction, credit, or other allowance the use or amount of which is limited or reduced under section 382 or 383 and the regulations thereunder. Nevertheless, because the limitations on the use of a deduction, credit, or other allowance under section 382(a)

or 383 may significantly reduce the value of the deduction, credit, or other allowance to an acquirer, the proposed regulations provide that the application of these limitations following an acquisition is relevant to the determination of whether, for purposes of section 269, the principal purpose of the acquisition was to evade or avoid Federal income taxes by securing the benefit of the deduction, credit, or other allowance.

Ownership changes to which section 382(l)(5) applies.

The proposed regulations clarify that the continuity of business enterprise requirement of section 382(c) of the Code does not apply to ownership changes to which section 382(l)(5) applies. In enacting section 382(l)(5), however, Congress neither explicitly nor implicitly excused bankruptcy reorganizations with a principal purpose of tax evasion or avoidance from its general direction that section 269 continue to apply in situations in which section 382(a) or section 383 also apply. Because the rate at which a corporation's surviving losses and credits may be used is not limited following an ownership change that qualifies under section 382(l)(5), the potential for tax evasion or avoidance is greater in a bankruptcy reorganization to which section 382(l)(5) applies. For example, when the corporation to be reorganized has substantial unused losses or credits but does not carry on more than an insignificant amount of an active trade or business, the principal purpose of reorganizing the corporation is likely to be to permit its creditors to recoup their losses, in part, through the tax system. The proposed regulations therefore provide that, absent strong evidence to the contrary, a requisite acquisition of control or property in connection with an ownership change to which section 382(l)(5) applies is considered to be made for the principal purpose of evasion or avoidance of Federal income tax unless the corporation carries on more than an insignificant amount of an active trade or business during and subsequent to the title 11 or similar case.

The Internal Revenue Service requests comments on whether there are other circumstances in which the acquisition of control or property of the reorganized corporation should or should not be considered to be made for the principal purpose of tax avoidance for purposes of section 269 of the Code.

The time of acquisition of control.

The proposed regulations clarify that, for purposes of section 269 of the Code, control is acquired when one or more persons acquire beneficial ownership of the requisite amount of stock. The proposed regulations further provide that, although insolvency or bankruptcy may cause the interests of creditors to predominate as a practical matter, creditor interests do not constitute beneficial ownership of the corporation's stock for purposes of section 269. As a result, creditors of a corporation in bankruptcy ordinarily will be considered to have acquired control for purposes of section 269 no earlier than the confirmation of the plan of reorganization. This result is required even though, under the rule of *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942), the interest of the creditors has taken on an equity-like character sufficient to satisfy the non-statutory continuity of proprietary interest test for corporate reorganizations. *See Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194 at 202 (1942) ("[I]t is one thing to say that the bondholders 'stepped into the shoes of the old stockholders' so as to acquire the proprietary interest in the insolvent company. It is quite another to say that they were the 'stockholders' within the purview of the [statutory provision].")

Relationship of section 269 to 11 U.S.C. §1129(d).

Section 1129(d) of the Bankruptcy Code provides that, upon request of a party in interest that is a governmental unit (such as the Internal Revenue Service), the bankruptcy court may not confirm a plan of reorganization if the principal purpose of the plan is the avoidance of taxes. In any hearing under 11 U.S.C. §1129(d), the Government has the burden of proof on the issue of tax avoidance. In contrast, when the Government asserts in the course of income tax litigation that an acquisition was undertaken for the principal purpose of evading or avoiding Federal income tax, the position of the Commissioner generally is presumed to be correct and the burden of proving to the contrary is on the taxpayer.

Because the burden of proof is reversed in a proceeding under 11 U.S.C. §1129(d), the proposed regulations provide that in determining for purposes of section 269 of the Internal Revenue Code whether an acquisition pursuant to a plan of reorganization in a case under title 11 of the United States Code was made for the principal purpose of evasion or avoidance of Federal income tax, the fact that a governmental unit did not seek a determination under 11 U.S.C. §1129(d) is not taken into account and any determination by a court order 11 U.S.C. §1129(d) that the principal purpose of the plan is not avoidance of taxes is not controlling.

Special Analyses

It has been determined that these proposed rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. 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, an initial Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, the proposed regulations are being sent to the Administrator of the Small Business Administration for comment on their impact on small business.

Comments and Request for a Public Hearing

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably a signed original and eight copies) to the Internal Revenue Service. All comments will be available for public inspection and copying in their entirety. A public hearing will be scheduled and held upon written request by any person who submits written comments on the proposed rules. Notice of the time and place for the hearing will be published in the Federal Register.

List of Subjects

26 CFR Sections 1.61-1 through 1.281-4

Deductions, Exemptions, Income Tax, Taxable Income.
26 CFR Sections 1.301–1 through 1.385–6

Income taxes, Corporate distributions, Corporations, Corporate adjustments, Reorganizations.

Proposed Amendments to the Regulations

The proposed amendments to 26 CFR, Chapter 1, Part 1 are as follows:

PART 1—[AMENDED]

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

Authority: 26 U.S.C. 7805; * * * Section 1.382–3 also issued under 26 U.S.C. 382(m).

Par. 2. Section 1.269–1 is amended to remove "1.269–6" from the first sentence and add "1.269–7" in lieu thereof.

Par. 3. Section 1.269–3 is amended as follows:

1. The last sentence of paragraph (a) is removed.

2. New paragraphs (d) and (e) are added to read as follows:

(d) *Ownership changes to which section 382(l)(5) applies; transactions indicative of purpose to evade or avoid tax.* Absent strong evidence to the contrary, a requisite acquisition of control or property in connection with an ownership change to which section 382(l)(5) applies is considered to be made for the principal purpose of evasion or avoidance of Federal income tax unless the corporation carries on more than an insignificant amount of an active trade or business during and subsequent to the title 11 or similar case (as defined in section 382(l)(5)(G)). The determination of whether the corporation carries on more than an insignificant amount of an active trade or business is based on all the facts and circumstances. These facts and circumstances may include, for example, the amount of business assets that continue to be used or the number of employees in the work force who continue employment. Where the corporation continues to utilize a significant amount of the historic business assets or work force, however, the requirement of carrying on more than an insignificant amount of an active trade or business may be met even though all trade or business activities temporarily cease.

(e) *Relationship of section 269 to 11 U.S.C. §1129(d).* In determining for purposes of section 269 of the Internal Revenue Code whether an acquisition pursuant to a plan of reorganization in a case under title 11 of the United States Code was made for the principal purpose of evasion or avoidance of Federal income tax, the fact that a governmental unit did not seek a determination under 11 U.S.C. §1129(d) is not taken into account and any determination by a court under 11 U.S.C. §1129(d) that the principal purpose of the plan is not avoidance of taxes is not controlling.

Par. 4. Section 1.269–5 is revised to read as follows:

§1.269–5 Time of acquisition of control.

(a) *In general.* for purposes of section 269, an acquisition of control occurs when one or more persons acquire beneficial ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.

(b) *Application of general rule to certain creditor acquisitions.* For purposes of section 269, creditors of an insolvent or bankrupt corporation (by themselves or in conjunction with other persons) acquire control of the corporation when they acquire beneficial ownership of the requisite amount of stock. Although insolvency or bankruptcy may cause the interests of creditors to predominate as a practical matter, creditor interests do not constitute beneficial ownership of the corporation's stock. For purposes of section 269, creditors of a bankrupt corporation are treated as acquiring beneficial ownership of stock of the corporation no earlier than the time a bankruptcy court confirms a plan of reorganization.

Example. Corporation *L* files a petition under chapter 11 of the Bankruptcy Code on January 5, 1987. A creditors' committee is formed. On February 22, 1987, and upon the request of the creditors, the bankruptcy court removes the debtor-in-possession from business management and operations and appoints a trustee. The trustee consults regularly with the creditors' committee in formulating both short-term and long-term management decisions. After three years, the creditors approve a plan of reorganization in which the outstanding stock of Corporation *L* is cancelled and its creditors receive shares of stock constituting all of the outstanding shares. The bankruptcy court confirms the plan of reorganization on March 23, 1990, and the plan is put into effect on May 25, 1990. For purposes of section 269, the creditors acquired control of Corporation *L* no earlier than March 23, 1990. Similarly, the determination of whether the creditors acquired control of Corporation *L* with the principal purpose of evasion or avoidance of Federal income tax is made by reference to the creditors' purposes as of no earlier than March 23, 1990.

Par. 5. The heading of §1.269–6 is revised to read as follows:

§1.269–6 Relationship of section 269 to section 382 before the Tax Reform Act of 1986.

Par. 6. New §1.269–7 is added to read as follows:

§1.269–7 Relationship of section 269 to sections 382 and 383 after the Tax Reform Act of 1986.

Section 269 and §§1.269–1 through 1.269–5 may be applied to disallow a deduction, credit, or other allowance notwithstanding that the utilization or amount of a deduction, credit, or other allowance is limited or reduced under section 382 or 383 and the regulations thereunder. However, the fact that the amount of taxable income or tax that may be offset by a deduction, credit, or other allowance is limited under section 382(a) or 383 and the regulations thereunder is relevant to the determination of whether the principal purpose of an acquisition is the evasion or avoidance of Federal income tax.

Par. 7. New §1.382–3 is added to read as follows:

§1.382–3 Special rules under section 382 for corporations under the jurisdiction of a court in a title 11 or similar case.

(a) *Introduction.* Under section 382(l)(5), section 382(a) does not apply to any ownership change if—

(1) the old loss corporation is (immediately before the ownership change) under the jurisdiction of the court in a title 11 or similar case, and

(2) the pre-change shareholders and qualified creditors of the old loss corporation (determined immediately before the ownership change) own (after the ownership change and as a result of being shareholders or creditors immediately before the ownership change) stock of the new loss corporation (or stock of a controlling corporation if also in bankruptcy)

that meets the requirements of section 1504(a)(2) (determined by substituting "50 percent" for "80 percent" each place it appears). Section 382(l)(5) applies only to a transaction that is ordered by the court or is pursuant to a plan approved by the court.

(b) *Continuity of business requirement.* If section 382(l)(5) and this section apply to an ownership change of a loss corporation, section 382(c) and the regulations thereunder do not apply with respect to the ownership change.

(c) [Reserved]

(d) *Coordination with definitions and nomenclature used in section 382.* Terms and nomenclature used in this section, and not otherwise defined herein, have the same respective meanings as in section 382 and the regulations thereunder.

Fred T. Goldberg, Jr.,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on August 13, 1990, 8:45 a.m., and published in the issue of the Federal Register for August 14, 1990, 55 F.R. 33137)

Notice of Proposed Rulemaking

Returns Relating to Certain Changes in Corporate Control or Capital Structure

CO-5-90

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: If any person acquires control of a corporation or if a corporation has a recapitalization or other substantial change in capital structure, section 6043(c) of the Internal Revenue Code (Code) provides that, when required by the Secretary, the corporation shall make a return setting forth the identity of the parties to the transaction, the fees involved, the changes in the capital structure involved, and such other information as the Secretary may require with respect to such transaction. Section 6043(c) was added to the Code by the Omnibus Budget Reconciliation Act of 1989 [Pub. L. 101-239, 1990-1 C.B. 210]. This document contains proposed regulations under section 6043(c) concerning reporting requirements under that section.

DATES: Written comments and requests for a public hearing must be received by August 6, 1990. The regulations are proposed to apply to transactions occurring after March 31, 1990.

ADDRESS: Send comments or requests for a public hearing to: Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Attention: CC:CORP:T:R [CO-005-90], Room 4429, Washington, D.C. 20044.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1980 (44 U.S.C. §3504(h)). Comments on the collection of information and suggestions for reducing the burden should be sent 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, with copies to the Internal Revenue Service, Attention: IRS Reports Clearance Officer T:FP, Washington, DC 20224.

The collection of information requirement in these regulations is in proposed §1.6403-4(a), reflected in the requirement that certain corporations file a return on Form 8820. This information is needed by the Internal Revenue Service to implement section 6043(c) of the Code. The respondents will be certain corporations for which there has been a transaction of $10,000,000 or more involving a substantial change in the corporation's capital structure or an acquisition of control of the corporation.

The estimated total reporting burden and the estimated average burden per respondent will be reflected on Form 8820. Response will be on occasion and the estimated annual number of respondents is 10,000.

Background

This document proposes regulations to be added to the Income Tax Regulations (26 CFR Part 1) and the Procedure and Administration Regulations (26 CFR Part 301) under section 6043(c) of the Code. The regulations are proposed to be issued under the authority of section 6043(c), as added by section 7208(b)(1) of the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, and under the authority of section 7805(a).

Explanation of Provisions

Section 6043(c) provides that if any person acquires control of a corporation, or if a corporation has a recapitalization or other substantial change in capital structure, the corporation, when required by the Secretary, shall make a return setting forth the identity of the parties to the transaction, the fees involved, the changes in the capital structure involved, and such other information as the Secretary may require with respect to such transaction.

A. Transactions to be Reported

The proposed regulations require that a corporation file a return on Form 8820 setting forth certain required information. As proposed, the form must be filed on or before the 15th day of the fourth month following the month in which a reportable transaction occurs or, if later, 120 days after the date of the Internal Revenue Bulletin in which the Internal Revenue Service has announced that Form 8820 is available to the public. The proposed regulations provide that a reportable transaction is either an acquisition of control of the corporation or a substantial change in the capital structure of the corporation. The proposed regulations further provide that a related transaction means (i) in the case of an acquisition of control by a person, any other acquisition of stock of the corporation, directly or indirectly, by the person or the corporation during the 365-day period ending on the date on which control is acquired; or (ii) in the case of a substantial change in capital structure, any other change in capital structure during the 365-day period ending on the date of the substantial change in capital structure.

The proposed regulations define control by reference to section 304(c)(1). In determining whether an

acquisition of control has occurred, the proposed regulations apply the constructive ownership rules of section 318(a) (except that section 318(a)(4), which provides for constructive ownership through an option to acquire stock, does not apply), as modified by section 304(c)(3)(B).

No return would be required for an acquisition of control if, during the 365-day period ending on the date on which control is acquired, the fair market value of the stock acquired in that transaction and any related transactions, as of the date or dates on which stock is acquired, aggregates to less than $10,000,000. In addition, no return would be required for an acquisition of control if the acquisition consists of the receipt of stock upon the organization of the corporation in a single transaction or series of transactions ending no more than 365 days after the first issuance of stock by the corporation.

As proposed, a corporation undergoes a substantial change in capital structure if (i) the corporation undergoes a change in capital structure, as defined in the proposed regulation; and (ii) the total fair market value of stock and value of debt (as defined in the proposed regulation), as of the date or dates on which the stock or debt is issued or distributed, is $10,000,000 or more.

A corporation undergoes a change in capital structure under the proposed regulations if the corporation (i) exchanges its stock for its debt or for its stock; (ii) exchanges its debt for its stock; (iii) distributes stock in a transaction described in section 305(b); (iv) distributes stock described in section 306(c); (v) distributes its stock or its debt, or the stock or debt of a controlled corporation (within the meaning of section 355) in a reorganization under section 368(a)(1) or a transaction under section 355; or (vi) has a significant net issuance of debt.

As proposed, a corporation has a significant net issuance of debt if, as of a date on which debt is issued, the value of the debt issued by the corporation during the 365-day period ending on that date exceeds the value of its debt retired during the same period by more than 50 percent of the value of the corporation's total long-term debt and owners' equity, as shown on the corporation's applicable statement of financial position. The applicable statement of financial position means a statement, for any date during the 365-day period, determined under principles similar to those of section 56(f)(3)(A) and (C). If the corporation has 2 or more statements described in the clause or subclause of section 56(f)(3)(A) with the lowest numerical designation, the applicable statement of financial position would be the one showing the lowest value of total long-term debt and owners' equity. The proposed regulations provide that certain debt incurred in the ordinary course of business, and in acquiring certain property, will not be taken into account in determining whether a significant net issuance of debt has occurred.

The proposed regulations provide that the Internal Revenue Service may specify by revenue procedure additional transactions for which returns on Form 8820 will be required. Reporting requirements established by revenue procedure will apply only to transactions completed more than 30 days after the date on which the revenue procedure is published in the Internal Revenue Bulletin.

The proposed regulations provide that a reportable transaction, and any related transaction, shall not be taken into account in determining whether a return on Form 8820 is required for any transaction subsequent to the reportable transaction. Furthermore, it is intended that if, by reason of acquiring control of a corporation, a person also indirectly acquires control of a corporation controlled by the first corporation, only the first corporation is required to file Form 8820 with respect to the transaction.

For the penalties for failure to file Form 8820 (including provision for waiver of those penalties), see section 6652(1). In addition, as is true generally with respect to reporting obligations, the criminal penalties of sections 7203, 7206 and 7207 would, in appropriate cases, apply to violations involving Form 8820.

B. Form 8820

It is expected that Form 8820 will require the following information: (i) the identities (including the employer identification or taxpayer identification numbers) of the corporation that has undergone the transaction giving rise to the filing requirement, of any other parties to the transaction or related transactions (other than public shareholders or debtholders who do not actively participate in the transaction), and if any common parent of a group (as defined in the instructions) of which any of these entities is a member; (ii) an indication of the type of transaction for which the return is filed (e.g., stock purchase, debt issuance, etc.); (iii) a schedule of stock or debt transferred, issued, distributed, or redeemed in the transaction or in related transactions, including the fair market value of the stock or value of the debt, and other identifying information with respect to that stock or debt; (iv) a description, including the amount and form, of fees paid to persons who provided services in connection with the transaction or related transactions, including but not limited to merchant bankers, investment bankers, underwriters, consultants, persons who appraised or valued any property or stock in connection with the transaction, attorneys, accountants, and investment advisors; and (v) an identification of any parties to the transaction or related transactions (other than public shareholders or debtholders who do not actively participate in the transaction) that are foreign persons or tax-exempt entities.

Special Analyses

It has been determined that these proposed regulations are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis 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, an initial Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations will be submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

Comments and Requests for a Public Hearing

Before adopting these proposed regulations, consideration will be given to any written comments that are

submitted (preferably an original and eight copies) to the Internal Revenue Service. In addition to any other comments the public may wish to make on the proposed regulations, the Service is particularly interested in comments concerning (i) the types of information proposed to be required by Form 8820, and (ii) the types of transactions for which the regulations require reporting. In this connection, the Service is considering, and requests comment on, whether additional reporting requirements under section 6043(c) are needed with respect to corporations in bankruptcy, in order to identify leveraging transactions not otherwise covered by the proposed regulations. All comments will be available for public inspection and copying. A public hearing will be held upon written request by any person who has submitted written comments. If a public hearing is held, notice of time and place will be published in the Federal Register.

List of Subjects

26 CFR Part 1.6001-1—1.6109-2

Income taxes, Administration and procedure, Filing requirements.

List of Subjects

26 CFR Part 301

Administrative practice and procedure, Bankruptcy, Courts, Crime, Employment taxes, Estate taxes, Excise taxes, Gift taxes, Income taxes, Investigations, Law enforcement, Penalties, Pensions, Statistics, Taxes, Disclosure of information, Filing requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR Parts 1 and 301 are proposed to be amended as follows: PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1986

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

Authority: 26 U.S.C. 7805; *** §1.6043-4 also issued under 26 U.S.C. 6043(c).

Par. 2. A new §1.6043-4 is added in the appropriate place to read as follows:

§1.6043-4 Information returns relating to certain changes in corporate control or capital structure.

(a) *General rule.* Except as otherwise provided in this section, a corporation shall file a return on Form 8820, setting forth such information as the form shall require, if a reportable transaction occurs. A reportable transaction is either an acquisition of control of the corporation, as defined in paragraph (c) of this section, or a substantial change in capital structure of the corporation, as defined in paragraph (d) of this section. The return is due on or before the 15th day of the fourth month following the month in which the reportable transaction occurred (or, if later, 120 days after the date of the Internal Revenue Bulletin in which the Internal Revenue Service announces that Form 8820 is available to the public).

(b) *Excluded corporations.* No return is required under this section for an acquisition of control or a substantial change in capital structure of—

(1) Any regulated investment company within the meaning of section 851,

(2) Any real estate investment trust within the meaning of section 856, and

(3) Any foreign corporation, unless 25 percent or more of its gross income from all sources for the 3-year period preceding the reportable transaction (or for the part of that period during which the corporation was in existence) was effectively connected (or treated as effectively connected, other than income described in section 884(d)(2)) with the conduct of a trade or business in the United States.

(c) *Acquisition of control of a corporation*—(1) *In general.* For purposes of this section, control of a corporation is acquired by a person if—

(i) before an acquisition of stock of the corporation, directly or indirectly, by the person or by the corporation, the person does not have control (as defined in the first sentence of section 304(c)(1)) of the corporation, and

(ii) after the acquisition, the person does have control (as defined in the first sentence of section 304(c)(1)) of the corporation.

(2) *Constructive ownership.* For purposes of this paragraph (c), the constructive ownership rules of section 318(a) (except for section 318(a)(4), providing for constructive ownership through an option to acquire stock), modified as provided in section 304(c)(3)(B), shall apply.

(3) *Person includes group.* For purposes of this paragraph (c), when two or more persons act together for the purpose of acquiring stock or control of a corporation, those persons shall be treated as a single person.

(4) *Exceptions*—(i) *Organization of corporation.* No return is required under this section for an acquisition of control of a corporation if the transaction consists of the receipt of stock upon the organization of the corporation in a single transaction or series of transactions ending no more than 365 days after the first issuance of stock by the corporation.

(ii) *Acquisitions involving less than $10,000,000.* No return is required under this section for an acquisition of control of a corporation if the fair market value of the stock acquired in the transaction and in any related transactions (as defined in paragraph (e) of this section), as of the date or dates on which the stock was acquired, is less than $10,000,000.

(d) *Substantial change in capital structure*—(1) *In general.* A corporation has a substantial change in capital structure if it has a change in capital structure (as defined in paragraph (d)(2) of this section) and the sum of the fair market value of stock and the value of debt issued or distributed in the transaction and in any related transactions (as defined in paragraph (e) of this section), as of the date or dates on which the stock or debt is issued or distributed, is $10,000,000 or more. For purposes of this paragraph (d), the value of debt is the greater of its fair market value or—

(i) its stated principal amount, if there is adequate stated interest (as defined in section 1274(c)(2)), or

(ii) its imputed principal amount (as defined in section 1274(b)).

(2) *Change in capital structure*—(i) *In general.* For purposes of this section, a corporation has a change in capital structure if the corporation—

(A) exchanges its stock for its debt or for its stock;

(B) exchanges its debt for its stock;

(C) distributes stock in a transaction described in section 305(b);

(D) distributes stock described in

section 306(c);

(E) distributes its stock or its debt, or stock or debt of a controlled corporation (within the meaning of section 355), in a reorganization under section 368(a)(1) or a transaction under section 355; or

(F) has a significant net issuance of debt, as defined in paragraph (d)(2)(ii) of this section.

(ii) *Significant net issuance of debt*—(A) *In general.* For purposes of this paragraph (d)(2), a corporation has a significant net issuance of debt if, during the 365-day period ending on a date on which debt is issued, the value of the debt issued by the corporation exceeds the value of the debt retired by the corporation (in each case as of the date or dates of issuance or retirement) by more than 50 percent of the sum of the corporation's long-term debt (determined without regard to paragraph (d)(2)(ii)(B) of this section) and owners' equity, as shown on the corporation's applicable statement of financial position. The applicable statement of financial position means a statement of financial position, determined according to principles similar to those of section 56(f)(3)(A) and (C), for any date during the 365-day period. If the corporation has 2 or more statements of a type described in the clause (or subclause) of section 56(f)(3)(A) with the lowest number designation, the applicable statement of financial position is the one that shows the smallest sum of long-term debt and owners' equity.

(B) *Certain debt not taken into account.* For purposes of this paragraph (d)(2)(ii), debt does not include—

(*1*) debt incurred in the ordinary course of business to acquire or carry goods or services, to the extent that the aggregate value of the debt does not exceed the fair market value of the goods or services, if—

(*i*) the debt is incurred substantially contemporaneously with the acquisition of the goods or services, and

(*ii*) the debt is reasonably expected to be repaid in full by the corporation within one year from the date on which it was incurred;

(*2*) debt incurred in the ordinary course of business and secured by accounts receivable, to the extent that the aggregate value of the debt does not exceed the fair market value of the accounts receivable;

(*3*) debt incurred in acquiring, constructing, or substantially improving any asset (other than stock of the corporation) and secured by that asset, to the extent that the aggregate value of the debt does not exceed the fair market value of the asset (or, in the case of a substantial improvement, does not exceed the cost of the improvement); or

(*4*) debt resulting from the refinancing of debt meeting the requirements of this paragraph (d)(2)(ii)(B) (including this paragraph (d)(2)(ii)-(B)(*4*)), provided that—

(*i*) the value of the debt resulting from the refinancing does not exceed the value of the refinanced debt on the date of the refinancing;

(*ii*) in the case of any initial or subsequent refinancing of a debt that was described in paragraph (d)(2)(ii)-(B)(*2*) or (*3*) of this section, the refinanced debt is secured by the asset described in paragraph (d)(2)(ii)(B)(*2*) or (*3*) of this section; and

(*iii*) in the case of any initial or subsequent refinancing of a debt that was described in paragraph (d)(2)(ii)-(B)(*1*) of this section, the refinanced debt is reasonably expected to be repaid in full by the corporation within one year of the date on which the original debt was incurred.

(3) *Stock.* For purposes of this paragraph (d), stock includes all rights to acquire stock.

(e) *Related transaction.* For purposes of this section, the term related transaction means—

(1) in the case of an acquisition of control of a corporation, any other acquisition of stock of the corporation, directly or indirectly, by the person acquiring control or by the corporation, during the 365-day period ending on the date of the acquisition of control; or

(2) in the case of a change in capital structure (as defined in paragraph (d)(2) of this section), any other change in the capital structure (as defined in paragraph (d)(2) of this section) of the corporation during the 365-day period ending on the date of the change in capital structure.

(f) *No double-counting of transactions.* No reportable transaction or any related transaction shall be taken into account in determining whether a return on Form 8820 is required for any transaction subsequent to the reportable transaction.

(g) *Additional transactions specified in revenue procedure.* The Internal Revenue Service may by revenue procedure specify transactions, in addition to those described in this regulation, for which returns on Form 8820 will be required. Reporting requirements established under this paragraph (g) will apply only to transactions completed more than 30 days after the date of the Internal Revenue Bulletin in which the revenue procedure setting forth the filing requirement is published.

(h) *Penalties for failure to file.* For the penalties for failure to file Form 8820, see section 6652(1). In addition, as is true generally with respect to reporting obligations, the criminal penalties of sections 7203, 7206 and 7207 would, in appropriate cases, apply to violations involving Form 8820.

(i) *Effective date.* This section applies to transactions occurring after March 31, 1990.

PART 301—PROCEDURE AND ADMINISTRATION

Par. 3. The authority citation for Part 301 is amended by adding the following citation:

Authority: 26 U.S.C. 7805; *** §301.6043(c)-1 is also issued under 26 U.S.C. 6043(c).

Par. 4. A new §301.6043(c)-1 is added in the appropriate place to read as follows:

§301.6043(c)-1 Information returns relating to certain changes in corporate control or capital structure.

For provisions relating to the requirement that a corporation file a return of information if control of the corporation is acquired by a person or if the corporation has a substantial change in capital structure, see §1.6043-4 of this chapter (Income Tax Regulations).

Fred T. Goldberg, Jr.,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on July 3, 1990, 8:45 a.m., and published in the issue of the Federal Register for July 5, 1990, 55 F.R. 27648)

Notice of Proposed Rulemaking

Proposed Regulations Under Section 108 of the Internal Revenue Code; Discharge of Indebtedness

CO-76-90

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations under section 108(e)(8)(A) of the Internal Revenue Code of 1986 ("the Code"). Section 108(e)(8)(A) was added by the Bankruptcy Tax Act of 1980 and amended by section 11325 of the Revenue Reconciliation Act of 1990. The proposed regulations provide rules for determining whether stock issued in exchange for indebtedness is nominal or token under section 108(e)(8)(A) of the Code.

DATES: Written comments and requests for a public hearing must be received by February 4, 1991.

ADDRESS: Send comments and requests for a public hearing to: Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, CC:CORP:T:R [CO-76-90], Room 4429, Washington, D.C. 20044.

SUPPLEMENTARY INFORMATION:

Background

This document concerns section 108(e)(8)(A) of the Code and adds proposed regulations §1.108-1. Section 108(e)(8)(A) was added by section 2(a) of the Bankruptcy Tax Act of 1980 (Pub. L. No. 96-589, 94 Stat. 3389) and amended by section 11325 of the Revenue Reconciliation Act of 1990 (Pub. L. No. 101-508, 104 Stat. 1388).

The regulations are proposed to be effective on December 6, 1990, and are proposed to apply to exchanges on or after December 6, 1990. Although the regulations are not proposed to apply to exchanges occurring before December 6, 1990, no inference is intended concerning the interpretation of section 108(e)(8)(A) prior to the effective date of these regulations. The Internal Revenue Service will apply the principles underlying the rules of the proposed regulations to exchanges occurring before December 6, 1990, in testing whether the stock transferred is "nominal or token" within the meaning of section 108(e)(8)(A).

Explanation of Provisions

(a) *Overview of Section 108*

Under section 61(a)(12) of the Code, gross income includes income from the discharge of indebtedness. Discharge of indebtedness income to a debtor generally arises when a creditor accepts less than full payment for an amount of indebtedness. Section 108 provides certain rules with respect to discharge of indebtedness income occurring in a title 11 case or when the debtor is insolvent. In general, insolvent debtors exclude discharge of indebtedness income from gross income to the extent of their insolvency (defined in section 108(d)(3)) while title 11 debtors exclude all income arising from a discharge of indebtedness pursuant to a plan approved by the bankruptcy court (section 108(d)(2)). Under section 108(b), title 11 and insolvent debtors must reduce certain tax attributes in an amount equal to the excluded amount of discharge of indebtedness income. If the amount of discharge of indebtedness income exceeds the amount of tax attributes, the excess is disregarded. S. Rep. No. 1035, 96th Cong., 2d. Sess. 2 (1980), 1980-2 C.B. 626.

Section 108(e)(10)(A) of the Code provides that a debtor corporation that transfers stock to a creditor in satisfaction of indebtedness is treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock. As a result, debtor corporations subject to section 108(e)(10)(A) realize discharge of indebtedness income to the extent the amount of the indebtedness exceeds the fair market value of the stock issued in exchange for the indebtedness. Under section 108(e)(10)-(B)(i), section 108(e)(10)(A) does not apply to any transfer of stock (other than disqualified stock) by a debtor corporation in a title 11 case or to the extent the debtor is insolvent. Disqualified stock, as defined in section 108(e)(10)(B)(ii), is stock with a stated redemption price if (a) the stock has a fixed redemption date, (b) the issuer of such stock has the right to redeem such stock at one or more times, or (c) the holder of such stock has the right to require its redemption at one or more times.

As a consequence of the exclusion in section 108(e)(10)(B)(i) of the Code, title 11 and insolvent debtors remain eligible for the common law exception to the realization of discharge of indebtedness income where a debtor corporation issues stock, other than disqualified stock, to its creditors in exchange for debt ("the stock-for-debt exception"). If the stock-for-debt exception applies, gross income does not arise from the exchange, the exclusion under section 108(a) of the Code does not apply since there is no gross income to exclude and, therefore, no reduction of tax attributes occurs under sections 108(b) and 1017.

Section 108(e)(8) of the Code prevents the application of the stock-for-debt exception in certain "*de minimis*" cases. Section 108(e)(8)(A) provides that the stock-for-debt exception does not apply to the issuance of nominal or token shares. The flush language of section 108(e)(8), which was added by the Revenue Reconciliation Act of 1990 (Pub. L. No. 101-508), provides that disqualified stock is not treated as stock in determining whether shares are nominal or token. Section 108(e)(8)(B) provides that the stock-for-debt exception does not apply with respect to an unsecured creditor, where the ratio of the value of the stock received by the unsecured creditor to the amount of its indebtedness canceled or exchanged for stock in the workout is less than 50 percent of a similar ratio computed for all unsecured creditors participating in the workout.

Thus, the stock-for-debt exception is available in the case of an insolvent or title 11 debtor only if the exchange of stock for debt satisfies the *de minimis* rules of section 108(e)(8) of the Code. If, for example, stock is considered nominal or token under section 108(e)(8)(A), the debtor is treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock. Any resulting discharge of indebtedness income is excluded from gross income to the extent provided under section 108(a), but attribute reduction is required under section 108(b).

(b) *Overview of proposed regulations*

The legislative history of section 108(e)(8)(A) of the Code indicates that a facts and circumstances inquiry must be made to ensure that the stock-for-debt exception is not circumvented by the issuance of nominal or token shares to a creditor who has no real equity interest in the corporation. S. Rep. No. 1035, 96th Cong., 2d. Sess. 17, 1980-2 C.B. 628. The proposed regulations provide a nonexclusive list of facts and circumstances to be taken into account in determining if stock is nominal or token. The factors are generally taken into account with respect to the issuance of stock to a creditor in exchange for indebtedness held by that creditor.

For purposes of making the nominal or token analysis, section 1.108-1(a)(2) of the Proposed Regulations adopts the flush language in section 108(e)(8) of the Code which provides that "disqualified stock" under section 108(e)(10)(B)(ii) will not be considered to be stock for purposes of section 108(e)(8). H. Rep. No. 964, 101st Cong., 2d Sess. 1099. Section 1.108-1(a)(2) does not apply to stock that is not disqualified stock under the effective date provisions of section 11325(c) of the Revenue Reconciliation Act of 1990. Accordingly, such stock is treated as stock for purposes of the Proposed Regulations.

In applying the facts and circumstances test, Prop. Reg. §1.108-1(b)-(1)(i) provides that the most important factor is the ratio of the fair market value of the stock issued to the creditor to the allocable indebtedness treated as exchanged for the stock ("Stock to Debt Ratio"). The transfer to a creditor of stock with a fair market value that is low relative to the allocable indebtedness that is discharged is evidence that the shares are nominal or token. The second factor, described in Prop. Reg. §1.108-1(b)(1)(ii), is a comparison of the fair market value of stock received by a creditor to the fair market value of the total consideration received by the creditor in the exchange ("Stock to Total Consideration Ratio"). If the fair market value of the stock is low compared to the fair market value of the total consideration received by the creditor, that is evidence that the shares are nominal or token. The third factor, described in Prop. Reg. §1.108-1(b)(1)(iii), is a comparison of the fair market value of the stock issued to the creditors as a group and the total fair market value of the outstanding stock after the bankruptcy reorganization or insolvency workout ("Stock to Total Stock Ratio"). The fact that the fair market value of the stock issued to the creditors as a group is low in comparison to the fair market value of all of the debtor corporation's outstanding stock is evidence that the shares are nominal or token. Whether a ratio described in Prop. Reg. §1.108-1(b)(1) is low depends upon the particular ratio and whether other facts and circumstances, including the other ratios, indicate that the stock transferred is nominal or token.

The proposed regulations provide special rules for calculating the Stock to Debt Ratio where a debtor issues preferred stock in exchange for outstanding debt. (These rules do not apply to stock that is "disqualified stock" under §1.108-1(a)(2) of the Proposed Regulations.) "Preferred stock," as described in Prop. Reg. §1.108-1(b)(2)(i), is stock that has a limited or fixed redemption price or liquidation preference and does not have a meaningful right to participate in corporate growth. For this purpose, a liquidation preference exists if the stock's right to share in liquidation proceeds is limited and preferred. In addition, a meaningful right to participate in corporate growth is not established by (i) a right to convert preferred stock into a class of stock other than preferred stock or (ii) the fact that the redemption price or liquidation preference exceeds the fair market value of the preferred stock. A meaningful right to participate in corporate growth generally denotes a higher degree of participation than a right to participate in corporate growth to any significant extent as used in other provisions of the Code.

The Stock to Debt Ratio is determined separately for each class of preferred stock; other classes of stock ("other stock") are aggregated in determining the Stock to Debt Ratio. Preferred stock is tested separately from other stock because preferred stock, unlike other stock, qualifies for the stock-for-debt exception only to the extent of the lesser of its redemption price or liquidation preference.

The proposed regulations provide that, in determining the Stock to Debt Ratio with respect to preferred stock, the fair market value of each class of preferred stock issued to the creditor is compared to the portion of the discharged indebtedness that is allocable to the preferred stock. In general, the amount of indebtedness allocable to a class of preferred stock is the lesser of the redemption price or liquidation preference of the preferred stock. The indebtedness that is allocable to a class of preferred stock may not be less than the fair market value of the preferred stock nor greater than the total amount of the indebtedness discharged. The determination of redemption price and liquidation preference is made with reference to the lowest redemption price or liquidation preference of the preferred stock for any period after its issuance established at the time of its issuance. Based on this comparison and other relevant factors, such as the Stock to Total Consideration Ratio and the Stock to Total Stock Ratio, a determination is made as to whether the issuance of the preferred stock to a given creditor is nominal or token.

If both common stock and preferred stock are issued by a debtor to a creditor, the Stock to Debt Ratio is determined separately for stock other than preferred stock. In determining the ratio with respect to other stock, the fair market value of all classes of other stock issued to a creditor is compared to the portion of the discharged indebtedness that is allocable to the other stock. The amount of the indebtedness allocable to the other stock is the adjusted issue price of the indebtedness discharged by the creditor, reduced by the amount of other consideration, if any, transferred to the creditor in exchange for the indebtedness. Accordingly, the adjusted issue price of the indebtedness discharged by a creditor is reduced by the sum of (i) the amount of money paid to the creditor, (ii) the issue price of new indebtedness issued to the creditor, (iii) the amount of indebtedness properly allocable to preferred stock issued to the creditor, and (iv) the fair market value of other property, including disqualified stock under section 108(e)(10)(B)(ii), transferred to the creditor in exchange for the indebtedness. The

amount of indebtedness allocable to preferred stock is generally determined in accordance with the rules described in the preceding paragraph. If preferred stock is determined to be nominal or token, however, the amount of allocable indebtedness is limited to the stock's fair market value. Based on a comparison of the fair market value of the other stock to the allocable indebtedness and other relevant factors, such as the Stock to Consideration Ratio and the Stock to Total Stock Ratio, a determination is made as to whether the other stock is nominal or token.

(c) *Proposed Standards*

The Service is also considering issuing a revenue procedure or other appropriate guidance setting forth specific circumstances in which shares issued to discharge indebtedness will not be considered nominal or token. The Service requests comments on the proposed standards set forth in the following paragraphs.

Under the proposed standards, stock (within the meaning of section 108(e)(8) of the Code) that is issued in exchange for indebtedness would not be nominal or token if:

(1) The fair market value of stock transferred to the creditor is at least 10% of the amount of the allocable indebtedness discharged (i.e., Stock to Debt Ratio is at least 10% for each class of stock for which a separate ratio is calculated) and the fair market value of the stock transferred to the creditor is at least 25% of the total fair market value of all consideration transferred in exchange for the debt (i.e., Stock to Total Consideration Ratio for that creditor is at least 25%);

(2) The fair market value of the stock transferred to the creditor is at least 25% of the total fair market value of all consideration transferred in exchange for the debt (i.e., Stock to Total Consideration Ratio for that creditor is at least 25%), and the fair market value of the stock transferred to the creditor is at least 25% of the total fair market value of all outstanding stock of the debtor after the bankruptcy reorganization or insolvency workout (i.e., Stock to Total Stock Ratio for that creditor is at least 25%); or

(3) The only consideration transferred in exchange for debt held by unsecured creditors is stock (i.e., Stock to Total Consideration Ratio for unsecured creditors as a group is 100%), and the stock transferred to the unsecured creditors as a group is 90% of the outstanding stock of the corporation after the bankruptcy reorganization or insolvency workout (i.e., Stock to Total Stock Ratio is 90%).

Special Analyses

It has been determined that these proposed rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. A Regulatory Flexibility Analysis is therefore not required under the Regulatory Flexibility Act (5 U.S.C. Chapter 6). Pursuant to section 7805(f) of the Internal Revenue Code, these proposed regulations will be submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

Comments and Requests for a Public Hearing

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably a signed original and eight copies) to the Internal Revenue Service. All comments will be available for public inspection and copying in their entirety. In particular, the Service invites comments on the proposed standards for determining when stock is more than nominal or token under section 108(e)(8)(A) of the Code. A public hearing will be scheduled and held upon written request by any person who submits written comments on the proposed rules. Notice of the time and place for the hearing will be published in the Federal Register.

List of Subjects

26 CFR 1.61 through 1.281-4

Deductions, Exemptions, Income tax, Taxable income.

Proposed Amendments to the Regulations

Accordingly, Title 26, Chapter 1, Part 1 of the Code of Federal Regulations, are proposed to be amended as follows. PART 1—[Amended]

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

Authority: 26 U.S.C. 7805; * * * Section 1.108-1 also issued under 26 U.S.C. sections 108(e)(8) and 108(e)(10)(B).

Par. 2. New §1.108-1 is added to read as set forth below.

§1.108-1 *Nominal or token shares issued to discharge indebtedness.*

(a) *Overview*—(1) *In general.* Under section 108(e)(10)(A), if a debtor corporation transfers stock to a creditor in satisfaction of its indebtedness, the corporation generally is treated as satisfying the indebtedness with an amount of money equal to the fair market value of the stock. Section 108(e)(10)(B) provides that this rule does not apply to any transfer of stock (other than disqualified stock) by a debtor corporation in a title 11 case or by any other debtor but only to the extent the debtor is insolvent. A title 11 or insolvent debtor does not realize discharge of indebtedness income to the extent the common law stock-for-debt exception applies. Section 108(e)(8), as added by the Bankruptcy Tax Act of 1980 and amended by the Revenue Reconciliation Act of 1990, prevents the application of the stock-for-debt exception in certain "*de minimis*" cases. Section 108(e)(8)(A) provides that the stock-for-debt exception does not apply if the shares of stock issued in exchange for the indebtedness are nominal or token.

(2) *Disqualified stock.* The flush language of section 108(e)(8) provides that "disqualified stock" (as defined in section 108(e)(10)(B)(ii)) is not treated as stock for purposes of section 108(e)(8). Section 108(e)(10)(B)-(ii) defines disqualified stock as stock with a stated redemption price if the stock has a fixed redemption date, the issuer of such stock has the right to redeem such stock at one or more times, or the holder of such stock has the right to require its redemption at one or more times. Accordingly, disqualified stock is not considered stock for purposes of this section. This paragraph (a)(2) applies generally to stock, to which section 108(e)(10)(B)-(ii) applies, that is transferred after October 9, 1990, in satisfaction of any indebtedness.

(b) *Facts and circumstances to be considered in determining nominal or token shares*—(1) *In general.* All relevant facts and circumstances must be considered in determining whether shares of stock issued to a creditor are nominal or token. Set forth below is a nonexclusive list of relevant factors to be taken into account in making this determination.

(i) *Stock to debt ratio.* A comparison of the fair market value of stock transferred to a creditor to the amount of discharged indebtedness allocable to that stock ("Stock to Debt Ratio") is relevant to the determination of whether shares of stock issued to the creditor are nominal or token. A low Stock to Debt Ratio is evidence that the shares issued in exchange for the discharged indebtedness are nominal or token. The Stock to Debt Ratio is the most important factor in making the determination of whether shares are nominal or token.

(ii) *Stock to total consideration ratio.* A comparison of the fair market value of stock transferred to a creditor to the fair market value of the total consideration received by the creditor in the exchange ("Stock to Total Consideration Ratio") is relevant to the determination of whether shares of stock are nominal or token. A low Stock to Total Consideration Ratio is evidence that the shares issued in exchange for the discharged indebtedness are nominal or token.

(iii) *Stock to total stock ratio.* A comparison of the fair market value of the stock transferred to the creditors as a group to the total fair market value of all of the outstanding stock of the corporation after the bankruptcy reorganization or insolvency workout ("Stock to Total Stock Ratio") is relevant to the determination of whether shares of stock are nominal or token. A low Stock to Total Stock Ratio is evidence that the shares issued in exchange for the discharged indebtedness are nominal or token.

(2) *Special rules*—(i) *Preferred stock.* For purposes of applying paragraph (b)(1)(i) of this section, the allocable indebtedness of each creditor that is discharged by each class of preferred stock issued to the creditor is equal to the lesser of the redemption price or liquidation preference of the respective class of preferred stock. This determination is made with reference to the lowest redemption price or liquidation preference of the preferred stock for any period after its issuance as established at the time of issuance. However, the allocable indebtedness may not be less than the fair market value of the preferred stock nor greater than the total amount of the indebtedness discharged. "Preferred stock" is stock that has a limited or fixed redemption price or liquidation preference and does not have a meaningful right to participate in corporate growth. For this purpose, a liquidation preference exists if the stock's right to share in liquidation proceeds is limited and preferred. In addition, solely for purposes of applying the tests of this section, a meaningful right to participate in corporate growth is not established by a right to convert preferred stock into stock other than preferred stock or the fact that the redemption price or liquidation preference exceeds the fair market value of the preferred stock.

(ii) *Other stock.* For purposes of paragraph (b)(1)(i) of this section, the allocable indebtedness of each creditor discharged by all stock other than preferred stock ("other stock") issued to the creditor is the adjusted issue price of the indebtedness discharged by the creditor, reduced by the amount of other consideration, if any, transferred to the creditor in exchange for the indebtedness, including:

(A) The amount of any money,

(B) The issue price of any new indebtedness,

(C) The amount of any indebtedness allocable to preferred stock under paragraph (b)(2)(i) of this section, and

(D) The fair market value of any other property, including any disqualified stock described in section 108(e)(10)(B)(ii).

For purposes of this section, the amount of indebtedness allocable to preferred stock is limited to the fair market value of the preferred stock if the preferred stock is determined to be nominal or token.

(iii) *Analysis of ratios.* Whether a ratio described in paragraph (b)(1) of this section is low depends upon the particular ratio and whether other facts and circumstances, including the other ratios, indicate that the stock transferred is nominal or token.

(iv) *Example.*

(a) Z Corporation is under the jurisdiction of a court in a case under title 11 of the United States Code. Creditor holds debt of Z with an adjusted issue price of $100x. Pursuant to a plan approved by the court, Z issues preferred stock with a redemption price and liquidation preference of $37x and a fair market value of $35x, common stock with a fair market value of $30x and $3x of cash to Creditor in discharge of the indebtedness of $100x. The preferred stock is first redeemable more than five years after its issuance and is not disqualified stock under section 108(e)(10)(B)(ii).

(b) Under paragraph (b)(2)(i) of this section, the fair market value of the preferred stock, $35x, is compared to the amount of allocable indebtedness. Allocable indebtedness is equal to the redemption price and liquidation preference of $37x.

(c) Under paragraph (b)(2)(ii) of this section, the fair market value of the other stock, $30x, is compared to the allocable portion of the indebtedness. Assuming the preferred stock is not nominal or token, the allocable indebtedness is the adjusted issue price of the indebtedness, $100x, less the sum of the amount of indebtedness allocated to the preferred stock under paragraph (b)(1)(i) of this section, $37x, and $3x, the amount of cash paid. Thus, the allocable indebtedness for determining whether the common stock is nominal or token is $60x ($100x-$37x-$3x).

(c) *Effective Date.* The proposed regulations apply to exchanges that occur on or after December 6, 1990.

Fred T. Goldberg, Jr.,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on December 6, 1990, 8:45 a.m., and published in the issue of the Federal register for December 7, 1990, 55 F.R. 50568)

Notice of Proposed Rulemaking

Limitations on Corporate Net Operating Loss Carryforwards

CO-81-90

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed amendments to §1.382-2T of the temporary Income Tax Regulations under section 382 of the Internal Revenue Code of 1986 ("the Code"). The proposed amendments provide for the aggregation of stock ownership in certain cases. Section 382 was amended by section 621 of the Tax Reform Act of 1986. Section 382 was further amended by section 10225 of the Revenue Act of 1987 (the "1987 Act"), sections 1006, 4012 and 5077 of the Technical and Miscellaneous Revenue Act of 1988 (the "1988 Act"), and sections 7205, 7304, 7811, 7815, and 7841 of the Revenue Reconciliation Act of 1989 (the "1989 Act").

DATES: Written comments and requests for a public hearing must be received by January 22, 1991. The proposed amendments to the temporary regulations are generally applicable to testing dates (as determined by applying the amendments) occurring on or after November 20, 1990. A special effective date is provided for groups that act pursuant to a plan prior to November 20, 1990. No inference should be drawn as to the effect of present law on the treatment of such entities.

ADDRESS: Send comments and requests for a public hearing to: Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, CC:CORP:T:R [CO-81-90], Room 4429, Washington, D.C. 20044.

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to Part 1 of Title 26 of the Code of Federal Regulations ("CFR") under section 382 of the Code. The amendments relate to the aggregation and segregation of certain ownership interests. Section 382 was amended by section 621 of the Tax Reform Act of 1986 (Pub. L. No. 99-514, 100 Stat. 2085 (1986) [1986-3 C.B. (Vol. 1) 1]). Section 382 was further amended by section 10225 of the 1987 Act (Pub. L. 100-203, 101 Stat. 1330 [1987-3 C.B. 1]), sections 1006, 4012 and 5077 of the 1988 Act (Pub. L. No. 100-647, 102 Stat. 3342), and sections 7205, 7304, 7811, 7815, and 7841 of the 1989 Act (Pub. L. No. 101-239, 103 Stat. 2106 [1990-1 C.B. 210]).

Explanation of Provisions

Overview of relevant provisions of the Code and regulations

Under section 382(a) of the Code, as amended, if an ownership change occurs with respect to a loss corporation (as defined in section 382(k)(1) and §1.382-2T(f)(1) of the Income Tax Regulations), the amount of the loss corporation's taxable income for a post-change year that may be offset by the pre-change losses (and certain built-in losses) of the loss corporation cannot exceed the section 382 limitation. The section 382 limitation for a post-change year is generally equal to the fair market value of the loss corporation's stock immediately before the ownership change multiplied by the applicable long-term tax-exempt rate as published in the Internal Revenue Bulletin.

In general, an ownership change involves an increase of more than 50 percentage points in stock ownership by 5-percent shareholders during the testing period (usually the three-year period ending on the date on which a transaction is tested for an ownership change). A 5-percent shareholder generally is an individual who owns, directly or pursuant to certain attribution rules, five percent or more of the stock of a loss corporation or individuals and entities separately owning less than five percent of the loss corporation that are aggregated into a group (referred to as a "public group") pursuant to certain aggregation rules under the temporary regulations.

As previously indicated, stock ownership is determined pursuant to certain attribution rules. These attribution rules are used to determine the ultimate beneficial owners of the loss corporation. For example, entity attribution rules require that stock be attributed from an entity owning (directly or indirectly by attribution) five percent or more of the loss corporation to the owners of the entity in proportion to their respective ownership interests.

To apply the aggregation rules, the loss corporation must identify each entity that owns (directly or indirectly by attribution) five percent or more of its stock. With respect to each such entity, the loss corporation must aggregate all owners of the entity that individually are attributed less than five percent of the loss corporation's stock. If these shareholders who, by attribution, each own less than five percent of the loss corporation (the "less-than-5-percent shareholders") own as a group five percent or more of the loss corporation, they are treated as a separate public group which is itself a 5-percent shareholder. A group of less-than-5-percent shareholders with direct ownership of the loss corporation is aggregated into a public group that is treated as a 5-percent shareholder regardless of whether it owns five percent or more of the loss corporation. Transfers of loss corporation stock among members of public groups generally are not taken into account in determining whether an ownership change has occurred.

The rule disregarding transfers of a loss corporation's stock among members of public groups is a rule of convenience designed to alleviate the burden of tracking trades among less-than-5-percent shareholders. Congress, however, recognized that there are situations in connection with transfers of stock involving less-than-5-percent-shareholders in which it is feasible to identify changes in ownership by these shareholders because, unlike in public trading, the changes occur as part of a single, integrated transaction. With respect to these transactions, Congress intended that, where identification of changes in ownership is reasonably feasible or a reasonable presumption can be applied, regulations should provide that the changes should be taken into account in determining whether an ownership change has occurred. Conf. Rep. No. 841, 99th Congress, 2d Sess., Part II at 176 (1986).

Proposed Amendments to §1.382-2T

For purposes of section 382 and the regulations thereunder, the temporary regulations define the term "entity" as "any corporation, estate, trust, association, company, partnership, or similar organization." Consequently, where an entity is or becomes a 5-percent shareholder, a loss corporation is required to identify changes in ownership by that entity that occur during the testing period.

An identifiable shift in the ownership of a loss corporation also occurs when a group of persons acting pursuant to a plan acquires five percent or more of the stock of the loss corporation. The temporary regulations are amended to make clear that the definition of the term "entity" includes a group of persons acting pursuant to a plan. Under the amendment, a group of persons must be aggregated into a separate public group where, pursuant to a plan, the group owns five percent or more of the loss corporation's stock in the aggregate, even though each member of the group individually owns less than five percent of such stock. Any shift in ownership by the group must be taken into account for purposes of determining whether an ownership change has occurred.

Pursuant to §1.382-2T(k)(1) of the regulations, with respect to stock that is subject to regulations of the Securities and Exchange Commission ("SEC"), the loss corporation may rely on the existence and absence of filings with the SEC to identify a group that, acting pursuant to a plan, acquires or owns five percent or more of the stock. However, where the loss corporation has actual knowledge that such a group exists, the presumption in §1.382-2T(k)(1) is inapplicable and the loss corporation must determine the amount of the loss corporation stock owned by the group for purposes of identifying its 5-percent shareholders.

Special Analyses

It has been determined that these proposed rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. 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 proposed regulations, and therefore, an initial Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations will be submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

Comments and Requests for a Public Hearing

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably a signed original and seven copies) to the Internal Revenue Service. All comments will be available for public inspection and copying in their entirety. A public hearing will be scheduled and held upon written request by any person who submits written comments on the proposed rules. Notice of the time and place for the hearing will be published in the Federal Register.

List of Subjects in 26 CFR Sections 1.301-1—1.383-3

Income taxes, Corporations, Corporate distributions, Corporate adjustments, Reorganizations.

Proposed Amendments to the Regulations

The notice of proposed rulemaking (to amend 26 CFR Part 1) that was published on August 11, 1987, (52 FR 29704) [LR-106-86, 1987-2 C.B. 1035] is amended and additional amendments to 26 CFR Part 1 are proposed as follows:

PART 1—AMENDED

Paragraph 1. The authority for Part 1 is amended by adding the following citations to read in part:

Authority: 26 U.S.C. Section 7805, *** §1.382-2T issued under 26 U.S.C. 382(g)(4)(C), 26 U.S.C. 382(i), 26 U.S.C. 382(k)(1), 26 U.S.C. 382(k)(6), 26 U.S.C. 382(1)(3), and 26 U.S.C. 382(m).

Par. 2. Section 1.382-2T is amended as follows:

1. Paragraph (f)(7) is amended by adding a new sentence as set forth below.

2. Examples (*5*) and (*6*) are added to paragraph (g)(4) as set forth below.

3. Paragraph (m)(10) is added as set forth below.

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

*****

(f) Definitions. ***

(7) *Entity.* *** An entity includes a group of persons acting pursuant to a plan.

*****

(g) 5-percent shareholders. ***

(4) Examples. ***

Example (*5*)—(i) L corporation has 1,000 shares of common stock outstanding. For the three-year period ending on October 1, 1991, L's stock was owned by unrelated individuals, none of whom owned five percent or more of L. A group of 20 individuals ("Group") agree among themselves to acquire more than five percent of L's stock. Group is not a corporation trust, association, partnership, or company. On October 1, 1991, pursuant to their plan, the members of Group purchases 600 shares of L common stock from the old shareholders of L (a total of 60 percent of L stock), with each member purchasing 30 shares.

(ii) Before the members of Group acquired L's stock on October 1, 1991, no individual or entity owned, directly or indirectly, five percent or more of the stock of L. As a result, all shareholders were aggregated into a public group and L was considered to be owned by a single 5-percent shareholder ("Public L") in accordance with paragraphs (g)(1) and (j)(1) of this section.

(iii) Under paragraph (f)(7) of this section, the agreement among members of Group constitutes a plan and Group is, therefore, an entity. Thus, the acquisition of more than five percent of the stock of L on October 1, 1991, by members of Group is not disregarded under paragraph (e)(1)(ii) of this section. Because no member of Group owns, directly or indirectly, five percent or more of the stock of L, paragraphs (g)(1) and (j)(1) require that the members of Group be aggregated into a separate public group, which will be presumed to consist of persons unrelated to the members of Public L. Because there is a shift of more than fifty percentage points in the ownership of L stock, an ownership change occurs on October 1, 1991, as a result of Group's purchase of the 600 shares.

Example (*6*)—(i) Prior to October 1, 1991, L's 1,000 shares of outstanding stock were owned by unrelated individuals, none of whom own five percent or more of the stock of L. L's management is concerned that L may become subject to a takeover bid. In separate meetings, L's management convinces 15 investors friendly to management to each acquire 4 percent of L's outstanding stock. Each investor is aware that L's management is meeting with other friendly investors. There is no formal or informal agreement between the 15 investors. On October 1, 1991, each investor purchases 4 percent of L's stock.

(ii) Under paragraph (f)(7) of this section, the group of investors ("Group") are treated as an entity because they are acting pursuant to a plan devised by L. Paragraphs (g)(1) and (j)(1) of this section require that on October 1, 1991, the Group be aggregated into a separate public group, which has increased its ownership of L stock by 60 percentage points over its lowest level of ownership in the three-year period ending on October 1, 1991. Accordingly, an ownership change occurs on that date.

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(m) Effective date. ***

(10)(i) In general. The second sentence of paragraph (f)(7) of this section and examples (5) and (6) of paragraph (g)(4) of this section apply

for testing dates (determined by applying such sentence and examples) on or after November 20, 1990, but with respect to any group of persons that acts pursuant to a plan before November 20, 1990, only if the group increases or reduces pursuant to the plan its ownership of stock of the loss corporation relative to its percentage ownership interest at the close of the day preceding November 20, 1990, by five percentage points or more on or after November 20, 1990.

(ii) Example—Prior to December 1, 1989, L, a loss corporation, is owned entirely by 1,000 unrelated individuals, none of whom owns as much as five percent of the stock of L ("Public L"). On December 1, 1989, 15 individuals ("Group") each acquired 3 percent, or 45 percent, in total, of L stock pursuant to a plan. Group is not a corporation, trust, association, partnership or company. On November 1, 1991, six members of Group each purchased an additional one percent of L stock, or 6 percent, in total, pursuant to the plan. Accordingly, Group increased its ownership in L by 51 percentage points over the testing period. No other 5-percent shareholder has increased his percentage interest of L stock during the testing period. As a result, an ownership change of L occurs on November 1, 1991.

Fred T. Goldberg, Jr.,
Commissioner of
Internal Revenue.

(Filed by the Office of the Federal Register on November 20, 1990, 8:45 a.m., and published in the issue of the Federal Register for November 21, 1990, 55 F.R. 48639)

Notice of Proposed Rulemaking

Corporations; Consolidated Returns—Special Rules Relating to Dispositions and Deconsolidations of Subsidiary Stock

CO-93-90

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed §§1.337(d)-2 and 1.1502-20. These regulations implement aspects of the repeal of the *General Utilities* doctrine by limiting losses of consolidated groups with respect to the stock of subsidiaries. Proposed §1.1502-20 also eliminates the duplication of loss with respect to consolidated groups. Final §1.337(d)-1 and temporary §1.337(d)-2T appear in *** [T.D. 8319, page 57, this Bulletin].

DATES: These regulations are proposed to be effective December 26, 1990. Section 1.337(d)-2 is proposed to generally apply to dispositions and deconsolidations of a subsidiary's stock after November 18, 1990, and before the effective date of §1.1502-20. Section 1.1502-20 is proposed to generally apply to dispositions and deconsolidations of a subsidiary's stock after January 31, 1991. Written comments must be delivered by January 15, 1991. A public hearing on these proposed regulations will be held Friday, January 25, 1991, beginning at 10:00 a.m. See the notice of public hearing on these proposed regulations elsewhere in *** [Announcement 90-139, 1990-51 I.R.B. 39].

ADDRESS: Send comments to: Internal Revenue Service, Attention: CC:CORP:T:R (CC:CO-93-90), Room 4429, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044.

SUPPLEMENTARY INFORMATION:

A. Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1980 (44 U.S.C. 3504(h)). Comments on the collection of information should be sent to the Office of Management and Budget, Attention: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, D.C. 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, T:FP, Washington, D.C. 20224.

The collection of information in this regulation is in §§1.337(d)-2(b)-(4), 1.337(d)-2(c)(1), 1.1502-20(b)(4), 1.1502-20(c)(3), 1.1502-20(g)(5), and 1.1502-20(h)(2). This information is required by the Internal Revenue Service to comply with sections 337(d) and 1502 and the regulations thereunder. This information will be used to determine that the proper amount of tax was reported by the taxpayer and whether, and to what extent, the taxpayer's return should be audited. The likely respondents are affiliated groups of corporations filing (or required to file) consolidated returns.

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

Estimated total annual reporting burden: 6000 hours.

The estimated average annual reporting burden per respondent is 2 hours.

Estimated number of respondents: 3000.

Estimated annual frequency of responses: 1.

B. Introduction

T.D. 8294, filed with the Federal Register on March 9, 1990, and published in the Federal Register on March 14, 1990 [1990-1 C.B. 66], added temporary §§1.1502-20T and 1.337(d)-1T to Part 1 of Title 26 of the Code of Federal Regulations.

Section 1.1502-20T added to the consolidated return regulations a general rule that disallowed all consolidated group losses on the disposition of a subsidiary's stock (the "loss disallowance rule"). The regulations also provided a number of related rules, including a basis reduction rule applicable on deconsolidation of a subsidiary's stock and an anti-stuffing rule applicable to transfers of property between members in connection with the disposition or deconsolidation of a subsidiary's stock. Also provided was a rule that permitted reattribution of a subsidiary's losses to the common parent to the extent loss would otherwise be disallowed to the consolidated group on the disposition of a subsidiary's stock. The rules added by §1.1502-20T generally applied to any disposition or deconsolidation of a subsidiary's stock on or after March 9, 1990.

Section 1.337(d)-1T added a transitional rule that generally limited loss on the disposition of a subsidiary's stock after January 6, 1987, if the subsidiary became a member of the

group after that date (a "transitional subsidiary") and the disposition was not subject to §1.1502-20T. Unlike §1.1502-20T, these regulations permitted the loss to the extent the group established that the loss was not attributable to the recognition of "built-in gain" on the disposition of assets owned by the subsidiary (or any lower tier subsidiary). Moreover, although §1.1502-20T reduced the basis of subsidiary stock on its deconsolidation, §1.337(d)-1T continued to treat the stock as subject to loss disallowance on later disposition.

Sections 1.1502-20T and 1.337(d)-1T implemented Notice 87-14, 1987-1 C.B. 445, in which the Internal Revenue Service announced its intention to publish regulations that would prevent utilization of §§1.1502-32 and 1.1502-33(c) (the "investment adjustment rules") to circumvent the repeal of the *General Utilities* doctrine by the Tax Reform Act of 1986 [Pub. L. 99-514, 1986-3 (Vol. 1) C.B. 1]. The loss disallowance rule of §1.1502-20T addressed another problem relating to the investment adjustment rules by preventing a subsidiary's losses from being duplicated as investment losses of the parent when the parent disposes of the subsidiary's stock.

Also filed with the Federal Register on March 9, 1990 and published on March 14, 1990, was a notice of proposed rulemaking (CO-78-87 [1990-1 C.B. 558]) that incorporated by cross reference the text of §§1.1502-20T and 1.337(d)-1T. Many written comments were received, and a public hearing was held on June 26, 1990.

After full consideration of the written comments and the testimony at the public hearing, the following actions are being taken:

1. Proposed §1.337(d)-1 is amended and promulgated as a final regulation, replacing temporary §1.337(d)-1T. See T.D. 8319, published in *** [page 57, this Bulletin], adding §1.337(d)-1.

2. New §1.337(d)-2T is promulgated as a temporary regulation. See T.D. 8319. Commentators characterized §1.1502-20T as far broader than required by Notice 87-14 and requested that taxpayers retain the ability to dispose of subsidiary stock under the more limited approach of §1.337(d)-1T until the rules of § 1.1502-20T are revised. Section 1.337(d)-2T continues the principles of §1.337(d)-1 by adding another transitional rule applicable to all subsidiary stock (not just stock of transitional subsidiaries and transitional parents). The new rule allows groups to establish that loss is not attributable to the recognition of built-in gain, but only if the group's entire equity interest in the subsidiary is disposed of in one or more transactions to unrelated persons before the effective date of new §1.1502-20. Section 1.337(d)-2T also provides basis reduction rules for subsidiary stock that is deconsolidated and anti-stuffing rules. The text of §1.337(d)-2T set forth in T.D. 8319 also serves as the text of proposed §1.337(d)-2, cross referenced in this document.

3. Section 1.1502-20T is withdrawn by T.D. 8319.

4. This document withdraws proposed §1.1502-20 as added by (CO-78-87) and adds new proposed §1.1502-20.

5. A Revenue Procedure will be issued as a consequence of these rules setting forth procedures under which the Internal Revenue Service will grant permission for all of the members of a group to discontinue filing consolidated returns. Conditions will be included to restrict reconsolidation of any member (or successor) for at least 5 years.

C. Revision of Loss Disallowance Rule

The preamble to §§1.337(d)-1T and 1.1502-20T, published on March 14, 1990, sets forth the rationale for adopting the loss disallowance rule. The rule was adopted in response to the direction in section 337(d) that regulations be prescribed to ensure that the purposes of the repeal of the *General Utilities* doctrine "may not be circumvented through the use of any provision of law or regulations (including the consolidated return regulations . . .)."

That preamble describes the various approaches considered and the reasons for rejecting approaches other than the loss disallowance rule. The preamble identified the principal purpose of the repeal of the *General Utilities* doctrine as being to require payment of a corporate-level tax in a transaction that results in stepping up the basis of corporate assets. The preamble notes that the most accurate method of achieving this goal would have been to require appraisals of assets (including assets of any lower tier subsidiary) at the time a subsidiary's stock is acquired, in order to determine the amount of built-in gain and loss attributable to each asset and liability, and to eliminate positive investment adjustments attributable to recognized built-in gain. This method, referred to as "tracing," was rejected because of the compliance and administrative burdens it would impose on taxpayers and the Internal Revenue Service and because it would rely heavily on appraisals. Other approaches were also rejected because they entailed either tracing or permitting the basis of corporate assets to be stepped up without payment of corporate-level tax.

By disallowing the stock loss, the loss disallowance rule also prevented the duplication of losses. Loss duplication occurs when the stock loss is also reflected in the basis of the subsidiary's assets or its loss carryovers.

After consideration of taxpayer comments, the Treasury Department and the Internal Revenue Service continue to believe that the loss disallowance rule is an appropriate means of implementing *General Utilities* repeal by preventing the elimination of corporate-level tax; that alternative methods of implementing *General Utilities* repeal are not acceptable, either because of the compliance and administrative burdens they would impose on taxpayers and the Internal Revenue Service or because they would not effectively prevent elimination of corporate-level tax; and that eliminating duplication of loss is an appropriate exercise of consolidated return regulation authority.

The Treasury Department and the Internal Revenue Service have determined, however, that the loss disallowance rule can be modified, consistent with implementation of *General Utilities* repeal, to permit loss to a limited extent. The modifications to the rule are intended to distinguish loss of unrealized built-in gain from both loss attributable to recognized built-in gain and loss duplication. In order to avoid tracing, the modified rule necessarily operates by the use of presumptions. Consistent with the single entity principles reflected in the investment adjustment rules and other

consolidated return regulations, the effect of the presumptions in the modified rule will generally be to phase in the loss disallowance rule based on the benefits of consolidation enjoyed by the group and the subsidiary. Thus, the modified rule provides a transition from separate return to consolidated status, phasing in loss disallowance as the group and the subsidiary operate in consolidated form and it becomes more appropriate to view the group's investment in the subsidiary as an investment in its assets and operations rather than in its stock.

D. Principal Comments on Original Proposed §1.1502-20

Many comments on original §1.1502-20 suggested alternative approaches to the loss disallowance rule.

1. Economic Loss

Virtually all commentators criticized §1.1502-20 for disallowing loss on the sale of subsidiary stock when the loss results from the subsidiary's decline in value rather than from investment adjustments attributable to recognition of built-in gain. The commentary centered on Example (6) in the preamble, which provided the following illustration:

> Corporation S has one asset with a basis of $0 and a value of $100. Corporation P buys all the stock of S for $100 and P and S elect to file consolidated returns. S's asset declines in value and is sold for $0. Because S's sale of its asset results in no gain or loss, P's basis in S remains $100. P then sells S for $0 and recognizes a loss of $100. The loss is disallowed by the loss disallowance rule.

The preamble states that, while it may be argued that loss should be allowed under these facts, an exception would require appraisals of assets (including assets of any lower tier subsidiary) and tracing of built-in gains and losses, thus imposing the very compliance and administrative burdens on taxpayers and the Internal Revenue Service that the loss disallowance rule was designed to avoid. The commentators maintained that disallowance of loss in this situation is unwarranted because the parent corporation has realized an economic loss, no self-help is available to recognize the loss, and the parent corporation has derived no benefit—through investment adjustments or otherwise—from filing consolidated returns with the subsidiary.

a. Tracing

To allow the deduction of economic loss, many commentators proposed abandoning the loss disallowance rule in favor of some form of tracing. Most of the commentators recognized that pure tracing would introduce many complexities and therefore suggested various ameliorative presumptions and limitations. However, these commentators generally would permit taxpayers to avoid use of presumptions and limitations that produce a detrimental result by electing back into tracing.

The Treasury Department and the Internal Revenue Service have reexamined the feasibility of tracing and confirmed their earlier determinations that a tracing system would be too burdensome for taxpayers and the Internal Revenue Service. The following are among the problems that would be presented by a tracing system:

(1) At the time a subsidiary was acquired, the assets of the subsidiary (and any lower tier subsidiary) would have to be valued on an asset-by-asset basis in order to prevent the netting of built-in gain and built-in loss and to trace economic loss with respect to each asset.

(2) To properly administer the system, it would be necessary to assign an earnings and profits basis to each asset based on its value at the time of acquisition and to adjust that basis (with corresponding adjustments to stock basis) to reflect earnings and profits depreciation and amortization. This would require establishing an additional set of earnings and profits books.

(3) If an acquired subsidiary owned the stock of any lower tier subsidiary, duplicate earnings and profits records would have to be maintained for each lower tier subsidiary's assets—one based on the value of the assets at the time of the acquisition and one based on the basis of the lower tier subsidiary's stock at the time of acquisition. Earnings and profits adjustments based on the value of the assets at the time of the acquisition would be used to determine gain or loss on the sale of the subsidiary stock that was acquired by purchase, and earnings and profits adjustments based on the basis of the lower tier subsidiary's stock at the time of the acquisition would be used to determine gain or loss on the disposition of that stock.

(4) Despite its complexity, a tracing system would not accurately measure economic loss to the extent a subsidiary's assets declined in value at a faster or slower rate than reflected by the earnings and profits depreciation and amortization. To achieve reasonable accuracy, assets would have to be revalued and assigned a new earnings and profits basis whenever values declined below the initial earnings and profits basis, as adjusted, but this would substantially increase compliance and administrative burdens.

The various presumptions and limitations proposed by commentators to mitigate these problems are less accurate than tracing and do not significantly ameliorate the compliance and administrative burdens of tracing. If a taxpayer is permitted to elect tracing when advantageous, the taxpayer will have to maintain the necessary books and records to evaluate the tracing alternative. Thus, even taxpayers generally relying on presumptions to determine loss would be subject to the burdens of tracing. Similarly, the Internal Revenue Service would be required to audit valuations and earnings and profits adjustments when tracing is used. Moreover, while an elective tracing system would entail most of the burdens of a pure tracing system, it would invariably operate to the detriment of the government because presumptions would be used only when favorable to taxpayers.

b. Loss Limitation

Many commentators proposed modifying the loss disallowance rule to allow loss based on objective factors reflecting the extent to which the group has benefited from filing consolidated returns with the subsidiary. Although the modifications necessarily increase the compliance and administrative burdens for taxpayers and the Internal Revenue Service, the Treasury Department and the Internal Revenue Service have determined that relief is appropriate to the extent the factors establish that loss cannot be attributable to recognized built-in

gain. Following is a summary of the principal proposals and the extent to which they have been adopted.

Positive Basis Adjustments. A number of commentators proposed that loss be disallowed only to the extent of positive investment adjustments, because loss attributable to recognized built-in gain cannot exceed the amount of positive adjustments. This proposal has been taken into account in modifying the loss disallowance rule. Subject to the loss duplication limitation described below, the modified rule allows loss on the disposition of subsidiary stock to the extent the loss exceeds the sum of:

(1) The aggregate gain attributable to the subsidiary's "extraordinary gain dispositions" after November 18, 1990, for all consolidated return years of the group (and any prior group from which the stock was acquired other than by purchase), and

(2) The aggregate positive investment adjustments and distributions from current earnings and profits (determined without regard to extraordinary gain dispositions) for all consolidated return years of the group (and any other group from which the stock was acquired other than by purchase).

The revised rules take into account extraordinary gain dispositions in addition to positive investment adjustments because not all recognized built-in gain results in positive investment adjustments. For example, a recognized built-in gain may be offset by an equal amount of recognized post-acquisition loss. Although the gain does not increase the basis of the stock, it prevents the post-acquisition loss from reducing the basis of the stock. Consequently, a stock loss exists because of the built-in gain, and it is comparable to stock loss resulting from positive adjustments attributable to built-in gain.

The modified rule permits netting of profits and losses arising in the same taxable year in determining investment adjustments, but does not permit netting of a positive and negative investment adjustment from different taxable years. In addition, losses from extraordinary dispositions may be netted with other sources of income in determining investment adjustments for a taxable year, but may not be taken into account in determining gain from extraordinary gain dispositions. These rules are based on the presumption that the positive adjustments, distributions from current earnings and profits, and gain from extraordinary gain dispositions may be attributable to built-in gain, but losses and deductions may be attributable to post-acquisition loss.

The netting of profits and losses within the same year for determining investment adjustments represents a compromise. Consistent with the desire to limit the compliance and administrative burdens associated with tracing (*e.g.*, differentiating built-in deductions and losses from post-acquisition deductions and loss), taxpayers are permitted to offset built-in gain with post-acquisition loss within the same year for purposes of determining positive adjustments.

Dispositions before November 19, 1990, are disregarded in determining gain from extraordinary gain dispositions.

Wasting Assets. A number of commentators proposed that the loss disallowance rule be revised to disregard investment adjustments attributable to the consumption of built-in gain assets through operations ("wasting assets") because such adjustments are outside the scope of preventing circumvention of *General Utilities* repeal. This problem was illustrated by Example (3) in the March 14, 1990, preamble. The revised rules do not adopt this proposal, and all positive investment adjustments are taken into account (whether from dispositions or consumption of wasting assets). Consumption of wasting assets is not outside the scope of *General Utilities* repeal because dispositions and consumption may produce identical investment adjustments, as illustrated by Examples (2) and (3) in that preamble. Failing to take wasting assets into account would treat taxpayers in similar economic circumstances differently.

Rates of Return. Because some of a subsidiary's earnings may be attributable to post-acquisition income rather than built-in gain, other commentators proposed that loss be disallowed only to the extent positive investment adjustments (and distributions from current earnings and profits) exceed a specified rate of return. Commentators argued that an artificial rate of return could be used to identify earnings not properly attributable to built-in gain.

This proposal has not been adopted in the revised rules. A rate of return approach requires selecting an appropriate rate despite the wide variances in rates of return in different industries, and determining the appropriate base against which the rate of return is applied. Appraisals may be required if a subsidiary is acquired in a carryover basis transaction, is a lower tier subsidiary of the acquired subsidiary, or is engaged in more than one industry, and may be required again if there are subsequent corporate contributions or contractions. A variety of special rules also would be required to address the treatment of tax-free business combinations.

Moreover, permitting any rate of return effectively presumes that subsidiaries whose stock has declined in value nevertheless have positive rates of return, and that, contrary to the tax laws generally (such as depreciation and amortization rules), the returns from an investment are first attributable to earnings on, rather than recovery of, the investment.

Caps on Disallowed Loss. A number of commentators also proposed an overall limitation on the disallowance of loss. Many of the commentators proposed an overall limitation based on net built-in gain in the subsidiary's assets at the time its stock is acquired. Net built-in gain would equal the excess of (1) the sum of stock purchase price and liabilities of the subsidiary (and any lower tier subsidiary) over (2) the sum of the aggregate tax basis and loss carryovers of the subsidiary (and any lower tier subsidiary).

This proposal has not been adopted in the revised rules because it would permit groups acquiring subsidiaries with both built-in gains and built-in losses to circumvent *General Utilities* repeal by selectively recognizing gross built-in gain in excess of the net built-in gain. The recognized built-in gain would produce positive investment adjustments without corresponding increases in the subsidiary's value, and would therefore permit the group to offset the gain with loss on disposition of the subsidiary's stock.

Other commentators proposed an overall limitation on the disallowance of loss based on actual gross built-in gain. This proposal was not adopted in the revised rules because it would require each of the subsidiary's assets

(including assets of any lower tier subsidiary) to be appraised at the time the subsidiary's stock is acquired. For reasons discussed under "Tracing" above, an appraisal-based system would be too burdensome for both taxpayers and the Internal Revenue Service.

The appraisal problem was avoided in other proposals by limiting loss disallowance based on the maximum potential built-in gain—the aggregate purchase price of the subsidiary's stock plus the aggregate amount of the liabilities of the subsidiary (and any lower tier subsidiary). This approach would generally provide relief only if the subsidiary is owned for a substantial period and would be inconsistent with the general approach of the revised rules, which is to phase out separate return treatment as the group and the subsidiary enjoy the benefits of consolidation.

2. Duplication of Loss

By denying all loss on the disposition of subsidiary stock, the loss disallowance rule eliminates the ability of consolidated groups to duplicate any loss reflected in a subsidiary's assets and loss carryovers. Commentators generally opposed the elimination of loss duplication. They argued that (1) loss duplication is available in the separate return context and should therefore be eliminated only by Congress, (2) loss duplication is beyond the scope of *General Utilities* repeal, and (3) new restrictions on loss duplication are unnecessary because an acquirer's use of the subsidiary's loss may be limited by sections 269, 382, 383(b) and 384, and §§1.1502-21(c) and 1.1502-22(c). Commentators who conceded that eliminating loss duplication is within the scope of authority under section 1502 nonetheless argued that it was inappropriate for the Service to eliminate it in connection with *General Utilities* repeal. For the reasons discussed below, the revised rules retain the elimination of loss duplication.

a. Gain and Loss Duplication in Consolidated Returns

In the separate return context, a subsidiary's earnings and profits (or deficits in earnings and profits) do not cause adjustments to its parent's basis in the subsidiary's stock. Consequently, the subsidiary's gains and losses may be recognized a second time (in effect, duplicated) when the parent sells the subsidiary's stock.

By contrast, the consolidated return regulations have, over the years, developed an extensive system of rules for adjusting the basis of subsidiary stock to reflect the subsidiary's earnings and profits. The primary effect of these rules is to reduce duplication of gain and loss.

Reduction of loss duplication in the consolidated return context began with *Charles Ilfeld Co. v. Hernandez*, 292 U.S. 62 (1934). In that case, the parent corporation deducted its subsidiaries' losses on the group's consolidated return and claimed a second loss on the dissolution of the subsidiaries. The Supreme Court rejected the parent's claimed loss on its investment in the subsidiaries, stating that it "would be the practical equivalent of double deduction." The principle of the *Ilfeld* decision was incorporated in the consolidated return regulations, but the regulations did not otherwise permit positive and negative adjustments to the basis of subsidiary stock.

In 1966, the consolidated return regulations were revised to incorporate an extensive system of positive and negative adjustments measured by earnings and profits of the subsidiary. These investment adjustment rules shifted the taxation of investment in a subsidiary significantly toward single entity treatment. A primary objective of the 1966 regulations was to eliminate the duplication of gain and loss at the parent and subsidiary levels. The regulations generally eliminated gain and loss duplication only if a subsidiary's assets are disposed of before its stock.

Changes in the tax law since 1966 have called into question the remaining loss duplication permitted under the current investment adjustment rules. There has been a general statutory shift in favor of single entity treatment of consolidated groups. See, *e.g.*, section 267(f). In addition, section 338(h)(10) has increased the ability of taxpayers to avoid gain duplication. Recent changes to the consolidated return regulations have consistently reflected this policy shift in favor of single entity treatment.

The repeal of the *General Utilities* doctrine compelled a major change in the investment adjustment rules. New proposed §1.1502-20 retains the elimination of loss duplication as an appropriate exercise of authority that simplifies the rules necessary for preventing circumvention of *General Utilities* repeal. It is not possible to differentiate between loss attributable to built-in gain and duplicated loss without resorting to tracing.

Commentators arguing for a tracing rule instead of loss disallowance argued that tracing could be used to eliminate investment adjustments attributable to built-in gain that cause loss but not those that reduce gain. This position is based on the proposition that gain duplication is inconsistent with the principles of consolidated returns. Loss duplication is equally inconsistent with these principles.

Although eliminating loss duplication deprives consolidated groups of a benefit they would enjoy had they filed separate returns, filing consolidated returns provides many benefits that are not available to corporations filing separate returns. Corporations electing to file consolidated returns are not entitled to retain all of the benefits of separate returns while availing themselves of the benefits of consolidated returns. Electing corporations, in fact, have historically suffered detriments unrelated to the benefits of consolidation. For example, a subsidiary's losses incurred while a member of a consolidated group cause negative investment adjustments, eliminating loss duplication, even if the loss is used against income arising before the subsidiary became a member. Similarly, dividend distributions cause negative investment adjustments even if the distributions are out of earnings and profits accumulated before the subsidiary became a member.

Eliminating loss duplication is consistent with the historic concerns under the consolidated return regulations and is an appropriate exercise of authority under section 1502.

b. Overlap of Loss Duplication with Other Loss Restrictions

The Code and regulations provide several limitations on the transfer of tax benefits, including sections 269, 382, 383(b), and 384, and the separate return limitation year rules under the consolidated return regulations. These provisions may limit a transferee's deductions following the disposition of stock at a loss for which the loss disallowance rule denies a deduction. Commentators argued that be-

:ause of these limitations, the ability o duplicate loss should not be a ;ignificant concern. However, these imitations focus on trafficking in tax benefits rather than duplication of loss at the corporate level. The limitations may apply in circumstances where there is no duplication and may not apply where there is duplication. Moreover, even if the limitations apply in a loss duplication case, they may not significantly limit the duplicated loss. Accordingly, these limitations do not solve the problem presented by loss duplication.

3. Scope of General Utilities Repeal

a. Time Limitation for Application of Rules

Commentators argued that loss (or positive investment adjustments) should be limited only for a specified period of time following a corporate acquisition. This argument assumes that Notice 87-14, which was issued soon after the effective date of the repeal of the *General Utilities* doctrine, was directed at so-called son-of-mirror transactions occurring in connection with acquisitions. Time periods suggested by commentators ranged from 2 years (by analogy to section 1059) to 10 years (by analogy to section 1374).

The repeal of the *General Utilities* doctrine applies to all corporations, not just those that have been held for less than a specified period, and is directed at elimination of corporate-level tax, not simply at son-of-mirror transactions. Where, as in section 1374, Congress intended to limit the period in which a corporate-level tax is imposed, it specifically did so by statute. It provided no such statutory limit in section 337(d), which directed the issuance of regulations to prevent circumvention of *General Utilities* repeal in the consolidated return context. It would thus be inconsistent with Congressional intent to limit the time period for disallowance of loss (or positive investment adjustments) on disposition of subsidiary stock.

b. Post-1986 Investment Adjustments

Commentators also argued that pre-1987 basis should be grandfathered because adjustments reflected in that basis are attributable to income and gain recognized before the effective date of *General Utilities* repeal. Under this theory, even though a post-1986 loss attributable to such basis may result in elimination of corporate-level gain, the events that gave rise to the loss occurred before 1987 when such elimination was permissible and should therefore be allowed. The legislative history of the Tax Reform Act of 1986 does not provide any evidence that Congress intended to allow elimination of corporate-level tax attributable to pre-1987 investment adjustments. The focus of the repeal was on preserving the corporate income tax and the legislation generally applies after December 31, 1986.

It is also questionable whether use of loss attributable to built-in gain was consistent with the corporate tax provisions as they existed prior to *General Utilities* repeal. Positive investment adjustments were generally intended to prevent duplication, not to permit elimination, of corporate-level gain. Since 1969, corporations have been increasingly required to recognize corporate-level gain with respect to non-liquidating distributions of appreciated property to shareholders. Because most dispositions of built-in gain assets that produce investment adjustments are non-liquidating distributions, it has long been questionable whether it was appropriate to permit all adjustments attributable to such dispositions to eliminate corporate-level gain. Accordingly, it would be inconsistent with Congressional intent to grandfather pre-1987 investment adjustments.

E. Explanation of New Proposed §1.1502-20

New proposed §1.1502-20 retains most of the provisions of former proposed §1.1502-20. Although loss on the sale by a member of stock of a subsidiary is generally disallowed, a new paragraph (c) has been added to permit the member to claim loss in certain circumstances.

1. Loss Disallowance Rule

No deduction is allowed under paragraph (a) for any loss recognized by a member with respect to the disposition of stock of a subsidiary. The rule does not affect the use by the group of "inside" losses of the subsidiary, such as operating losses. Disallowance is deferred with respect to deferred transactions under the consolidated return regulations. The loss disallowance rule takes precedence over other loss disallowance and deferral rules of the Code and regulations, however, and these other rules apply only to the extent loss is not disallowed under the loss disallowance rule. An exception is provided to the loss disallowance rule to the extent gain is taken into account by the group with respect to common stock of the same subsidiary that is sold to the same purchaser pursuant to a single plan.

2. Basis Reduction on Deconsolidation

The basis of a subsidiary's stock is reduced under paragraph (b) to its fair market value immediately before the subsidiary's stock is deconsolidated. Stock that remains outstanding is treated as deconsolidated when it is no longer owned by a member of any consolidated group of which the subsidiary is also a member.

The basis reduction rule complements the loss disallowance rule by eliminating loss that is built into the basis of the subsidiary's stock immediately before the stock ceases to be subject to the loss disallowance rule. For example, assume that a group sells 25 percent of a subsidiary's stock to a nonmember, thus disaffiliating the subsidiary. The group has a built-in loss in the subsidiary's stock that it continues to own, but because the stock is no longer subject to the loss disallowance rule, the basis of the stock is reduced to its fair market value to eliminate the loss. Because stock must remain outstanding to be subject to the basis reduction rule, transactions such as section 332 liquidations are not deconsolidation events.

A special rule applies to cases in which the basis of subsidiary stock is reduced, and the group realizes a loss on the disposition of the stock within 2 years after the basis reduction. The taxpayer must attach a statement to the return for the year of the disposition, disclosing information with respect to the disposition and prior basis reduction. If the statement is not attached to the return, no deduction is allowed for any loss claimed on the disposition. Dispositions after the 2-year period that are pursuant to an agreement, option, or other arrangement entered into within the period are treated as though they occurred within the 2-year period for

purposes of the information statement requirement.

3. Allowed loss

In order to allow only economic loss, paragraph (c) identifies those factors that contribute to avoidance of corporate-level tax. Loss disallowance and basis reduction do not apply to stock of a subsidiary to the extent the loss or reduction exceeds a share's allocable part of the sum of the following factors:

(i) Earnings and profits, net of directly related expenses, from extraordinary gain dispositions.

(ii) The aggregate amount of positive adjustments for earnings and profits for all consolidated return years to the extent not included in the extraordinary gain disposition factor.

(iii) The amount of any duplicated loss.

These factors are explained more fully below.

a. Extraordinary Gain Dispositions

Extraordinary gain dispositions are dispositions after November 18, 1990, resulting in gain for purposes of computing earnings and profits, of capital assets, property used in a trade or business, and specified bulk asset dispositions. Discharge of indebtedness is also treated as an extraordinary gain disposition.

All applicable dispositions producing gain are presumed to be attributable to built-in gain. Dispositions producing gains are not offset by dispositions producing losses. These rules are necessary to avoid tracing. The amount included under this factor may be derived from tax return entries and associated work papers.

b. Positive Investment Adjustments

All positive adjustments are presumed to be attributable to built-in gain, including built-in gain recognized through the wasting of built-in gain assets. Netting is not permitted between the positive adjustments for years with earnings and the negative adjustments for years with deficits, but is permitted with respect to positive and negative adjustments within the same year.

Because the distribution of current earnings and profits does not eliminate the effect of recognized built-in gain, even though the distribution may eliminate a positive adjustment, such distributions are also included under this factor. Assume, for example, that a subsidiary recognizes $100 of built-in gain. If no distribution is made in the year the gain is recognized, the subsidiary's stock basis increases by $100 without a corresponding increase in value. By contrast, if $100 is distributed, the basis remains unchanged but the subsidiary's value declines by $100.

c. Duplicated Loss

Duplicated loss is the excess of (A) the sum of the aggregate asset basis and the aggregate loss carryovers of the subsidiary (and any lower tier subsidiary), over (B) the value of the subsidiary's assets. For this purpose, aggregate asset basis does not include any stock and securities in another subsidiary, and loss carryovers include deferred deductions. The value of the subsidiary's assets is measured by the value of the subsidiary's stock, any liabilities of the subsidiary (and any lower tier subsidiary), and other relevant items. If 80 percent or more of the subsidiary's stock is purchased in a single transaction, the stock's value is no greater than its grossed-up purchase price.

d. Dispositions and Adjustments in Prior Consolidated Groups

The extraordinary dispositions and positive investment adjustment factors include amounts attributable to prior consolidated groups, but only if these amounts continue to be reflected in the basis of the subsidiary's stock.

This factor would apply, for example, if a target is acquired from another consolidated group, and the target has a lower tier subsidiary that also becomes a member of the acquiring group, because the basis of the lower tier subsidiary continues to reflect any such amounts from the prior group.

4. Anti-Stuffing Rule

Paragraph (e) provides an anti-stuffing rule, in order to prevent a group from transferring assets after March 8, 1990, so as to avoid the recognition of gain or impact of the loss disallowance rule. The rule applies if the transfer occurs within 2 years of a direct or indirect disposition or deconsolidation of subsidiary stock. The proposed regulations clarify that, if an asset is transferred with the requisite view to avoid the recognition of gain or impact of the loss disallowance rule, it is not necessary for the transfer to be related to a subsequent disposition or deconsolidation of stock provided the disposition or deconsolidation occurs within the 2-year period.

Increases to the basis of subsidiary stock resulting from the recognition of built-in gain can have the effect of deferring tax on unrealized post-acquisition appreciation of a subsidiary's assets when its stock is sold. A comparable benefit can be achieved without post-acquisition appreciation if, for example, appreciated assets are transferred to the subsidiary or one subsidiary's appreciated stock is transferred to another subsidiary. To prevent this benefit, the rule requires reduction of the basis of the subsidiary's stock to the extent necessary to cause recognition of the amount of gain that would have been recognized if the stuffing transaction had not occurred.

5. Investment Adjustments and Earnings and Profits

The proposed regulations clarify that the earnings and profits of a member are reduced by the amount of a loss recognized on the sale of a subsidiary's stock, even though the loss is disallowed.

The proposed regulations also provide that a member's earnings and profits are reduced by the amount of any basis reduction required on the deconsolidation of a subsidiary's stock. This rule is needed because the basis reduction eliminates a future recognition of the loss (and the associated future reduction in earnings and profits).

Under the investment adjustment system, these reductions in earnings and profits tier up and cause disallowed losses and basis reductions on deconsolidation to be reflected as reductions in the basis of higher tier members. Coordination rules are provided to prevent overlapping investment adjustments.

The proposed regulations also make clear that, for purposes of the consolidated return regulations, a basis reduction under this section is generally treated as a negative investment adjustment under §1.1502-32(e)(1). Thus, for example, the consolidated return rules applying to investment adjustments generally apply to basis reductions under §1.1502-20(b). However, any basis reduction under this section is not treated as a §1.1502-32(e)(1) adjustment for pur-

poses of determining the amount of any basis reduction account with respect to the stock under §1.1502-32T(a).

6. Election to Retain Losses of Subsidiary

A common parent may elect to reattribute to itself a portion of the net operating loss carryovers and net capital loss carryovers attributable to a subsidiary (or to any lower tier subsidiary) that is leaving the group. If the election is made, the reattributed losses are not apportioned to the subsidiary under §1.1502-79. Instead, they remain part of the loss carryovers of the group. Reattribution is available only to the extent that a member is otherwise subject to loss disallowance with respect to the subsidiary's stock. This reattribution is not permitted with respect to the basis reduction of stock of a subsidiary that is deconsolidated.

The common parent may elect to retain particular losses of a subsidiary (or any lower tier subsidiary), without regard to their character or the year in which they arose and whether or not they arose within the consolidated group. Retained losses may not be carried back to any prior taxable year of the common parent. If a disallowed loss arises from a worthless stock deduction and the subsidiary whose losses are reattributed remains a member of the group, the subsidiary need not join in the common parent's election.

Reattribution is not permitted to the extent that a subsidiary and all higher tier subsidiaries are insolvent within the meaning of section 108(d)(3) at the time of the disposition. To the extent of its insolvency, the subsidiary's losses are not reattributable because they are deemed to be borne by creditors. For purposes of determining insolvency, preferred stock of the subsidiary not owned by members is treated as a liability to the extent of the preferred stock's liquidation preference.

Solely for the purpose of the investment adjustment and earnings and profits rules, a loss that is reattributed to the common parent is treated as absorbed by the subsidiary (or lower tier subsidiary), thereby causing a reduction in the stock basis and earnings and profits of the subsidiary whose losses are reattributed. These adjustments reduce the subsidiary's stock basis and earnings and profits to reflect the loss. The adjustments reduce or eliminate the member's loss on the disposition of the subsidiary's stock, thus reducing or eliminating the effect of the loss disallowance rule on the disposition.

7. Effective Dates

The loss disallowance and the basis reduction rules generally apply with respect to dispositions and deconsolidations after January 31, 1991. However, taxpayers may irrevocably elect to accelerate the application of these rules, in lieu of §1.337(d)-2, to all dispositions and deconsolidations after November 18, 1990. Any such election will not accelerate the date that the extraordinary gain disposition rule described in §1.1502-20(c)(2)(i) applies.

F. Explanation of Transitional Rules

1. General Rules

In response to comments, the effective date of §1.1502-20 has been deferred and new §1.337(d)-2 provides a transitional rule carrying forward the rules of 1§.337(d)-1 that allow loss to the extent the group establishes the loss is not attributable to the recognition of built-in gain. For a description of the provisions of §1.337(d)-1, see T.D. 8294, published on March 14, 1990, and T.D. 8319, published on November 26, 1990.

For purposes of §1.337(d)-2, gain recognized by a consolidated group (or a prior consolidated group) on the disposition of an asset is built-in gain to the extent the asset has an excess of value over basis attributable to a separate return year (as defined in §1.1502-1(e)) with respect to the consolidated group (or prior consolidated group).

Unlike §1.337(d)-1, §1.337(d)-2 is a prospective rule which taxpayers may take into account when planning transactions. Accordingly, §1.337(d)-2 contains a deconsolidation rule and an anti-stuffing rule similar to those contained in proposed §1.1502-20, in order to limit circumvention of the basic loss limitation rule. The deconsolidation and anti-stuffing rules are described in part E, above.

2. Effective Dates

Section 1.337(d)-2 generally applies with respect to dispositions and deconsolidations after November 18, 1990. However, a group may establish that loss is not attributable to the recognition of built-in gain only if the group's entire equity interest in a subsidiary is disposed of in one or more transactions to unrelated persons before February 1, 1991 (the effective date of §1.1502-20). Thus, it does not apply if only a portion of the stock held by the group is disposed of, or if the stock is sold to a related party. The ability to establish that loss is not attributable to built-in gain is limited under §1.337(d)-2 in order to avoid the need for continued application of these rules to deconsolidated subsidiaries for a substantial period.

Special Analysis

It has been determined that these rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required.

It is hereby certified that these rules do not have a significant impact on a substantial number of small entities. The rules will primarily affect affiliated groups of corporations filing (or required to file) consolidated returns, which tend to be larger businesses. It will 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, the notice of proposed rulemaking for the regulations was submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted, consideration will be given to any written comments that are submitted (preferably a signed original and eight copies) to the Internal Revenue Service. All comments will be available for public inspection and copying in their entirety.

A public hearing will be held on Friday, January 25, 1991, beginning at 10:00 a.m., in the Internal Revenue Service Auditorium, Seventh Floor, 7400 Corridor, Internal Revenue Building, 1111 Constitution Avenue, N.W., Washington D.C. For further information, see the notice of public hearing on these proposed regulations

in *** [Announcement 90-139, 1990-51 I.R.B. 39].

List of Subjects

26 CFR 1.301-1 through 1.383-3

Corporate adjustments, Corporate distributions, Corporations, Income taxes, Reorganizations.

26 CFR 1.1501-1 through 1.1564-1

Income taxes, Controlled group of corporations, Consolidated returns.

Proposed Amendments to the Regulations

The proposed amendments to 26 CFR Chapter I are as follows:

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

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

Authority: 26 U.S.C. 7805; *** §1.337(d)-2 also issued under 26 U.S.C. 337 (d); *** §1.1502-20 also issued under 26 U.S.C. 337(d) and 1502.

Par. 2. The temporary regulation §1.337(d)-2T, published in *** [T.D. 8319, page 57, this Bulletin], is hereby also proposed as a final regulation under section 337(d) of the Internal Revenue Code of 1986, except that paragraph (c)(1)(i) is revised to read as follows:

§1.337(d)-2T Loss limitation window period (temporary).

* * * * *

(c) * * *

(1) * * *

(i) The consolidated group disposes (in one or more transactions), before February 1, 1991, of its entire equity interest in the subsidiary to persons not related to any member of the consolidated group within the meaning of sections 267(b) and 707(b)(1) (substituting "10 percent" for "50 percent" each place that it appears), and

* * * * *

Par. 3. The notice of proposed rulemaking published March 14, 1990 (55 FR 9463) by cross reference to T.D. 8294 is withdrawn.

Par. 4. New §1.1502-20 is added to read as follows:

§1.1502-20 Disposition or deconsolidation of subsidiary stock.

(a) *Loss disallowance*—(1) *General rule.* No deduction is allowed for any loss recognized by a member with respect to the disposition of stock of a subsidiary.

(2) *Disposition.* "Disposition" means any event in which gain or loss is recognized, in whole or in part.

(3) *Single entity treatment of gain and loss*—(i) *Timing.* If loss with respect to the disposition of a subsidiary's stock is deferred, paragraph (a)(1) of this section does not apply until the loss is taken into account. For this purpose, the amount of the loss deferred and when the loss is taken into account are determined under §§1.1502-13, 1.1502-13T, 1.1502-14, and 1.1502-14T, without the application of any other provision of the Code or regulations, such as section 267(f), that provides for disallowance or deferral of the loss.

(ii) *Netting.* Paragraph (a)(1) of this section does not apply to the extent gain is taken into account by members with respect to common stock of the same subsidiary that is sold to the same purchaser pursuant to a single plan. Gain to which this paragraph (a)(3)(ii) applies is taken into account with respect to shares on which loss is recognized under the plan in proportion to the amount of the loss deduction that would have been disallowed under paragraph (a)(1) with respect to each share if this paragraph did not apply.

(4) *Coordination with loss deferral rules.* If paragraph (a)(1) of this section applies to a loss subject to deferral or disallowance under any other provision of the Code or the regulations, the other provision applies to the loss only to the extent it is not disallowed under paragraph (a)(1).

(5) *Examples.* For purposes of the examples in this section, unless otherwise stated, the group files consolidated returns on a calendar year basis, the facts set forth the only corporate activity, and all sales and purchases are with unrelated buyers or sellers. The basis of each asset is the same for determining earnings and profits adjustments and taxable income. Tax liability and its effect on basis, value, and earnings and profits are disregarded. "Investment adjustment system" means the rules of §§1.1502-32 and 1.1502-33(c). The principles of this paragraph (a) are illustrated by the following examples:

Example (1). Loss attributable to recognized built-in gain. P buys all the stock of T for $100, and T becomes a member of the P group. T has an asset with a basis of $0 and a value of $100. T sells the asset for $100. Under the investment adjustment system, P's basis in the T stock increases to $200. Five years later, P sells all the stock of T for $100 and recognizes a loss of $100. Under paragraph (a)(1) of this section, no deduction is allowed to P for the $100 loss.

Example (2). Effect of post-acquisition appreciation. P buys all the stock of T for $100, and T becomes a member of the P group. T has an asset with a basis of $0 and a value of $100. T sells the asset for $100. Under the investment adjustment system, P's basis in the T stock increases to $200. T reinvests the proceeds of the sale in an asset that appreciates in value to $180. Five years after the sale, P sells all the stock of T for $180 and recognizes a $20 loss. Under paragraph (a)(1) of this section, no deduction is allowed to P for the $20 loss.

Example (3). Disallowance of duplicated loss. P forms S with a contribution of $100 in exchange for all the shares of S stock, and S becomes a member of the P group. S has an operating loss of $60. The group is unable to use the loss, and the loss becomes a net operating loss carryover attributable to S. Five years later, P sells the stock of S for $40, recognizing a $60 loss. Under paragraph (a)(1) of this section, P's $60 loss on the sale of the S stock is disallowed. (See paragraph (g) of this section for the elective reattribution of S's $60 net operating loss to P in connection with the sale.)

Example (4). Deemed asset sale election. (i) P forms S with contribution of $100 in exchange for all the S stock, and S becomes a member of the P group. S buys an asset for $100, and the value of the asset declines to $40. P sells all the stock of S to Pl for $40. Under paragraph (a)(1) of this section, P's $60 loss on the sale of the S stock is disallowed.

(ii) If P and Pl instead elect deemed asset sale treatment under section 338(h)(10), T is treated as selling all of its assets, and no loss is recognized by P on its sale of the T stock. As a result of the recharacterization of the stock sale as an asset sale, the $60 loss in the asset is recognized. Under the section 338(h)(10) regulations, T is treated as liquidating into P following the deemed asset sale, and the $60 loss is inherited by P.

Example (5). Gain and loss recognized with respect to stock sold pursuant to a single plan. P, the common parent of a group, owns 50 shares of the stock of T with an aggregate basis of $50, and S, a wholly owned subsidiary of P, owns the remaining 50 shares of T with an aggregate basis of $100. All of the stock of T has the same terms. P and S sell all the stock of T to the public for $140. P therefore recognizes a gain of $20 and S recognizes a loss of $30. For purposes of paragraph (a)(3)(ii) of this section, the public is considered to be 1 purchaser and the sale of the T stock by P and S is considered to be pursuant to a single plan. Accordingly, the amount of S's $30 loss disallowed under paragraph (a)(1) of this section is limited to $10 ($30 reduced by P's $20 gain on T stock taken into account in a sale to the same purchaser pursuant to a single plan).

Example (6). Deferred loss and recognized gain. (i) P, the common parent of a group, owns 50 shares of the stock of T with an aggregate basis of $10, and S, a wholly owned subsidiary of P, recently purchased the remaining 50 shares of T stock in which it has an aggregate basis of $50. T has an asset with a basis of $40 and a value of $100. T sells the asset for $100. Under the investment adjustment system, P's basis in the T stock increases from $10 to $40, and S's basis in the T stock increases from $50 to $80. S sells its block of T stock to P for $50 in a deferred intercompany transaction, and S liquidates 2 years later. P subsequently sells all the stock of T for $100 to X, a member of the same controlled group (as defined in section 267(f)) as P but not a member of the P consolidated group.

(ii) Under paragraph (a)(3)(i) of this section, the application of paragraph (a)(1) of this section to S's $30 loss is deferred, because S's loss is deferred under §1.1502-13(c) (determined without the application of any other provision of the Code or regulations that provides for disallowance or deferral of the loss).

(iii) S's deferred $30 loss is inherited by P under §1.1502-13(c)(6) following the liquidation of S. When the T stock is sold to X (a member of the same controlled group but not a member of the P consolidated group), the inherited deferred $30 loss is taken into account under §1.1502-13(f) and paragraph (a)(3) of this section.

(iv) In the same transaction that S's $30 deferred intercompany loss is taken into account, P recognizes a $10 gain with respect to its block of historic T stock. Under paragraph (a)(3)(ii) of this section, the gain reduces by $10 the application of paragraph (a)(1) of this section to the $30 loss. Consequently, only $20 of the $30 loss is disallowed. The remaining $10 loss to which paragraph (a)(1) does not apply is subject to section 267(f).

(b) *Basis reduction on deconsolidation*—(1) *General rule.* If a member's basis in a share of stock of a subsidiary exceeds its value immediately before a deconsolidation of the share, the basis of the share is reduced at that time to an amount equal to its value. If both a disposition and a deconsolidation occur with respect to a share in the same transaction, paragraph (a) of this section applies and, to the extent necessary to effectuate the purposes of this section, this paragraph (b) applies following the application of paragraph (a).

(2) *Deconsolidation.* "Deconsolidation" means any event that causes a share of stock of a subsidiary that remains outstanding to be no longer owned by a member of any consolidated group of which the subsidiary is also a member.

(3) *Value.* "Value" means fair market value.

(4) *Loss within 2 years after basis reduction*—(i) *In general.* If the basis of a share of stock is reduced under this paragraph (b) and a direct or indirect disposition of the stock occurs within 2 years after the date of the basis reduction, a separate statement entitled "STATEMENT PURSUANT TO SECTION 1.1502-20(b)(4)" must be filed with the taxpayer's return for the year of disposition. If the taxpayer fails to file the statement as required, no deduction is allowed for any loss recognized on the disposition. A disposition after the 2-year period described in this paragraph (b)(4) that is pursuant to an agreement, option, or other arrangement entered into within the 2-year period is treated as a disposition within the 2-year period for purposes of this section.

(ii) *Contents of statement.* The separate statement required under paragraph (b)(4)(i) of this section must contain—

(A) The name and employer identification number (E.I.N.) of the subsidiary.

(B) The amount of prior basis reduction with respect to the stock of the subsidiary under paragraph (b)(1) of this section.

(C) The basis of the stock of the subsidiary immediately before the disposition.

(D) The amount realized on the disposition.

(E) The amount of the deduction not disallowed under paragraph (b)(4)(i) of this section.

(F) The amount of loss disallowed under paragraph (b)(4)(i) of this section.

(5) *Examples.* The principles of this paragraph (b) are illustrated by the following examples:

Example (1). Simultaneous application of loss disallowance rule and basis reduction rule to stock of the same subsidiary. (i) P forms S with $100 in exchange for all 100 shares of S stock, and S becomes a member of the P group. The value of S declines from $100 to $50, and P sells 60 shares of S stock for $30. The sale causes a deconsolidation of the remaining 40 shares held by P.

(ii) Under paragraph (b)(1) of this section, P must reduce the basis of the 40 shares of S stock it continues to own from $40 to $20, the value of the shares immediately before the deconsolidation.

(iii) Although P's disposition of the 60 shares also causes a deconsolidation of these shares, paragraph (b)(1) of this section provides that, if both paragraph (a) and paragraph (b) of this section apply to a share in the same transaction, paragraph (a) applies first and paragraph (b) applies only to the extent necessary to effectuate the purposes of this section. Under paragraph (a)(1), P's $30 loss on the sale of the 60 shares is disallowed. Under the facts of this example, it is not necessary to also apply paragraph (b) of this section to the 60 shares in order to effectuate the purposes of this section.

Example (2). Deconsolidation of subsidiary stock on contribution to a partnership. P buys all the stock of T for $100, and T becomes a member of the P group. P later transfers all the stock of T to partnership M in exchange for a partnership interest in M, in a transaction to which section 721 applies. At the time of the exchange, P's basis in the T stock is $100 and the T stock's value is $75. Under paragraph (b)(1) of this section, the transfer to M causes a deconsolidation of the T stock, and P must reduce its basis in the T stock, immediately before the transfer to M, from $100 to the stock's $75 value at that time. As a result, P has a basis of $75 in its interest in M, and M has a basis of $75 in the stock of T.

Example (3). Simultaneous application of loss disallowance rule and basis reduction rule to stock of different subsidiaries. (i) P owns all the stock of S, which in turn owns all the stock of S1, and S and S1 are members of the P group. P's basis in the S stock is $100 and S's basis in the S1 stock is $100. S1 buys all the stock of T for $100, and T becomes a member of the P group. T has an asset with a basis of $0 and a value of $100. T sells the asset for $100. Under the investment adjustment system, S1's basis in the T stock, S's basis in the S1 stock, and P's basis in the S stock each increase from $100 to $200. S then sells all the S1 stock for $100 and recognizes a loss of $100.

(ii) Under paragraph (a)(1) of this section, S's $100 loss on the sale of the S1 stock is disallowed.

(iii) If S1 and T are not members of a consolidated group immediately after the sale of the stock of S1, the T stock is deconsolidated, and under paragraph (b)(1) of this section, S1 must reduce the basis of the T stock to $100, its value immediately before the sale.

(iv) If S1 and T are members of a consolidated group immediately after the sale of the S1 stock, the T stock is not deconsolidated, and no reduction is required under paragraph (b)(1).

Example (4). Extending the time period for dispositions. (i) In Year 1, P, the common parent of a group, buys all 100 shares of the stock of T for $100. T's only asset has a basis of $0 and a value of $100. T sells the asset for $100. Under the investment adjustment system, P's basis in the T stock increases from $100 to $200. At the beginning of Year 5, P causes T to issue 30 additional shares of stock to the public for $30. This issuance causes a deconsolidation of the T stock owned by P, and paragraph (b)(1) of this section requires P to reduce its basis in the T stock from $200 to $100.

(ii) Within 2 years, P agrees to sell all of its T stock for $90 at the end of Year 7. Under paragraph (b)(1), P's disposition of the T stock at the end of Year 7 is treated as occurring within the 2-year period following the deconsolidation of the T stock, because the disposition is pursuant to an agreement reached within 2 years after the deconsolidation. Accordingly,

P's $10 loss may not be deducted unless P files the statement required under paragraph (b)(4) of this section. This result is reached whether or not the agreement is in writing. P's disposition would also have been treated as occurring within the 2-year period if the disposition were pursuant to an option issued within the period.

(c) *Allowable loss*—(1) *General rule.* The amount of loss disallowed under paragraph (a)(1) of this section and the amount of basis reduction under paragraph (b)(1) of this section with respect to a share of stock shall not exceed the sum of the following amounts—

(i) *Extraordinary gain dispositions.* The share's allocable part of any member's earnings and profits, net of directly related expenses, from extraordinary gain dispositions.

(ii) *Positive investment adjustments.* Earnings and profits, other than those included in paragraph (c)(1)(i) of this section, which result in adjustments with respect to the share under §1.1502-32(b)(1)(i) and (c)(1).

(iii) *Duplicated loss.* The amount of duplicated loss with respect to the share.

(2) *Operating rules.* For purposes of applying paragraph (c)(1)—

(i) *Extraordinary gain dispositions defined.* An "extraordinary gain disposition" is an actual or deemed disposition after November 18, 1990, resulting (net of directly related expenses) in a gain for purposes of computing earnings and profits, of—

(A) A capital asset as defined in section 1221 (determined without the application of any other provision of the Code or regulations).

(B) Property used in a trade or business as defined in section 1231(b) (determined without the application of any holding period requirement).

(C) An asset described in section 1221(1), (3), (4), or (5), if substantially all the assets in such category from the same trade or business are disposed of in 1 transaction (or series of related transactions).

(D) Assets disposed of in an applicable asset acquisition under section 1060(c).

A discharge of indebtedness is also treated as an extraordinary gain disposition. Federal income taxes are not directly related expenses unless reflected as negative investment adjustments with respect to the share under §1.1502-32 and not reimbursed.

(ii) *Investment adjustments.* Earnings and profits are treated as resulting in adjustments with respect to a share if they would have resulted in such adjustments but for distributions with respect to the share. If the adjustments with respect to a share are modified pursuant to §1.1502-32(c)(3), the adjustments taken into account under paragraph (c)(1)(ii) of this section shall be appropriately modified.

(iii) *Duplicated loss.* "Duplicated loss" equals the excess (if any) of—

(A) The sum of—

(*1*) The aggregate adjusted basis of the assets of the subsidiary (and any other subsidiary in which the subsidiary owns stock) other than any stock and securities that the subsidiary owns in another subsidiary, and

(*2*) Any losses attributable to the subsidiary (and any lower tier subsidiary) and carried to the subsidiary's first taxable year following the disposition or deconsolidation, and

(*3*) Any deferred deductions (such as deductions deferred under section 469) of the subsidiary (and any lower tier subsidiary), over

(B) The sum of—

(*1*) The value of the subsidiary's stock, and

(*2*) Any liabilities of the subsidiary (and any lower tier subsidiary), and

(*3*) Any other relevant items.

If 80 percent or more in value of the stock of a subsidiary is acquired by purchase (as defined in paragraph (c)(2)(iv)(B) of this section) in a single transaction (or in a series of related transactions during any 12-month period), the value of the subsidiary's stock is no greater than the purchase price of the stock divided by the percentage of the stock (by value) so purchased.

(iv) *Applicable periods*—(A) *Consolidated return years of the group.* Amounts described in paragraph (c)(1) of this section include all consolidated return years of the group and are determined as of the date of the disposition or deconsolidation in accordance with the group's application of the principles of §1.1502-32.

(B) *Prior consolidated groups.* Amounts described in paragraph (c)(1)(i) and (ii) of this section include any such amounts with respect to the share that are attributable to any separate return year following the most recent purchase of the share or deconsolidation of the share subject to §1.337(d)-2(b) or paragraph (b) of this section. Stock is acquired by "purchase" if the transferee is not related to the transferor within the meaning of sections 267(b) and 707(b)(1), substituting "10 percent" for "50 percent" each place that it appears, and the transferee's basis in the stock is determined wholly by reference to the consideration paid for such stock.

(3) *Statement of allowed loss.* Paragraph (c)(1) of this section applies only if the separate statement required under this paragraph (c)(3) is filed with the taxpayer's return for the year of the disposition or deconsolidation. The statement must be entitled "ALLOWED LOSS UNDER SECTION 1.1502-20(c)," and contain—

(i) The name and employer identification number (E.I.N.) of the subsidiary.

(ii) The basis of the stock of the subsidiary immediately before the disposition or deconsolidation.

(iii) The amount realized on the disposition and the amount of fair market value on the deconsolidation.

(iv) The amount of the deduction not disallowed under paragraph (a)(1) of this section by reason of this paragraph (c) and the amount of basis not reduced under paragraph (b)(1) of this section by reason of this paragraph (c).

(v) The amount of loss disallowed under paragraph (a)(1) of this section and the amount of basis reduced under paragraph (b)(1) of this section.

(4) *Examples.* For purposes of the examples in this paragraph, unless otherwise stated, the group files the statement required under paragraph (c)(3) of this section. The principles of this paragraph (c) are illustrated by the following examples:

Example (1). Allowed loss attributable to lost built-in gain. (i) Individual A forms T. P buys all the stock of T from A for $100, and T becomes a member of the P group. T has a capital asset with a basis of $0 and a value of $100. The value of the asset declines, and T sells the asset for $40. Under the investment adjustment system, P's basis in the T stock increases to $140. P then sells all the stock of T for $40 and recognizes a loss of $100.

(ii) The amount of the $100 loss disallowed under paragraph (a)(1) may not exceed the amount determined under paragraph (c)(1) of this section. The $40 of T's earnings and

profits is from an extraordinary gain disposition, as defined in paragraph (c)(2)(i), and therefore is described in paragraph (c)(1)(i). (No amount is described under paragraph (c)(1)(ii) because T has no earnings and profits resulting in positive investment adjustments with respect to the share when the earnings and profits are determined without regard to extraordinary gain dispositions.) Because this amount is the only amount described in paragraph (c)(1), the amount of P's $100 loss that is disallowed under paragraph (a)(1) is limited to $40.

Example (2). Extraordinary gain dispositions. (i) Individual A forms T. P buys all the stock of T from A for $100 in Year 1, and T becomes a member of the P group. T owns a capital asset, asset 1, with a basis of $0 and a value of $100. T sells asset 1 for $100 in Year 1 and invests the proceeds in a trade or business asset, asset 2. During Year 2, asset 2 produces $30 of gross operating income and $20 of cost recovery deductions. At the end of Year 2, asset 2 has an $80 adjusted basis and T disposes of asset 2 for $85; however, because T incurs $20 of expenses directly related to the sale of asset 2, the disposition produces a $15 loss for computing earnings and profits. Under the investment adjustment system, P's basis in the T stock increases by $95, to $195, because T has $110 of earnings and a $15 loss. P sells the T stock for $95 in Year 5 and recognizes a $100 loss.

(ii) The amount of loss disallowed under paragraph (a)(1) may not exceed the amount determined under paragraph (c)(1) of this section. The $100 of earnings and profits from the disposition of asset 1 is from an extraordinary gain disposition, as defined in paragraph (c)(2)(i), and therefore is described in paragraph (c)(1)(i). This amount is not reduced by the $15 loss on the sale of asset 2 because that sale is not an extraordinary gain disposition when determined net of directly related expenses. (No amount is described under paragraph (c)(1)(ii) because T would have no earnings and profits which result in positive investment adjustments with respect to the share when the earnings and profits are determined without regard to extraordinary gain dispositions.) Because the $100 amount described under paragraph (c)(1)(i) equals P's $100 loss from the disposition of T stock, all of the loss is disallowed.

Example (3). Positive investment adjustments. (i) Individual A forms T. S, a member of the P group, buys all the stock of T from A for $100, and T becomes a member of the P group. T has an asset with a basis of $0 and a value of $100. The asset earns $100 of operating income in Year 1 and declines in value to $0. T invests the operating income in another asset which produces a $25 operating deficit during Year 2. Under the investment adjustment system, S's basis in the T stock increases to $175. S sells all the stock of T for $75 in Year 5 and recognizes a loss of $100.

(ii) The amount of loss disallowed under paragraph (a)(1) may not exceed the amount determined under paragraph (c)(1) of this section. No amount is described under paragraph (c)(1)(i) because T had no extraordinary gain dispositions. The $100 of earnings and profits from operations in Year 1 is earnings and profits which are described in paragraph (c)(1)(ii). This amount is not reduced by the $25 deficit from operations in Year 2. Because the $100 amount described under paragraph (c)(1)(ii) equals S's $100 loss from the disposition of T stock, all of the loss is disallowed.

(iii) The result would have been the same if, prior to the decline in the value of the first asset (the value of the T stock was $200, $100 cash and a $100 asset), S had sold the T stock to P for $200 at no gain or loss, and P then sold the T stock to the unrelated buyer for $75 (after the asset declined in value by $100) and recognized a $100 loss. The stock had $100 of positive investment adjustments during the P group's consolidated return years, and, as a result, the investment adjustments are considered to be described in paragraph (c)(1)(ii) even if the adjustments are not reflected in the basis of the T stock at the time of the disposition to the unrelated buyer.

Example (4). Treatment of net operating income as attributable to built-in gain. (i) Individual A forms T. P buys all the stock of T from A for $100, and T becomes a member of the P group. T has a capital asset with a basis of $0 and a value of $100. The asset declines in value to $40. The asset earns $100 of operating income unrelated to its $60 decline in value. Under the investment adjustment system, P's basis in the T stock increases to $200. P then sells all the stock of T for $140 (land worth $40 and $100 cash) and recognizes a loss of $60.

(ii) The amount of loss disallowed under paragraph (a)(1) may not exceed the amount determined under paragraph (c)(1) of this section. The $100 adjustment to the basis of the T stock is an amount described in paragraph (c)(1)(ii). Because this amount exceeds the amount of loss otherwise disallowed under paragraph (a)(1), P's entire $60 loss from the disposition of T stock is disallowed.

Example (5). Carryover basis transactions—amounts attributable to separate return years. (i) Individual A forms T. S purchases all the stock of T from A for $100, and T becomes a member of the S group. T has a capital asset with a basis of $0 and a value of $100. T sells the asset for $100. Under the investment adjustment system, S's basis in the T stock increases to $200. P buys all of the stock of S for $100, and both S and T become members of the P group. S then sells the T stock for $100 and recognizes a loss of $100.

(ii) The amount of loss disallowed under paragraph (a)(1) may not exceed the amount determined under paragraph (c)(1) of this section. Under paragraph (c)(2)(iv)(B) of this section, the $100 adjustment to S's basis in the T stock while a member of the S group is an amount described in paragraph (c)(1)(ii) with respect to the P group. Because this amount equals the loss otherwise disallowed under paragraph (a)(1), S's $100 loss from the disposition of T stock is disallowed.

Example (6). Duplicated loss. (i) Individual A forms T with a contribution of $100 in exchange for all of the T stock. Individual B forms T1 with a contribution of land that has a $90 basis and $100 value. T buys all the stock of T1 from B for $100. P buys all the stock of T from A for $100, and both T and T1 become members of the P group. The value of T1's land declines to $40. P sells all of the T stock for $40 and recognizes a loss of $60.

(ii) The amount of loss disallowed under paragraph (a)(1) may not exceed the amount determined under paragraph (c)(1) of this section. Under paragraph (c)(1)(iii) of this section, the amount of duplicated loss is $50. This is computed under paragraph (c)(2)(iii) as the excess of (A) the $90 aggregate adjusted basis of the assets of T and T1 (other than stock and securities of T1 owned by T), over (B) the $40 fair market value of the T stock (determined under paragraph (c)(2)(iv)). Because this amount is the only amount described in paragraph (c)(1), the amount of P's $60 loss disallowed under paragraph (a)(1) is limited to $50.

(iii) The result would be the same if the value of T1's property did not decline and T1 instead had an operating loss of $60 (attributable to borrowed funds) which the P group was unable to use. In that case, the $50 excess of the sum of (A) the $90 aggregate adjusted basis of the assets of T and T1 (other than stock and securities of members of the P group), plus the $60 net operating loss attributable to T1 and carried to its first taxable year following the disposition, over (B) the sum of the $40 fair market value of the T stock, plus the $60 of T1 liabilities, is an amount described in paragraph (c)(1)(iii). (See paragraph (g) of this section for the elective reattribution of T1's $60 net operating loss to P in connection with the sale.)

(d) *Successors*—(1) *General rule.* This section applies, to the extent necessary to effectuate the purposes of this section, to any property the basis of which is determined, directly or indirectly, in whole or in part, by reference to the basis of a subsidiary's stock.

(2) *Examples.* The principles of this paragraph (d) are illustrated by the following examples:

Example (1). Status of successor as member. (i) P, the common parent of a group, buys all the stock of T for $100. T's only asset has a basis of $0 and a value of $100. T sells the asset for $100, and buys another asset for $100. Under the investment adjustment system, P's basis in the T stock increases to $200, and the earnings and profits of P increase by $100. P later transfers all the stock of T to an unrelated consolidated group in exchange for 10 percent of the stock of X, the common parent of that group, in a transaction described in section 368(a)(1)(B). At the time of the exchange, the value of the X stock received by P is $80.

(ii) Under section 358, P has a basis of $200 in the X stock it receives in exchange for T. Under section 362, X has a $200 basis in the T stock.

(iii) Neither paragraph (a)(1) nor (b)(1) of this section applies to the stock of T on P's transfer of the stock to the X group, because no gain or loss is recognized on the transfer, and the transfer is not a deconsolidation of the stock of T under paragraph (b)(2) of this section.

(iv) The X stock owned by P after the reorganization is a successor interest to the T stock because P's basis in the X stock is determined by reference to P's basis in the T stock. The purposes of this section require that, notwithstanding T's status as a member of the X group, the reorganization exchange be treated as a deconsolidation event. Because X is not a member of the P group, a failure to reduce the basis of the X stock owned by P to its fair market value would permit the P group

to recognize and deduct the loss attributable to the T stock. The transfer of T stock to X therefore constitutes a deconsolidation of the T stock and P must reduce its basis in the T stock immediately before the transfer from $200 to its $80 value at that time.

Example (2). Continued application after deconsolidation. (i) P, the common parent of a group, buys all the stock of T for $100. T's only asset has a basis of $0 and a value of $100. T sells the asset for $100, and buys another asset for $100. Under the investment adjustment system, P's basis in the T stock increases to $200. P later transfers all the stock of T to partnership M in exchange for a partnership interest in M, in a transaction to which section 721 applies. The value of the T stock immediately before the transfer to M is $100. Less than 2 years later, P sells its interest in M for $80.

(ii) Under paragraph (b)(1) of this section, because the stock of T is deconsolidated on the transfer to M, immediately before the transfer to M, P reduces its basis in the T stock to the stock's $100 value immediately before the transfer. As a result, P has a basis of $100 in its interest in M, and M has a basis of $100 in the T stock.

(iii) When P sells its interest in M for $80, it recognizes a $20 loss. Because the basis of P's interest in M is determined by reference to P's basis in the T stock, and the reporting requirements could otherwise be circumvented, P's partnership interest in M is a successor interest to the T stock. Under paragraph (b)(4) of this section, P is required to file a statement with its return for the year of its disposition of its interest in M in order to deduct its loss. If P does not file the required statement described in paragraph (b)(4) of this section, P's loss on the disposition of its interest in M is disallowed.

(e) *Anti-stuffing rule*—(1) *Application.* This paragraph (e) applies if—

(i) A transfer of any asset (including stock and securities) after March 8, 1990, is followed within 2 years by a direct or indirect disposition or a deconsolidation of stock, and

(ii) The transfer is with a view to avoiding, directly or indirectly, in whole or in part—

(A) The disallowance of loss on the disposition or the basis reduction on the deconsolidation of stock of a subsidiary, or

(B) The recognition of the unrealized gain on the transferred asset. A disposition after the 2-year period described in this paragraph (e)(1) that is pursuant to an agreement, option, or other arrangement entered into within the 2-year period is treated as a disposition within the 2-year period for purposes of this section.

(2) *Basis reduction.* If this paragraph (e) applies, the basis of the stock is reduced, immediately before the disposition or deconsolidation, to cause recognition of gain in an amount equal to the loss disallowance or basis reduction, or the gain recognition, otherwise avoided by reason of the transfer.

(3) *Examples.* The principles of this paragraph (e) are illustrated by the following examples:

Example (1). Basic stuffing case. (i) In Year 1, P buys all the stock of T for $100, and T becomes a member of the P group. T has an asset with a basis of $0 and a value of $100. T sells the asset for $100. Under the investment adjustment system, P's basis in the T stock increases from $100 to $200. In Year 5, P transfers to T an asset with a basis of $0 and a value of $100 in a transaction to which section 351 applies, with the view described in paragraph (e)(1) of this section. In Year 6, P sells all the stock of T for $200.

(ii) Under paragraph (e)(2) of this section, P must reduce the basis in its T stock by $100 immediately before the sale. This basis reduction causes a $100 gain to be recognized on the sale.

(iii) The $100 basis reduction also would be required if the T stock is deconsolidated in Year 6 instead of being sold. P must reduce the basis in its T stock by $100 immediately before the deconsolidation.

(iv) The $100 basis reduction also would be required if the P stock were acquired at the beginning of Year 6 by the M group, even though the asset transfer took place outside the M group. Paragraph (e)(1) requires only that the transferor have the view at the time of the transfer.

Example (2). Stacking rules. (i) In Year 1, P buys all the stock of T for $100, and T becomes a member of the P group. T has an asset with a basis of $0 and a value of $100. T sells the asset for $100. Under the investment adjustment system, P's basis in the T stock increases from $100 to $200. In Year 5, when the value of the T stock remains $100, P transfers to T an asset with a basis of $0 and a value of $100 in a transaction to which section 351 applies, with the view described in paragraph (e)(1) of this section. Thereafter, the value of the contributed asset declines to $10. In Year 6, P sells all the T stock for $110.

(ii) Because the transferred asset declined in value by $90, the transfer enabled P to avoid the disallowance of loss on the sale of T only to the extent of $10. Under paragraph (e)(2) of this section, P must reduce the basis in its T stock immediately before the sale to cause recognition of gain in an amount equal to the loss disallowance otherwise avoided by reason of the transfer. The amount of this basis reduction is $100, causing a $10 gain to be recognized on the sale.

(iii) Assume, instead, that the transferred asset does not decline in value and that T reinvests the $100 in proceeds from the asset sale in another asset that appreciates in value to $190. In Year 6, P sells T for $290. Because the new asset appreciated in value by $90, the transfer enabled P to avoid the disallowance of loss on the sale of T only to the extent of $10. Under paragraph (e)(2) of this section, P must reduce the basis in its T stock immediately before the sale to cause recognition of gain in an amount equal to the loss disallowance otherwise avoided by reason of the transfer. The amount of this basis reduction is $10, causing a $100 gain to be recognized on the sale.

Example (3). Contribution of built-in loss asset. (i) In Year 1, P forms S with a contribution of $100 in exchange for all of S's stock, and S becomes a member of the P group. S buys an asset for $100, and the asset appreciates in value to $200. P then buys all the stock of T for $100, and T becomes a member of the P group. T has an asset with a basis of $0 and a value of $100. T sells the asset for $100, and under the investment adjustment system P's basis in the T stock increases from $100 to $200. In Year 5, when the value of the T stock remains $100, P transfers the T stock to S in a transaction to which section 351 applies, with the view described in paragraph (e)(1) of this section. The transfer causes P's basis in the S stock to increase from $100 to $300 and the value of S to increase from $200 to $300. In Year 6, P sells the S stock for $300.

(ii) Under paragraph (e)(2) of this section, P must reduce the basis in its S stock immediately before the sale to cause recognition of gain in an amount equal to the gain recognition otherwise avoided by reason of the transfer. The amount of this basis reduction is $100, causing a $100 gain to be recognized on the sale.

Example (4). Absence of view. (i) In Year 1, P forms S with a contribution of $100, and S becomes a member of the P group. S buys 2 assets, asset 1 with a basis of $50, which appreciates to $100, and asset 2 with a basis of $50 which declines in value to $0. S sells asset 1 for $100. Under the investment adjustment system, P's basis in the S stock increases from $100 to $150. In Year 5, S transfers asset 2 to P in a transaction to which §1.1502-14(a) applies, with a view to having the group retain the loss inherent in the asset. This transfer reduces P's basis in the S stock from $150 to $100. In Year 6, P sells all the stock of S for $100.

(ii) The transfer from S to P achieves a result that could have been obtained by other methods that would not have been prevented by this section. The transfer therefore is not with the view described in paragraph (e)(1) of this section, P is not required to reduce the basis of its S stock under paragraph (e)(2) of this section. P is in substantially the same position holding asset 2 as it would be if S sold the asset and the resulting loss was available to the P group (either through S or by reattribution under paragraph (g) of this section).

Example (5). Extending the time period for dispositions. (i) In Year 1, P buys all the stock of T for $100, and T becomes a member of the P group. T has an asset with a basis of $0 and a value of $100. T sells the asset for $100. Under the investment adjustment system, P's basis in the T stock increases from $100 to $200. At the beginning of Year 5, P transfers to T an asset with a basis of $0 and a value of $100 in a transaction to which section 351 applies, with the view described in paragraph (e)(1) of this section. Within 2 years, P agrees to sell all the stock of T for $200 at the end of Year 7.

(ii) Under paragraph (e)(1) of this section, P's disposition of the T stock at the end of Year 7 is treated as occurring within the 2-year period following P's transfer of the asset to T, because the disposition is pursuant to an agreement reached within 2 years after the transfer. Accordingly, under paragraph (e)(2) of this section, P must reduce the basis in its T stock by $100 immediately before the sale. This result is reached whether or not the agreement is in

writing. P's disposition would also have been treated as occurring within the 2-year period if the disposition were pursuant to an option issued within the period.

(f) *Investment adjustments and earnings and profits*— (1) *Effect on investment adjustments and earnings and profits*—(i) *General rule.* For purposes of determining investment adjustments under §1.1502-32 and earnings and profits under §1.1502-33(c) with respect to a member that owns stock in a subsidiary, any deduction that is disallowed, or any amount by which basis is reduced, under this section is treated as a loss absorbed by the member in the tax year in which the disallowance or basis reduction occurs.

(ii) *Example.* (A) In Year 1, P forms S with a contribution of $100, and S becomes a member of the P group. S buys all the stock of T for $100. T has an asset with a basis of $0 and a value of $100. In Year 2, T sells the asset for $100. Under the investment adjustment system, S's basis in the T stock increases to $200, and P's basis in the S stock increases to $200. In Year 6, S sells all the stock of T for $100, and S's recognized loss of $100 is disallowed under paragraph (a)(1) of this section.

(B) Under paragraph (f)(1) of this section, the earnings and profits of S for Year 6 are reduced by $100, the amount of the loss disallowed under paragraph (a)(1). P's basis in the S stock is reduced from $200 to $100 under the investment adjustment system. Correspondingly, P's earnings and profits for Year 6 are reduced by $100, the amount of the loss disallowed under paragraph (a)(1) of this section.

(2) *Coordination rules*—(i) *Order of adjustments.* Deconsolidation of a share is treated as a disposition of the share for purposes of determining when investment adjustments are made to the share.

(ii) *No tiering up of certain adjustments.* If the basis of stock of a subsidiary owned by a member (the "owning member") is reduced under this section on the deconsolidation of the stock, no corresponding adjustment is made under §1.1502-32 to the basis of the stock of the owning member (or any higher tier member) if a disposition or deconsolidation occurs in the same transaction with respect to all the stock of the owning member. In the case of a disposition or deconsolidation in the same transaction of less than all the stock of the owning member, appropriate adjustments shall be made under §1.1502-32 with respect to the stock of the owning member (or any higher tier member).

(iii) *Example.* (A) P, the common parent of a group, owns all the stock of S, S owns all the stock of S1, and S1 owns all the stock of S2. P's basis in the S stock is $100, S's basis in the S1 stock is $100, and S1's basis in the S2 stock is $100. In Year 1, S2 buys T for $100. T has an asset with a basis of $0 and a value of $100. In Year 2, T sells the asset for $100. Under the investment adjustment system, the basis of each subsidiary's stock increases from $100 to $200. In Year 6, S sells all the stock of S1 for $100 to A, an individual, and recognizes a loss of $100. S1, S2, and T are not members of a consolidated group immediately after the sale because the new S1 group does not file a consolidated return for its first taxable year.

(B) Under paragraph (a)(1) of this section, no deduction is allowed to S for its loss on the sale of the S1 stock. Under paragraph (f)(1) of this section, S's earnings and profits for Year 6 are reduced by the $100 loss that is disallowed. Correspondingly, under the investment adjustment system, S's reduction in earnings and profits causes a reduction in P's basis in the S stock, and a reduction in P's earnings and profits for Year 6.

(C) Under paragraph (b)(1) of this section, because the stock of T and S2 is deconsolidated, S2 must reduce the basis of the T stock from $200 to $100 (its value immediately before the deconsolidation), and S1 must reduce the basis of the S2 stock from $200 to $100 (its value immediately before the deconsolidation). Under paragraph (f) (1), S2's earnings and profits for Year 6 are reduced by the $100 reduction to the basis of the T stock, and S1's earnings and profits are reduced by the $100 reduction to the basis of the S2 stock. Under paragraph (f)(2)(ii) of this section, because the stock of S2 is deconsolidated in the same transaction, the basis reduction to the T stock does not cause any corresponding investment adjustment to the stock of S2, or to the stock of any higher tier subsidiary. Similarly, because the stock of S1 is disposed of in the same transaction, the reduction to the basis of the S2 stock does not cause an investment adjustment to the stock of S1, or the stock of any higher tier subsidiary.

(iv) *Basis reduction treated as investment adjustment.* For purposes of the consolidated return regulations, the amount of any basis reduction to stock under this section is generally treated as a net negative adjustment under §1.1502-32(e) (in addition to the adjustment otherwise required under §1.1502-32(e)) with respect to the stock. The amount of the basis reduction is not treated as a net negative adjustment for purposes of §1.1502-32T(a), however.

(g) *Reattribution of subsidiary's losses to common parent*—(1) *Reattribution rule.* If a member disposes of stock of a subsidiary and the member's loss would be disallowed under paragraph (a)(1) of this section, the common parent may make an irrevocable election to reattribute to itself any portion of the net operating loss carryovers and net capital loss carryovers attributable to the subsidiary (and any lower tier subsidiary) without regard to the order in which they were incurred, provided the amount reattributed does not exceed the amount that would be disallowed if an election under this paragraph (g) were not made. The common parent succeeds to the reattributed losses as if the losses were succeeded to on the day of the disposition in a transaction to which section 381 applies. Any owner shift of the subsidiary (including any deemed owner shift resulting from section 382(g)(4)(D) or 382(l)(3)) in connection with the disposition will not be taken into account under section 382 with respect to the reattributed losses.

(2) *Insolvency limitation.* Losses of a subsidiary may not be reattributed under this paragraph (g) to the extent that the subsidiary and all higher tier subsidiaries are insolvent within the meaning of section 108(d)(3) at the time of the disposition. For purposes of determining insolvency, preferred stock of a subsidiary that is not owned by members is treated as a liability to the extent of the amount of preferred distributions to which the stock would be entitled if the subsidiary were liquidated on the date of the disposition.

(3) *Investment adjustments.* Any losses reattributed under this paragraph (g) are treated for purposes of determining investment adjustments under §1.1502-32 and earnings and profits under §1.1502-33(c) as absorbed by the subsidiary (or lower tier subsidiary) immediately before the disposition. The losses, however, are not treated as absorbed for other tax purposes, such as section 172 or section 1212.

(4) *Examples.* The principles of this paragraph (g) are illustrated by the following examples:

Example (1). Basic reattribution case. (i) P, the common parent of a group, forms S with a contribution of $100. S has an operating loss of $60, which produces a deficit in earnings and profits that reduces P's basis in the S stock by $60 under the investment adjustment system. The group is unable to use the loss, and the loss becomes a net operating loss carryover attributable to S. Under the investment adjustment system, P's basis in the S stock is increased by $60, the amount of the unused loss, thus preserving P's $100 basis in the S stock. The remaining assets of S appreciate in value, and P sells all the stock of S for $55. But for an election to reattribute losses under this paragraph (g), P would have a $45 loss on the sale of S that would be disallowed.

(ii) P elects under paragraph (g)(1) of this section to reattribute to itself $45 of S's losses (the maximum amount permitted). As a result, $45 of the $60 net operating loss carryover attributable to S is reattributed to P. This reattributed loss may be included in the net operating loss carryover to subsequent consolidated return years of the P group. The remaining $15 of net operating loss carryover attributable to S is carried over to the first separate return year of S.

(iii) The $45 reattributed loss is treated, solely for purposes of the investment adjustment system, as absorbed by S immediately before the disposition. This reduces P's basis in the S stock to $55 immediately before the disposition. As a result, P does not recognize any gain or loss on the disposition. However, this deemed absorption for purposes of determining investment adjustments does not affect the use of the loss by the P group.

(iv) Assume that $20 of S's losses arose in Year 1 and $40 in Year 2, and that P elects to reattribute all $40 from Year 2 and $5 from Year 1. These losses retain their character as ordinary losses arising in Years 1 and 2. The losses continue to be subject to any limitations originally applicable to S, but P succeeds to them and may absorb the losses independently of S. (For example, P's use of the Year 2 losses does not depend on S's use of the Year 1 losses that were not reattributed to P.)

Example (2). Lower tier subsidiary. (i) P, the common parent of a group, forms S with a contribution of $100. S then forms T with a contribution of $40, and T borrows $60 from an unrelated lender. S has a net operating loss of $30. T has a net operating loss of $55 and is insolvent by $15. The group is unable to use these losses and the losses become net operating loss carryovers attributable to T and S. Under the investment adjustment system, S's basis in the T stock remains $40 and P's basis in the S stock remains $100. P sells all of the S stock for $30 ($100 invested, less S's $30 net operating loss and S's $40 unrealized loss on its investment in T stock). But for an election to reattribute losses under this paragraph (g), P would have a $70 loss on the sale of the S stock that would be disallowed.

(ii) S's $30 portion of the net operating loss carryover may be reattributed to P under paragraph (g)(1) of this section. Because T is insolvent by $15, paragraph (g)(2) of this section provides that only $40 of its $55 portion of the net operating loss carryover may be reattributed to P under paragraph (g)(1). There is no limitation, however, on which $40 of T's $55 loss may be reattributed.

(iii) P elects under paragraph (g)(1) of this section to reattribute to itself $40 of T's losses (the maximum amount permitted). P does not elect, however, to reattribute to itself any of S's losses. As a result, $40 of the $85 net operating loss carryover is reattributed to P. This reattributed loss may be included in the net operating loss carryover to subsequent consolidated return years of the P group. Of the $45 remaining net operating loss carryover, the $15 attributable to T and $30 attributable to S are carried over to their first separate return years.

(iv) The loss reattributed from T is treated, solely for purposes of the investment adjustment system, as absorbed by T immediately before the disposition. This reduces P's basis in the S stock to $60 immediately before the disposition. As a result, P recognizes only a $30 loss on the disposition of its S stock ($30 sale proceeds and $60 basis). However, this deemed absorption for purposes of determining investment adjustments does not affect the use of the loss by the P group.

Example (3). Separate return limitation year losses. (i) P, the common parent of a group, buys the stock of S for $100. S has a net operating loss carryover of $40 from a separate return limitation year, and assets with a value and basis of $100. The assets of S decline in value by $40, and P sells all the stock of S for $60. But for an election to reattribute losses under this paragraph (g), P would have a $40 loss on the sale of S that would be disallowed.

(ii) S's $40 loss carryover from a separate return limitation year is included in the P group's net operating loss carryovers and may be reattributed to P under paragraph (g)(1) of this section.

(iii) P elects under paragraph (g)(1) of this section to reattribute to itself S's $40 loss (the maximum amount permitted). Following the reattribution, the loss is included in the net operating loss carryover to subsequent consolidated return years of the P group.

(iv) The loss reattributed from S is treated, solely for purposes of the investment adjustment system, as absorbed by S immediately before the disposition. This reduces P's basis in the S stock to $100 immediately before the disposition. As a result, P recognizes no gain or loss on the disposition of its S stock. However, this deemed absorption for purposes of determining investment adjustments does not affect the use of the loss by the P group.

(5) *Time and manner of making the election*—(i) *In general.* The election described in paragraph (g)(1) of this section must be made in a separate statement entitled "THIS IS AN ELECTION UNDER SECTION 1.1502-20(g)(1) TO REATTRIBUTE LOSSES OF [insert names and employer identification numbers (E.I.N.) of each subsidiary whose losses are reattributed] TO [insert name and employer identification number of common parent]." The statement must include the following information—

(A) For each subsidiary, the amount of each net operating loss and net capital loss, and the year in which each arose, that is reattributed to the common parent, and

(B) If a subsidiary ceases to be a member, the name and employer identification number of the person acquiring the subsidiary's stock.

The statement must be signed by the common parent, and by each subsidiary with respect to which loss is reattributed under this paragraph (g) that does not remain a member of the common parent's group immediately following the disposition. The statement must be filed with the group's income tax return for the tax year of the disposition and, if the subsidiary (or lower tier subsidiary) ceases to be a member, a copy delivered on or before the time that return is required to be filed by the acquirer. If the acquirer is a subsidiary in a consolidated group, the name and employer identification number of the common parent of the group must be included in the statement, and a copy of the statement must also be delivered to the common parent.

(ii) *Filing of subsidiary's copy of statement.* The subsidiary whose losses are reattributed (or the common parent of any consolidated group that acquires the subsidiary or lower tier subsidiary) must attach its copy of the statement described in paragraph (g)(5)(i) of this section to its return for the first year ending after the due date, including extensions, of the return in which the election required by paragraph (g)(5)(i) is to be filed.

(h) *Effective dates*—(1) *General rule.* This section is effective December 26, 1990. Except as otherwise provided in this paragraph (h), this section applies with respect to dispositions and deconsolidations after January 31, 1991. For this purpose, dispositions deferred under §§1.1502-13, 1.1502-13T, 1.1502-14, and 1.1502-14T are deemed to occur at the time the deferred gain or loss is taken into account unless the stock was deconsolidated before February 1, 1991. If stock of a subsidiary became worthless during a taxable year including February 1, 1991, the disposition with respect to the stock is treated as occurring on the date the stock became worthless.

(2) *Election to accelerate effective date*—(i) *In general.* A group may make an irrevocable election to apply this section to all its members, in lieu of §1.337(d)-2, with respect to all dispositions and deconsolidations after November 18, 1990.

(ii) *Time and manner of making the election—in general.* The election described in paragraph (h)(2) of this section must be made in a separate statement entitled "THIS IS AN ELECTION UNDER SECTION 1.1502-20(h)(2) TO ACCELERATE THE APPLICATION OF §1.1502-20 TO THE CONSOLIDATED GROUP OF WHICH [insert name and em-

ployer 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 tax year of the first disposition or deconsolidation to which the election applies. If the separate statement required under this paragraph (h)(2)(ii) is to be filed with a return the due date (including extensions) of which is before April 16, 1991, the statement may be filed with an amended return for the year of the disposition or deconsolidation. Any other filings required under this §1.1502-20, such as the statement required under §1.1502-20(c)(3), which ordinarily cannot be made with an amended return, must be made at such time and in such manner as permitted by the Commissioner.

(3) *Binding contract rule.* For purposes of this paragraph (h), if a disposition or deconsolidation is pursuant to a binding written contract entered into before March 9, 1990, and in continuous effect until the disposition or deconsolidation, the date the contract became binding is treated as the date of the disposition or deconsolidation.

(4) *Cross reference.* For transitional loss limitation rules, see §§1.337(d)-1 and 1.337(d)-2.

Par. 5. Section 1.267(f)-3T is redesignated as §1.267(f)-3, and is revised to read as follows:

§1.267(f)-3 Disposition or deconsolidation of subsidiary stock.

For purposes of applying section 267(f)(2) to the sale or exchange of the stock of one member of a consolidated group by another member, see §§1.337(d)-1(a), 1.337(d)-2(a), and 1.1502-20(a). For purposes of this section, the definitions in §1.1502-1 apply.

Par. 6. Paragraph (e)(1) of §1.337(d)-1 is revised to read as follows:

§1.337(d)-1 Transitional loss limitation rule.

* * * * *

(e) *Effective dates*—(1) *General rule.* This section is effective November 19, 1990, and applies with respect to dispositions after January 6, 1987. After November 18, 1990, however, this section applies only if the stock was deconsolidated (as that term is defined in §1.337(d)-2(b)(2)) before November 19, 1990, and only to the extent the disposition is not subject to §1.337(d)-2 or §1.1502-20.

* * * * *

Par. 7. Paragraph (r) of §1.1502-12 is revised to read as follows:

§1.1502-12 Separate taxable income.

* * * * *

(r) For rules relating to loss disallowance or basis reduction on the disposition or deconsolidation of stock of a subsidiary, see §§1.337(d)-1, 1.337(d)-2 and 1.1502-20.

* * * * *

Par. 8. The last sentence of §1.1502-32(a) is revised to read as follows:

§1.1502-32 Investment adjustment.

(a) *** For rules relating to loss disallowance or basis reduction on the disposition or deconsolidation of stock of a subsidiary, see §§1.337(d)-1, 1.337(d)-2 and 1.1502-20.

* * * * *

Par. 9. The last sentence of §1.1502-33(c)(6) is revised to read as follows:

§1.1502-33 Earnings and profits.

* * * * *

(c) * * *

(6) * * * For rules relating to the effect on earnings and profits of loss disallowance or basis reduction on the disposition or deconsolidation of stock of a subsidiary, see §§1.337(d)-1, 1.337(d)-2 and 1.1502-20.

* * * * *

Par. 10. Section 1.1502-79 is amended by adding paragraph (a)(1)(iii) to read as follows:

§1.1502-79 Separate return years.

(a) * * *

(1) * * *

(iii) For rules permitting the reattribution of losses of a subsidiary to the common parent in the case of loss disallowance or basis reduction on the disposition or deconsolidation of stock of the subsidiary, see §1.1502-20.

* * * * *

Fred T. Goldberg, Jr.,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on November 19, 1990, 3:43 p.m., and published in the issue of the Federal Register for November 26, 1990, 55 F.R. 49075)

Notice of Proposed Rulemaking

Nondiscrimination Requirements for Qualified Plans

EE-61-88

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document amends previously proposed regulations under the nondiscrimination requirements for qualified retirement plans under section 401(a)(4) and the average benefit percentage test under section 410(b)(2)(A)(ii) of the Internal Revenue Code. The amendments delay the effective dates in those proposed regulations. These amendments will provide the public with extra time to comply with the regulations and will affect sponsors of and participants in tax-qualified retirement plans.

DATES: Written comments must be delivered by February 1, 1991.

ADDRESSES: Send written comments to: Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Attention: CC:CORP:T:R (EE-61-88), Washington, D.C. 20044. In the alternative, comments may be hand delivered to: Internal Revenue Building, Room 4429, 1111 Constitution Ave., N.W., Attention: CC:CORP:T:R (EE-61-88), Washington, D.C.

SUPPLEMENTARY INFORMATION:

Statutory Authority

This document amends previously proposed regulations under sections 401(a)(4) and 410(b) of the Internal Revenue Code. These regulations are proposed to be issued under the authority contained in sections 401(a)(4), 410(b), and 7805 of the Code.

Explanation of Provisions

On May 14 and September 14, 1990, the Treasury Department and the Internal Revenue Service published proposed comprehensive nondiscrimination regulations for qualified retirement plans under section 401(a)(4) and the average benefit percentage test under section 410(b)(2)(A)(ii) (55 FR 19897 [EE-61-88, 1990-1 C.B. 573] and 55 FR 37888 [EE-49-90, page 714, this Bulletin].

The proposed regulations contain a number of requirements that are satisfied by reasonable, good faith compliance for plan years beginning before 1991. Since publication, the Treasury and the Service have received many comments requesting a delay of the effective date and an extension of the period in which reasonable, good faith compliance is permitted. After studying the issue, the Treasury and the Service have decided to delay the effective date of these regulations from plan years beginning on or after January 1, 1991, to plan years beginning on or after January 1, 1992. This extension is limited to the provisions specified in this document and does not apply to other regulations under sections amended or added by the Tax Reform Act of 1986.

In addition, consistent with the change in the effective date for the average benefit percentage test, employers may choose to test employee stock ownership plans separately for purposes of that test for plan years beginning before January 1, 1992, in conformity with §1.410(b)-7(e) prior to its amendment by the September 14, 1990, proposed regulations. Further, employers that meet the reasonable, good faith requirement of §1.401(a)(4)-13 for the 1989, 1990, and 1991 plan years by operating their plans in accordance with the proposed regulations as published on May 14, 1990, need not take into account for those years the transitional rules provided for proposed §1.401(a)(4)-13(c). However, the provisions of §1.401(a)(4)-13(c) are proposed to be effective for those plans for the first plan year beginning on or after January 1, 1992.

This document is part of a coordinated package of guidance allowing employers an additional period to make amendments for certain requirements of the Tax Reform Act of 1986. It is issued concurrently with Notice 90-73, *** [page 353, this Bulletin] which (1) extends the expiration date of the remedial amendment period under section 401(b) until the end of the first plan year beginning after December 31, 1991, for certain disqualifying provisions and (2) extends the transitional date for the safe harbors under section 403(b)(12) in Notice 89-23, 1989-1 C.B. 654.

The amendments to the proposed regulations delay the time of required compliance with the proposed regulations. Accordingly, this document amends the sections of the proposed regulations published on May 14 and September 14, 1990, that are listed below, to delay the effective date and extend the reasonable, good faith compliance period for the proposed regulations under section 401(a)(4) and the average benefit percentage test under section 410(b)(2)(A)(ii).

Regulation section	*Subject*
1.401(a)-4, A-1(a)(1)	Optional forms of benefit
1.401(a)(4)-3	Nondiscrimination in amount of benefits
1.401(a)(4)-6	Defined benefit plans with employee contributions
1.401(a)(4)-7	Effect of section 401(l) permitted disparity
1.401(a)(4)-8	Conversion of contributions and benefits
1.401(a)(4)-13	Effective dates
1.410(b)-10(d)	Effective dates and transition rules
1.411(d)-4, A-1(b)(1)	Section 411 protected benefits

For plan years in which the amendments made by section 1112(a) of TRA '86 apply to a plan, but before the proposed effective date, a plan must be operated in accordance with a reasonable, good faith interpretation of the requirements of section 401(a)(4). Whether compliance is reasonable and in good faith will generally be determined on the basis of facts and circumstances, including the extent to which the employer has consistently resolved all unclear issues in its favor. Reasonable, good faith compliance will be deemed to exist, however, if a plan is operated in accordance with the proposed regulations.

Reliance on These Proposed Regulations

Taxpayers may rely on these proposed regulations for guidance pending issuance of final regulations. If future regulations are more restrictive, they will be applied without retroactive effect.

Special Analyses

It has been determined that these proposed rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. 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, an initial Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations will be submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

Written Comments

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably a signed original and eight copies) to the Internal Revenue Service. All comments will be available for public inspection and copying in their entirety.

List of Subjects

26 CFR 1.401-0 through 1.425-1

Employee benefit plans, Employee stock ownership plans, Income taxes, Individual retirement accounts, Pensions, Stock options.

Proposed Amendments to the Regulations

The notice of proposed rulemaking (to amend 26 CFR Part 1) that were published on May 14, 1990 (55 FR 19897), and September 14, 1990 (55 FR 37888), are amended as follows:

INCOME TAX REGULATIONS
(26 CFR Part 1)

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

Authority: 26 U.S.C. 7805. *** §§1.401(a)-4, 1.401(a)(4)-3, 1.401(a)(4)-6, 1.401(a)(4)-7, 1.401(a)(4)-8, and 1.401(a)(4)-13 also issued under 26 U.S.C. 401(a)(4), §1.410(b)-10 also issued under 26 U.S.C. 410(b).

Par. 1a. The authority citation for Part 1 is further amended by revising the citation for §1.411(d)-4 as follows:

Authority: *** §1.411(d)-4 also issued under 26 U.S.C. 411(d)(6).

Par. 2. Section 1.401(a)-4 as proposed to be amended on May 14, 1990 (55 FR 19907), is amended by revising the last sentence of A-1(a)(1) to read as follows:

§1.401(a)-4 Optional forms of benefit.

*****

A-1: (a) *In general*—(1) *Scope.* *** See §1.401(a)(4)-4(d) for the definition of an optional form of benefit for plan years beginning after December 31, 1991.

*****

Par. 3. Section 1.401(a)(4)-3 as proposed on May 14, 1990 (55 FR 19912), is amended by revising the last sentence of paragraphs (c)(3)(iii) and the last sentence of paragraph (c)(3)(iv)(A) to read as follows:

§1.401(a)(4)-3 Nondiscrimination in amount of benefits.

*****

(c) *General test for nondiscrimination in amount of benefits provided.* ***

(3) *Determining accrual rates.* ***

(iii) *Accrued-to-date method.* *** This method may, but need not, be applied solely with respect to benefits accrued and participation in plan years beginning after a selected date no later than December 31, 1991.

(iv) *Projected accrual rate method*—(A) *In general.* *** This method may, but need not, be applied solely with respect to benefits accrued and participation in plan years beginning after a selected date no later than December 31, 1991.

*****

Par. 4. Section 1.401(a)(4)-6 as proposed on May 14, 1990 (55 FR 19920), is amended as follows:

1. Paragraph (b)(3)(ii) is revised to read as set forth below.

2. Paragraph (b)(5) is revised to read as set forth below.

3. Paragraph (c)(4)(iii) is revised to read as set forth below.

§1.401(a)(4)-6 Defined benefit plans with employee contributions.

*****

(b) *Determination of employer-derived and employee-derived benefits* ***

(3) *Minimum benefit method* ***

(ii) *Minimum benefit.* A plan satisfies this paragraph (b)(3)(ii) if it provides that in plan years beginning after December 31, 1991, each employee will accrue a benefit that equals or exceeds the sum of—

(A) The accrued benefit derived from employee contributions made for plan years beginning after December 31, 1991, determined in accordance with section 411(c) and

(B) Fifty percent of the total benefit accrued in plan years beginning after December 31, 1991, as determined under the plan benefit formula without regard to that portion of the formula designed to satisfy the minimum benefit requirement of this paragraph (b)(3)(ii).

*****

(5) *Cessation of employee contributions method.* If a plan provides that no employee contributions, other than employee contributions allocated to separate accounts, may be made to the plan for plan years beginning after December 31, 1991, the plan may treat all benefits under the plan (other than benefits attributable to employee contributions allocated to separate accounts) as employer-derived.

(c) *Employee contributions not allocated to separate accounts* ***

(4) *Grandfather rule for plans in existence on May 14, 1990.* ***

(iii) For plan years beginning after December 31, 1991, all employees under the plan are permitted to make employee contributions at a uniform rate with respect to all compensation under the plan; and

*****

Par. 5. Section 1.401(a)(4)-7 as proposed on May 14, 1990 (55 FR 19921), is amended by revising the first sentence of paragraph (d)(4)(i) to read as follows:

§1.401(a)(4)-7 Effect of section 401(l) permitted disparity.

*****

(d) *Special rules* ***

(4) *Transition rules*—(i) *Scope.* This paragraph (d)(4) provides rules that are applicable to a plan that was in existence prior to the first plan year beginning before January 1, 1989, that uses either the accrued-to-date method or the projected method under paragraph (c)(5)(iii) or (iv) of this section to impute disparity, and that applies such methods solely with respect to benefits accrued and participation in plan years beginning after a selected date no later than December 31, 1991. ***

*****

Par. 6. Section 1.401(a)(4)-8 as proposed on May 14, 1990 (55 FR 19924), is amended by revising the last sentence of paragraph (b)(3)(i) to read as follows:

§1.401(a)(4)-8 Conversion of contributions and benefits.

*****

(b) *Nondiscriminatory benefits under a defined contribution plan.* ***

(3) *Option to use accrued-to-date method*—(i) *In general.* *** The method provided in this paragraph (b)(3)(i) may, but need not, be applied solely with respect to participation, and adjusted account balances attributable to allocations accrued, in plan years beginning after a selected date no later than December 31, 1991, which date is the same for all employees in the plan.

*****

Par. 7. Section 1.401(a)(4)-13 as proposed on May 14, 1990 (55 FR 19930), and amended on September 14, 1990 (55 FR 37899), is amended by revising the first sentence of paragraph (a) and by revising paragraph (c)(6)(ix) to read as follows:

§1.401(a)(4)-13 Effective dates.

(a) *In general.* Sections 1.401(a)(4)-1 through 1.401(a)(4)-13 apply to plan years beginning on or after January 1, 1992. ***

*****

(c) *Transitional rules for certain defined benefit plans* ***

(6) *Definitions* ***

(ix) *Reconstructed compensation for the freeze year.* The term "reconstructed compensation for the freeze year" means an employee's compensation for the freeze year determined under the following method in the same manner for every employee in the plan: First, select a single plan year beginning after the close of the freeze year but beginning not later than December 31, 1992; second, determine the employee's compensation for the selected plan year under the same compensation definition used to determine the employee's compensa-

tion for the current plan year under paragraph (c)(6)(ii)(A)(*3*) of this section; third, multiply the employee's compensation for the selected plan year by a fraction, the numerator of which is the employee's compensation for the freeze year determined under the same compensation definition used to determine the employee's frozen accrued benefit, and the denominator of which is the employee's compensation for the selected plan year determined under the compensation definition used to determine the employee's frozen accrued benefit.

Par. 8. Section 1.410(b)-10(d), as proposed on May 14, 1990 (55 FR 19934), is amended by revising the first sentence to read as follows:

§1.410(b)-10 Effective dates and transition rules.

*****

(d) *Effective date for average benefit percentage test.* Section 1.410(b)-5 applies to plan years beginning on or after January 1, 1992. ***

Par. 9. Section 1.411(d)-4, as proposed to be amended on May 14, 1990 (55 FR 19935), is amended by revising the last sentence of A-1(b)(1) to read as follows:

§1.411(d)-4 Section 411(d)(6) protected benefits.

*****

A-1: ***

(b) *Optional forms of benefit—*(1) *In general.* *** See §1.401(a)(4)-4(d) for the definition of an optional form of benefit for plan years beginning on or after January 1, 1992. *****

John D. Johnson,
Acting Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on November 30, 1990, 8:45 a.m., and published in the issue of the Federal Register for December 3, 1990, 55 F.R. 49906)

Notice of Proposed Rulemaking

Nondiscrimination Requirements for Qualified Plans; Application of Average Benefit Percentage Test to ESOPs

EE-49-90

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains amendments to two sets of previously proposed regulations. The amendments to the first set revise and amplify certain rules under the nondiscrimination requirements for qualified retirement plans under section 401(a)(4) of the Internal Revenue Code. The amendments to the second set change the rules governing the application of the average benefit percentage test under section 410(b) of the Code to employee stock ownership plans. In addition to reflecting changes made by the Tax Reform Act of 1986 (TRA '86), these proposed regulations interpret the section 401(a)(4) requirement that contributions or benefits provided under a tax-qualified retirement plan not discriminate in favor of highly compensated employees and the related section 410(b) minimum coverage requirements. These regulations will provide the public with guidance necessary to comply with the law and will affect sponsors of and participants in tax-qualified retirement plans.

DATES: Written comments must be received by November 13, 1990.

ADDRESSES: Send comments to: Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Attn: CC:CORP:T:R (EE-49-90), Room 4429, Washington, D.C. 20044. In the alternative, to ensure timely receipt by the Service, comments can be hand-delivered to: Internal Revenue Service, Attn: CC:CORP:T:R (EE-49-90) Room 4429, 1111 Constitution Avenue, N.W., Washington, D.C. 20224.

SUPPLEMENTARY INFORMATION:

Statutory Authority

This document contains amendments of previously proposed regulations under sections 401(a)(4), 401(a)(5), 401(l), and 410(b) of the Internal Revenue Code. These regulations and amendments are proposed to conform the regulations to sections 1111, 1112(a), and 1114 of TRA '86. These regulations are to be issued under the authority contained in sections 401(a)(4), 401(l), 410(b), and 7805 of the Code.

Amendments to Certain Nondiscrimination Rules

On May 14, 1990, the Treasury Department and the Internal Revenue Service published proposed comprehensive nondiscrimination regulations for qualified plans under section 401(a)(4) and certain other related Code sections. Since publication, the Treasury and the Service have received many comments and have continued to analyze the proposed regulations to ensure that they function as intended. In the course of this ongoing review, the Treasury and the Service have become aware of certain issues on which immediate guidance would be helpful. This document therefore amends proposed §§1.401(a)(4)-2, 1.401(a)(4)-3, and 1.401(a)(4)-9 published on May 14, 1990 (55 FR 19897) [EE-61-88, 1990-1 C.B. 573], and proposed §1.401(l)-3 published on November 15, 1988 (53 FR 45917) [EE-159-86, 1988-2 C.B. 798], and amended on May 14, 1990 (55 FR 19947) [EE-22-90, 1990-1 C.B. 617], to clarify and amplify certain nondiscrimination rules under those sections of the proposed regulations. The Treasury and the Service are still evaluating comments received on additional aspects of the proposed regulations. Therefore, no inference should be drawn from the fact that an issue is not addressed in this document or from the fact that only certain aspects of an issue are addressed.

1. *Use of safe harbors not precluded by certain plan provisions*

The proposed regulations published May 14, 1990, provide two safe harbors for defined contribution plans with uniform formulas and three safe harbors for defined benefit plans with uniform formulas. These safe harbors can be used to establish nondiscrimination with respect to the amount of contributions or benefits. In response to numerous inquiries, this document clarifies that many common plan provisions, such as limits on compensation or service taken into account, do not prevent use of the safe harbors.

2. *Safe harbor for defined contribution plans with a uniform formula weighted for age or service*

Proposed regulations §1.401(a)(4)-2(b)(3) provides a safe harbor for defined contribution plans with a uni-

form allocation formula weighted for age or service. Under the safe harbor, the dollar amount of allocations may vary solely on account of compensation, age, years of service, or years of plan participation. This document makes clear that a common feature of such plans—weighing allocations by whole increments of compensation—is permissible under the safe harbor. In line with the traditional design of these plans, compensation can be taken into account in uniform increments of up to $200, with the same weight assigned to every increment. Of course, an employee's actual compensation must be used to determine average allocation rates under the second prong of the safe harbor.

3. *Safe harbor for unit credit formula using fractional rule accrual*

A number of commentators suggested amending proposed §1.401(a)-(4)-3(b)(2)(iv) which provides a safe harbor for defined benefit plans with uniform unit credit formulas under which benefits accrue under the fractional accrual rule. Under the safe harbor, no employee can accrue in any 1 year more than 133⅓ percent of the benefit that any other employee can accrue, disregarding employees with projected service in excess of 40 years. Because an employee who accrues the maximum benefit over 40 years accrues it at a rate of 2.5 percent annually, no other employee can accrue the maximum benefit at a rate of more than 3.33 percent annually (133⅓ percent of 2.5 percent) over 30 years. In contrast, under the flat benefit plan safe harbor, the maximum benefit can be accrued over 25 years. Commentators suggested that these two safe harbors be made parallel. In response to these comments, the proposed regulations have been amended to permit an employer to disregard employees with years of projected service in excess of 33 years in determining whether the plan satisfies this requirement of the safe harbor. This permits the maximum benefit for plans using the unit credit fractional rule safe harbor to be accrued over no less than 25 years, as is the case with plans using the flat benefit safe harbor.

Of course, an integrated plan that uses the unit credit fractional rule safe harbor must still satisfy section 401(l) in form, including the uniformity requirement under section 401(l). A unit credit fractional accrual plan, like a flat benefit fractional accrual plan, would violate the uniformity requirement under section 401(l) unless the maximum benefit is accrued over a period of at least 35 years.

4. *Grouping of allocation or accrual rates*

In response to a number of inquiries, this document clarifies the operation of the grouping rules for allocation and accrual rates under proposed §§1.401(a)(4)-2(c)(5) and 1.401(a)(4)-3(c)(3)(v). The effect of the amendments is to clarify the intended flexibility available to employers applying the grouping rules.

5. *Compensation for the plan year*

Under the proposed regulations, compensation for the entire plan year is taken into account in determining whether a defined contribution plan satisfies section 401(a)(4) with respect to the amount of contributions. A number of commentators have suggested that, in the case of defined contribution plans, it is consistent with the principle of nondiscrimination to measure compensation by reference to the portion of the plan year during which an employee is a plan participant. The Treasury and the Service agree. This document therefore amends the proposed regulations to implement this suggestion.

Under the proposed regulations, in determining whether a defined benefit plan satisfies section 401(a)(4) with respect to the amount of benefits, compensation must generally be based on the plan year. Alternatively, compensation can be based on any consecutive period of at least 12 months (36 months in the case of a plan using the special compensation rule in §1.401(a)(4)-3(f)(2)), provided the period over which compensation is determined ends within the plan year being tested. A number of commentators have asked whether the requirement that the period end within the plan year precludes the use of a final average pay formula that determines an employee's accrual based on the employee's highest compensation over a specified number of years if those years do not end within the plan year being tested. This document clarifies the proposed regulations to provide specifically that a final average pay plan may use an employee's highest average compensation for a specified period even if that period does not end within the current plan year. This rule for final average pay plans is only available if the specified period in which the highest compensation is determined includes at least 36 consecutive months and compensation for a period ending within the current plan year is considered in determining the employee's highest paid period.

This document also modifies §1.401(a)(4)-3(f)(2) to provide that a career average plan that bases an employee's total benefit on compensation for a period of at least 36 consecutive months (or the employee's period of employment, if shorter) will satisfy the requirements of that section even if the plan determines an employee's benefit based on each year of service separately, using compensation separately calculated for each year, and sums the benefit for each year to determine the total retirement benefit.

6. *Calculating, restructuring, and testing most valuable accrual rates*

In order to establish nondiscrimination in the amount of benefits, the proposed regulations require a defined benefit plan not using a safe harbor to demonstrate that no highly compensated employee has a most valuable accrual rate that exceeds that of any nonhighly compensated employee in the plan. Many commentators have pointed out the difficulty some plans have in satisfying this requirement.

A number of factors contribute to this difficulty. First, in contrast to normal accrual rates, most valuable accrual rates are especially sensitive to differences in the demographic characteristics of individual employees. Second, the manner in which most valuable accrual rates are calculated—particularly under the annual method—tends to accentuate these differences. Third, under the proposed regulations, a plan cannot be restructured on the basis of most valuable accrual rates. Finally, if the plan is also tested for normal accrual rates and is restructured under the rate segment method, difficulties may be experienced when segments of the most valuable accrual rate are allocated to corresponding segments of the normal accrual rate.

Some of these difficulties stem from the use in the proposed regulations of the actuarial methods employed in Rev. Rul. 81-202, 1981-2 C.B. 93, and from the interaction of those actuarial methods with aspects of the proposed regulations that are entirely new. These issues are under active review by the Treasury and the Service, and both agencies are committed to their prompt resolution.

This document contains several changes that affect the calculation, restructuring, and testing of most valuable accrual rates. First, the proposed regulations are amended to permit a plan to freeze an employee's highest most valuable accrual rate for testing purposes. This modification is designed to prevent the decrease in an employee's most valuable accrual rate that otherwise occurs after the employee passes the age at which the maximum subsidy is provided under the plan. Second, the annual method is amended to prevent decreases in the most valuable accrual rate from resulting in negative rates of accrual. Third, as discussed in greater detail below, the restructuring rules are amended to permit restructuring on the basis of most valuable accrual rates and to permit sequential restructuring of normal and most valuable accrual rates.

The Treasury and the Service acknowledge that these amendments may not provide a complete solution to the difficulties described above. The agencies are therefore considering more comprehensive approaches to resolving these issues. Comments from interested taxpayers on these issues are welcomed.

7. *Restructuring generally*

The proposed regulations permit plans to be restructured into component plans that separately satisfy sections 401(a)(4) and 410(b). These rules are intended to permit employers to provide benefits under one plan that previously could have been provided only under multiple plans. The Treasury and the Service have determined that certain limitations in the proposed regulations on the use of restructuring are not necessary to accomplish this purpose and have therefore amended the proposed regulations to permit greater flexibility in restructuring in the manner described below. These amendments generally allow plans to be restructured under either of the two rate-based methods by reference to employees' most valuable retirement benefits (while retaining the existing restructuring alternatives based on normal retirement benefits), and to allow sequential restructuring using the same or, in certain cases, a different method. They do not permit inconsistent restructuring, under which different component plans are created depending on which benefits are being tested. Although some commentators have requested this rule, it is not compatible with the purposes of restructuring noted above.

The first amendment permits plans to be restructured on the basis of either normal or most valuable accrual or allocation rates under the total rates and rate segments methods. As originally issued, the proposed regulations require that the total rates and rate segments methods be applied only on the basis of normal accrual or allocation rates. This limitation may present a problem in those cases where the restructured plan must satisfy section 401(a)(4) with respect to both normal and most valuable accrual or allocation rates. Under defined benefit plans with features such as subsidized early retirement, a variety of most valuable accrual rates is generally associated with each level of normal accrual rates. The first amendment therefore lifts the prohibition on applying the total rates and rate segments methods on the basis of most valuable accrual or allocation rates. This amendment also has the effect of permitting defined benefit plans with uniform formulas that are subject to testing only on the basis of most valuable accrual rates to be restructured and tested on that same basis.

The second amendment permits sequential restructuring of plans. As originally issued, the proposed regulations prohibited more than one method of restructuring from being applied to a plan in any one plan year and also prohibited any one of these methods from being applied more than once in that year. This restriction made it difficult to restructure plans with complex benefit structures into component plans satisfying section 401(a)(4), even in cases where the same benefits could have been provided through separate plans that individually satisfied that section.

For example, an employer could have two defined benefit plans, one covering employees at plant X under a safe harbor formula (Plan X) and the other covering employees at plant Y under a formula that does not satisfy any of the safe harbors (Plan Y). Under the proposed regulations the employer could test Plan X under the applicable safe harbor and at the same time apply the total rate method of restructuring to test Plan Y under the general rules. If the two plans were combined, however, the employer would be forced to apply a single method of restructuring to the entire plan and to apply it only once. Thus, if the employer used the employee group method to restructure the plan into two component plans, one covering employees at plant X and the other covering employees at plant Y, the employer could take advantage of the safe harbor for the first component plan, but would not be able to test the second component plan using total rate restructuring. On the other hand, if the total rate method were used, the employer would have to apply that method to the whole plan and could not restructure out the first component plan under the employee group method to take advantage of the safe harbor.

The second amendment therefore generally permits component plans to be further restructured to the same extent as plans or aggregated plans. The requirements of sections 401(a)(4) and 410(b) are then applied to the smallest resulting component plans. For example, the plan described above could first be restructured into two component plans covering employees at plants X and Y respectively using the employee group method. The first component plan could then be tested under a safe harbor, while the second component plan could be further restructured using the total rate method. Furthermore, the total rate method could be applied more than once to the second component plan, so that, if the second component plan provided two levels of normal retirement benefits and two levels of most valuable benefits, the plan could be restructured first on the basis of employees' normal accrual rates into two new component plans providing the same normal retirement benefits. It could then be restructured further on the basis of employees'

most valuable accrual rates into a total of four new component plans, each providing the same normal and most valuable benefits to employees in that component and each satisfying the requirements of section 410(b).

As noted above, a number of commentators have also suggested that employers be permitted to use different component plans to satisfy section 401(a)(4) with respect to normal and most valuable accrual or allocation rates. Similarly, still different component plans could be used to test benefits, rights, and features. The proposed regulations do not permit inconsistent restructuring of this type because it would conflict with the objective of allowing a plan to be restructured only into components that would satisfy section 401(a)(4) if they were separate plans.

In addition to these amendments, the Treasury and the Service are considering a number of other amendments to the restructuring rules to make them simpler and easier to apply. For example, some commentators have suggested that the rules for allocating most valuable accrual rates among rate segments under the rate segments method need to be clarified. Another amendment that has been suggested to lessen complexity in the rate-based restructuring methods is the elimination of these methods altogether while, at the same time, significantly expanding the employee group method by eliminating certain limitations that currently apply to it, for example, the commonality requirement described in section 8 of this preamble and the reasonableness prong of the nondiscriminatory classification test under section 410(b). Comments are requested on these and other possible ways to simplify the restructuring rules.

8. *Restructuring plans subject to section 401(k) and (m)*

Although the proposed regulations permit plans subject to section 401(k) and (m) to be restructured on the basis of employee groups, these plans may not use the total rate or rate segment methods of restructuring. While the proposed regulations do not impose explicit requirements for determining permissible restructured employee groups, they do, by necessary inference, require that restructured employee groups share some common attribute other than that of a similar accrual or allocation rate. The restriction on the use of total rate or rate segment restructuring would be meaningless if the only common attributes shared by the employee group were similar accrual or allocation rates. Other elements of the restructuring rules also reflect the fact that the employee groups used under the employee groups methods differ from groups of employees with similar accrual or allocation rates. For example, although different definitions of compensation may be used to determine allocation or accrual rates within each employee group, the same definition of compensation must be used for all employees under the total rates and rate segments methods. Similarly, accrual or allocation rates may be grouped within separate employee groups, but must be grouped for all employees before creating component plans based on total rates or rate segments.

Common attributes that provide a basis for employee group restructuring include, for example, employment at the same work site or in the same job classification. Similarly, permissible common attributes arise where employees work for the same division or subsidiary, work for a unit acquired in a specific merger or acquisition, or have been hired during a specified period. Restructuring may also be done on the basis of employee groups whose common attribute is coverage under the same contribution or benefit formula. In contrast, employee classifications that are based on total rates or rate segments or are created solely because they produce results similar to the total rate or rate segment methods do not constitute employee groups. Thus, for example, the proposed regulations therefore do not allow plans subject to section 401(k) or (m) to be restructured into two component plans, one of which consists of employees deferring 5 percent or more of their compensation and the other consisting of all other employees. Similarly, plans cannot be restructured into components on the basis of whether employees made elective deferrals in the current or prior plan years.

A number of comments have requested clarification of the requirement that an employee group share common attributes. These comments have led the Treasury and the Service to consider whether the employee groups method may contain inherent uncertainties and may therefore be difficult to apply. Any such uncertainties would cause particular problems for plans subject to section 401(k) and (m), which cannot benefit from the restructuring rules unless they satisfy the commonality requirement. The comments also indicate that, without objective standards, the employee groups method may provide a means to circumvent the actual deferral and actual contribution percentage tests and may therefore be inconsistent with the statutory requirements applicable to these plans.

As a result of these comments, the Treasury and the Service believe that it may be appropriate to develop more objective limits on the ability to restructure plans subject to section 401(k) and (m). A number of options are under consideration, including the following: (1) prohibiting restructuring for plans subject to section 401(k) or (m); (2) prohibiting restructuring, but permitting an employer to disregard nonhighly compensated employees not needed to satisfy the 70 percent ratio test of section 410(b)(1)(B), or some higher level of coverage, in applying the actual deferral and actual contribution percentage tests; (3) requiring that employee groups be designated in advance in the plan document; and (4) defining more precisely the employee groups that can serve as the basis of component plans. It is anticipated that any such changes would also apply to plans that are restructured to satisfy the special age and service safe harbor in proposed §1.401(a)(4)-2(b)(3) or the alternative flat benefit safe harbor in proposed §1.401(a)(4)-3(b)(4). Comments are specifically requested on these and other possible limitations on plan restructuring.

In accordance with the preamble to the proposed regulations, any new limitations on restructuring of plans subject to section 401(k) and (m) or using the safe harbors cited above will apply only to plan years beginning after the date of publication of future regulations. Pending publication of future regulations, plans subject to section 401(k) and (m) and plans using the cited safe harbors may therefore continue to be restruc-

tured in the manner provided in the proposed regulations.

9. *Transitional rules for defined benefit plans*

Commentators have expressed interest in amending plans to satisfy the requirements of the defined benefit safe harbors in situations where plan benefits previously accrued under a nonuniform formula. In addition, commentators have requested rules permitting use of the defined benefit safe harbors in appropriate situations by plans with potentially nonuniform current accruals representing updates of pre-effective date accrued benefits to reflect compensation increases.

In response to these concerns, and in order to facilitate access to the defined benefit safe harbors, this document amends the proposed regulations to provide employers that wish to use safe harbor testing for existing defined benefit plans with several transition rule alternatives. These options, which are provided in §1.401(a)(4)-13(c), include approaches that freeze pre-effective date accrued benefits as well as approaches that disregard potentially nonuniform current accruals that result from the wear-away of benefits accrued under a prior formula or from compensation increases with respect to such prior accrued benefits. These transition rules focus on the immediate transition issues faced by plans with respect to the 1989, 1990 and 1991 plan years. Consideration is being given to the extent to which similar ongoing transition rules should be provided for subsequent plan amendments.

The same transition rules also apply for purposes of applying the annual method of determining accrual rates under §1.401(a)(4)-3(c)(3)(ii), as proposed on May 14, 1990. This modification makes it clear that an existing defined benefit plan may not use the annual method to disguise compensation updates of benefits accrued in prior years under a now frozen formula in a manner that discriminates in favor of highly compensated employees.

Amendments to Minimum Coverage Requirements

This document also amends proposed §1.410(b)-7 published on May 18, 1989 (54 FR 21437), and §1.410(b)-5 published on May 14, 1990 (55 FR 19897), to require that employee stock ownership plans ("ESOPs") be aggregated with other qualified plans of an employer in applying the average benefit percentage test of section 410(b)(2)(A)(ii) (the "average benefit percentage test"). At the same time, this document reaffirms the separate testing requirement for ESOPs for all other purposes under section 410(b) as well as for purposes of section 401(a)(4) and (5). In addition, this document clarifies the operation of the disaggregation rules under proposed §1.410(b)-7 generally.

1. *Separate Testing of ESOPs*

An ESOP is a qualified stock bonus plan, or a combination of a qualified stock bonus plan and a qualified money purchase pension plan, that is designed to invest primarily in employer securities and that meets the other requirements prescribed in the Code and regulations for recognition as an ESOP. The regulatory requirements applicable to recognition of a plan as an ESOP are set forth in final regulations under §54.4975-11. These regulations were proposed in 1976 and finalized in 1977 and 1978.

Section 54.4975-11(e)(1) of the regulations prohibits an ESOP from being considered together with any other plan for purposes of applying section 410(b) or section 401(a)(4) and (5). This separate testing requirement is intended to prevent an ESOP, except in very limited circumstances, from being aggregated with another plan to determine whether the employees covered under the ESOP (or the other plan) constitute a minimum coverage group under section 410(b), or to determine whether the ESOP (or the other plan) satisfies the nondiscrimination requirements of section 401(a)(4) and (5). Together with the other rules applicable to ESOPs (including the prohibition on integration with social security), the separate testing requirement furthers the Congressional purpose of encouraging widespread employee stock ownership through ESOPs. See H.R. Rep. No. 1280, 93d Cong., 2d Sess. 313 (1974) (Conference Report to the Employee Retirement Income Security Act of 1974). In the context of section 410(b), the separate testing requirement ensures that an ESOP covers a minimum coverage group without relying on any other plan and that other plans cover minimum coverage groups without relying on the ESOP. Congress explicitly endorsed the separate testing requirement for ESOPs in the Conference Report to the Tax Reform Act of 1976. H.R. Rep. No. 1515, 94th Cong., 2d Sess. 541 (1976).

The prohibition on considering an ESOP (including a tax credit employee stock ownership plan described in section 409 of the Code) with another plan for purposes of the minimum coverage rules is reflected in the proposed regulations under section 410(b) that were published on May 18, 1989. Section 1.410(b)-7(c)(2) provides that the portion of a plan that is an ESOP and the portion of the plan that is not an ESOP are treated as separate plans for purposes of section 410(b). Section 1.410(b)-7(e) specifically provides that ESOPs must separately satisfy the average benefit percentage test. Comments received on the proposed regulations under section 410(b) have questioned whether the separate testing requirement should apply under the average benefit percentage test in particular and under section 410(b) in general.

a. *Average benefit percentage test*

The Treasury and the Service have reexamined the application of the separate testing requirement under the average benefit percentage test in light of the requirement's purpose as well as the statutory language and legislative history of the average benefit percentage test. Based on this review, the Treasury and the Service have determined that existing law is best read as requiring the aggregation of ESOPs with all other qualified plans of the employer in performing the average benefit percentage test.

Under the law in effect prior to TRA '86, section 410(b) required a qualified plan to cover a group of employees described in former section 410(b)(1)(A) or (B). The tests set forth in those provisions were known respectively as the "percentage" test and the "nondiscriminatory classification" test. In TRA '86, Congress amended section 410(b) to replace the existing percentage tests with the per-

centage and ratio tests of current section 410(b)(1)(A) and (B) respectively. The 410(b) regulations published May 18, 1989, incorporate these two tests into the ratio percentage test of proposed §1.410(b)-2(b)-(2). In addition, Congress required that the average benefit percentage test be satisfied in order for a plan to be tested under the nondiscriminatory classification test in periods following the effective date of TRA '86. This latter requirement is reflected in current section 410(b)(2).

The ratio percentage test and the nondiscriminatory classification test focus on the group of employees covered under a plan and establish minimum criteria that the group must satisfy. In contrast, the average benefit percentage test does not describe a minimum group of employees that must be covered under a plan and imposes no direct restrictions on the group's composition. Instead, the test focuses on the relative level of contributions or benefits provided to highly and nonhighly compensated employees under all qualified plans of the employer. Under the test, all nonexcludable employees of the employer are taken into account, regardless of which plan they are covered under or, indeed, whether they are covered under any plan at all. In this sense, the average benefit percentage test is not a minimum coverage test. Rather, as described above, it is more properly viewed as a precondition to use of the nondiscriminatory classification test in periods following the effective date of TRA '86. Because the average benefit percentage test is not a minimum coverage test, the policy behind the separate testing requirement for ESOPs does not compel extending that requirement to the average benefit percentage test.

Furthermore, the statutory language and the legislative history to TRA '86 are best read as requiring the aggregation of ESOPs with all other qualified plans of the employer for purposes of the average benefit percentage test. Section 410(b)(2)(C) defines the benefit percentage used in the average benefit percentage test as the employer-derived contribution or benefit of an employee under "all qualified plans maintained by the employer." Section 410(b)(2)(E) in turn provides that the term "qualified plan" includes any plan that meets the requirements of section 401(a). In explaining how benefit percentages are calculated under the average benefit percentage test, the TRA '86 Conference Report states, "In no case may an employer disregard any qualified plan in determining benefit percentages." H.R. Rep. No. 841, 99th Cong., 2d Sess. II-414 (1986).

For the reasons set forth above, the Treasury and the Service have decided to reverse the position taken in the regulations proposed on May 18, 1989, and to eliminate the separate testing requirement for ESOPs for purposes of the average benefit percentage test. These proposed regulations therefore amend proposed §1.410(b)-7 to provide that ESOPs must be aggregated with all other plans of the employer for purposes of the average benefit percentage test. A conforming amendment is also made to the average benefit percentage test regulations under proposed §1.410(b)-5.

b. *Sections 401(a)(4), 401(a)(5), and other provisions of section 410(b)*

After carefully reviewing the relevant provisions in the statute, legislative history, and regulations, the Treasury and the Service have determined that Congress intended the separate testing requirement to continue to apply for all purposes under sections 410(b) and 401(a)(4) and (5) other than the average benefit percentage test. The Conference Report to TRA '86 indicates that Congress was well aware of the regulatory prohibition on considering an ESOP together with another plan for purposes of the nondiscrimination rules under sections 410(b) and 401(a)(4) and (5). See H.R. Rep. No. 841, 99th Cong., 2d Sess. II-411 n.1 (1986). Further, nowhere in the legislative history did Congress indicate any dissatisfaction with the separate testing requirement in §54.4975-11(e). Given the earlier explicit endorsement of the separate testing requirement in the Conference Report to the Tax Reform Act of 1976 and the explicit recognition of the requirement in the Conference Report to TRA '86, the Treasury and the Service have concluded that, for purposes other than the average benefit percentage test, it would be inconsistent with Congressional intent to permit an ESOP to be tested together with another plan except in the limited circumstances permitted under §54.4975-11(e). Thus, the proposed regulations under section 410(b) have not been amended to eliminate the separate testing requirement for ESOPs under the ratio percentage and nondiscriminatory classification tests.

2. *Clarification of disaggregation rules generally*

The Treasury and the Service have received inquiries about how the mandatory disaggregation rules of proposed §1.410(b)-7(c) apply to separate plans. This document clarifies that the rules apply not only to portions of the same plan but also to separate plans. Thus, two or more separate plans that would be subject to disaggregation if they were portions of the same plan cannot be aggregated. An analogous rule is provided under the mandatory aggregation rule of proposed §1.410(b)-7(e) for purposes of the average benefit percentage test.

This document also clarifies that the transition rule in proposed §1.410(b)-7(c)(2) provided for an ESOP that is a portion of a larger plan does not apply to an ESOP that is a separate plan. The transition rule was provided solely because some taxpayers had interpreted the regulations under §54.4975-11(e)(1) as not requiring the disaggregation of an ESOP that was a portion of a larger plan from other portions of the same plan. In contrast, no similar ambiguity existed regarding application of the separate testing requirement under §54.4975-11(e)(1) in the case of an ESOP that is a separate plan. Therefore, no transitional rule was needed for ESOPs that are separate plans.

Effective Date

The amended portions of the section 401(a)(4), 401(l), and 410(b) regulations are proposed to be effective as previously set forth in the prior notices of proposed rulemaking to which they relate. Solely for purposes of the mandatory aggregation of ESOPs with other plans of an employer for purposes of the average benefit percentage test, employers may choose to test ESOPs separately under that test for plan years beginning before January 1, 1991, in conformity with proposed §1.410(b)-7(e)

prior to its amendment by this document.

Consistent with the statement in the preamble to the proposed regulations that future regulations that are more restrictive will be applied prospectively, employers that meet the reasonable, good faith requirement of §1.401(a)(4)-13 for the 1989 and 1990 plan year by operating their plans in accordance with the proposed regulations as published on May 14, 1990, need not take into account for those years the transitional rules provided in proposed §1.401(a)(4)-13(c). However, the provisions of §1.401(a)(4)-13(c) are proposed to be effective for those plans for the first plan year beginning on or after January 1, 1991.

Reliance on These Proposed Regulations

Taxpayers may rely on these proposed regulations for guidance pending issuance of final regulations. If future regulations are more restrictive, such guidance will be applied without retroactive effect.

Special Analyses

It has been determined that these proposed rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. 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, an initial Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations will be submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

Comments and Public Hearing

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably a signed original and eight copies) to the Internal Revenue Service. Written comments must be received by November 13, 1990. All comments will be available for public inspection and copying in their entirety.

These regulations can be discussed at the public hearing concerning Nondiscrimination Requirements for Qualified Plans (EE-61-88), Miscellaneous Regulations for Qualified Plans (EE-22-90), Minimum Participation (EE-44-87), and Definition of Compensation (EE-129-86) proposed regulations that were published on May 14, 1990. The public hearing is scheduled for Wednesday, September 26, 1990, at 10:00 a.m., and continuing at 10:00 a.m. each day, if necessary, on Thursday, September 27, 1990, and Friday, September 28, 1990, in the I.R.S. Auditorium, Seventh Floor, 7400 Corridor, Internal Revenue Building, 1111 Constitution Ave., N.W., Washington, D.C. Individuals who have requested to speak at that hearing do not need to submit a separate request, nor do they need to amend any previously submitted outline of oral comments in order to speak on this document at the hearing. If necessary, a separate additional hearing may be held on issues addressed in this document. If a public hearing is held, notice of the time and place will be published in the Federal Register.

Comments on Previously Proposed Regulations

Although the preamble to the regulations proposed on May 14, 1990, requested that comments be submitted by July 13, 1990, the Treasury and the Service welcome additional comments. Individuals who have previously submitted comments are specifically encouraged to submit additional comments on the modifications contained in this document or to modify the comments they have already submitted. Comments submitted on these regulations, or on the regulations proposed on May 14, 1990, will be considered if they are received by November 13, 1990. The Treasury and the Service will also attempt to consider comments submitted after that date.

List of Subjects

26 CFR 1.401-0 through 1.425-1

Employee benefit plans, Employee stock ownership plans, Income taxes, Individual retirement accounts, Pensions, Stock options.

Proposed Amendments to the Regulations

The notices of proposed rulemaking (to amend 26 CFR Part 1) that were published on May 18, 1989 (54 FR 21437), and May 14, 1990 (55 FR 19897 and 55 FR 19947), are amended as follows:

INCOME TAX REGULATIONS
(26 CFR Part 1)

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

Authority: 26 U.S.C. 7805.*** §§1.401(a)(4)-2, 1.401(a)(4)-3, and 1.401(a)(4)-9 also issued under 26 U.S.C. 401(a)(4), §1.401(l)-3 also issued under 26 U.S.C. 401(l) and §§1.410(b)-5 and 1.410(b)-7 also issued under 26 U.S.C. 410(b).

Par. 2. Section 1.401(a)(4)-2 as proposed on May 14, 1990 (55 FR 19911), is amended as follows:

1. Paragraphs (b)(2), (b)(3)(i), and (b)(3)(ii) are revised to read as set forth below.

2. Paragraph (b)(4) is added as set forth below.

3. Paragraphs (c)(2), (c)(5), (e)(1), and (f) are revised to read as set forth below.

§1.401(a)(4)-2 Nondiscrimination in amount of contributions.

* * * * *

(b) *Safe harbors for defined contribution plans****

(2) *Safe harbor for defined contribution plans with a uniform allocation formula.* A defined contribution plan satisfies this safe harbor if the plan allocates all amounts taken into account under paragraph (c)(2) of this section for the plan year under a single uniform formula that allocates the same percentage of compensation or the same dollar amount to every employee under the plan.

(3) *Safe harbor for defined contribution plans with a uniform allocation formula weighted for age or service.****

(i) The plan allocates all amounts taken into account under paragraph (c)(2) of this section for the plan year under a single uniform formula weighted for age or service. A single uniform formula weighted for age or service is one that would allocate to each employee in the plan the same percentage of compensation or the same dollar amount, if every employee in the plan had the same age and the same number of years of service or plan participation. Solely for purposes of this paragraph (b)(3)(i), a formula is deemed to allocate the

same percentage of compensation to each employee in the plan if the formula determines allocations under a weighing system that takes into account compensation in uniform increments no greater than $200 and that assigns the same weight to every increment. Thus, the dollar amount of allocations under a single uniform formula weighted for age or service may vary solely on account of compensation, age, years of service, or years of plan participation. The factors used to produce these variations must apply uniformly to all employees in the plan and must meet the effective availability requirement of §1.401(a)(4)-4.

(ii) The average of the allocation rates for highly compensated employees in the plan does not exceed the average of the allocation rates for nonhighly compensated employees in the plan. For this purpose, allocation rates are determined in accordance with paragraph (c) of this section, without taking into account the disparity permitted under paragraph (c)(4) of this section and §1.401(a)(4)-7, and without grouping allocation rates under paragraph (c)(5) of this section.

(4) *Use of safe harbors not precluded by certain plan provisions*—(i) *In general.* A plan does not fail to satisfy the requirements of paragraph (b)(2) or (b)(3) of this section merely because the plan contains a provision described in this paragraph (b)(4). Unless otherwise provided, the provision must apply uniformly to all employees in the plan.

(ii) *Section 409(n) limits.* The formula limits allocations to employees in accordance with section 409(n) (or section 1042(b)(3) of the Internal Revenue Code of 1954 as in effect immediately prior to the Tax Reform Act of 1986).

(iii) *Section 415 limits.* The formula limits allocations to employees in accordance with section 415.

(iv) *Certain other limits on allocations.* The formula limits allocations otherwise provided under the formula to a maximum dollar amount or a maximum percentage of compensation, or limits the amount of compensation or the number of years of service or plan participation taken into account in determining the amount of allocations. These limits must apply uniformly to all employees in the plan or, alternatively, to all highly compensated employees in the plan.

(v) *Certain conditions on allocations.* The formula provides that allocations to an employee for the plan year are conditioned on the employee's employment on the last day of the plan year or on the employee's completion of a minimum number of hours of service during the plan year (not to exceed 1,000).

(vi) *Section 401(l) permitted disparity.* The formula takes permitted disparity into account in a manner allowed under section 401(l), provided that every employee in the plan has the same integration level, the same base contribution percentage, and the same excess contribution percentage. For definitions of these terms, see §1.401(l)-1(b)(5), (b)(10), and (b)(11). This paragraph (b)(4)(vi) applies solely for purposes of paragraph (b)(2) of this section.

(vii) *Entry dates.* The plan provides one or more entry dates during the plan year in accordance with section 410(a)(4).

(viii) *Dollar allocation per hour of service.* Rather than determining allocations based on the same percentage of compensation or the same dollar amount, the formula determines allocations based on the same dollar amount per hour of service performed by each employee under the plan during the plan year.

(c) *General test for nondiscrimination in amount of contributions provided****

(2) *Allocations taken into account.* The amounts taken into account in determining allocation rates include all employer contributions and forfeitures that are treated as allocated to the account of an employee for the plan year, other than amounts listed in paragraph (c)(3) of this section. In the case of a defined contribution plan subject to section 412, the amount of employer contributions taken into account is the amount of employer contributions required to be allocated under the plan to the employee's account for the plan year, even if all or part of the required contribution is not actually made. For purposes of this paragraph (c)(3), amounts that would be treated as allocated to the account of an employee for the plan year but for the limits of section 409(n) (or section 1042(b)(3) of the Internal Revenue Code of 1954 as in effect immediately prior to the Tax Reform Act of 1986) are treated as allocated to the account of the employee.

* * * * *

(5) *Grouping of allocation rates.* An employer may treat all employees who have allocation rates within a range of no more than 5 percent (not 5 percentage points) above or below a midpoint rate chosen by the employer as having an allocation rate equal to that midpoint rate. If allocation rates are determined as a percentage of compensation, an employer may, as an alternative, treat all employees who have allocation rates within a range of no more than one-quarter of a percentage point above or below a midpoint rate chosen by the employer as having an allocation rate equal to that midpoint rate. Allocation rates within a given range may be grouped under this paragraph (c)(5) only if the allocation rates of highly and nonhighly compensated employees are dispersed throughout the range in a reasonably comparable manner and the range does not overlap with any other range chosen by the employer. An employer may choose to group the allocation rates of some employees into ranges and not to group the allocation rates of other employees into ranges, provided that the allocation rates of all employees within each range chosen by the employer are grouped within that range. If allocation rates are determined as a percentage of compensation, an employer may apply either grouping method described in this paragraph (c)(5) and, in addition, may apply one method with respect to one group of employees and the other method with respect to another group of employees, provided that only one method is applied with respect to any given employee or group of employees.

* * * * *

(e) *Alternative methods for satisfying this section*—(1) *In general.* A plan that is not subject to section 401(k) or (m) and that does not satisfy any of the tests in paragraph (b) or (c) of this section satisfies the requirements of this section if it does so using one or more of the alternative testing methods set forth in paragraphs (e)(2) through (4) of this section.

* * * * *

(f) *Period for determining compensation with respect to a plan year*—(1) *In general.* For purposes of this section, compensation for a plan year is determined by measuring compensation during any one of the periods described in paragraph (f)(2) through (4) of this section. Whichever period is selected must be applied uniformly to determine the compensation of every employee in the plan.

(2) *Plan year.* This period consists of the plan year.

(3) *Calendar year ending in plan year.* This period consists of the calendar year ending within the plan year.

(4) *Period of plan participation during the plan year.* This period consists of the portion of the plan year during which the employee is a participant in the plan. This rule may be used to determine compensation for the plan year in which participation begins, the plan year in which participation ends, or both. Selection of this period must be made on a reasonably consistent basis from plan year to plan year in a manner that does not discriminate in favor of highly compensated employees. Discrimination might arise, for example, where this period is selected in all plan years except a plan year in which a highly compensated employee enters the plan at midyear.

Par. 3. Section 1.401(a)(4)-3 as proposed on May 14, 1990 (55 FR 19912), is amended as follows:

1. Paragraphs (b)(2)(ii)(B), (b)(2)(iv), (b)(2)(v) Examples 3, 4, and 5, and (b)(3)(ii)(A) are revised to read as set forth below.

2. Paragraph (b)(3)(iii) is removed and paragraph (b)(3)(iv) is redesignated as (b)(3)(iii).

3. The last sentence of (b)(4) is revised to read as set forth below.

4. A new paragraph (b)(5) is added as set forth below.

5. Paragraphs (c)(3)(ii) and (c)(3)(v) are revised to read as set forth below.

6. A new paragraph (c)(3)(vii) is added as set forth below.

7. Paragraphs (e)(1), (f)(2)(i)(A), (f)(2)(ii) Introductory text, and (f)(7) are revised and in paragraph (f)(2)(ii) the current example is designated Example 1 and new Example 2 is added to read as set forth below.

§1.401(a)(4)-3 Nondiscrimination in amount of benefits.

* * * * *

(b) *Safe harbors for defined benefit plans with uniform formulas* * * *

(2) *Safe harbor for unit credit plans* ***

(ii) *Uniform unit credit formula* ***

(B) The benefit formula provides that the same dollar amount or the same percentage of compensation will be accrued for the current and subsequent plan years by all employees in the plan who have the same number of years of service credited under the plan for purposes of benefit accruals. In making this determination, the effect of the limits under section 415 is disregarded.

* * * * *

(iv) *Unit credit formula using fractional rule accrual.* A unit credit plan that provides that benefits are accrued under the fractional accrual rule of section 411(b)(1)(C) satisfies the requirements of this paragraph (b)(2) only if under the formula no employee in the plan can accrue, in any one year, more than 133⅓ percent of the benefit (expressed as a percentage of compensation or a dollar amount) that any other employee in the plan can accrue, disregarding employees with projected service in excess of 33 years. (Of course, employees with projected service in excess of 33 years are still taken into account for all other purposes, including the determination of whether all employees in the plan are subject to the same benefit formula.) Such a plan need not satisfy section 411(b)(1)(B) or paragraph (b)(2)(ii)(B) of this section. For purposes of the rule in this paragraph (b)(2)(iv), if a plan provides a disparity that by its terms satisfies section 401(l), an employee can be treated as accruing benefits either at the excess benefit percentage rate in the case of an excess plan or at the rate prior to reduction by the offset in the case of an offset plan. Section 1.401(l)-1(b) defines "excess plan," "offset plan," and "excess benefit percentage."

(v) *Examples.****

Example 3. Plan C provides for a benefit equal to 1.6 percent of compensation times each year of service up to 25. Plan C further provides that an employee's accrued benefit as of a given year equals the benefit projected as of normal retirement age multiplied by the ratio of the employee's years of service as of the year to the employee's projected years of service as of normal retirement age (i.e., the plan benefits accrue under the fractional rule of section 411(b)(1)(C)). The greatest benefit that an employee can earn in any one year is 1.6 percent of compensation (this is the case for any employee in the plan who will have 25 or fewer years of projected service at normal retirement age). The lowest benefit that will accrue for an employee in the plan with no more than 33 projected years of service is 1.212 percent (this is the case for any employee in the plan with 33 years of projected service under the formula). Since 1.6 percent is not more than 133⅓ percent of 1.212 percent, Plan C satisfies the rule in paragraph (b)(2)(iv) of this section.

Example 4. Plan D satisfies section 401(l) and provides for a benefit equal to 1.0 percent of compensation up to the integration level, and 1.6 percent of compensation over the integration level, times each year of service up to 35. Plan D further provides that an employee's accrued benefit as of a given year equals the benefit projected as of normal retirement age multiplied by the ratio of the employee's years of service as of the year to the employee's projected years of service as of normal retirement age (i.e., the plan benefits accrue under the fractional rule of section 411(b)(1)(C)). For purposes of satisfying the 133⅓ percent rule in paragraph (b)(2)(iv) of this section, all employees in the plan can be assumed to accrue benefits at the excess rate of 1.6 percent. Thus, the greatest benefit that an employee can earn in any one year is 1.6 percent of pay (this is the case for any employee in the plan who will have 35 or fewer years of projected service at normal retirement age). The lowest benefit that will accrue for an employee under the plan with no more than 33 projected years of service is 1.6 percent (this is the case of an employee in the plan with 33 years of projected service under the formula). Since 1.6 percent is not more than 133⅓ percent of 1.6 percent, Plan D satisfies the rule in paragraph (b)(2)(iv) of this section.

Example 5. Plan E provides for a benefit equal to 4 percent of compensation times each year of service up to 10 and 1 percent of compensation times each year of service in excess of 10 and not in excess of 30. Plan E further provides that an employee's accrued benefit as of a given year equals the benefit projected as of normal retirement age multiplied by the ratio of the employee's years of service as of the year to the employee's projected years of service as of normal retirement age (i.e., the plan benefits accrue under the fractional rule of section 411(b)(1)(C)). The greatest benefit that an employee can earn in any one year is 4 percent of compensation (this is the case for any employee who will have 10 or fewer years of projected service at normal retirement age). The lowest benefit that will accrue for an employee with no more than 33 projected years of service is 1.82 percent (this is the case of an employee with 33 years of projected service under the formula). Since 4 percent is more than 133⅓ percent of 1.82 percent, Plan E fails to satisfy the rule in paragraph (b)(2)(iv) of this section.

(3) *Safe harbor for flat benefit plans****

(ii) *Uniform flat benefit formula.* ***

(A) All employees in the plan are

subject to the same benefit formula providing the same flat benefit.

* * * * *

(4) *Alternative safe harbor for flat benefit plans.* * * * For purposes of this paragraph (b)(4), the normal accrual rate is determined in the same manner as under paragraph (c)(3)(ii) of this section, except that accrual rates may not be grouped under paragraph (c)(3)(v) of this section.

(5) *Use of safe harbors not precluded by certain plan provisions*—(i) *In general.* A plan does not fail to satisfy the requirements of paragraph (b)(2), (b)(3), or (b)(4) of this section merely because the plan contains a provision described in this paragraph (b)(5). Unless otherwise provided, the provision must apply uniformly to all employees in the plan.

(ii) *Pre-effective date accrued benefits.* The plan provides for benefits that were accrued in plan years beginning before the effective date applicable to the plan under §1.401(a)(4)-13(a) or (b) and that were accrued under a formula that does not satisfy any of the safe harbors in this paragraph (b). This paragraph (b)(5)(ii) applies solely to plans that satisfy the transitional rules of §1.401(a)(4)-13(c).

(iii) *Section 415 limits.* The formula limits accruals in accordance with section 415 or provides for increases in accrued benefits based solely on adjustments under section 415(d)(1) in the maximum benefit permitted under section 415(b)(1).

(iv) *Certain other limits on accruals.* The formula limits accruals to a maximum dollar amount or a maximum percentage of compensation, or limits the amount of compensation or the number of years of service or plan participation taken into account in determining the amount of accruals. The formula must apply these limits uniformly to all employees in the plan or, alternatively, all highly compensated employees in the plan.

(v) *Certain conditions on accruals.* The formula provides that accruals by an employee for the plan year are less than a full accrual (including a zero accrual) because of a plan provision permitted by section 411(b)(4) for employees who do not complete a full year of service.

(vi) *Section 401(l) permitted disparity.* The formula takes permitted disparity into account in a manner allowed under section 401(l).

(vii) *Entry dates.* The plan provides one or more entry dates during the plan year in accordance with section 410(a)(4).

(viii) *Dollar accrual per hour of service.* Rather than accruing the same percentage of compensation or the same dollar amount, each employee with the same number of years of service accrues the same dollar amount per hour of service performed by the employee during the plan year. This rule applies solely for purposes of paragraph (b)(2) of this section and solely with respect to a plan that satisfies the accrual rule of section 411(b)(1)(B) (the 133⅓ percent rule).

(c) *General test for nondiscrimination in amount of benefits provided* ***

* * * * *

(3) *Determining accrual rates****

(ii) *Annual accrual method*—(A) *In general.* Under the annual accrual method of determining the normal and most valuable accrual rates, the accrual rate for an employee in the plan for a plan year is the percentage amount (not less than zero) determined by subtracting:

(*1*) The employee's relevant benefit (i.e., normal retirement benefit or most valuable annuity) accrued as of the close of the prior plan year, expressed as a percentage of the employee's compensation as of the close of that prior year, from

(*2*) The employee's relevant benefit accrued as of the close of the plan year, expressed as a percentage of the employee's compensation as of the close of that year.

(B) *Requirements for plans with pre-effective date accrued benefits.* If a plan provides benefits that were accrued in plan years beginning before the effective date applicable to the plan under §1.401(a)(4)-13(a) and (b) and that were accrued under a formula that differs from the formula used to determine benefit accruals in the current plan year, the plan can determine an employee's accrual rate under paragraph (c)(3)(ii)(A) of this section only if the plan satisfies the transitional rules of §1.401(a)(4)-13(c). A plan described in the preceding sentence that does not satisfy those transitional rules can only determine the normal and most valuable annual accrual rate for an employee in the plan for the plan year as the percentage amount (not less than zero) determined by:

(*1*) Subtracting the employee's relevant benefit accrued as of the close of the prior plan year from the employee's relevant benefit accrued as of the close of the plan year, and

(*2*) Dividing this difference by the employee's compensation for the plan year.

(C) *Effect of past service credit.* In calculating the relevant accrued benefit as of the close of the plan year, amounts attributable to a past service credit described in §1.401(a)(4)-5(b)(1) are not taken into account. Of course, the past service credit must satisfy the requirements of §1.401(a)(4)-5.

* * * * *

(v) *Grouping of accrual rates.* An employer may treat all employees who have accrual rates within a range of no more than 5 percent (not 5 percentage points) above or below a midpoint rate chosen by the employer as having an accrual rate equal to that midpoint rate. If accrual rates are determined as a percentage of compensation, an employer may, as an alternative, treat all employees who have accrual rates within a range of no more than one-twentieth of a percentage point above or below a midpoint rate chosen by the employer as having an accrual rate equal to that midpoint rate. Accrual rates within a given range may be grouped under this paragraph (c)(3)(v) only if the accrual rates of highly and nonhighly compensated employees are dispersed throughout the range in a reasonably comparable manner and the range does not overlap with any other range chosen by the employer. An employer may choose to group the accrual rates of some employees into ranges and not to group the accrual rates of other employees into ranges, provided that the accrual rates of all employees within each range chosen by the employer are grouped within that range. If accrual rates are determined as a percentage of compensation, an employer may use either grouping method described in this paragraph (c)(3)(v) and, in addition, may use one method with respect to one group of employees and the other method with respect to another group of employees, provided

that only one method is used with respect to any given employee or group of employees.

* * * * *

(vii) *Floor on most valuable accrual rate.* The most valuable accrual rate of an employee calculated under the three methods in this paragraph (c)(3) may, at the option of the employer, be calculated for all employees under the plan using the rule described in this paragraph (c)(3)(vii). An employee's most valuable accrual rate for any year is not less than the highest most valuable accrual rate for that employee in any prior year, provided that the decrease in the employee's most valuable accrual rate in years subsequent to that prior year results merely from an increase in the employee's age. This paragraph (c)(3)(vii) is illustrated by the following example:

Example. Plan X provides normal retirement benefits of 1 percent per year of service at age 65 and unreduced retirement benefits for employees who attain age 55 with 30 years of service. The plan determines accrual rates under the accrued to date method. Employee A was hired at age 25, and Employee B was hired at age 26. Employee A's and Employee B's most valuable accrual rate would therefore be determined at ages 55 and 56, respectively. Under the rule in this paragraph (c)(3)(vii), Plan X may treat Employee A's most valuable accrual rate determined in the year when A is age 55 as A's most valuable accrual rate in subsequent years. Similarly, Employee B's most valuable accrual rate determined when B is age 56 may be used in subsequent years.

* * * * *

(e) *Alternative methods for satisfying this section*—(1) *In general.* A plan that does not satisfy any of the tests in paragraph (b) or (c) of this section satisfies the requirements of this section if it does so using one or more of the alternative testing methods set forth in paragraphs (e)(2) through (5) of this section.

* * * * *

(f) *Special rules****

(2) *Compensation formulas*—(i) *Special rule.* In general, a compensation formula satisfies the requirements of this paragraph (f)(2) if:

(A) The formula bases benefits on compensation for a period of at least 3 consecutive years or 3 consecutive 12-month periods (or the employee's period of employment, if shorter), or the formula determines an employee's benefit based on each year of service separately, using compensation separately calculated for each year, and sums the benefit for all years to determine the total retirement benefit.

* * * * *

(ii) *Examples.* The special rule of this paragraph (f)(2) is illustrated by the following examples:

*Example 1.****

Example 2. Plan B is a career average pay plan that bases an employee's benefit for each plan year on compensation earned within that plan year. Thus, an employee's total accrued benefit under the plan is equal to the sum of the benefits accrued in each individual plan year that the employee is a participant in the plan. Because the employee's total accrued benefit under the plan equals the sum of benefits computed separately for each plan year based on compensation for that year, the plan satisfies the requirements of paragraph (f)(2) of this section.

* * * * *

(7) *Computation of compensation on other than plan year basis*—(i) *In general.* For purposes of this section, compensation is generally determined based on the plan year, except as otherwise provided in paragraph (f)(7)(ii) of this section. Nevertheless, an employer may, but need not, determine compensation on the basis of any consecutive period ending within the plan year as long as it is at least 12 months in duration and is used uniformly for all employees in the plan for that plan year. Any 12 month period permitted under the rules of this paragraph (f)(7) can be used for purposes of satisfying the requirements of paragraph (f)(2) of this section provided the formula bases benefits on a total period of compensation that satisfies the duration requirements of paragraph (f)(2) of this section.

(ii) *Special rule for highest average pay plans.* A definition of compensation will satisfy the requirements of paragraphs (f)(2)(i)(A) and (f)(7) of this section if it provides that the accruals for all employees are based on an employee's highest compensation determined over a specified period (e.g., a final average pay plan that bases benefits for an employee on the average of the employee's highest 3 consecutive years' compensation), even though the period of highest compensation does not end within the plan year. This rule may be used only if the highest paid period includes at least 36 consecutive months (or the employee's period of employment, if shorter) and, in determining an employee's highest years of compensation, the 12-month period ending within the plan year is taken into account. The rules in this paragraph (f)(7)(ii) are illustrated by the following example:

Example. Plan M is a final average pay plan that bases benefits for all employees on the average of each employee's high 3 consecutive calendar years' compensation. The plan year is a fiscal year from July 1 to June 30. In determining an employee's high 3 years, the plan takes into account compensation earned in all calendar years including the calendar year ending within the plan year. Employee A, who was hired on January 1, 1990, has compensation for calendar years 1990 through 1994 of $100,000, $130,000, $100,000, $90,000 and $90,000, respectively. Therefore, for the plan year beginning July 1, 1994, Employee A's high 3-year average is the average of the compensation earned in 1990, 1991 and 1992 ($110,000). The definition of compensation satisfies the requirements of paragraph (f)(7)(i) of this section because, even though Employee A's benefit accrual is based on compensation for a period not ending within the plan year, the plan formula took into account compensation ending within the plan year in determining A's 3 highest years of compensation.

Par. 4. §1.401(a)(4)-9, as proposed on May 14, 1990 (55 FR 19926) is amended as follows:

1. Paragraphs (d)(2)(i)(B) and (d)(2)(i)(C) are revised to read as set forth below.

2. Paragraphs (d)(2)(ii) through (d)(2)(v) are redesignated as paragraph (d)(2)(iii) through (d)(2)(vi).

3. A new paragraph (d)(2)(ii) is added to read as set forth below.

4. Redesignated paragraphs (d)(2)(iii), (d)(2)(iv) and (d)(2)(v) are revised to read as set forth below.

5. Paragraph (d)(3) is revised to read as set forth below.

§1.401(a)(4)-9 Definition of a plan, plan aggregation, and restructuring.

* * * * *

(d) *Plan restructuring****

(2) *Identification of component plans*—(i) *Permissible bases for restructuring****

* * * * *

(B) *Total rates.* A plan or aggregated plan (other than a plan subject to section 401(k) or (m)) may be restructured into component plans, each consisting of normal accrual or allocation rates equal to a different specified rate (or within a different specified range), and all benefits, rights, and features provided under the plan or aggregated plan to employees having normal accrual or allocation rates equal to the specified rate (or within the specified range). Alternatively, a plan or aggregated plan (other than a

plan subject to section 401(k) or (m)) may be restructured into component plans, each consisting of most valuable accrual or allocation rates equal to a different specified rate (or within a different specified range) and all normal retirement benefits and other benefits, rights and features provided under the plan or aggregated plan to employees having most valuable accrual or allocation rates equal to the specified rate (or within the specified range). An employee can be included in only one such component plan. Further, a component plan consisting of rates equal to a specified rate (or within a specified range) must include all the rates equal to the specified rate (or all rates within the specified range) under the plan or aggregated plan. Thus, for example, a plan benefiting employees A and B, both of whom have 1 percent normal accrual rates, cannot be restructured under this method into one component plan containing A's 1 percent rate and another containing B's 1 percent rate.

(C) *Rate segments.* A plan or aggregated plan (other than a plan subject to section 401(k) or (m)) may be restructured into component plans, each consisting of a different incremental segment of employees' normal accrual or allocation rates, the associated most valuable accrual or allocation rates, and all associated benefits, rights, and features. Alternatively, a plan or aggregated plan may be restructured into component plans, each consisting of a different incremental segment of employees' most valuable accrual or allocation rates, the associated normal accrual or allocation rates, and all associated benefits, rights and features. An employee can be included in more than one such component plan, but only with respect to different incremental segments of the employee's total rate under the plan or aggregated plan. Incremental segments are not permitted to overlap, and a component plan consisting of a specified incremental segment of employees' accrual or allocation rates must include this segment of all employees' rates. Thus, for example, a plan under which employees A, B, and C have normal accrual rates of 1, 1, and 2 percent, respectively, may not be restructured under this method into one component plan containing A's 1 percent rate and the first 1 percent of C's rate, and another competent plan containing B's 1 percent rate and the remaining 1 percent of C's rate.

* * * * *

(ii) *Sequential restructuring.* A component plan identified under one of the methods in paragraph (d)(2)(i) of this section may be further restructured into smaller component plans, to the same extent as a plan or aggregated plan, using the same method. In addition, one or more component plans created using the employee group method (other than a plan subject to section 401(k) or (m)) may be further restructured using the total rate or rate segment methods. If component plans are restructured in this manner, the requirements of section 401(a)(4) are applied, pursuant to paragraph (d)(1) of this section, to the smallest resulting component plans rather than to any intermediate component plans.

(iii) *Consistency rules.* A portion of a plan that is treated as part of one component plan for a plan year may not be treated as part of another component plan for the same plan year. For purposes of this paragraph (d)(2)(iii), only the ultimate component plans into which a plan or aggregated plan is restructured are taken into account. Thus, intermediate component plans that are further restructured into smaller component plans pursuant to paragraph (d)(2)(ii) are ignored.

(iv) *Application of grouping rules.* If the grouping rules in §1.401(a)(4)-2(c)(5) or 1.401(a)(4)-3(c)(3)(v) are used in combination with the employee group method in paragraph (d)(2)(i)(A) of this section, the grouping rules can be applied only after restructuring. If the grouping rules are used in combination with the total rate or rate segment method in paragraph (d)(2)(i)(B) or (C) of this section, the grouping rules can be applied only before restructuring. In no event may the grouping rules be applied more than once to any portion of a plan or aggregated plan restructured under this paragraph (d).

(v) *Application of uniformity requirement for definitions of compensation.* The uniformity requirement applicable to the definition of compensation under §1.401(a)(4)-12(a) and to a compensation formula under §§1.401(a)(4)-2(f), 1.401(a)(4)-3(f)(2)-(i)(B), and 1.401(a)(4)-3(f)(7) is applied only after restructuring in the case of a plan or aggregated plan that uses the employee group method of paragraph (d)(2)(i)(A) of this section, and only before restructuring in the case of a plan or aggregated plan that uses the total rate or rate segment method of paragraph (d)(2)(i)(B) or (C) of this section. The same rule applies for purposes of the consistency rule of §1.414(s)-1T(b).

* * * * *

(3) *Satisfaction of section 401(a)(4) by a component plan.* The rules applicable in determining whether a component plan satisfies section 401(a)(4) are the same as those applicable to a plan or aggregated plan, except as provided in paragraph (d)(2) of this section. Thus, for example, in the case of a defined benefit plan, the normal and most valuable benefits tested under §1.401(a)(4)-3 must generally be separately identified with respect to each component plan. However, if a defined benefit plan has a uniform formula, as described in §1.401(a)(4)-3(c)(1)(ii), only the most valuable benefits tested under §1.401(a)(4)-3(c)(1)(ii) need be separately identified with respect to each component plan. Similarly, a component plan that consists of a uniform formula under a defined benefit plan that satisfies one of the safe harbors in §1.401(a)(4)-3(b) may be tested under the safe harbor, even if the other component plans are tested under the general test of §1.401(a)(4)-3(c). Further, if a component plan includes portions of two plans, the special rules for aggregated plans in paragraph (c) of this section must be satisfied.

* * * * *

Par. 5. Section 1.401(a)(4)-13, as proposed on May 14, 1990 (55 FR 19930), is amended by adding new paragraph (c) to read as follows:

§1.401(a)(4)-13 Effective dates.

* * * * *

(c) *Transitional rules for certain defined benefit plans—(1) In general.* For purposes of the defined benefit safe harbors and the annual accrual method referred to in §1.401(a)(4)-3(b)(5)(ii) and (c)(3)(ii)(B), respectively, a defined benefit plan satisfies the transitional rules of this paragraph (c) if it satisfies either paragraph (c)(2),

(c)(3), or (c)(4) of this section with respect to the treatment of pre-effective date accrued benefits. Certain definitions applicable for purposes of this paragraph (c) are provided in paragraph (c)(6) of this section.

(2) *Section 401(l) plans.* A defined benefit plan satisfies this paragraph (c)(2) if the plan satisfies section 401(l), including the effective date and transition rules of §1.401(l)-3(l). In addition, if the plan is adjusting accrued benefits under §1.401(l)-3(l)-(7), then the plan must provide meaningful coverage as of the close of the freeze year and meaningful benefit accruals in the current plan year.

(3) *Non-section 401(l) plans that freeze all pre-effective date accrued benefits.* A defined benefit plan not satisfying section 401(l) satisfies this paragraph (c)(3) if the plan freezes all pre-effective date accrued benefits in accordance with one of the formulas set forth in paragraph (c)(5) of this section.

(4) *Non-section 401(l) plans that provide current accruals with respect to pre-effective date accrued benefits.* A defined benefit plan not satisfying section 401(l) satisfies this paragraph (c)(4) if:

(i) The plan provides meaningful coverage as of the close of the freeze year;

(ii) The plan provides meaningful benefit accruals in the current plan year;

(iii) The plan provides current accruals with respect to pre-effective date accrued benefits solely in accordance with one of the formulas set forth in paragraph (c)(5) of this section;

(iv) As of May 9, 1990 (or an earlier date selected by the employer but not before December 13, 1988), and without regard to any amendments to the plan adopted after that date, the plan contained a benefit formula under which increases in an employee's pre-effective date accrued benefits would have been determined by reference to the employee's compensation in plan years beginning after the close of the freeze year;

(v) For purposes of §1.401(a)(4)-3(b), if applicable, the formula used to determine benefit accruals in the current plan year does not take into account the disparity permitted under section 401(l); and

(vi) For purposes of determining accrual rates under §1.401(a)(4)-3(c)-(3)(ii), if applicable, the plan does not take into account the disparity permitted under §1.401(a)(4)-7 unless the plan makes the minimum benefit adjustment set forth in paragraph (c)(6)(ii) of this section.

(5) *Formulas for plans that do not satisfy section 401(l)*—(i) *In general.* For purposes of paragraph (c)(3) and (c)(4) of this section, an employee's accrued benefit under the plan must be determined as of the first plan year beginning after the freeze year under one of the formulas set forth in paragraph (c)(5)(ii), (iii), or (iv) of this section. The same formula must be adopted in accordance with paragraph (c)(3) or (c)(4) of this sec-tion and must be applied with respect to all employees who have pre-effective date accrued benefits under the plan and who have at least one hour of service with the employer in a plan year beginning after the freeze year. For this purpose, two or more plans are treated as a single plan if they are aggregated and treated as a single plan for purposes of sections 401(a)(4) and 410(b). Solely for purposes of paragraph (c)(4) of this section, these formulas are applied by substituting the employee's "adjusted accrued benefit" for the employee's "frozen accrued benefit."

(ii) *Formula without wear-away.* An employee's accrued benefit under the plan is equal to the sum of:

(A) The employee's frozen accrued benefit, and

(B) The employee's accrued benefit determined under the formula applicable to benefit accruals in the current plan year as applied to years of credited service after the freeze year.

(iii) *Formula with wear-away.* An employee's accrued benefit under the plan is equal to the greater of:

(A) The employee's frozen accrued benefit, or

(B) The employee's accrued benefit determined under the formula applicable to benefit accruals in the current plan year as applied to the employee's total years of credited service for the employer.

(iv) *Formula with extended wear-away.* An employee's accrued benefit under the plan is equal to the greater of:

(A) The sum determined under paragraph (c)(5)(ii) of this section, or

(B) The employee's accrued benefit determined under the formula applicable to benefit accruals in the current plan year as applied to the employee's total years of credited service for the employer.

(6) *Definitions*—(i) *In general.* In addition to the definitions set forth in §1.401(a)(4)-12, the following definitions apply for purposes of this paragraph (c) and §1.401(a)(4)-3(b)(5)(ii) and (c)(3)(ii)(B).

(ii) *Adjusted accrued benefit*—(A) *General rule.* The term "adjusted accrued benefit" means an employee's frozen accrued benefit multiplied by a fraction (not less than 1) determined under one of the following methods that is the same for every employee in the plan:

(*1*) The numerator is the employee's compensation for the current plan year determined under the compensation definition used to determine the frozen accrued benefit (subject to section 401(a)(17)), and the denominator is the employee's compensation for the freeze year determined under the same compensation definition used for the numerator;

(*2*) The numerator is the employee's compensation for the current plan year determined under a compensation definition that satisfies §1.401(a)(4)-3(f)(2), and the denominator is the employee's compensation for the freeze year determined under the same compensation definition used for the numerator; or

(*3*) The numerator is the employee's compensation for the current plan year determined under a compensation definition that satisfies §1.401(a)(4)-3(f)(2), and the denominator is the employee's reconstructed compensation for the freeze year.

If a plan makes a minimum benefit adjustment for purposes of paragraph (c)(4)(vi) of this section, an employee's frozen accrued benefit is first adjusted in the same manner as provided in §1.401(l)-3(l)(7)(ii)(C) and then multiplied by the fraction determined under one of the preceding methods.

(B) *Permissible compensation definitions.* Any compensation definition used for purposes of this paragraph (c)(6)(ii) must be the same for every employee with pre-effective date ac-

crued benefits under the plan. The definition may, but need not, be the same as the compensation definition used in the current plan year for other purposes under section 401(a)(4).

(C) *Option to make less than the full permitted adjustment.* In lieu of the adjustment described in the first sentence of paragraph (c)(6)(ii)(A) of this section (and, if applicable, after the minimum benefit adjustment described in the last sentence of that paragraph has been made), the frozen accrued benefit of every employee in the plan may be increased by adding to the frozen accrued benefit the product determined by multiplying the frozen accrued benefit by the product of two percentages. The first percentage is the single percentage designated in the plan for this purpose (not to exceed 100 percent). The second percentage is determined by finding the difference between the numerator and the denominator of the fraction determined for the employee under one of the methods described in the first sentence of paragraph (c)(6)(ii)(A) of this section and then by dividing that difference by the denominator of the employee's fraction. In addition, a plan may impose a uniform maximum dollar amount on the adjusted accrued benefit of every employee in the plan. Furthermore, the plan can, at any time, terminate all future adjustments permitted under this paragraph (c)(6)(ii).

(iii) *Benefit accruals in the current plan year.* The term "benefit accruals in the current plan year" means benefit accruals in the current plan year other than increases in pre-effective date accrued benefits.

(iv) *Freeze year.* The term "freeze year" means the last plan year in which pre-effective date accrued benefits were accrued under the plan. Notwithstanding the preceding sentence, for purposes of paragraph (c)(2) of this section, the term "freeze year" means the last plan year beginning before January 1, 1989 (or, in the case of a collectively bargained plan, the applicable effective date under section 401(l)).

(v) *Frozen accrued benefit.* The term "frozen accrued benefit" means an employee's accrued benefit under the plan determined as of the close of the freeze year, as if the employee terminated employment with the employer on that date, and without regard to any amendment to the plan adopted after May 9, 1990 (or an earlier date selected by the employer but not before December 13, 1988). For this purpose, service for the employer after the date on which the employee is deemed to have terminated employment is nonetheless still taken into account for purposes of vesting and determining eligibility for benefits (including any optional form of benefit) with respect to the frozen accrued benefit. In addition, the plan may provide for increases in the frozen accrued benefit of every employee in the plan based solely on the adjustments under section 415(d)(1) in the maximum benefit permitted under section 415(b)(1). Notwithstanding the preceding three sentences, for purposes of paragraph (c)(2) of this section, the term "frozen accrued benefit" means the frozen accrued benefit as defined in §1.401(l)-3(l)(7)(ii)(B).

(vi) *Meaningful benefit accruals in the current plan year.* The term "meaningful benefit accruals in the current plan year" means benefit accruals in the current plan year that are meaningful in comparison to the rate at which pre-effective date accrued benefits accrued in the freeze year and preceding plan years.

(vii) *Meaningful coverage as of the close of the freeze year.* A plan provides meaningful coverage as of the close of the freeze year if the group of employees with frozen accrued benefits under the plan as of the close of the freeze year satisfies the minimum coverage requirements of section 410(b) as in effect on that date (including the average benefit percentage test, if applicable). In order to satisfy the requirement in the preceding sentence, an employer can amend the plan to grant past service credit under the formula in effect as of the close of the freeze year to nonhighly compensated employees, provided that the amount of past service granted them is reasonably comparable, on average, to the amount of past service highly compensated employees have under the plan. An amendment described in the preceding sentence is not considered as adopted after May 9, 1990 (or the earlier date selected by the employer), for purposes of paragraph (c)(4)(iv) or (c)(6)(v) of this section. Benefits granted nonhighly compensated employees under the amendment are also treated as pre-effective date accrued benefits for purposes of paragraph (c)(6)(viii) of this section.

(viii) *Pre-effective date accrued benefits.* The term "pre-effective date accrued benefits" means benefits that were accrued in plan years beginning before the effective date applicable to the plan under paragraph (a) or (b) of this section and that were accrued under a formula that is different from the formula used to determine benefit accruals in the current plan year.

(ix) *Reconstructed compensation for the freeze year.* The term "reconstructed compensation for the freeze year" means an employee's compensation for the freeze year determined under the following method in the same manner for every employee in the plan: First, select a single plan year beginning after the close of the freeze year but beginning not later than December 31, 1991; second, determine the employee's compensation for the selected plan year under the same compensation definition used to determine the employee's compensation for the current plan year under paragraph (c)(6)(ii)(A)(3) of this section; third, multiply the employee's compensation for the selected plan year by a fraction, the numerator of which is the employee's compensation for the freeze year determined under the same compensation definition used to determine the employee's frozen accrued benefit, and the denominator of which is the employee's compensation for the selected plan year determined under the compensation definition used to determine the employee's frozen accrued benefit.

Par. 6. Section 1.401(l)-3, as proposed on November 15, 1988 (53 FR 45928), and amended on May 14, 1990 (55 FR 19953), is amended by revising paragraphs (l)(7)(i), (l)(7)(ii)-(C), and (l)(7)(ii)(D)(2), and adding new paragraphs (l)(7)(ii)(D)(3) and (l)(8) to read as follows:

§1.401(l)-3 Permitted disparity with respect to employer-derived benefits.

* * * * *

(l) *Effective dates and transitional rules****

(7) *Special rule*—(i) *In general.* A plan that satisfies the requirements of paragraph (l)(7)(iii) of this section will

not fail to satisfy the requirements of paragraph (l)(1) of this section solely because, for purposes of applying paragraphs (l)(2), (3), and (4) of this section, the plan uses the adjusted accrued benefit calculated under paragraph (l)(7)(ii) of this section in lieu of the participant's accrued benefit, determined under the plan as of the close of the last plan year beginning before January 1, 1989, as if the participant terminated employment with the employer.

(ii) *Calculation of adjusted accrued benefit****

(C) *Minimum benefit adjustment*—(1) *Excess or offset plans.* In the case of an excess plan, each employee's frozen accrued benefit is adjusted so that the base benefit percentage is not less than 50 percent of the excess benefit percentage. In the case of an offset plan, each employee's offset applied to determine the frozen accrued benefit is adjusted so that it does not exceed 50 percent of the benefit determined without regard to application of the offset.

(*2*) *Other plans.* In the case of a plan that is neither an excess nor an offset plan, each employee's frozen accrued benefit is adjusted in a manner that is economically equivalent (taking into account the plan's benefit formula, accrual rate, and relevant employee factors, such as period of service) to the adjustment required for excess and offset plans under paragraph (l)(7)(ii)(C)(1) of this section.

(D) *Final pay adjustment****

(*2*) *Alternative adjustment.* In lieu of the adjustment described in paragraph (l)(7)(ii)(D)(*1*) of this section, and after the minimum benefit adjustment described in paragraph (l)(7)(ii)(C) of this section has been made, the frozen accrued benefit of every employee under the plan may be increased in the same manner as provided in §1.401(a)(4)-13(c)(6)(ii)-(A)(2) or (3) for adjusting accrued benefits for plans that do not satisfy section 401(l).

(*3*) *Option to make less than the full permitted adjustments.* In lieu of the adjustment described in paragraph (l)(7)(ii)(D)(1) of this section and after the minimum benefit adjustment described in paragraph (l)(7)(ii)(C) of this section has been made, the frozen accrued benefit of every employee in the plan may be increased by adding to the frozen accrued benefit the product determined by multiplying the frozen accrued benefit by the product of two percentages. The first percentage is the single percentage designated in the plan for this purpose (not to exceed 100 percent). The second percentage is determined by finding the difference between the numerator and the denominator of the fraction determined for the employee under paragraph (l)(7)(ii)(D)(1) and then by dividing that difference by the denominator of the employee's fraction. In addition, a plan may impose a uniform maximum dollar amount on the adjusted accrued benefit of every employee in the plan. Furthermore, the plan can, at any time, terminate all future final pay adjustments permitted under this paragraph (l)(7)(ii)(D).

* * * * *

(8) *Additional rule.* Paragraphs (l)(2), (3), and (7) of this section require the determination of an employee's accrued benefit under the plan as of the close of the last plan year beginning before January 1, 1989, as if the employee terminated employment with the employer on that date (the employee's "frozen accrued benefit" as defined in paragraph (l)(7)(ii)(B) of this section). For this purpose, service with the employer after the date on which the employee is deemed to have terminated employment is nonetheless still taken into account for purposes of vesting and determining eligibility for benefits (including any optional form of benefit) with respect to the accrued benefit so determined. In addition, a plan may provide for increases in those accrued benefits based solely on adjustments under section 415(d)(1) in the maximum benefit permitted under section 415(b)(1).

Par. 7. Section 1.410(b)-5(d), as proposed on May 14, 1990 (55 FR 19931), is amended by revising the second sentence of paragraph (d)(1) to read as follows:

§1.410(b)-5 Average benefit percentage test.

* * * * *

(d) *Calculation of employee benefit percentages*—(1) *In general.**** These rules are generally the same as the rules used for calculating allocation and accrual rates under an aggregated plan under section 401(a)(4), except that plans (or portions of plans) that are ESOPs or that are subject to section 401(k) or (m) are taken into account.***

* * * * *

Par. 8. Section 1.410(b)-7, as proposed on May 18, 1989 (54 FR 21448), is amended by revising paragraphs (c)(2), (d)(1), (d)(2), (e)(1), and (e)(2) to read as follows:

§1.410(b)-7 Definition of plan and rules governing plan disaggregation and aggregation.

* * * * *

(c) *Mandatory disaggregation of certain plans* * * *

(2) *ESOPs and non-ESOPs.* The portion of a plan that is an employee stock ownership plan described in section 4975(e)(7) or section 409 (an ESOP) and the portion of the plan that is not an ESOP are treated as separate plans for purposes of section 410(b) except as otherwise permitteddunder §54.4975-11(e). Notwithstanding §§1.410(b)-10 and 54.4975-11(a)-(5), an employer may treat the rule in this paragraph (c)(2) as not effective for plan years beginning before January 1, 1990.

* * * * *

(d) *Permissive aggregation for ratio percentage and nondiscriminatory classification tests*—(1) *In general.* For purposes of applying the ratio percentage and nondiscriminatory classification tests of §1.410(b)-2, except as provided in paragraphs (d)(2) and (d)(3) of this section, an employer may elect to designate two or more separate plans (determined after application of paragraph (b) of this section) of the employer as a single plan. If an employer elects to treat two or more of its separate plans as a single plan under this paragraph, the plans must be treated as a single plan for all purposes under sections 401(a)(4) and 410(b). See §§1.401(k)-1(b)(5)(i) and 1.401(m)-1(b)(4)(i) for special aggregation rules applicable to plans subject to section 401(k) or (m) and related plans that are treated as part of the same plan for purposes of those sections.

(2) *Rules of disaggregation apply.* An employer cannot elect to aggregate portions of a plan that are disaggregated under the rules of paragraph (c) of this section. Similarly, an employer also cannot elect to aggregate two or more separate plans that would be disaggregated under the

rules of paragraph (c) of this section if they were portions of the same plan. (For purposes of the preceding sentence, the special transitional rule in paragraph (c)(2) of this section does not apply.) In addition, an employer cannot elect to aggregate an ESOP with another plan (including another ESOP) except as permitted under §54.4975-11(e).

* * * * *

(e) *Mandatory aggregation for average benefit percentage test*—(1) *In general.* In determining whether a plan satisfies §1.410(b)-2(b)(3), it is necessary to determine whether the average benefit percentage test of §1.410(b)-5 is satisfied. For purposes of applying the average benefit percentage test, all qualified plans of the employer must be taken into account to form a deemed single plan, including plans (or portions of plans) that are ESOPs or that are subject to section 401(k) or (m).

(2) *Rules of disaggregation.* Once all qualified plans of the employer have been aggregated to form a deemed single plan under paragraph (e)(1) of this section, that deemed single plan must be disaggregated under the rules in paragraphs (c)(1), (c)(5), and (c)(6) of this section and may, at the option of the employer, be disaggregated under the rules of paragraph (c)(4) of this section. Each deemed separate plan that includes a plan (or a portion of a plan) that does not satisfy the ratio percentage test of §1.410(b)-2(b)(2) must separately satisfy the average benefit percentage test of §1.410(b)-5.

* * * * *

Fred T. Goldberg, Jr.,
Commissioner of
Internal Revenue.

(Filed by the Office of the Federal Register on September 12, 1990, 8:45 a.m., and published in the issue of the Federal Register for September 14, 1990, 55 F.R. 37888)

Notice of Proposed Rulemaking

Minimum Funding Requirements—Plan Restoration

EE-86-90

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In *** [T.D. 8317, page 72, this Bulletin], the Internal Revenue Service is issuing temporary regulations relating to the minimum funding requirements of section 412 of the Internal Revenue Code of 1986 as they apply to plans that are restored by the Pension Benefit Guaranty Corporation. The text of those temporary regulations also serves as the text for this Notice of Proposed Rulemaking. These regulations provide the public with guidance necessary to comply with the law. They will affect sponsors of and participants in pension plans covered under Title IV of the Employee Retirement Income Security Act ("ERISA").

DATES: Written comments and requests for a public hearing must be delivered or mailed by December 24, 1990.

ADDRESSES: Send comments and requests for a public hearing to: Internal Revenue Service. P.O. Box 7604, Ben Franklin Station, Attention: CC:CORP:T:R (EE-86-90) Washington, D.C. 20044.

SUPPLEMENTARY INFORMATION:

Background

The temporary regulations in *** [T.D. 8317, page 72, this Bulletin] amend 26 CFR by adding a new §1.412(c)(1)-3T to Part 1 of Title 26 of the Code of Federal Regulations to provide guidance with respect to the minimum funding requirements in situations involving plans restored by the Pension Benefit Guaranty Corporation pursuant to its authority in section 4047 of the Employee Retirement Income Security Act of 1974 ("ERISA"). The regulations are proposed to be issued under the authority contained in section 7805 of the Code (26 U.S.C. 7805). For the text of the temporary regulations, see T.D. 8317 published in *** [page 72, this Bulletin].

Special Analyses

It has been determined that these proposed rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. 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, an initial Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations will be submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

Comments and Requests for Public Hearing

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably eight copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is held, notice of the time and place will be published in the Federal Register.

Fred T. Goldberg, Jr.,
Commissioner of
Internal Revenue.

(Filed by the Office of the Federal Register on October 22, 1990, 8:45 a.m., and published in the issue of the Federal Register for October 23, 1990, 55 F.R. 42728)

Notice of Proposed Rulemaking

Bad Debt Reserves of Banks

FI-81-86

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed income tax regulations relating to the repeal of bad debt reserves for large banks. The proposed regulations implement section 585(c) of the Internal Revenue Code.

DATES: Written comments and requests for a public hearing must be received by February 11, 1991.

ADDRESSES: Send comments and requests for a public hearing to: Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Attn: CC:CORP:T:R (FI-81-86), Room 4429, Washington, D.C. 20044.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1980 (44 U.S.C. 3504(h)). Comments on the collections of information should be sent to the Office of Management and Budget, Attn: Desk Officer for Department of the Treasury, Office of Information and Regulatory Affairs, Washington, D.C. 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer T:FP, Washington, D.C. 20224.

The collections of information in these regulations are in §1.585-8. This information is required by the Internal Revenue Service in connection with making or revoking an election. This information will be used to monitor elections made by respondents. The likely respondents are banks.

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

Estimated total reporting burden: 625 hours.

The estimated burden per respondent varies from 10 minutes to 20 minutes, depending on individual circumstances, with an estimated average of 15 minutes.

Estimated number of respondents: 2,500.

Estimated number of responses per respondent: 1.

Background

This document provides proposed regulations on the repeal, for large banks, of the reserve method of accounting for bad debts that is allowed by section 585 of the Internal Revenue Code. These regulations reflect Code section 585(c), which was added by section 901 of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, 2375-2380 (1986) [1986-3 C.B. (Vol. 1) 1, 292], and amended by section 1009(a) of the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342, 3445 (1988) [1988-3 C.B. 1, 105]. When finalized, these proposed regulations will supersede related portions of 26 CFR 5h.5, which provides temporary regulations on the time and manner of making various elections under the Tax Reform Act of 1986.

Explanation of Provisions

New Code section 585(c) provides that large banks may not use the reserve method of section 585 for taxable years beginning after December 31, 1986. After this date, large banks must use the specific charge-off method of accounting for bad debts. Section 585(c) also provides procedures for changing from the reserve method of section 585 to the specific charge-off method. Section 585(c)(3) provides a recapture method of change, and section 585(c)(4) provides an elective cut-off method of change.

The regulations contained in this document propose to implement section 585(c) by adding new §§1.585-5 through 1.585-8 and by making conforming amendments in §§1.585-1, 1.585-2 and 1.585-3. Proposed §1.585-5 states the general rule of denial of bad debt reserves for large banks and provides guidance on determining whether an institution is a large bank. Proposed §§1.585-6, 1.585-7 and 1.585-8 provide guidance for large banks on changing from the reserve method of section 585 to the specific charge-off method. The regulations are proposed to be effective for taxable years beginning after December 31, 1986.

§1.585-5: Denial of bad debt reserves for large banks

Proposed §1.585-5(a) states the general rule of denial of bad debt reserves for large banks. This section also requires a large bank to change in its "disqualification year" to the specific charge-off method of accounting for bad debts. Proposed §1.585-5(d)(1) defines the term "disqualification year" for this purpose.

Pursuant to proposed §1.585-5(a), a large bank that maintained a bad debt reserve under section 585 for the taxable year immediately before its disqualification year must follow the rules prescribed in proposed §1.585-6 or §1.585-7 for changing to the specific charge-off method. However, these rules do not apply to a large bank that maintained a reserve under section 593 for the taxable year immediately before its disqualification year.

Proposed §1.585-5(b) provides rules for determining whether an institution is a large bank. Proposed §1.585-5(b)(1) states the $500 million test of section 585(c)(2). Under this test, a bank is a large bank if — for the current taxable year or for any preceding taxable year beginning after December 31, 1986 — the bank has average total assets in excess of $500 million or the bank is a member of a parent-subsidiary controlled group that has average total assets in excess of $500 million.

Proposed §1.585-5(c) provides rules for determining the average total assets of a bank or group for any taxable year. Under proposed §1.585-5(c)(1), this average is based on the total assets held by the bank or group on each "report date" during the year. Proposed §1.585-5(c)(2) defines the term "report date" for this purpose. Proposed §1.585-5(c)(3) provides that the amount of assets held by a bank or group is the adjusted bases of the assets for Federal income tax purposes. Proposed §1.585-5(c)(4) provides a method of estimating the adjusted tax bases of assets for this purpose.

Proposed §§1.585-5(b)(2) and 1.585-5(b)(3) also provide rules for determining whether an institution is a large bank. Under proposed §1.585-5(b)(2), certain banks that receive assets from a large bank and remain under that bank's control are treated as large banks. Under proposed §1.585-5(b)(3), certain banks that acquire substantially all of the assets of a large bank also are treated as large banks. Comments are requested on the scope of these rules.

§1.585-6: Recapture method of change

Proposed §1.585-6 provides guidance on using the recapture method set forth in section 585(c)(3). Under this method, a bank includes the balance of its bad debt reserve in income over a four-year period, and recapture is suspended for any taxable years in which the bank is financially troubled.

Proposed §1.585-6(a) provides general rules for using the recapture

method. If a bank follows the rules prescribed in proposed §1.585-6, its change to the specific charge-off method will be treated as made with the consent of the Commissioner. Proposed §1.585-6(b) specifies the portion of the reserve to be included in income in each year of the recapture period.

Proposed §1.585-6(c) explains the consequences of a disposition of loans by a large bank that is using the recapture method. Pursuant to proposed §1.585-6(c)(1), such a disposition generally does not affect the bank's obligation to recapture its reserve under proposed §1.585-6. However, if the bank ceases to engage in the business of banking before it completes recapture of its reserve, it must include the remaining amount of the reserve in income at that time. Pursuant to proposed §1.585-6(c)(3), if a bank transfers loans to another corporation in a section 381 transaction, the acquiring corporation steps into the transferor's shoes with respect to completing the recapture method.

Proposed §1.585-6(d) provides guidance for financially troubled banks. Proposed §1.585-6(d)(1) requires suspension of recapture for any taxable year in which a bank is financially troubled. Proposed §1.585-6(d)(2) allows a bank that is financially troubled for its disqualification year to elect to recapture more than 10 percent of its reserve. This election may be made for the bank's disqualification year, for the first taxable year after the disqualification year in which the bank is not financially troubled, or for any intervening taxable year. Proposed §1.585-6(d)(3) explains when a bank is considered financially troubled.

Proposed §1.585-6(d)(4) implements section 585(c)(3)(C), which provides relief from certain penalties for failure to pay estimated tax. Essentially this section waives the penalty for failure to pay estimated tax in cases where a bank that is financially troubled in one quarter (and therefore does not pay quarterly estimated tax attributable to recapture) is not financially troubled for the year as a whole (and thus has underpaid its estimated tax). In effect, proposed §1.585-6(d)(4) provides that the determination of whether a bank is financially troubled, for purposes of waiving the penalty for failure to pay an installment of estimated tax, is to be made as of the last day prescribed for payment of the installment, based on the portion of the taxable year that precedes and includes that day.

§1.585-7: Elective cut-off method of change

Proposed §1.585-7 provides guidance on using the cut-off method set forth in section 585(c)(4). Under this method, a bank continues to maintain its reserve for loans that it held when it became a large bank ("pre-disqualification loans"), but it may not deduct new additions to the reserve. If the reserve balance at the end of any taxable year exceeds the amount of the bank's outstanding pre-disqualification loans, the bank must include the amount of the excess in income for that year.

Proposed §1.585-7(a) provides general rules for using the cut-off method. Proposed §1.585-7(b) provides guidance on maintaining the reserve for pre-disqualification loans, and proposed §1.585-7(c) provides guidance on including excess amounts of the reserve in income.

Proposed §1.585-7(d) explains the consequences of a disposition of loans by a large bank that is using the cut-off method. Generally the bank reduces the balance of its outstanding pre-disqualification loans by the amount of the loans disposed of. However, proposed §1.585-7(d)(2) provides a special rule for section 381 transactions, and proposed §1.585-7(d)(3) addresses dispositions that are intended to change the status of pre-disqualification loans.

§1.585-8: Making and revoking elections

Proposed §1.585-8 provides rules on making and revoking the elections allowed under section 585(c). These are the election to recapture more than 10 percent of a bank's bad debt reserve and the election to use the cut-off method of change instead of the recapture method.

Proposed §1.585-8(a) provides rules on the time of making elections. Under proposed §1.585-8(a)(1), any election under section 585(c) must be made by the later of the date that is 60 days after the proposed regulations are published as final regulations, or the due date (taking extensions into account) of the electing bank's tax return for the year for which the election is made. Proposed §1.585-8(a)(2) waives the penalty for certain failures to pay estimated tax that result from making or revoking an election.

Proposed §1.585-8(b) provides rules on the manner of making elections. For tax returns filed after the proposed regulations are published as final regulations, proposed §1.585-8(b)(1) requires an election to be made by attaching a statement to the electing bank's tax return for the year for which the election is made. This section also describes the information to be included in the statement.

Proposed §1.585-8(c) provides rules on revoking elections. An election allowed under section 585(c) may be revoked without the consent of the Commissioner on or before the final date for making the election. After this date, the election may be revoked only with the Commissioner's consent. Proposed §1.585-8(c) also provides rules on the manner of revoking an election.

Proposed §1.585-8(d) addresses elections relating to banks that are members of parent-subsidiary controlled groups. Such an election is to be made by the bank. An election made by one member of a group is not binding on any other member.

Special Analyses

It has been determined that these proposed rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. 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, an initial Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations will be submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

Comments and Request for a Public Hearing

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably an original and eight copies) to the Internal Revenue Service. All comments will be avail-

able for public inspection and copying in their entirety. A public hearing will be scheduled and held upon written request by any person who submits written comments on the proposed rules. Notice of the time and place for the hearing will be published in the Federal Register.

List of Subjects

26 CFR 1.581-1 through 1.601-1
Banks, Income taxes.

26 CFR Part 5h
Elections under various public laws, Income taxes.

Proposed Amendments to the Regulations

Accordingly, Title 26, Chapter 1, Parts 1 and 5h of the Code of Federal Regulations are proposed to be amended as follows.

PART 1—[AMENDED]

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

Authority: 26 U.S.C. 7805 * * * Sections 1.585-5 through 1.585-8 also issued under 26 U.S.C. 585(b)(4).

Par. 2. Section 1.585-1 is amended as follows:

1. The first sentence of paragraph (a) is amended by removing "166(c)" and inserting in lieu thereof "585(a) (or, for taxable years beginning before January 1, 1987, section 166(c))".

2. The seventh sentence of paragraph (a) is amended by removing "166(c) and the regulations thereunder" and inserting in lieu thereof "585 (or, for taxable years beginning before January 1, 1987, section 166(c)) and the regulations under section 166".

3. The tenth sentence of paragraph (a) is amended by removing "(a), (b), and (c)".

4. The following new sentence is added at the end of paragraph (a): "For rules relating to large banks, see §§1.585-5 through 1.585-8.".

5. Paragraph (b) is revised to read as follows:

§1.585-1 Reserve for losses on loans of banks.

* * * *

(b) *Application of section* — (1) *In general.* Except as provided in paragraph (b)(2) of this section, section 585 and this section apply to the following financial institutions:

(i) Any bank (as defined in section 581 and the regulations thereunder) other than a mutual savings bank, domestic building and loan association, or cooperative bank, to which section 593 applies, and

(ii) Any corporation to which paragraph (b)(1)(i) of this section would apply except for the fact that it is a foreign corporation and in the case of any such foreign corporation, the rules provided by section 585, this section, §§1.585-2, 1.585-3, and 1.585-4 apply only with respect to loans outstanding the interest on which is effectively connected with the conduct of a banking business within the United States.

(2) *Exception.* For taxable years beginning after December 31, 1986, section 585(a) and (b) and this section do not apply to any large bank (as defined in §1.585-5(b)). For these years, a large bank may not deduct any amount under section 585 or any other section for an addition to a reserve for bad debts.

Par. 3. In §1.585-2, the last sentence of paragraph (d)(3) is amended by adding "585(a)(1) or former section" immediately before "166(c)".

Par. 4. Section 1.585-3 is amended as follows:

1. The first sentence of paragraph (a) is amended by removing "166(c)" and inserting in lieu thereof "585(a) (or, for taxable years beginning before January 1, 1987, section 166(c))".

2. The first sentence of paragraph (b) is amended by removing "166(c)" and inserting in lieu thereof "585(a) (or, for taxable years beginning before January 1, 1987, section 166(c))".

3. The second and third sentences of paragraph (b) are amended by removing "166(c)" and inserting in lieu thereof "585(a) (or former section 166(c))".

Par. 5. New §§1.585-5, 1.585-6, 1.585-7 and 1.585-8 are added to read as follows:

§1.585-5 Denial of bad debt reserves for large banks.

(a) *General rule.* For taxable years beginning after December 31, 1986, a large bank (as defined in paragraph (b) of this section) may not deduct any amount under section 585 or any other section for an addition to a reserve for bad debts. However, for these years, except as provided in §1.585-7, a large bank may deduct amounts allowed under section 166(a) for specific debts that become worthless in whole or in part. Any large bank that maintained a reserve for bad debts under section 585 for the taxable year immediately preceding its disqualification year (as defined in paragraph (d)(1) of this section) must follow the rules prescribed in §1.585-6 or §1.585-7 for changing from the reserve method of accounting for bad debts that is allowed by section 585, to the specific charge-off method of §1.585-5(b)(2)accounting for bad debts, in its disqualification year. However, the rules prescribed in §§1.585-6 and 1.585-7 do not apply to a large bank that maintained a reserve for bad debts under section 593 for the taxable year immediately preceding its disqualification year.

(b) *Large bank* — (1) *General definition.* For purposes of this section, a large bank is any institution described in §1.585-1(b)(1)(i) or (ii) if, for the taxable year (or for any preceding taxable year beginning after December 31, 1986)—

(i) the average total assets of the institution (determined under paragraph (c) of this section) exceed $500,000,000, or

(ii) the institution is a member of a parent-subsidiary controlled group (as defined in paragraph (d)(2) of this section) and the average total assets of the group exceed $500,000,000.

(2) *Large bank resulting from transfer by large bank where control is retained.* If a large bank (as defined in paragraph (b)(1) or (b)(3) of this section) transfers a significant portion of its assets directly or indirectly to another corporation (the "transferee") and, after the transfer, more than 50 percent (in voting power or value) of the outstanding stock of the transferee is owned by the §1.585-5(b)(3)(i) bank, the transferee is treated as a large bank for any taxable year ending after the date of the transfer in which it is an institution described in §1.585-1(b)(1)(i) or (ii). For this purpose, stock of a transferee is considered owned by a transferor bank if it is owned by any member of a parent-subsidiary controlled group (as defined in paragraph (d)(2) of this section) of which the bank is a member, by any related

party within the meaning of section 267(b) or 707(b), or by any person that received the stock in a transaction to which section 355 applies.

(3) *Large bank resulting from transfer of substantially all the assets of large bank* — (i) *In general.* If a corporation acquires substantially all of the assets of a large bank (as defined in paragraph (b)(1) or (b)(2) of this section) and the acquiring corporation's method of accounting for bad debts with respect to its banking business (determined under paragraph (b)(3)(ii) of this section) immediately after the acquisition is the method used immediately before the acquisition by the large bank whose assets are acquired, the acquiring corporation is treated as a large bank for any taxable year ending after the date of the acquisition in which it is an institution described in §1.585-1(b)(1)(i) or (ii). See §§1.585-6(c)(3) and 1.585-7(d)(2) for rules on the treatment of assets acquired from large banks in section 381(a) transactions.

(ii) *Determination of method.* An acquiring corporation's method of accounting for bad debts, determined under this paragraph (b)(3)(ii), is the method determined by applying §1.381(c)(4)-1, regardless of whether section 381(a) applies to the acquisition. In applying §1.381(c)(4)-1 for this purpose, the following rules apply: (1) a large bank whose assets are acquired is considered to be on the specific charge-off method with respect to all of its assets immediately before the acquisition; (2) if an acquiring corporation has more than one banking business immediately after the acquisition, all such businesses are treated as one integrated business; and (3) if an acquiring corporation's banking business does not have a principal method of accounting for bad debts under §1.381(c)(4)-1, the business's method is considered to be the method used immediately before the acquisition by the bank whose assets are acquired.

(4) *Examples.* The following examples illustrate the principles of this paragraph (b):

Example 1. Bank M, a calendar year taxpayer, is an institution described in §1.585-1(b)(1)(i). For its taxable year beginning on January 1, 1987, M has average total assets of $600 million. Since M's average total assets for 1987 exceed $500 million, M is a large bank for that year. Pursuant to §1.585-5(d)(1), 1987 is M's disqualification year. If M maintained a bad debt reserve under section 585 for its immediately preceding taxable year (1986), M must change in 1987 to the specific charge-off method of accounting for bad debts, in accordance with §1.585-6 or §1.585-7.

Example 2. Assume the same facts as in Example 1. Also assume that in 1988 M disposes of a portion of its assets and, as a result, M's average total assets for taxable year 1988 fall to $400 million. M remains a large bank for taxable year 1988 and succeeding taxable years, since its average total assets for a preceding taxable year (1987) beginning after December 31, 1986, exceeded $500 million.

Example 3. Bank P, a calendar year taxpayer, is an institution described in §1.585-1(b)(1)(i). P has average total assets of $300 million for its taxable year beginning on January 1, 1988. For the same year, P is a member of a parent-subsidiary controlled group (within the meaning of §1.585-5(d)(2)) that has average total assets of $800 million. In February 1989, the group sells its stock in P to several individual investors. P is a large bank for taxable year 1988 because it is a member of a group described in §1.585-5(b)(1)(ii) for that year. P also is a large bank for taxable year 1989 and succeeding taxable years because it was a member of a group described in §1.585-5(b)(1)(ii) for a preceding taxable year (1988) beginning after December 31, 1986.

Example 4. Bank Q is a large bank, within the meaning of §1.585-5(b)(1), for its taxable year beginning on January 1, 1988, and hence for all later years. On March 1, 1989, Q transfers $200 million of its $600 million of assets to Bank R, a newly created subsidiary, in a transaction to which section 351 applies; these assets are R's only assets. On the same day, Q then spins off R in a transaction to which section 355 applies. After these transactions, the shareholders of Q own more than 50 percent of R's outstanding stock. Although R's average total assets do not exceed $500 million, R becomes a large bank on March 1, 1989, pursuant to §1.585-5(b)(2). These transactions do not affect Q's status as a large bank.

Example 5. Bank S is a large bank, within the meaning of §1.585-5(b)(1)(ii), for its taxable year beginning on January 1, 1987. As a result, S changes to the specific charge-off method of accounting for bad debts in that year. Bank T, which is not a large bank under §1.585-5(b)(1) or §1.585-5(b)(2), uses the reserve method of accounting for bad debts. On June 30, 1988, T acquires substantially all of S's assets in a transaction to which section 381(a) does not apply. Immediately before the acquisition, S's banking business has total assets of $200 million, and T's has total assets of $250 million. To determine whether T is a large bank under §1.585-5(b)(3), it is necessary to determine under §1.585-5(b)(3)(ii) T's method of accounting for bad §1.585-5(c)(2)(i)debts with respect to its banking business immediately after the acquisition. This determination requires an application of §1.381(c)(4)-1. For this purpose, T's original and acquired banking businesses are treated as an integrated business. Applying §1.381(c)(4)-1(c)(2)(iii), it is determined that the business's principal method of accounting for bad debts immediately after the acquisition is the reserve method. Hence, the acquisition does not cause T to become a large bank under §1.585-5(b)(3).

(c) *Average total assets* — (1) *In general.* For purposes of paragraph (b)(1) of this section, the average total assets of an institution or group for any taxable year are determined by —

(i) computing, for each report date (as defined in paragraph (c)(2) of this section) within the taxable year, the amount of total assets (as defined in paragraph (c)(3) of this section) held by the institution or group as of the close of business on the report date;

(ii) adding these amounts; and

(iii) dividing the sum of these amounts by the number of report dates within the taxable year.

(2) *Report date* — (i) *Institutions.* A report date for an institution generally is the last day of the regular period for which the institution must report to its primary Federal regulatory agency. However, an institution that is required to report to its primary Federal regulatory agency more frequently than quarterly may choose the last day of the calendar quarter as its report date, and an institution that is required to report to its primary Federal regulatory §1.585-5(c)(2)(iii) agency less frequently than quarterly must choose the last day of the calendar quarter as its report date. If an institution does not have a Federal regulatory agency, its primary State regulatory agency is considered its primary Federal regulatory agency for purposes of this paragraph (c)(2)(i). In the case of a short taxable year that does not otherwise include a report date, the last day of the taxable year is the institution's report date for the year.

(ii) *Groups.* A report date for a parent-subsidiary controlled group is the report date, determined under paragraph (c)(2)(i) of this section, for any one member of the group that is an institution described in §1.585-1(b)(1)(i) or (ii). The same report date must be used in applying paragraph (b)(1)(ii) of this section to all members of a parent-subsidiary controlled group for a taxable year.

(iii) *Member of group for only part of taxable year.* If an institution is a member of a parent-subsidiary controlled group for only part of a taxable year, paragraph (b)(1)(ii) of this section is applied to the institution for that year on the basis of the group's average total assets for the portion of the year that the institution is a member of the group. Thus, only the group's report dates that are

included in that portion of the year are taken into account in determining the group's average total assets for purposes of applying paragraph (b)(1)(ii) to the institution. If no §1.585-5(c)(4)(i) report date of the group is included in that portion of the year, the first or last day of that portion of the year must be treated as the group's report date for purposes of this paragraph (c)(2)(iii).

(3) *Total assets.* The amount of total assets held by an institution or group is the amount of cash, plus the sum of the adjusted bases of all other assets, held by the institution or group. For this purpose, the adjusted basis of an asset is its basis for Federal income tax purposes, determined under sections 1012, 1016 and other applicable sections of the Internal Revenue Code. In determining the amount of total assets held by a group, any asset of a member of the group that is an interest in another member of the group is not to be counted.

(4) *Estimated adjusted tax bases* — (i) *In general.* The amount of the adjusted Federal income tax bases ("tax bases") of assets held on a report date may be estimated, for purposes of applying paragraph (c)(3) of this section. This estimate must be based on the adjusted bases of the assets on that date as determined by reference to the asset holder's books and records maintained for financial reporting purposes ("book bases"). The estimate must reflect any change in the ratio between the asset holder's tax and book bases of assets that occurs during the taxable year, and the estimate must assume that this change occurs §1.585-5(c)(4)(ii) ratably. If an institution or group member estimates the tax bases of assets held on any report date during a taxable year, it must do so for all assets (other than cash) held on that report date, and it must do so for all other report dates during the year. However, the tax bases of assets may not be estimated for any report date that is the first or last day of the taxable year.

(ii) *Formulas.* The estimated amount of the tax bases of assets held on any report date during a taxable year is based on the following variables: the total book bases of the assets on the report date ("B"); the asset holder's "tax/book ratio" as of the close of the preceding taxable year ("R"); and the result (whether positive or negative) obtained when R is subtracted from the asset holder's "tax/book ratio" as of the close of the current taxable year ("Y"). For purposes of determining R and Y, an asset holder's "tax/book ratio" is the ratio of (1) the total tax bases of all of the holder's assets (other than cash) to (2) the total book bases of those assets. If an asset holder's taxable year is the calendar year and its report date is the last day of the calendar quarter, its estimated tax bases of assets held on the first three report dates of the year are determined under the following formulas:

1st Report Date = B x (R + ¼Y)
2nd Report Date = B x (R + ½Y)
3rd Report Date = B x (R + ¾Y)

For an example illustrating the application of these formulas, see Example 2 in paragraph (c)(5) of this section.

(5) *Examples.* The following examples illustrate the principles of this paragraph (c):

Example 1. Bank U is a fiscal year taxpayer, and its fiscal year ends on January 31. U reports to its primary Federal regulatory agency as of the last day of the calendar quarter. Thus, U's report dates under §1.585-5(c)(2)(i) are March 31, June 30, September 30, and December 31. For its taxable year beginning on February 1, 1987, U has total assets (within the meaning of §1.585-5(c)(3)) of $480 million on March 31, $490 million on June 30, $510 million on September 30, and $540 million on December 31. Thus, pursuant to §1.585-5(c)(1), U's average total assets for its taxable year beginning on February 1, 1987, are $505 million.

Example 2. Bank W is a calendar year taxpayer, and its report date (within the meaning of §1.585-5(c)(2)(i)) is the last day of the calendar quarter. The adjusted tax bases of all of W's assets (other than cash) are $450z on December 31, 1989, and $480z on December 31, 1990. The book bases of those assets are $500z on December 31, 1989; $520z on March 31, 1990; $540z on June 30, 1990; $560z on September 30, 1990; and $600z on December 31, 1990. Applying the formulas provided in §1.585-5(c)(4)(ii), W's "tax/book ratio" as of the close of 1989 ("R"), is 0.9 (450z/500z). W's "tax/book ratio" as of the close of 1990 is 0.8 (480z/600z). Thus, "Y" is -0.1. The estimated adjusted tax bases of all of W's assets (other than cash) on the first three report dates of 1990 are as follows:

1st = B x (R + ¼Y)
= $520z x [0.9 + ¼(−0.1)]
= $455z
2nd = B x (R + ½Y)
= $540z x [0.9 + ½(−0.1)]
= $459z
3rd = B x (R + ¾Y)
= $560z x [0.9 + ¾(−0.1)]
= $462z

(d) *Definitions.* The following definitions apply for purposes of this section and §§1.585-6, 1.585-7 and 1.585- 8:

(1) *Disqualification year.* A bank's disqualification year is its first taxable year beginning after December 31, 1986, for which the bank is a large bank within the meaning of paragraph (b) of this section.

(2) *Parent-subsidiary controlled group.* A parent-subsidiary controlled group includes all of the members of a controlled group of corporations described in section 1563(a)(1). The members of such a group are determined without regard to whether any member is an "excluded member" described in section 1563(b)(2), a foreign entity, or a commercial bank.

§1.585-6 Recapture method of changing from the reserve method of section 585.

(a) *General rule.* This section applies to any large bank (as defined in §1.585-5(b)) that maintained a reserve for bad debts under section 585 for the taxable year immediately preceding its disqualification year (as defined in §1.585-5(d)(1)) and that does not elect the cut-off method set forth in §1.585-7. Except as otherwise provided in paragraphs (c) and (d) of this section, any bank to which this section applies must include in income the amount of §1.585-6(b)(2) its net section 481(a) adjustment (as defined in paragraph (b)(3) of this section) over the four-year period beginning with the bank's disqualification year. If a bank follows the rules prescribed in this section, its change to the specific charge-off method of accounting for bad debts in its disqualification year will be treated as a change in accounting method that is made with the consent of the Commissioner. Paragraph (b) of this section specifies the portion of the net section 481(a) adjustment to be included in income in each year of the recapture period; paragraph (c) provides rules on the effect of disposing of loans; and paragraph (d) provides rules on the suspension of recapture by financially troubled banks.

(b) *Four-year spread of net section 481(a) adjustment* — (1) *In general.* If a bank to which this section applies does not make the election allowed by paragraph (b)(2) of this section, the

bank must include in income the following portions of its net section 481(a) adjustment in each year of the four-year recapture period: 10 percent in the bank's disqualification year; 20 percent in the first taxable year after its disqualification year; 30 percent in the second taxable year after its disqualification year; and 40 percent in the third taxable year after its disqualification year.

(2) *Election to include more than 10 percent in disqualification year.* A bank to which this section applies §1.585-6(b)(3) may elect to include in income, in its disqualification year, any percentage of its net section 481(a) adjustment that is larger than 10 percent. Any such election must be made at the time and in the manner prescribed by §1.585-8. If a bank makes such an election, the bank must include in income the remainder, if any, of its net section 481(a) adjustment in the following portions: 2/9 of the remainder in the first taxable year after the bank's disqualification year; 1/3 of the remainder in the second taxable year after its disqualification year; and 4/9 of the remainder in the third taxable year after its disqualification year. For this purpose, the remainder of a bank's net section 481(a) adjustment is any portion of the adjustment that the bank does not elect to include in income in its disqualification year.

(3) *Net section 481(a) adjustment.* For purposes of this section, the amount of a bank's net section 481(a) adjustment is the amount of the bank's reserve for bad debts as of the close of the taxable year immediately preceding its disqualification year. Since the change from the reserve method of section 585 is initiated by the taxpayer, the amount of the bank's bad debt reserve for this purpose is not reduced by amounts attributable to taxable years beginning before 1954.

(4) *Examples.* The following examples illustrate the principles of this paragraph (b):

Example 1. Bank M is a large bank within the meaning of §1.585-5(b). M's disqualification year is its taxable year beginning on January 1, 1989, and M maintained a bad debt reserve under section 585 for the preceding taxable year. Pursuant to §1.585-5(a), M must change from the reserve method of accounting for bad debts to the specific charge-off method in its disqualification year. M does not elect the cut-off method set forth in §1.585-7. Thus, M must follow the recapture method set forth in this §1.585-6. M's net section 481(a) adjustment, as defined in §1.585-6(b)(3), is $2 million. M does not make the election allowed by §1.585-6(b)(2). Pursuant to §1.585-6(b)(1), M must include the following amounts in income: $200,000 in taxable year 1989; $400,000 in 1990; $600,000 in 1991; and $800,000 in 1992.

Example 2. Assume the same facts as in Example 1, except that M elects under §1.585-6(b)(2) to recapture 55 percent of its net section 481(a) adjustment in its disqualification year. Pursuant to §1.585-6(b)(2), M must include the following amounts in income: $1,100,000 in taxable year 1989; $200,000 in 1990; $300,000 in 1991; and $400,000 in 1992.

(c) *Effect of disposing of loans* — (1) *In general.* Except as provided in paragraphs (c)(2) and (c)(3) of this section, if a bank to which this section applies sells or otherwise disposes of any of its outstanding loans on or after the first day of its disqualification year, the disposition does not affect the bank's obligation under this section to include in income the amount of its net section 481(a) adjustment, and the disposition does not affect the amount of this adjustment.

(2) *Cessation of banking business.* If a bank to which this section applies ceases to engage in the business of §1.585-6(c)(3) banking before it is otherwise required to include in income the full amount of its net section 481(a) adjustment, the bank must include in income the remaining amount of the adjustment in the taxable year in which it ceases to engage in the business of banking. For this purpose, a bank is not considered to have ceased engaging in the business of banking if the cessation is the result of a transaction to which section 381(a) applies.

(3) *Section 381 transactions.* If a bank to which this section applies transfers outstanding loans to another corporation on or after the first day of the bank's disqualification year (and before it has included in income the full amount of its net section 481(a) adjustment) in a transaction to which section 381(a) applies, the acquiring corporation steps into the shoes of the transferor with respect to using the recapture method prescribed in this §1.585-6. The unrecaptured balance of the transferor's net section 481(a) adjustment carries over in the transaction to the acquiring corporation, and this corporation must complete the four-year recapture procedure begun by the transferor. In the section 381(a) transaction, the acquiring corporation assumes all of the transferor's rights and obligations under paragraph (b) of this section. However, if an acquiring corporation that is not a large bank (within the meaning of §1.585-5(b)) establishes a bad §1.585-6(c)(4) debt reserve for loans received in the section 381(a) transaction, the section 481(a) adjustment carried over in the transaction is at least partially offset by a new negative section 481(a) adjustment attributable to the reserve. See §1.381(c)(4)-1.

(4) *Examples.* The following examples illustrate the principles of this paragraph (c):

Example 1. Bank P is a bank to which this §1.585-6 applies. P's disqualification year is its taxable year beginning on January 1, 1989, and P recaptures 10 percent of its net section 481(a) adjustment in that year pursuant to §1.585-6(b)(1). In 1990 P disposes of a portion of its loan portfolio in a transaction to which section 381(a) does not apply, and P continues to engage in the business of banking. Pursuant to §1.585-6(c)(1), the disposition does not affect P's obligation under §1.585-6(b)(1) to recapture the remainder of its net section 481(a) adjustment in 1990, 1991 and 1992. Nor does the disposition affect the amount of the adjustment.

Example 2. Assume the same facts as in Example 1, except that P ceases to engage in the business of banking in 1990, and this cessation is not the result of a transaction to which section 381(a) applies. Pursuant to §1.585-6(c)(2), in 1990 P must include in income the remaining 90 percent of its net section 481(a) adjustment.

Example 3. Assume the same facts as in Example 1, except that P's 1990 disposition of loans is a transaction to which section 381(a) applies. Thus, in the transaction, P transfers substantially all of its loans to an acquiring corporation (Q). Q may be treated as a large bank, pursuant to §1.585-5(b)(2) or §1.585-5(b)(3), for taxable years ending after the date of the transaction. If so, and if Q was on the reserve method of accounting immediately before the section 381(a) transaction, it must change to the specific charge-off method for all of its loans. Regardless of whether Q is a large bank, pursuant to §1.585-6(c)(3) Q steps into P's shoes with respect to using the recapture method prescribed in §1.585-6. The unrecaptured balance of P's net section 481(a) adjustment carries over to Q in the section 381(a) transaction, and Q must complete the four-§1.585-6(d)(2) year recapture procedure begun by P. However, if Q is not a large bank and Q establishes a bad debt reserve for loans received in the transaction, the section 481(a) adjustment that is carried over is at least partially offset by a new negative section 481(a) adjustment.

(d) *Suspension of recapture by financially troubled banks* — (1) *In general.* Except as provided in paragraph (d)(2) of this section, a bank that is financially troubled (within the meaning of paragraph (d)(3) of this

section) for any taxable year shall not include any amount in income under paragraphs (a) and (b) of this section for that taxable year and must disregard that taxable year in applying paragraphs (a) and (b) to other taxable years. See paragraph (d)(4) of this section for rules on determining estimated tax payments of financially troubled banks, and see paragraph (d)(5) for examples illustrating this paragraph (d).

(2) *Election to recapture.* A bank that is financially troubled (within the meaning of paragraph (d)(3) of this section) for its disqualification year may elect to include in income, in one taxable year, any percentage of its net section 481(a) adjustment that is greater than 10 percent. This election may be made for the bank's disqualification year, for the first taxable year after the disqualification year in which the bank is not financially troubled (within the meaning of paragraph (d)(3) of this section), or for any intervening taxable year. Any such election must be made at §1.585-6(d)(3)(i) the time and in the manner prescribed by §1.585-8. A bank that makes this election shall include an amount in income under paragraphs (a) and (b) of this section in the year for which the election is made ("election year") and shall not disregard this year in applying paragraphs (a) and (b) to other taxable years. Such a bank must follow the rules of paragraph (b)(2) of this section in applying paragraph (b) to later taxable years, treating the election year as the disqualification year for purposes of applying paragraph (b)(2). However, if the bank is financially troubled for any year after its election year, the bank shall not include any amount in income under paragraphs (a) and (b) of this section for the later year and must disregard the later year in applying paragraphs (a) and (b) to other taxable years.

(3) *Definition of financially troubled* — (i) *In general.* For purposes of this section, a bank is considered financially troubled for any taxable year if the bank's nonperforming loan percentage for that year exceeds 75 percent. For this purpose, a bank's nonperforming loan percentage is the percentage determined by dividing (1) the sum of the outstanding balances of the bank's nonperforming loans (as defined in paragraph (d)(3)(iii) of this section) as of the close of each quarter of the taxable year, by (2) the sum of the amounts of the bank's equity (as defined in paragraph (d)(3)(iv) of this section) as of the close of §1.585-6(d)(3)(ii) each such quarter. If a taxable year consists of less than 3 months, the last day of the taxable year is treated as the last day of a quarter. In lieu of determining its nonperforming loan percentage on the basis of loans and equity as of the close of each taxable quarter, a bank may, for all years, determine this percentage on the basis of loans and equity as of the close of each report date (as defined in §1.585-5(c)(2)). In the case of a bank that is a foreign corporation, all nonperforming loans and equity of the bank are taken into account, including loans and equity that are not effectively connected with the conduct of a banking business within the United States.

(ii) *Parent-subsidiary controlled groups.* If a bank is a member of a parent-subsidiary controlled group (as defined in §1.585-5(d)(2)) for the taxable year, the nonperforming loans and the equity of all members of the group that are financial institutions within the meaning of section 265(b)(5) (or comparable foreign financial institutions) are treated as the nonperforming loans and the equity of the bank for purposes of paragraph (d)(3)(i). However, any asset of a member financial institution that represents an equity interest in another member financial institution is not to be counted. Likewise, any nonperforming loan of a member financial institution that is a loan to another member financial institution is not to be counted.

(iii) *Nonperforming loan.* For purposes of this section, a nonperforming loan is any loan that is considered to be nonperforming by the holder's primary Federal regulatory agency (or, if the holder does not have a Federal regulatory agency, any loan that would be considered nonperforming under the standards prescribed by the Federal Financial Institutions Examination Council).

(iv) *Equity.* For purposes of this section, the equity of a bank or other financial institution is its equity (*i.e.*, assets minus liabilities) as determined by the institution's primary Federal regulatory agency (or, if the institution does not have a Federal regulatory agency, by its primary State regulatory agency). The balance in a reserve for bad debts is not treated as equity.

(4) *Estimated tax payments of financially troubled banks.* If a bank is financially troubled (within the meaning of paragraph (d)(3) of this section) for any quarter of a taxable year, it must be determined, for purposes of applying section 6655(e)(2)(A)(i) with respect to the installment of estimated tax for the quarter (and any later quarter of the taxable year), whether the bank is required to include an amount in income under paragraphs (a) and (b) of this section for the taxable year. This determination is to be made as of the last day prescribed for payment of the installment, based on the portion of the taxable year that §1.585-7(a) precedes and includes that day. That is, the determination is to be made as if the last day prescribed for payment were the last day of the taxable year.

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

Example 1. Bank R is a bank to which this §1.585-6 applies. R's disqualification year is its taxable year beginning on January 1, 1987. R is not financially troubled (within the meaning of §1.585-6(d)(3)) for taxable year 1987 or for any taxable year after 1989, but it is financially troubled for taxable years 1988 and 1989. Since R is not financially troubled for its disqualification year, R must include an amount in income under §1.585-6(a) and (b) for that year (taxable year 1987). R may make the election allowed by §1.585-6(b)(2) for that year. Since R is financially troubled for taxable years 1988 and 1989, pursuant to §1.585-6(d)(1) R does not include any amount in income under §1.585-6(a) and (b) for these years, and it treats taxable years 1990, 1991 and 1992 as the first, second and third taxable years after its disqualification year for purposes of applying §1.585-6(a) and (b).

Example 2. Assume the same facts as in Example 1, except that R is financially troubled for taxable year 1987 (its disqualification year). R may make the election allowed by §1.585-6(d)(2) for 1987 (the disqualification year), for 1990 (the first year after the disqualification year in which R is not financially troubled), or for 1988 or 1989 (the intervening years). R elects to include 60 percent of its net section 481(a) adjustment in income in 1987. Thus, the remainder of the adjustment, for purposes of applying the rules of §1.585-6(b)(2), is 40 percent. R must include in income 2/9 of the remainder in 1990, 1/3 of the remainder in 1991, and 4/9 of the remainder in 1992.

§1.585-7 Elective cut-off method of changing from the reserve method of section 585.

(a) *General rule.* Any large bank (as defined in §1.585-5(b)) that maintained a reserve for bad debts under §1.585-7(a) section 585 for the taxable year immediately preceding its disqualification year (as defined in §1.585-5(d)(1)) may elect to use the cut-off method set forth in this section. Any such election must be made at the time and in the manner prescribed by §1.585-8. If a bank makes this election, the bank must maintain its bad debt reserve for its pre-disqualification loans, as prescribed in paragraph (b) of this section, and the bank must include in income any excess balance in this reserve, as required by paragraph (c) of this section. The bank may not deduct, for its disqualification year or any subsequent taxable year, any amount allowed under section 166(a) for pre-disqualification loans (as defined in paragraph (b)(2) of this section) that become worthless in whole or in part, except as allowed by paragraph (b)(1) of this section. However, except as provided in paragraph (d)(3) of this section, the bank may deduct, for its disqualification year or any subsequent taxable year, amounts allowed under section 166(a) for loans that the bank originates or acquires on or after the first day of its disqualification year and that become worthless in whole or in part. If a bank makes the election allowed by this paragraph (a), its change to the specific charge-off method of accounting for bad debts in its disqualification year is not a change in accounting method to which the provisions of section 481 apply.

(b) *Maintaining reserve for pre-disqualification loans* — (1) *In general.* A bank that makes the election allowed by paragraph (a) of this section must maintain its bad debt reserve for its pre-disqualification loans (as defined in paragraph (b)(2) of this section). Except as provided in paragraph (d)(3) of this section, the bank must charge against the reserve the amount of any losses resulting from these loans (including losses resulting from the sale or other disposition of these loans), and the bank must add to the reserve the amount of recoveries with respect to these loans. In general, the reserve must be maintained in the manner provided by former section 166(c) of the Internal Revenue Code and the regulations thereunder. However, after the balance in the reserve is reduced to zero, the bank is to account for any losses and recoveries with respect to outstanding pre-disqualification loans under the specific charge-off method of accounting for bad debts, as if the bank always had accounted for these loans under this method. See paragraph (d)(2) of this section for rules on the obligation to maintain a reserve under this paragraph (b) when a bank transfers loans in a section 381 transaction.

(2) *Definition of pre-disqualification loans.* For purposes of this section, a pre-disqualification loan of a bank is any loan that the bank held on the last day of its §1.585-7(d)(2) taxable year immediately preceding its disqualification year (as defined in §1.585-5(d)(1)).

(c) *Amount to be included in income when reserve balance exceeds loan balance.* If, as of the close of any taxable year, the balance in a bank's reserve that is maintained under paragraph (b) of this section exceeds the balance of the bank's outstanding pre-disqualification loans, the bank must include in income the amount of the excess for the taxable year. The balance in the reserve is then reduced by the amount of this excess. See paragraph (d) of this section for rules on the application of this paragraph (c) when a bank disposes of loans.

(d) *Effect of disposing of loans* — (1) *In general.* Except as provided in paragraphs (d)(2) and (d)(3) of this section, if a bank that makes the election allowed by paragraph (a) of this section sells or otherwise disposes of any of its outstanding pre-disqualification loans, the bank is to reduce the balance of its outstanding pre-disqualification loans by the amount of the loans disposed of, for purposes of applying paragraph (c) of this section.

(2) *Section 381 transactions.* If a bank that makes the election allowed by paragraph (a) of this section transfers outstanding pre-disqualification loans to another corporation in a transaction to which section 381(a) applies, the acquiring corporation steps into the shoes of §1.585-7(d)(3) the transferor with respect to using the cut-off method of change, unless the acquiring corporation is not a large bank (within the meaning of §1.585-5(b)) and uses a reserve method of accounting for bad debts attributable to the pre-disqualification loans received in the transaction. If an acquiring corporation steps into the transferor's shoes with respect to using the cut-off method, the transferor's bad debt reserve immediately before the section 381(a) transaction carries over to the acquiring corporation, and this corporation must complete the cut-off method begun by the transferor. For purposes of completing the transferor's cut-off method, the acquiring corporation's balance of outstanding pre-disqualification loans immediately after the section 381(a) transaction is the balance of these loans that it receives in the transaction, and the acquiring corporation assumes all of the transferor's rights and obligations under this section. See §1.381(c)(4)-1.

(3) *Dispositions intended to change the status of pre-disqualification loans.* This paragraph (d)(3) applies if a bank that makes the election allowed by paragraph (a) of this section sells, exchanges, or otherwise disposes of a significant amount of its pre-disqualification loans (as defined in paragraph (b)(2) of this section) and the transaction has as one of its principal purposes the avoidance of the provisions of this section by increasing §1.585-7(e) the amount of loans for which deductions are allowable under the specific charge-off method. If this paragraph (d)(3) applies, the District Director may disregard the disposition for purposes of paragraphs (b)(1) and (d)(1) of this section or treat the replacement loans as pre-disqualification loans. If loans are so treated as pre-disqualification loans, no deductions are allowable under the specific charge-off method for the loans, except as provided in paragraph (b)(1) of this section, and the disposition that causes the loans to be so treated may be disregarded for purposes of paragraphs (b)(1) and (d)(1) of this section. For purposes of paragraph (d)(3) if a bank sells pre-disqualification loans and uses the proceeds of the sale to originate new loans, this paragraph (d)(3) does not apply to the transaction.

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

Example 1. Bank M is a bank that properly elects to use the cut-off method set forth in this §1.585-7. M's disqualification year is its taxable year beginning on January 1, 1987. On December 31, 1986, M had outstanding loans of $700 million (pre-disqualification loans), and the balance in its bad debt reserve was $10 million. M must maintain its reserve for its pre-disqualification loans in accordance with §1.585-7(b), and it may not deduct any addition to this reserve for taxable year 1987 or any later year. For these years, M may deduct amounts allowed under section 166(a) for loans that it originates or acquires after December 31, 1986, and that become worthless in whole or in part.

Example 2. Assume the same facts as in Example 1. Also assume that in 1987 M collects $150 million of its pre-disqualification loans, M determines that $2 million of its pre-disqualification loans are worthless, and M recovers $1 million of pre-disqualification loans that it had previously charged against the reserve as worthless. On December 31, 1987, the balance in M's bad debt reserve is $9 million ($10 million $2 million + $1 million), and the balance of its outstanding pre-disqualification loans is $548 million ($700 million $150 million $2 million).

Example 3. Assume the same facts as in Examples 1 and 2. Also assume that on December 31, 1990, the balance in M's bad debt reserve is $5 million and the balance of its outstanding pre-disqualification loans is $25 million. In 1991 M collects $21 million of its outstanding pre-disqualification loans and determines that $1 million of its outstanding pre-disqualification loans are worthless. Thus, on December 31, 1991, the balance in M's bad debt reserve is $4 million ($5 million - $1 million), and the balance of its outstanding pre-disqualification loans is $3 million ($25 million - $21 million - $1 million). Accordingly, M must include $1 million ($4 million $3 million) in income in taxable year 1991, pursuant to §1.585-7(c). On January 1, 1992, the balance in M's reserve is $3 million ($4 million $1 million).

Example 4. Assume the same facts as in Examples 1 through 3. Also assume that in 1992 M transfers substantially all of its assets to another corporation (N) in a transaction to which section 381(a) applies, and N is treated as a large bank under §1.585-5(b)(3) for taxable years ending after the date of the transaction. Pursuant to §1.585-7(d)(2), N steps into M's shoes with respect to using the cut-off method. M's bad debt reserve immediately before the section 381(a) transaction carries over to N, and N must complete the cut-off procedure begun by M. For this purpose, N's balance of outstanding pre-disqualification loans immediately after the section 381(a) transaction is the balance of these loans that it receives from M.

§1.585-8 Rules for making and revoking elections under §§1.585-6 and 1.585-7.

(a) *Time of making elections* — (1) *In general.* Any election under §1.585-6(b)(2), §1.585-6(d)(2) or §1.585-7(a) must be made on or before the later of

(i) [*Insert date that is 60 days after this regulation is published as a final regulation in the Federal Register*], §1.585-8(b)(1)or

(ii) the due date (taking extensions into account) of the electing bank's original tax return for its disqualification year (as defined in §1.585-5(d)(1)) or, for elections under §1.585-6(d)(2), the year for which the election is made.

(2) *No extension of time for payment.* Payments of tax due must be made in accordance with Chapter 62 of the Internal Revenue Code. However, if an election under §1.585-6(b)(2), §1.585-6(d)(2) or §1.585-7(a) is made or revoked on or before [*Insert date that is 60 days after this regulation is published as a final regulation in the Federal Register*] and the making or revoking of the election results in an underpayment of estimated tax (within the meaning of section 6655(a)) with respect to an installment of estimated tax due on or before the date the election was so made or revoked, no addition to tax will be imposed under section 6655(a) with respect to the amount of the underpayment attributable to the making or revoking of the election.

(b) *Manner of making elections* — (1) *In general.* Except as provided in paragraph (b)(2) of this section, an electing bank must make any election under §1.585-6(b)(2), §1.585-6(d)(2) or §1.585-7(a) by attaching a statement to its tax return (or amended return) for its disqualification §1.585-8(b)(2) year or, for elections under §1.585-6(d)(2), the year for which the election is made. This statement must contain the following information:

(i) the name, address and taxpayer identification number of the electing bank;

(ii) the nature of the election being made (i.e., whether the election is to include in income more than 10 percent of the bank's net section 481(a) adjustment under §1.585-6(b)(2) or (d)(2) or to use the cut-off method under §1.585-7); and

(iii) if the election is under §1.585-6(b)(2) or (d)(2), the percentage being elected.

(2) *Certain tax returns filed before [Insert date that this regulation is published as a final regulation in the Federal Register].* A bank is deemed to have made an election under §1.585-6(b)(2) or (d)(2) if the bank evidences its intent to make an election under section 585(c)(3)(A)(iii)(I) or section 585(c)(3)(B)(ii) for its disqualification year (or, for elections under §1.585- 6(d)(2), the election year), by designating a specific recapture amount on its tax return or amended return for this year (or attaching a statement in accordance with §5h.5(a)(3)(i)), and this return is filed before [*Insert date that this regulation is published as a final regulation in the Federal Register*]. A bank is deemed to have made an §1.585-8(c)(1)(iii) election under §1.585-7(a) if the bank evidences its intent to make an election under section 585(c)(4) for its disqualification year by attaching a statement in accordance with §5h.5(a)(3)(i) to its tax return or amended return for this year, and this return is filed before [*Insert date that this regulation is published as a final regulation in the Federal Register*].

(c) *Revocation of elections* — (1) *On or before final date for making election.* An election under §1.585-6(b)(2), §1.585-6(d)(2) or §1.585-7(a) may be revoked without the consent of the Commissioner on or before the final date prescribed by paragraph (a)(1) of this section for making the election. To do so, the bank that made the election must file an amended tax return for its disqualification year (or, for elections under §1.585-6(d)(2), the year for which the election was made) and attach a statement that —

(i) includes the bank's name, address and taxpayer identification number;

(ii) identifies and withdraws the previous election; and

(iii) if the bank is making a new election under §1.585-6(b)(2), §1.585-6(d)(2) or §1.585-7(a), contains the information described in paragraphs (b)(1)(ii) and (b)(1)(iii) of this section.

(2) *After final date for making election.* An election under §1.585-6(b)(2), §1.585-6(d)(2) or §1.585-7(a) may be revoked only with the consent of the Commissioner after the final date prescribed by paragraph (a)(1) of this section for making the election. The Commissioner will grant this consent only in extraordinary circumstances, such as circumstances that would justify granting an extension of time under §1.9100-1 for making an

election. See Revenue Procedure 79-63, 1979-2 C.B. 578, for factors considered in applying §1.9100-1.

(d) *Elections by banks that are members of parent-subsidiary controlled groups.* In the case of a bank that is a member of a parent-subsidiary controlled group (as defined in §1.585-5(d)(2)), any election under §1.585-6(b)(2), §1.585-6(d)(2) or §1.585-7(a) with respect to the bank is to be made separately by the bank. An election made by one member of such a group is not binding on any other member of the group.

PART 5h—[AMENDED]

Paragraph 6. The authority for Part 5h is amended by removing the following citations: "585(c)(3)(A)-(iii)(I), 585(c)(4),".

Par. 7. Section 5h.5 is amended as follows:

1. The table in paragraph (a)(1) is amended by removing each line, from each column, that relates to section 901(a) of the Act and to section 585(c)(3)(A)(iii)(I) or 585(c)(4) of the Code.

2. Paragraph (a)(4)(ii) is amended by removing "901(a) (Code sections 585(c)(3)(B)(ii) and 585(c)(4)),".

Fred T. Goldberg, Jr.,
Commissioner of Internal Revenue

(Filed by the Office of the Federal Register on December 11, 1990, 8:45 a.m., and published in the issue of the Federal Register for December 12, 1990, 55 F.R. 51124)

Notice of Proposed Rulemaking

Exception from the Prohibition of Federal Guarantees—Permitted Investments of Tax-Exempt Bond Proceeds

FI-84-90

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In *** [T.D. 8313, page 37, this Bulletin], the Internal Revenue Service is issuing temporary regulations relating to the prohibition of federal guarantees with respect to bonds the interest on which is excludable from gross income. The temporary regulations provide that investments in obligations issued by the Resolution Funding Corporation pursuant to the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 are excepted from the prohibition of federal guarantees. The text of the temporary regulations also serves as the comment document for this notice of proposed rulemaking.

DATES: Written comments and requests for a public hearing must be received by December 14, 1990. These regulations are proposed to be effective for investments made on or after October 2, 1990.

ADDRESS: Send comments and requests for a public hearing to: Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Attn: CC: CORP:T:R (FI-84-90), Room 4429, Washington, D.C. 20044.

SUPPLEMENTARY INFORMATION:

Background

The temporary regulations published in *** [T.D. 8313, page 37, this Bulletin] add new §1.149(b)(3)-1T to the Income Tax Regulations (26 CFR Part 1). The new temporary regulations permit investments of tax-exempt bond proceeds in obligations issued by the Resolution Funding Corporation. The text of the new temporary regulations serves as a comment document for this notice of proposed rulemaking.

For the text of the temporary regulations, see T.D. 8313 published in *** [page 37, this Bulletin].

Special Analyses

It has been determined that these proposed rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. 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, an initial Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations will be submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

Comments and Requests for a Public Hearing

Before the adoption of these proposed regulations, consideration will be given to any written comments that are submitted (preferably a signed original and eight copies) to the Internal Revenue Service. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Internal Revenue Service by any person who also submits written comments. If a public hearing is held, notice of the time and place will be published in the Federal Register.

Proposed Amendments to the Regulations

The temporary regulations, T.D. 8313, published in *** [page 37, this Bulletin], are hereby also proposed as final regulations under section 149 of the Internal Revenue Code.

Fred T. Goldberg, Jr.,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on October 10, 1990, 11:51 a.m., and published in the issue of the Federal Register for October 15, 1990, 55 F.R. 41695)

Notice of Proposed Rulemaking

Backup Withholding and Due Diligence

IA-224-82

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document provides proposed regulations that relate to backup withholding under section 3406(a)(1)(A), (B), (C), and (D) of the Internal Revenue Code of 1986 (the "Code") when a payee fails to provide a taxpayer identification number in the manner required to a person required to make an information return, when the Internal Revenue Service or a broker notifies a payor or broker that a payee has furnished an incorrect taxpayer identification number, when a payee is subject to notified payee underreporting, or when a payee fails to certify, under penalties of perjury, that the

payee is not subject to backup withholding due to notified payee underreporting. These proposed regulations also reference the provisions of the Temporary Employment Tax Regulations under the Interest and Dividend Tax Compliance Act of 1983 (Part 35a) that were published in the Federal Register in question and answer format (Part 35a) on October 4, 1983 (48 FR 45362), November 25, 1983 (48 FR 53106), December 20, 1983 (48 FR 56332), February 28, 1984 (49 FR 7227), August 22, 1984 (49 FR 33237, 33240), April 23, 1987 (52 FR 13430), November 23, 1987 (52 FR 44861), and April 11, 1989 (54 FR 14341) concerning the actions that payors must take to establish the due diligence defense to the penalty under section 6676(b) for filing an information return with a missing or an incorrect taxpayer identification number.

Changes to the applicable tax law that are reflected in this document were made by the Interest and Dividend Tax Compliance Act of 1983 (97 Stat. 369), the Tax Reform Act of 1984 (98 Stat. 494), and the Tax Reform Act of 1986 (100 Stat. 2748). These regulations do not address the changes in law made by the Omnibus Budget Reconciliation Act of 1989 (103 Stat. 2106). These regulations affect payors, brokers, and payees of certain reportable payments and provide them with the guidance necessary to comply with the law.

DATES: Written comments and requests for a public hearing must be received by January 25, 1991. These regulations are proposed to be generally effective with respect to reportable payments made and transactions occurring after December 31, 1983.

ADDRESSES: Send comments and requests for a public hearing to: Internal Revenue Service, CC:CORP:T:R (IA-224-82) LR-224-82, Room 4429, 1111 Constitution Avenue, N.W., Washington, D.C. 20224.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection-of-information requirements contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget in accordance with the requirements of the Paperwork Reduction Act (44 U.S.C. 3504 (h)). Comments on the collection-of-information requirements should be sent to the Office of Management and Budget, Attention: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, D.C. 20503, with copies to the Internal Revenue Service, ATTN: IRS Reports Clearance Officer T:FP, Washington, D.C. 20224.

The collection-of-information requirements in this regulation are in §31.3406(a)-1; §31.6011(a)-11; §31.6051-4(a); §31.6302(c)-1(a)(1)(i)-(d) and §31.6413(a)-3. This information is required by the Internal Revenue Service to enable the Internal Revenue Service to enforce sections 3406, 6011, 6051, 6302, and 6413 of the Code. This information will be used to encourage compliance with respect to the reporting and payment of taxes on interest and dividend income and other reportable payments. The likely respondents and/or recordkeepers are: individuals, State or local governments, businesses, other for-profit institutions, Federal agencies, nonprofit institutions, and small businesses or organizations.

These estimates are an approximation of the average time expected to be necessary for a collection of information. They are based on such information as is available to the Internal Revenue Service. Individual respondents/recordkeepers may require greater or less time, depending on their particular circumstances. Estimated total annual reporting and/or recordkeeping burden: 98,582 hours.

The estimated average annual burden per respondent/recordkeeper is approximately 1 hour. Estimated number of respondents and/or recordkeepers: 105,000.

Estimated annual frequency of responses: 17.

Submission to Small Business Administration

Pursuant to section 7805(f) of the Code, the rules proposed in this document will be submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

BACKGROUND

This document contains proposed regulations relating to the requirement that a payor or broker withhold 20 percent from any reportable payment under section 3406(a)(1)(A) or (a)(1)(B), or 20 percent from any reportable interest or dividend payment under section 3406(a)(1)(C) or (a)(1)(D) of the Code. These provisions were added to the Code by section 104 of the Interest and Dividend Tax Compliance Act of 1983 (Pub. L. 98-67, 97 Stat. 369, 371). These proposed regulations are proposed to be issued under the authority contained in section 3406(a), (b), (c), (e), (g), (h), and (i), section 6042(c), section 6044(e), section 6049(c), section 6103(q), section 6109, section 6302(c), section 6676, and section 7805 of the Code.

On October 4, 1983, the Federal Register published Temporary Employment Tax Regulations under the Interest and Dividend Tax Compliance Act of 1983 (26 CFR Part 35a) under sections 3406 and 6676(b) of the Internal Revenue Code of 1954 (26 CFR Part 35a.9999-1; T.D. 7916, 48 FR 45362 [1983-2 C.B. 272], as amended on November 25, 1983, by T.D. 7922, 48 FR 53111 [1983-2 C.B. 282], on November 23, 1987, by T.D. 8163, 52 FR 44861 [1987-2 C.B. 226], and on April 11, 1989, by T.D. 8248, 54 FR 14341 [1989-1 C.B. 280]). Additional temporary regulations were published in the Federal Register on November 25, 1983 (26 CFR Part 35a.9999-2; T.D. 7922, 48 FR 53106 [1983-2 C.B. 282], as amended on December 20, 1983, by T.D. 7929, 48 FR 56342 [1984-1 C.B. 285], on March 13, 1984, by T.D. 7922, 49 FR 9417, and on November 23, 1987, by T.D. 8163, [1987-2 C.B. 226] and on April 11, 1989, by T.D. 8248, 54 FR 14341 [1989-1 C.B. 280]), on December 20, 1983 (26 CFR Part 35a.9999-3; T.D. 7929, 48 FR 56332, as amended on January 3, 1984, by T.D. 7933, 49 FR 63 [1984-1 C.B. 300], on August 22, 1984, by T.D. 7966, 49 FR 33236 [1984-2 C.B. 324], on November 23, 1987, by T.D. 8163, 52 FR 44861, and on April 11, 1989, by T.D. 8248, 54 FR 14341), on February 28, 1984 (26 CFR Part 35a.9999-3A; T.D. 7946, 49 FR 7227 [1984-1 C.B. 302]), on August 22, 1984 (26 CFR Part 35a.9999-4T, T.D. 7966, 49 FR 33237, as amended on August 29, 1984, by T.D. 7972, 49 FR 34340 [1984-2 C.B. 327]; and 26 CFR Part 35a.9999-5, T.D. 7967, 49 FR 33240 [1984-2 C.B. 329], as

amended on September 19, 1984, by T.D. 7973, 49 FR 36645 [1984-2 C.B. 170], on August 20, 1985, by T.D. 8046, 50 FR 33526 [1985-2 C.B. 61], on April 3, 1986, by T.D. 8046, 51 FR 11447, and on December 19, 1986, by T.D. 8110, 51 FR 45453 [1987-1 C.B. 81], on May 19, 1988, by T.D. 8202, 53 FR 17927 [1988-1 C.B. 78]), on April 23, 1987 (26 CFR Part 35a.3406-2; T.D. 8137, 52 FR 13430 [1987-1 C.B. 302]), and on November 23, 1987 (26 CFR Part 35a.3406-1; T.D. 8163, 52 FR 44861 [1987-2 C.B. 226], as amended on April 11, 1989, by T.D. 8248, 54 FR 14341 [1989-1 C.B. 280]). Those regulations were published primarily to provide guidance under the Interest and Dividend Tax Compliance Act of 1983.

Explanation of Provisions

On August 31, 1983, after a news release was issued soliciting comments on backup withholding, a hearing was held at the Internal Revenue Service. The Service received numerous comments, all of which were carefully considered in preparation of both these proposed regulations and the temporary regulations that were published in question and answer format during 1983 and subsequently.

These proposed regulations generally reorganize and restate, in traditional regulation form, the rules contained in the previously published temporary regulations on backup withholding with changes in several areas where commentators have sought clarification. The Service recognizes that the proposed regulations are lengthy, but believes this is needed in order to provide clear guidance for the numerous situations where backup withholding is or is not applicable. In addition, an extensive table of contents has been added to make the regulations more accessible to readers.

General rules. These proposed regulations require withholding by a payor or broker at a 20 percent rate in certain situations. In general, payments that are subject to backup withholding include: (1) payments of rents, commissions, fees, or other forms of compensation for services and other fixed or determinable gains, profits, or income payments that are subject to reporting under section 6041 or 6041A(a); (2) payments of dividends that are subject to reporting under section 6042; (3) payments of patronage dividends that are subject to reporting under section 6044; (4) payments of interest and original issue discount that are subject to reporting under section 6049; (5) payments of certain fishing boat operators that are subject to reporting under section 6050A; (6) certain transactions effectuated by brokers and barter exchanges that are subject to reporting under section 6045; and (7) payments of royalties that are subject to reporting under section 6050N.

With respect to payments of interest, original issue discount, dividends, or patronage dividends (hereafter, "reportable interest or dividend payments"), backup withholding is required in four situations. First, backup withholding is required if a payee does not provide a taxpayer identification number to the payor in the manner required. An individual's taxpayer identification number is the individual's social security number. A nonindividual's taxpayer identification number is the entity's employer identification number. The term "nonindividual" means a trust, estate, corporation, or similar entity. With respect to pre-1984 accounts or instruments, the payee is required to provide his taxpayer identification number, either in writing or orally. With respect to accounts established or instruments acquired after 1983, the payee is required to certify, under penalties of perjury, that the payee's taxpayer identification number is correct. Second, backup withholding is required if the Internal Revenue Service or a broker notifies the payor that the payee's taxpayer identification number is incorrect. Third, backup withholding is required if the Internal Revenue Service or a broker notifies the payor that the payee is subject to backup withholding due to notified payee underreporting. Fourth, with respect to accounts established or instruments acquired after 1983, backup withholding is required if a payee fails to certify, under penalties of perjury, that the payee is not subject to backup withholding due to notified payee underreporting.

With respect to other reportable payments, backup withholding is required only in two situations. First, backup withholding applies if the payee does not provide a taxpayer identification number in the manner required. With respect to post-1983 brokerage or barter exchange relationships, the customer is required to certify, under penalties of perjury, that the taxpayer identification number provided is correct. With respect to all remaining types of reportable payments (e.g., rents, royalties, commissions, rents, pension or annuity distributions, etc.), the taxpayer identification number is not required to be certified under penalties of perjury. Second, backup withholding is required if the Internal Revenue Service or a broker notifies the payor that the payee's taxpayer identification number is incorrect.

Clarification and modifications. With respect to a "window transaction" as defined in these proposed regulations, backup withholding applies only if the payee fails to furnish a taxpayer identification number. The payee does not have to certify, under penalties of perjury, that the number provided is correct. In addition, commentators have questioned whether backup withholding is required with respect to a window transaction if the Internal Revenue Service notifies the payor to withhold either because of an incorrect taxpayer identification number under section 3406(a)(1)(B) or a notified payee underreporting under section 3406(a)(1)(C). Because requiring backup withholding on window transactions due to notification from the Service to withhold would create administrative problems for payors, these proposed regulations provide that the payor is required to withhold only on redemptions of United States savings bonds, or payments on interest coupons, commercial paper, or banker's acceptances, any of which are in definitive form, if the payee fails to provide a taxpayer identification number. Thus, payors of window transactions are not required to check their records to determine if the payee is subject to backup withholding under section 3406(a)(1)(B) or (C). Many commentators questioned the meaning of "in definitive form"; these proposed regulations provide a definition.

A person who furnishes a number that does not contain nine digits or contains an alpha character (*i.e.*, an obviously incorrect number) is treated

as failing to provide a taxpayer identification number. Thus, backup withholding applies to payments made to any payee who furnishes an obviously incorrect number. Commentators have questioned whether a number that contains nine identical digits (e.g., 999-99-9999) or nine sequential digits (e.g., 012-345-678) is a number with respect to which they should impose backup withholding on the account or instrument. Payors should not impose backup withholding when a payee furnishes such numbers because an obviously incorrect number for purposes of backup withholding is one that does not contain nine numerals. While the Service recognizes that these other numbers are likely to be erroneous, administrative problems for payors would result if the payor were required to determine whether a number containing nine digits is correct.

Backup withholding will apply with respect to numbers with nine numerals only when the Service notifies the payor that the number is incorrect. In this connection, payors are required to backup withhold only if the payor receives a notice of an incorrect number from the Internal Revenue Service under section 3406(a)(1)(B) on or after January 1, 1990.

Backup withholding only applies to reportable payments that are not withheld upon under another provision of the Code. Thus, payors are not required to withhold on a payment under more than one section of the Code.

Commentators requested clarification on the amount of a payment subject to backup withholding. These proposed regulations provide generally that the reporting threshold is to be ignored in determining the amount subject to backup withholding. Backup withholding, therefore, applies to the first dollar of any payment. There are limited exceptions to this rule, however, that are described in these proposed regulations. For example, a payor can elect not to withhold on reportable interest or dividend payments of $10 or less and which on an annualized basis would be $10 or less. This minimal payment rule means that payors look at the amount on a payment-by-payment basis. Thus, payors are not required to add the payments that they have made thus far in the year to determine whether the payee was paid more than $10 during the year. Payors are, however, required to annualize each payment. Annualization means that payors determine the amount the payment would have been for a 1-year period rather than for the period for which it is paid. For example, with respect to a savings account that pays interest quarterly, payors would not have to withhold on any quarterly payment that is $2.50 or less.

These proposed regulations do not require that a separate annualization computation be made for payments made on accounts opened between a payor's customary paying date. Because this could create administrative and programming problems for payors, these proposed regulations provide that, with respect to accounts opened during the payment cycle, a payor will be allowed to assume that the payment was made for the entire payment cycle.

Barter exchanges or brokers who effect sales of securities where the amount of the gross proceeds or other reportable payment under section 6045 is not more than $10 are also not required to withhold on those minimal amounts if the barter exchange or broker so elects. In addition, any window transaction that aggregates $10 or less is not subject to withholding if the payor so elects. Brokers, barter exchanges, or payors with respect to window transactions are not required to annualize the payments.

Commentators have requested guidance on whether backup withholding applies in instances where the sale of a fractional share results in less than $20 of gross proceeds that are not otherwise subject to information reporting under §5f.6045-1(c)(3)(ix). Although section 3406 permits backup withholding regardless of the amount that must be paid before an information return is required to be made, these regulations provide that gross proceeds of less than $20 resulting from the sale of a fractional share will not be subject to backup withholding.

With respect to taxable reinvestment plans, the regulations allow payors to ignore fees, commissions, or any discount in the purchase price of the shares in determining the amount subject to withholding.

A payor may elect to reduce the amount of interest subject to withholding when a premature withdrawal penalty is imposed with respect to a time savings account, a certificate of deposit, or similar deposit.

These proposed regulations describe the procedures for determining the amount of original issue discount subject to backup withholding. Commentators have questioned whether a subsequent holder of a short-term discount obligation is required to certify, under penalties of perjury, that the purchase price is correct. These proposed regulations provide that the holder is not required to certify such information.

With respect to payments that are subject to reporting under sections 6041 or 6041A(a) (e.g., rents, commissions, nonemployee compensation), the payor is generally not required to withhold on payments that aggregate less than $600 during a calendar year. Once the payment or payments aggregate $600, however, backup withholding applies to the entire payment that causes the amount to equal or exceed $600 and to any subsequent payments made to the payee during the year. For example, if a payor pays nonemployee compensation of $550 to a person on February 25 and pays $50 on December 3, these proposed regulations clarify that the payor is only required to withhold 20 percent of $50 even though $600 of reportable payments were paid during the year. Exceptions to the $600 rule exist if the payor was required to make an information return for the preceding calendar year or the payor was required to impose backup withholding during the preceding calendar year. In these instances, the payor is required to withhold on the first dollar of any payment to the payee.

In the case of a corporate reorganization where a payee is required to exchange stock held in the former corporation for stock in the new corporation before the dividends which have been paid with respect to the stock in the new corporation will be provided to the payee, the temporary regulations provide that the dividend is considered paid for purposes of backup withholding on the payment date without regard to when the payee actually exchanges the stock and receives the dividend. Commentators

have stated, however, that current industry practice for paying and recordkeeping purposes is to treat the dividend as paid on the date that the shares are exchanged since that is the date the payee receives the dividend. Thus, these proposed regulations provide that in the case of a corporate reorganization, the dividends are treated as paid for purposes of backup withholding on the date that the payee actually exchanges the stock in the former corporation and receives the dividend.

The temporary regulations and these proposed regulations provide similar rules for a person who is awaiting a taxpayer identification number and set forth the requirements for such a payee to qualify for a 60-day exemption period. Both regulations also provide that the exemption does not apply to window transactions. These proposed regulations provide further that the exemption does not apply to the redemption of a bearer bond that is subject to reporting under section 6045. As with window transactions, the payor with respect to a bearer bond would not have funds on which to withhold after the 60-day period if the payee did not provide a taxpayer identification number. Thus, these proposed regulations provide that a person who presents a bearer bond after September 27, 1990, will be subject to backup withholding unless the person provides a certified taxpayer identification number.

Moreover, with respect to other reportable gross proceeds under section 6045, the regulations provide that when a payee instructs a broker to sell or retire an obligation and the customer does not have a taxpayer identification number, the broker may allow the payee to furnish the number in the manner required within 60 days of the sale provided the customer provides an awaiting-TIN certificate and does not withdraw or reinvest more than 80 percent of the gross proceeds. If the broker does not receive the customer's taxpayer identification number in the manner required on or before the 60th day after the sale or redemption, the broker is required to withhold 20 percent of the gross proceeds.

Commentators have also requested a definition of a readily tradable instrument. Accordingly, these regulations provide a definition. In addition, with respect to a readily tradable instrument acquired through a broker and not held in street name, the regulations clarify that a payor may assume that the taxpayer identification number and other information received from a broker are correct. The broker is generally required only to notify the payor if the payee failed to provide a certification to the broker that the taxpayer identification number is correct or that the payee is not subject to backup withholding due to notified payee underreporting. The payor may ignore a notice from the broker that the payee has failed to make the certification to the broker, however, if the payor has received the certification directly from the payee.

The payor of an instrument acquired through a broker is required to send a notice to the payee if (1) the broker notifies the payor of the readily tradable instrument that the payee failed to provide the certifications (and the payor has not received that certification from the payee directly) or (2) the broker notifies the payor that the Internal Revenue Service notified the broker that the payee is subject to backup withholding or the Internal Revenue Service notifies the payor to impose backup withholding. Whenever the payor is required to notify the payee that backup withholding has commenced or will commence with respect to a readily tradable instrument, the notice must inform the payee of the condition or conditions for imposing backup withholding and explain what the payee must do to stop backup withholding. These proposed regulations amend the language of the notice that the payor sends to notify the payee that backup withholding has commenced or will commence as a result of a certification failure. With respect to the notice that a payor is required to send after being notified by the Service or a broker that a payee is subject to backup withholding under section 3406(a)(1)(B) or section 3406(a)(1)(C), these proposed regulations incorporate those requirements set forth in the temporary regulations.

Special rules exist when an account is established directly with, or an instrument is acquired directly from, the payor by means of electronic or mail communication. The temporary regulations provide that, at the payor's option, the payee may be given 30 days to provide the required certifications as long as the payee furnishes a taxpayer identification number at the time of acquisition. Many commentators asked whether this special rule in the temporary regulations is limited to mutual funds. These proposed regulations clarify that these special rules apply to an account or other readily tradable instrument that is established directly with, or acquired directly from, any payor, including bank deposits, certificates of deposit, or repurchase agreements, provided the account or instrument is established or acquired by means of electronic or mail communication. In addition, these proposed regulations clarify that a broker who holds an instrument as nominee for a payee (*i.e.*, in street name) is considered a payor. Accordingly, these special rules apply where an instrument is acquired from a broker by means of electronic or mail communication and the broker holds the instrument in street name for a payee.

With respect to a post-1983 brokerage account through which a readily tradable instrument is sold by electronic means (*i.e.*, by telephone or wire instruction), commentators requested clarification of the special rule that the broker may permit the customer to furnish the required certification that his taxpayer identification number is correct within 30 days of the sale, provided the customer furnishes his taxpayer identification number at the time of the sale and does not withdraw or reinvest more than 80 percent of the gross proceeds before furnishing the certification. Although the temporary regulations provide that reinvestment of up to 80 percent of the gross proceeds in other securities will not be considered a withdrawal, commentators objected to the provision that withdrawal of any amount of cash results in immediate imposition of backup withholding. These proposed regulations alter that rule and provide that as long as at least 20 percent of the gross proceeds are held in cash, the broker may permit the customer to furnish the required certification within 30 days of the sale. If no certified number is received within 30 days of the sale or if the customer withdraws or

reinvests more than 80 percent of the gross proceeds before the broker receives the certification, however, the broker must withhold 20 percent of the reportable gross proceeds at that time. Thus, the broker rules more closely parallel the special 30-day rule with respect to reportable interest or dividends.

In the case of an issuer or its paying agent of a taxable interest coupon who receives an envelope or "shell" used for processing the coupon signed by the payee stating that the interest is exempt from taxation under section 103(a) (relating to interest on certain State or local governmental obligations), commentators requested clarification of whether the amount is subject to backup withholding if the interest is not, in fact, tax-exempt. Because the middleman payor (e.g., bank or broker) may only treat the interest as tax-exempt by receiving a properly completed "shell" or envelope from the payee (including the payee's name, address, and taxpayer identification number) under §1.6049-5(b)(2), the issuer will not be required to withhold even if the interest is taxable because the shell or envelope will contain the payee's taxpayer identification number. If the middleman payor does not receive a properly completed shell or envelope from the payee, including the payee's taxpayer identification number, the middleman payor is not permitted to treat the interest as tax-exempt. Accordingly, the middleman payor would be required to impose backup withholding if the interest is not, in fact, tax-exempt and the payee did not furnish his taxpayer identification number.

Many commentators questioned whether specific transactions are subject to broker reporting under section 6045. Examples provided in these regulations show that certain transactions are covered under section 6045 and thus are subject to backup withholding. Please note, however, that real estate transactions subject to information reporting by a real estate reporting person, as defined under section 6045(e)(2), are not subject to backup withholding (pursuant to section 3406(h)(5)(D)) except as provided in regulations. These proposed regulations do not contain backup withholding requirements with respect to real estate transactions.

Many commentators also questioned whether they were required to obtain a certificate each time a payee opens a new account or brokerage relationship even if the payor already has a certificate from the payee. These proposed regulations clarify that a payor, at its option, may require a payee to file only one Form W-9 for all accounts or instruments of the payee. If the payor elects this option and already has a certificate on file with respect to the payee, the payor is not required to obtain another certificate from the payee.

Many commentators questioned whether the payor or broker must provide the Form W-9 instructions to the payee with respect to new accounts or brokerage relationships where the payor or broker devises a substitute Form W-9. These proposed regulations provide that the instructions or the substance of those instructions do not have to be furnished to the payee. With respect to such accounts, the payee need only be instructed to strike out the language of the certification that relates to payee underreporting if the payee is subject to backup withholding due to notified payee underreporting.

Many commentators questioned whether a payee, who has never furnished a taxpayer identification number with respect to a pre-1984 account or a brokerage account other than a post-1983 brokerage account, must certify, under penalties of perjury, that his number is correct if the payee furnishes his taxpayer identification number for the first time after 1983. These proposed regulations clarify that the payee is not required to certify that his taxpayer identification number is correct if he is furnishing the number with respect to a pre-1984 account or a brokerage relationship other than a post-1983 brokerage account.

Clarification has also been requested with respect to how backup withholding applies to accrued interest. The regulations under section 6049 provide that when a bond is purchased between interest payment dates, the portion of the purchase price attributable to accrued interest is not reportable under section 6049. If a broker is involved in the transfer of the obligation, however, the broker is required to report the gross proceeds of the sale. Accrued interest is a portion of the proceeds of the sale. The regulations under section 6045 provide that, in reporting the total gross proceeds, the broker is required to file a Form 1099-INT showing the amount of accrued interest and is required to file a Form 1099-B showing the remainder of the proceeds of the sale. Therefore, backup withholding will apply to the gross proceeds of the sale (including the accrued interest portion) if the payee does not provide a taxpayer identification number in the manner required or the Internal Revenue Service notifies the broker that the payee's number is incorrect.

Based on the questions received relating to the treatment of grantor trusts, these proposed regulations adopt the rule in the temporary regulations in the Federal Register on April 11, 1989 (54 FR 14341) that relate to grantor trusts with ten or fewer grantors. Accordingly, these proposed regulations provide that a grantor trust with ten or fewer grantors is not a payor for purposes of backup withholding. Such grantor trust is not required to impose backup withholding when it receives a reportable payment. However, the trustee of a grantor trust having ten or fewer grantors may not certify, under penalties of perjury, that the trust is not subject to backup withholding due to notified payee underreporting or that the taxpayer identification number provided by the trustee is correct unless each grantor has furnished the trustee with such certifications, and the trustee uses the taxpayer identification numbers provided by the grantors on the Form 1041 filed by the trustee. Grantor trusts that have more than ten grantors are considered payors of such payments to each grantor (payee), in proportion to each grantor's ownership of the trust.

Many commentators requested clarification in the depositing procedures for amounts withheld under backup withholding. These proposed regulations provide that the payor must remit the amounts withheld under backup withholding in the same manner that an employer remits social security and income tax withheld from wages. Thus, the eighth-monthly trigger procedures are used. A payor may aggregate amounts withheld for backup withholding with

amounts withheld from wages to determine when to remit the withheld amounts. Alternatively, a payor may elect to remit amounts withheld under backup withholding separately from amounts withheld from wages. Regardless of the manner in which the payor elects to treat withheld amounts for purposes of determining the time within which such amounts are required to be deposited, a payor must report the amounts withheld under section 3406 on the same Form 941 that the payor uses to report the employment taxes deposited. The Form 941 has been revised to include a Schedule A to report amounts deposited for backup withholding. If the payor decides to treat backup withholding as a separate tax, the payor should mark 945 on the FTD coupon (Federal Tax Deposit coupon) in remitting backup withholding, should complete Schedule A, and should attach the schedule to Form 941 when the payor (employer) reports to the Internal Revenue Service the amounts remitted during the quarter. With respect to a payor who has a paying agent, the Service has issued Rev. Proc. 84-33 explaining the procedures for an agent to use in depositing and reporting withheld amounts.

Clarification also has been requested with respect to the refund of amounts erroneously withheld under section 3406. These proposed regulations provide that a payor may refund the amount erroneously withheld from the payee during the same calendar year. Payors must retain a receipt of the amount refunded. A cancelled check or a notation on the payee's statement will be treated as the required receipt.

With respect to erroneous withholding on a payment to a middleman payor, the regulations provide that the middleman payor may adjust deposits of the tax which the middleman payor is required to make, by claiming a credit for the amount of tax withheld by the upstream payor. The middleman payor would pay the full amount to the payee if no condition for imposing backup withholding exists with respect to its payee.

For purposes of information reporting under section 6041 and backup withholding, a reportable gambling winning is any winning (other than from keno, bingo, or slot machines) that is $600 or more and that is based on betting odds of 300 to 1, or higher. Reportable gambling winnings will be subject to backup withholding if tax is not actually withheld under section 3402(q) and the payee does not provide a taxpayer identification number.

Effect of the Tax Reform Act of 1984 on Backup Withholding. The Tax Reform Act of 1984 (98 Stat. 494) made three material technical corrections relating to backup withholding under section 3406. First, section 6042 was amended to provide that payments made to exempt recipients (as defined in section 6049(b)(4)) are not subject to information reporting under section 6042. Because such payments are not subject to information reporting, backup withholding will not apply to such payments of dividends. These proposed regulations, unlike the temporary regulations, do not expand the class of payees to which backup withholding will not apply. For example, if the payment is reportable because it is made to a payee who is not an exempt recipient (determined under the applicable reporting section), then backup withholding will apply unless the payment is made to an organization exempt from taxation under section 501(a) or an individual retirement plan, the United States, a State, a foreign government, an international organization, or any wholly owned agency or instrumentality of the foregoing). Because backup withholding is intended to be the enforcement mechanism of the information reporting system, these regulations do not provide any additional exempt recipients under section 3406(g)(1)(A) for purposes of backup withholding.

Second, the Act contains a technical correction to provide rules under section 643 to deal with the allocation of credit for amounts withheld from reportable payments to trusts, estates, and their beneficiaries.

Finally, the Act has a technical correction to coordinate pension and annuity withholding under section 3405 with information reporting under section 6041 and backup withholding under section 3406. The applicable regulations in this document concerning pension and annuity payments will continue to apply for such payments made prior to December 31, 1984, unless the payor elected otherwise, and to certain distributions made after June 30, 1984. See §31.3406(g)-2(c)(1).

Effect of the Tax Reform Act of 1986 on Backup Withholding. The Tax Reform Act of 1986 ("the 1986 Act") made two significant changes in the law relating to backup withholding that are reflected in these proposed regulations. First, the 1986 Act added section 6050N to the Internal Revenue Code to require information reporting on royalty payments. Under prior law, royalty payments were reported under section 6041 to the extent the payments totaled $600 or more during a calendar year. These payments were treated as reportable under section 6041 and hence subject to backup withholding if one of the two conditions for imposing backup withholding existed. In addition, royalty payments under section 6041 were treated as "reportable" for backup withholding purposes if the payor was required to make an information return under section 6041 for the immediately preceding calendar year with respect to payments to the payee or if the payor was required to withhold during the preceding calendar year with respect to payments to the payee that were reportable under section 6041. In either of these two events the payor was required to withhold whether or not the payor's payments to the payee equalled or exceeded $600 for the year. After the enactment of section 6050N, however, royalty payments are only subject to information reporting and, hence, to backup withholding if the payments aggregate $10 or more during the calendar year.

The 1986 Act also imposes a statement mailing requirement for payee statements of royalties reportable under section 6050N(a), and it amends the separate mailing provisions under prior law by imposing an identical statement mailing requirement on payee statements of dividends, patronage dividends, and interest under sections 6042(c), 6044(e), and 6049(c). The Internal Revenue Service issued guidance to the public on the statement mailing requirement in Notice 87-17, 1987-1 C.B. 454. That notice specifically provided that the payee statement could not be perforated to a permissible enclosure in a statement mailing. Many commentators objected to this limitation and stated that

the purpose of the liberalization of the separate mailing requirement was, in part, to permit a perforated statement. Upon reconsideration, the Internal Revenue Service issued Notice 87-70, 1987-2 C.B. 380, to permit the statement to be perforated to a check or statement of a payee's account. These proposed regulations reflect the statement-mailing rules in Notice 87-17 as modified by Notice 87-70. The proposed rules in this document containing the statement-mailing requirements will amend earlier proposed regulations on information reporting that were published in the Federal Register on February 29, 1988 (53 FR 5991).

Effect of the Omnibus Budget Reconciliation Act of 1989 on Due Diligence. These proposed regulations reference the questions and answers in the temporary regulations relating to the due diligence requirement under section 6676, which imposed a $50 penalty on a payor filing an information return with a missing TIN or an incorrect TIN unless the payor exercised due diligence. However, effective for information returns filed with respect to the 1989 calendar year and thereafter, the Act repealed section 6676. The questions and answers referenced in these proposed regulations thus apply only to information returns with respect to calendar years prior to 1989. These proposed regulations do not provide guidance with respect to the penalty under section 6721 for filing an information return with a missing or an incorrect taxpayer identification number.

Changes from the Temporary and Proposed Regulations Issued under Section 3406(a)(1)(B), Backup Withholding due to an Incorrect TIN. The rules and regulations section of this issue of the Federal Register contains amendments to temporary regulation §35a.3406-1, which provides rules for backup withholding under section 3406(a)(1)(B). The substance of that regulation, as amended, is included in these proposed regulations.

One amendment made to §35a.3406-1 exempts certain fiduciary and nominee accounts from backup withholding under section 3406(a)(1)(B) until final regulations are issued. Under these proposed regulations, such accounts would not be exempt from backup withholding under section 3406(a)(1)(B) following receipt of a "B" notice after final regulations are issued. The Service invites comments from payors on how fiduciary and nominee accounts can be formatted on information returns so that the correct name/TIN combination can be identified and backup withholding can be avoided.

Changes from the Temporary Regulations Issued under Section 3406(a)(1)(C), Notified Payee Underreporting. The proposed regulations on backup withholding due to notified payee underreporting as set forth in §31.3406(c)-1 of this document incorporates those rules in the temporary regulations on this subject that were published in the Federal Register on April 23, 1987 (52 FR 13430), with several changes. This document clarifies the rules in the temporary regulations and adds examples to illustrate how some of the substantive provisions should apply.

For instance, the Internal Revenue Service received several inquiries concerning how a paying agent must impose backup withholding under section 3406(a)(1)(C). The inquiry arises because a paying agent may remit reportable interest or dividend payments on behalf of a payor to a payee who also maintains a separate account with the paying agent that pays reportable interest or dividends. Thus, the question that has arisen is whether the paying agent must search its own accounts as well as the accounts of the instructing payor to impose backup withholding on the payee under section 3406(a)(1)(C). The proposed regulations in this document provide that the paying agent is only required to search the accounts of the payor stated on the notice using that payor's taxpayer identification number.

Payors also asked whether they must check their records each time a payee opens a new post-1983 account paying reportable interest or dividends and makes the certification required under section 3406(a)(1)(D). These proposed regulations clarify that payors do not have an affirmative duty to search their records in this circumstance.

Several payors were concerned about which information they should use to locate the accounts of a payee subject to backup withholding under section 3406(a)(1)(C) in those circumstances in which the notice from the Service instructing the payor to commence backup withholding under section 3406(a)(1)(C) lists information from a joint account. Because of this concern, the provisions in §31.3406(c)-1 of these proposed regulations on joint accounts are clarified. In addition, these proposed regulations provided examples to show the application of backup withholding on a joint account.

Finally, the regulations under proposed §31.3406(c)-1 provide that a payor who fails to send the notice required under section 3406(a)(4) to a payee subject to backup withholding under section 3406(a)(1)(C) may be subject to civil or criminal penalties.

Certain Reportable Payments Made Outside the United States by Foreign Persons, Foreign Offices of United States Banks and Brokers, and Others. The temporary regulations state that the applicability of the backup withholding rules to certain reportable payments made outside the United States is under consideration. *See* §35a.9999-3(A-34),(A-36);§35a.9999-4(A-1), (A-5). It has been decided not to require backup withholding with respect to such reportable payments unless the payor has actual knowledge that the payee is a United States person, and the proposed regulations reflect this decision at §31.3406(g)-1(e).

Concluding Comments

The Internal Revenue Service, in proposing these regulations, has strived to provide as much flexibility as possible to payors in complying with the backup withholding rules. For example, many payors commented that they would need time to process taxpayer identification numbers or certificates that they receive from their payees. The regulations provide them with the needed flexibility by requiring that payors process a number or certificate within 30 days of filing, but permitting payors to process them sooner if they choose.

Many payors requested that they be able to prepare and provide certificates to their payees. The proposed regulations allow payors to devise their own certificates that may be incorporated into account signature cards or other instrument purchase

agreements as long as the payor complies with the specifications of Rev. Proc. 83-89, 1983-2 C.B. 613. The Service has also given payors the authority to refuse to accept forms or certificates the payor itself has not prepared, so long as the payor promptly furnishes to the payee an acceptable form.

In response to requests by some payors, the proposed regulations provide that due to the volume of certificates payors receive, payors are permitted to retain only a microfilm or microfiche copy of the certificate and to destroy the paper certificates.

The temporary regulations provide that, with respect to the proceeds of a broker or barter exchange transaction, backup withholding applies on the sale date (*i.e.*, the date the transaction is entered on the books of the broker or barter exchange). Several commentators have indicated that this rule is difficult to administer because payment often occurs after the sale date. Accordingly, the proposed regulations provide that the obligation to backup withhold arises on the sale date, but that the broker or barter exchange is not required to satisfy its backup withholding liability until payment is made.

The proposed regulations describe exempt recipients and allow them to be treated as exempt recipients at the option of the payor even though they have not filed a certificate claiming exempt status with the payor. This rule is provided because some payors explained that they do not have the capability of determining whether the payee is an exempt recipient. Thus, the regulations provide that a payor may refuse to treat a payee as exempt unless the payee files a certificate and may treat a payee who does not file a certificate as a payee who is not an exempt recipient. Further, many payors commented on the problems that would result if the payor withheld on such an exempt recipient. As a result of these concerns, if a payor withholds on an exempt recipient because the payee fails to provide a certificate, the proposed regulations allow a payor, at its option, to treat the amount as erroneously withheld and refund it to the exempt recipient.

With respect to a payment in property, the proposed regulations allow the payor to withhold from an alternative source. If the alternative account or source is not payable to the person or persons listed on the account subject to backup withholding, then the payor must obtain a written statement from the non-common owner(s) of the alternative source property allowing the payor to withhold from the alternative account or source. Additionally, payors expressed concern about their liability for backup withholding on a payment in property when there is no alternative source of cash available to withhold upon. Thus, these proposed regulations provide that, except with respect to prizes, awards and gambling winnings, the obligation to backup withhold may be deferred, at the payor's option, until the payor makes a cash payment to the account subject to backup withholding or cash is otherwise deposited in the account.

Finally, the Internal Revenue Service recognizes that there may be industry-specific business and regulatory constraints that make it difficult for certain types of payors to comply with certain backup withholding procedures. Accordingly, the Internal Revenue Service requests comments on these and other areas in which payors need additional flexibility. The Internal Revenue Service will attempt to accommodate such needs to the extent that doing so is consistent with the statute and would not unduly burden effective tax enforcement and administration.

Special Analyses

These proposed rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. Although this document is a notice of proposed rulemaking that solicits public comments, the notice and public procedure requirements of 5 U.S.C. §553 do not apply because the regulations proposed herein are interpretative. Therefore, an initial Regulatory Flexibility Analysis is not required by the Regulatory Flexibility Act (5 U.S.C. Chapter 6).

Comments and Requests for a Public Hearing

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably nine copies) to the Commissioner of Internal Revenue. Interested parties are encouraged to submit written comments by mail and to make oral comments on both the substantive and operational aspects of backup withholding under section 3406 and the penalty under section 6676 at any hearing that might be scheduled. All written comments will be available for public inspection and copying. A public hearing will be held upon written request to the Internal Revenue Service by any person who has submitted written comments. The Internal Revenue Service anticipates scheduling one hearing to accommodate requests (1) under this notice of proposed rulemaking, and (2) under the amendments to the temporary regulations under section 3406(a)(1)(B) concerning the imposition of backup withholding due to an incorrect taxpayer identification number in this issue of the Federal Register. Notice of the time and place of the public hearing will be published in the Federal Register.

List of Subjects

26 CFR 1.6001-1—1.6109-2

Income taxes, Administration and procedure, Filing requirements, Reporting and Recordkeeping requirements.

26 CFR Part 31

Employment taxes, Income taxes, Lotteries, Railroad retirement, Social security, Unemployment tax, Withholding, Interest and Dividend Tax Compliance Act of 1983.

26 CFR Part 301

Administrative practice and procedure, Bankruptcy, Courts, Crime, Employment taxes, Estate taxes, Excise taxes, Gift taxes, Income taxes, Investigations, Law enforcement, Penalties, Pensions, Reporting and Recordkeeping requirements, Statistics, Taxes, Disclosure of information, Filing requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Proposed amendments to the regulations

The proposed amendments to 26 CFR Parts 1, 31, 301, and 602 read as follows:

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

Paragraph 1. Authority for Part 1 continues to read in part:

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

Par. 2. Section 1.6042-5, as proposed on February 29, 1988 (53 FR 5995), is amended by adding the text of paragraph (c)(2) to read as set forth below:

§1.6042-5 Official statements to recipients of dividends paid after December 31, 1983.

* * * * *

(c) *Manner of providing the official statement to the recipient.* * * *

(2) *Statement mailing requirement for forms to be filed after October 22, 1986*—(i) *In general.* With respect to a Form 1099 that is required to be filed after October 22, 1986 (without regard to extensions), the mailing of a Form 1099 to a payee-recipient required under section 6042(c) must qualify as a statement mailing. A statement mailing shall contain the required Form 1099 (written statement). In addition, the mailing may contain the following enclosures:

(A) A check with respect to the account reported on the written statement,

(B) A letter explaining why a check with respect to such account is not enclosed with the written statement (for example, because a dividend has not been declared payable),

(C) A statement of the taxpayer's specific account with the payor if payments on such account are reflected on the written statement,

(D) A letter limited to an explanation of the tax consequences of the information set forth on the enclosed written statement,

(E) Payee statements related to other Forms 1099, Form 1098, and Form 5498 (or the account balance on a Form 5498), Forms W-2 and W-2P, and

(F) Any documents concerning the solicitation of the Form W-9 and Form W-8. Further, to qualify as a statement mailing, the outside of the envelope in which the written statement is mailed and each nontax enclosure enclosed in the envelope must contain, in a bold and conspicuous type, the legend: "Important Tax Return Document Enclosed". For purposes of this paragraph, a nontax enclosure is any item listed in paragraph (c)(2)(i)(A), (B), or (C) of this section. A statement mailing includes a separate mailing as described under paragraph (c)(1) of this section. However, a payor is not required to include the legend on the outside of an envelope containing a separate mailing. The requirement to provide the written statement in person or by first-class mail may be satisfied by sending the written statement and any enclosures described in this paragraph by intra-office mail, provided that intra-office mail is used by the payor in sending account activity, balance information, and other correspondence to the payee. If a payor does not personally deliver the written statement (*i.e.*, Form 1099) to the recipient or mail it to the recipient in a statement mailing as described in this paragraph, the payor shall be considered to have failed to mail the statement required under section 6042(c) and will be subject to the penalty under section 6722.

(ii) *Limitation on enclosures.* No enclosures, other than those permitted under paragraph (c)(2)(i) of this section, and no promotional or advertising material are permitted in the mailing of the written statement. Even a *de minimis* amount of such material violates the statement mailing requirement. However, a logo on the envelope containing the written statement and on nontax enclosures as described in paragraph (c)(2)(i) of this section does not violate the written statement requirement.

(iii) *Perforated written statement.* The written statement required under section 6042(c) and paragraph (c)(2) of this section may be perforated to a check or to a statement of the payee's specific account with the payor as described in paragraph 6042(c)(2)(i)-(A) or (C). The enclosure to which the written statement is perforated must contain, in a bold and conspicuous type, the legend: "Important Tax Return Document Attached".

* * * * *

Par. 3. Section 1.6044-6, as proposed on February 29, 1988 (53 FR 5996), is amended by adding the text of paragraph (c)(2) to read as set forth below:

§1.6044-6 Official statements to recipients for payments after December 31, 1983.

* * * * *

(c) *Manner of providing the official statement to the recipient.****

(2) *Statement mailing requirement for forms to be filed after October 22, 1986*—(i) *In general.* With respect to a Form 1099 that is required to be filed after October 22, 1986 (without regard to extensions), the mailing of a Form 1099 to a payee-recipient required under section 6044(e) must qualify as a statement mailing. A statement mailing shall contain the required Form 1099 (written statement). In addition, the mailing may contain the following enclosures:

(A) A check with respect to the account reported on the written statement,

(B) A letter explaining why a check with respect to such account is not enclosed with the written statement (for example, because a dividend has not been declared payable),

(C) A statement of the taxpayer's specific account with the payor if payments on such account are reflected on the written statement,

(D) A letter limited to an explanation of the tax consequences of the information set forth on the enclosed written statement,

(E) Payee statements related to other Forms 1099, Form 1098, and Form 5498 (or the account balance on a Form 5498), Forms W-2 and W-2P, and

(F) Any documents concerning the solicitation of the Form W-9 and Form W-8.

Further, the outside of the envelope in which the written statement is mailed and each nontax enclosure included in the envelope must contain, in a bold and conspicuous type, the legend: "Important Tax Return Document Enclosed". For purposes of this paragraph, a nontax enclosure is any item listed in paragraph (c)(2)(i)(A), (B), or (C) of this section. A statement mailing includes a separate mailing as described under paragraph (c)(1) of this section. However, a payor is not required to include the legend on the outside of an envelope containing a separate mailing. The requirement to provide the written statement in person or by first-class mail may be satisfied by sending the written statement and any enclosures described in this paragraph by intra-office mail, provided that intra-office mail is used by the payor in sending account activity, balance

information, and other correspondence to the payee. If a payor does not personally deliver the written statement (*i.e.*, the Form 1099) to the recipient or mail it to the recipient in a statement mailing as described in this paragraph, the payor shall be considered to have failed to mail the statement required under section 6044(e) and will be subject to the penalty under section 6722.

(ii) *Limitation on enclosures.* No enclosures, other than those permitted under paragraph (c)(2)(i) of this section, and no promotional or advertising material are permitted in the mailing of the written statement. Even a de minimis amount of such material violates the statement mailing requirement. However, a logo on the envelope containing the written statement and on any enclosure as described in paragraph (c)(2)(i) of this section does not violate the written statement requirement.

(iii) *Perforated written statement.* The written statement required under section 6044(e) and paragraph (c)(2) of this section may be perforated to a check or to a statement of the payee's specific account with the payor as described in paragraph 6044(c)(2)(i)-(A) or (C). The enclosure to which the written statement is perforated must contain, in a bold and conspicuous type, the legend: "Important Tax Return Document Attached".

* * * * *

Par. 4. Section 1.6049-6(e), as proposed on February 29, 1988 (53 FR 6009), is amended by adding paragraphs (e)(5)(ii), (iii), and (iv) to read as set forth below:

§1.6049-6 Statements to recipients of interest payments and holders of obligations as to which there is attributable original issue discount.

* * * * *

(e) *Official statement to recipient for payments made after December 31, 1983.* * * *

* * * * *

(5) *Manner and time of providing the official statement to the recipient.* ***

* * * * *

(ii) *Statement mailing requirement for forms to be filed after October 22, 1986.* With respect to a Form 1099 that is required to be filed after October 22, 1986 (without regard to extensions), the mailing of a Form 1099 to a payee-recipient required under section 6049(c) must qualify as a statement mailing. A statement mailing shall contain the required Form 1099 (written statement). In addition, the mailing may contain the following enclosures:

(A) A check with respect to the account reported on the written statement,

(B) A letter explaining why a check with respect to such account is not enclosed with the written statement (for example, because interest on the account has not been paid or credited to the account),

(C) A statement of the taxpayer's specific account with the payor if payments on such account are reflected on the written statement,

(D) A letter limited to an explanation of the tax consequences of the information set forth on the enclosed written statement,

(E) Payee statements related to other Forms 1099, Form 1098, and Form 5498 (or the account balance on a Form 5498), Forms W-2 and W-2P, and

(F) Any documents concerning the solicitation of the Form W-9 and Form W-8.

Further, to qualify as a statement mailing, the outside of the envelope in which the written statement is mailed and each nontax enclosure included in the envelope must contain, in a bold and conspicuous type, the legend: "Important Tax Return Document Enclosed". For purposes of this paragraph, a nontax enclosure is any item listed in paragraph (e)(5)(ii)(A), (B), or (C) of this section. A statement mailing includes a separate mailing as described under paragraph (e)(5)(i) of this section. However, a payor is not required to include the legend on the outside of an envelope containing a separate mailing. The requirement to provide the written statement in person or by first-class mail may be satisfied by sending the written statement and any permissible enclosures by intra-office mail, provided that intra-office mail is used by the payor in sending account activity, balance information, and other correspondence to the payee. If a payor does not personally deliver the written statement (*i.e.*, Form 1099) to the recipient or mail it to the recipient in a statement mailing as described in this paragraph, the payor shall be considered to have failed to mail the statement required under section 6049(c) and will be subject to the penalty under section 6722.

(iii) *Limitation on enclosures.* No enclosures, other than those permitted under paragraph (e)(5)(ii) of this section, and no promotional or advertising material are permitted in the mailing of the written statement. Even a *de minimis* amount of such material violates the statement mailing requirement. However, a logo on the envelope containing the written statement and on any enclosure as described in paragraph (e)(5)(ii) of this section does not violate the written statement requirement.

(iv) *Perforated written statement.* The written statement required under section 6049(c) and paragraph (e)(5)(ii) of this section may be perforated to a check or to a statement of the payee's specific account with the payor as described in paragraph (e)(5)(ii)(A) or (C). The enclosure to which the written statement is perforated must contain, in a bold and conspicuous type, the legend:

"Important Tax Return Document Attached".

* * * * *

Par. 5. A new §1.6050N-1 is added to read as follows:

§1.6050N-1 Statement to recipients of royalties paid after December 31, 1986.

(a) *In general*—(1) *Manner of providing the official statement to the payee.* With respect to a Form 1099 that is required to be filed after December 31, 1986 (without regard to extensions), reporting the payment of royalties under section 6050N, the payor making such payments is required under section 6050N(b) to furnish a written statement to each person whose name is required to be shown on the Form 1099 (recipient). The written statement shall be furnished either in person or in a statement mailing by first class mail. The requirement to furnish a written statement shall be met by furnishing an official Form 1099 to the recipient. The official Form 1099 shall be the form prescribed by the Secretary for the calendar year. For purposes of section 6050N(b) and this paragraph (a), a payor may use a form that contains provisions that are substantially similar to those of the official Form 1099 if the payor complies with

all applicable revenue procedures relating to substitute Forms 1099. The mailing of a Form 1099 to a recipient required under section 6050N(b) must qualify as a statement mailing.

(i) *Statement mailing requirement.* A statement mailing shall contain the required Form 1099 (written statement). In addition, the mailing may contain the following enclosures:

(A) A check with respect to the account reported on the written statement,

(B) A letter explaining why a check with respect to such account is not enclosed with the written statement (for example, because a royalty payment has not been made),

(C) A statement of the taxpayer's specific account with the payor if payments on such account are reflected on the written statement,

(D) A letter limited to an explanation of the tax consequences of the information set forth on the enclosed written statement,

(E) Payee statements related to other Forms 1099, Form 1098, and Form 5498 (or the account balance on a Form 5498), Forms W-2 and W-2P), and

(F) Any documents concerning the solicitation of the Form W-9 and Form W-8.

Further, to qualify as a statement mailing, the outside of the envelope in which the written statement is mailed and each nontax enclosure included in the envelope must contain, in a bold and conspicuous type, the legend: "Important Tax Return Document Enclosed". For purposes of this paragraph, a nontax enclosure is any item listed in paragraph (a)(1)(i)(A), (B), or (C) of this section. However, a payor is not required to include the legend on the outside of an envelope that contains a mailing that would qualify as a separate mailing. See §1.6042-5(c)(1). The requirement to provide the written statement in person or by first-class mail may be satisfied by sending the written statement and any enclosures described in this paragraph by intra-office mail, provided that intra-office mail is used by the payor in sending account activity, balance information, and other correspondence to the payee. If a payor does not personally deliver the written statement (*i.e.*, the Form 1099) to the recipient or mail it to the recipient in a statement mailing as described in this paragraph, the payor shall be considered to have failed to mail the statement required under section 6050N(b) and will be subject to the penalty under section 6722.

(ii) *Limitation on enclosures.* No enclosures, other than those permitted under paragraph (a)(1)(i) of this section, and no promotional or advertising material are permitted in the mailing of the written statement. Even a *de minimis* amount of such material violates the statement mailing requirement. However, a logo on the envelope containing the written statement and on any enclosure as described in paragraph (a)(1)(i) of this section does not violate the written statement requirement.

(2) *Perforated written statement.* The written statement required under section 6050N(b) and paragraph (a)(1) of this section may be perforated to a check or to a statement of the payee's specific account with the payor as described in paragraph (a)(1)(i)(A) or (C). The enclosure to which the written statement is perforated must contain, in a bold and conspicuous type, the legend: "Important Tax Return Document Attached".

(b) *Penalty.* For provisions relating to the penalty provided for failure to furnish a statement under this section, see section 6722.

PART 31—EMPLOYMENT TAXES AND COLLECTION OF INCOME TAX AT SOURCE

Par. 6. The authority for Part 31 is amended by adding following citation:

Authority: 26 U.S.C. 7805 *** Section 31.3406(a)-1 also issued under 26 U.S.C. 3406(a), (b), (c), (e), (g), (h), and (i); 26 U.S.C. 6103(g); and 26 U.S.C. 6302(c).

Par. 7. The following sections 31.3406-0 through 31.3406(i)-1 are added to read as follows:

§31.3406-0 Outline of the backup withholding regulations. This section lists paragraphs contained in §§31.3406-0 through 31.3406(i)-1.

§31.3406(a)-1 Withholding requirement on reportable payments made after December 31, 1983.

§31.3406 (a)-2 The obligation of payors to backup withhold.

(a) In general.
(b) Middlemen treated as payors.
(c) Exceptions.
(d) Examples.

§31.3406(a)-3 Accounts subject to backup withholding.

§31.3406(a)-4 Time when payments are considered to be paid and subject to backup withholding.

(a) Reportable interest or dividend payments.
(b) Other reportable payments.
(c) Middleman payor.
(1) In general.
(2) Special rule for common trust funds.
(d) Special rule for grantor trusts.
(e) Examples.

§31.3406(b)(1)-1 Reportable payment.

(a) In general.
(b) Reportable interest or dividend payment defined.
(c) Other reportable payment defined.

§31.3406(b)(2)-1 Reportable interest payment.

(a) Interest subject to withholding.
(1) In general.
(2) Special rule for tax-exempt interest.
(3) Examples.
(b) Amount subject to withholding.
(1) In general.
(2) Withholding adjustment for penalty for premature withdrawal.
(i) Special rule.
(ii) Examples.

§31.3406(b)(2)-2 Original issue discount.

(a) Original issue discount subject to withholding.
(b) Time and amount subject to backup withholding with respect to short-term obligations.
(1) No payment prior to maturity.
(2) Payment prior to maturity.
(c) Transferred short-term obligations.
(1) Subsequent holder may establish purchase price.
(2) If subsequent holder is unable to establish purchase price.
(3) If obligation is transferred.
(d) Time and amount subject to withholding with respect to long-term obligations.
(1) No payments prior to maturity.
(2) Registered long-term obligations with payments prior to maturity.

(3) Bearer long-term obligations with payments prior to maturity.
(i) Payments prior to maturity.
(ii) Payments at maturity.
(e) Transferred long-term obligations.
(1) Subsequent holder.
(2) If obligation is transferred.
(f) Examples.

§31.3406(b)(2)-3 Window transactions.

(a) Requirement to withhold.
(b) Window transaction defined.
(c) Manner of furnishing taxpayer identification number in the case of a window transaction.
(d) Examples.

§31.3406(b)(2)-4 Reportable dividend payment.

(a) Dividends subject to withholding.
(b) Examples.
(c) Dividends not subject to withholding.
(d) Amount subject to withholding.
(1) In general.
(2) Reasonable estimate of amount of dividend subject to withholding.
(3) Reinvested dividends.

§31.3406(b)(2)-5 Reportable patronage dividend.

(a) Patronage dividends subject to withholding.
(b) Examples.
(c) Amount subject to withholding.
(1) Failure to provide taxpayer identification number or notification of incorrect taxpayer identification number.
(2) Notified payee underreporting or payee certification failure.
(3) Examples.

§31.3406(b)(3)-1 Reportable payments of rents, commissions, nonemployee compensation, etc.

(a) Payments subject to withholding.
(b) Amount subject to withholding.
(1) In general.
(2) Special rule with respect to payments aggregating $600 or more for the calendar year.
(3) Determination of whether payments aggregate $600 or more.
(4) Exceptions.
(5) Examples.

§31.3406(b)(3)-2 Reportable barter exchanges and gross proceeds of sales of securities or commodities by brokers.

(a) Transactions subject to withholding.
(b) Examples.
(c) Amount subject to withholding.
(1) In general.
(2) Foreign currency contracts, forward contracts, or regulated futures contracts.
(3) Security sales made through a margin account.
(4) Security short sales.
(i) Amount subject to backup withholding.
(ii) Time of withholding.
(5) Fractional shares.
(6) Examples.

§31.3406(b)(3)-3 Reportable payments by certain fishing boat operators.

(a) Payments subject to withholding.
(b) Examples.
(c) Amount subject to withholding.
(1) In general.
(2) Examples.

§31.3406(b)(3)-4 Reportable payments of royalties.

(a) Royalty payments subject to withholding.
(b) Amount subject to withholding.

§31.3406(b)(4)-1 Exemption for certain minimal payments.

(a) In general.
(b) Manner of making the election.
(c) Annualization.
(1) Reportable interest or dividend payment.
(2) Window transaction, original issue discount, and broker reporting.
(d) Examples.

§31.3406(c)-1 Notified payee underreporting of reportable interest or dividend payments.

(a) Requirement to withhold.
(1) In general.
(2) Definition of notified payee underreporting.
(3) Definition of a payee underreporting.
(b) Notice to payors and brokers reporting backup withholding.
(1) Notice from the Internal Revenue Service.
(2) Notice from a broker.
(3) Accounts subject to backup withholding.
(c) Notice from payors of backup withholding due to a payee underreporting.
(1) In general.
(2) Form of the notice to the payee with respect to notified payee underreporting.
(3) Exceptions.
(4) Penalty for failure to provide notice.
(d) Notice to stop backup withholding.
(1) In general.
(2) Date notice to stop withholding will be provided.
(i) Underreporting corrected or bona fide dispute.
(ii) No underreporting or undue hardship.
(e) Period during which withholding is required.
(1) In general.
(2) Stop date.
(i) Underreporting corrected or bona fide dispute.
(ii) No underreporting or undue hardship.
(iii) Payor election to shorten or eliminate grace period.
(iv) Examples.
(f) Notice to payees from the Internal Revenue Service.
(1) Notice period.
(2) Payee subject to withholding.
(3) Disclosure of names of payors and brokers.
(4) Backup withholding certification.
(g) Determination by the Internal Revenue Service that backup withholding should not start or should be stopped.
(1) In general.
(2) No underreporting.
(3) Correcting any payee underreporting.
(i) Before issuance of a statutory notice of deficiency.
(ii) After issuance of a statutory notice of deficiency.
(4) Undue hardship.
(5) Bona fide dispute.
(h) Requests for determinations.
(1) In general.
(2) Determinations made during the notice period.
(3) Determinations made after the notice period.
(i) Reserved.

(j) Payees filing a joint return.
(1) In general.
(2) Exceptions.
(i) Innocent spouse.
(ii) Examples.
(iii) Divorced or legally separated payee.
(k) Penalties.
(1) Failure to withhold.
(2) False certification.
(i) Criminal penalty under section 7205(b).
(ii) Civil penalty under section 6682.
(A) In general.
(B) Waiver of penalty.
(C) Procedure for seeking a waiver.
(3) Delay of assessment.

§31.3406(d)-1 Manner required for furnishing a taxpayer identification number.

(a) Requirement to withhold.
(b) Reportable interest or dividend account.
(1) Manner required for furnishing a taxpayer identification number with respect to a pre-1984 account or instrument.
(2) Determination of pre-1984 account or instrument.
(i) In general.
(ii) Account or instrument automatically acquired on the maturity or termination of an account.
(iii) Special rule for short-term discount instrument acquired before January 1, 1985.
(iv) Insurance policies.
(v) Acquisitions and mergers.
(3) Manner required for furnishing a taxpayer identification number with respect to an account or instrument that is not a pre-1984 account.
(4) Special rule with respect to the acquisition of a readily tradable instrument in a transaction between parties unrelated to the payor if the parties act without the assistance of a broker.
(5) Examples.
(c) Brokerage account.
(1) Manner required for furnishing a taxpayer identification number with respect to a brokerage relationship that is not a post-1983 brokerage account.
(i) In general.
(ii) Definition of a brokerage account that is not a post-1983 brokerage account.
(iii) Definition of a post-1983 brokerage account.
(2) Manner required for furnishing a taxpayer identification number with respect to a post-1983 brokerage account.
(3) Examples.
(d) Rents, commissions, nonemployee compensation, and certain fishing boat operators, etc.
(1) Manner required.
(2) Example.

§31.3406(d)-2 Payee certification failure.

(a) Requirement to withhold.
(b) Exceptions.

§31.3406(d)-3 Special 30-day rules for certain reportable payments.

(a) Account or readily tradable instrument acquired directly from the payor (including a broker who holds an instrument in street name).
(1) Account or instrument acquired directly from the payor by electronic means.
(2) Account or instrument acquired directly from payor by mail communication.
(3) Examples.
(b) Special rule with respect to the sale of an instrument for a customer pursuant to a telephone or wire instruction.
(1) Special rule.
(2) Example.

§31.3406(d)-4 Special rules for readily tradable instruments acquired through a broker.

(a) Readily tradable instruments acquired through a broker who is not a payor.
(1) Instrument acquired through post-1983 brokerage accounts.
(2) Transactions entered into through a brokerage account that is not a post-1984 brokerage account.
(3) Payor must notify payee.
(i) Failure to provide certification.
(ii) Notified payee underreporting and incorrect taxpayer identification numbers.
(b) Notices.
(1) Form of notice by broker to payor.
(2) Form of notice by payor to payee.
(c) Payors' reliance on information from broker.
(1) In general.
(2) Amount subject to withholding.
(3) Examples.

§31.3406(d)-5 Backup withholding when the Service or a broker notifies the payor to withhold because the payee's taxpayer identification number is incorrect.

(a) Requirement that a payor backup withhold due to notification of an incorrect taxpayer identification number.
(1) In general.
(2) Definition of reportable payment.
(i) In general.
(ii) Exceptions.
(3) Transitional exclusion for payments to a fiduciary or nominee account.
(4) Definition of incorrect taxpayer identification number.
(5) Definition of account.
(b) Notice regarding an incorrect taxpayer identification number.
(1) Notice from the Internal Revenue Service to payors and brokers.
(2) Notice from a broker to a payor.
(3) Accounts subject to backup withholding.
(4) Joint accounts.
(i) In general.
(ii) Exception.
(iii) Change in order of names.
(5) Payor determination of the account or accounts of the payee that contain the incorrect taxpayer identification number.
(i) Payors.
(ii) Brokers.
(c) Notice from payors of backup withholding due to an incorrect taxpayer identification number.
(1) In general.
(2) Procedures.
(i) In general.
(ii) Two or more notices for a payee in the same calendar year.
(3) Requirements of substitute notice to the payee.
(4) Payor must use newly provided certified number.

(d) Period during which backup withholding is required due to notification of an incorrect taxpayer identification number.
(1) In general.
(2) Grace periods.
(i) Starting backup withholding.
(ii) Stopping backup withholding.
(e) Manner required for payee to furnish certified taxpayer identification number.
(f) Notification of two incorrect taxpayer identification numbers within a 3-year period.
(1) In general.
(2) Notice to payee who has provided two incorrect taxpayer identification numbers within 3 years.
(3) Period during which backup withholding is required due to a second notification of an incorrect number within 3 years.
(4) Grace periods.
(i) Starting backup withholding.
(ii) Stopping backup withholding.
(g) Procedure for furnishing a correct taxpayer identification number to the Internal Revenue Service.
(h) Notice from the Internal Revenue Service to stop backup withholding.
(i) Reserved.
(j) Examples.

Appendix to §31.3406(d)(5)—("B" Notice)

§31.3406(e)-1 Period during which withholding is required.

(a) In general.
(b) Special rule for determining when the payor receives a taxpayer identification number or certificate from a payee.
(c) Failure to furnish taxpayer identification number in the manner required.
(d) Payee certification failure.
(e) Notification of incorrect taxpayer identification number.
(f) Notified payee underreporting.
(g) Examples.

§31.3406(f)-1 Confidentiality of information.

(a) Confidentiality and liability for violation— In general.
(b) Permissible use of information.
(1) In general.
(2) Window transactions.
(c) Specific restrictions on the use of information.
(d) Examples.

§31.3406(g)-1 Exception for payments to certain payees and certain other payments.

(a) Exempt recipients.
(1) In general.
(2) Payments subject to reporting under section 6041 or 6041A (a).
(3) Determination of whether a person is described in paragraph (a)(1) of this section.
(4) Prepaid or advance premium life-insurance contracts.
(5) Examples.
(b) Middleman.
(c) International organizations.
(d) United States deposits and accounts of foreign payees.
(e) Certain reportable payments made outside the United States by foreign persons, foreign offices of United States banks and brokers, and others.

§31.3406(g)-2 Exception for reportable payments for which withholding is otherwise required.

(a) In general.
(b) Payment of wages.
(c) Distribution from a pension, annuity, or other plan of deferred compensation.
(1) In general.
(2) Special rule.
(3) Distributions not subject to backup withholding.
(4) Examples.
(d) Payment with respect to an oil or gas interest.
(e) Gambling winnings.
(1) In general.
(2) Definition of a reportable gambling winning and determination of amount subject to backup withholding.
(f) Real estate transactions.
(g) Limited exception for certain payments immediately after a merger or an acquisition of accounts.
(h) Certain gross proceeds.

§31.3406(g)-3 Exemption while payee is awaiting for a taxpayer identification number.

(a) In general.
(1) Withholding not required for 60 days.
(2) Withholding during 60-day period on accounts paying reportable interest or dividends.
(i) Effective for awaiting-TIN certificates received after December 31, 1987, and before July 1, 1988.
(ii) Effective for awaiting-TIN certificates received on or after July 1, 1988.
(b) Special rule for readily tradable instruments.
(c) Exceptions.
(1) In general.
(2) Special rule for amounts subject to reporting under section 6045 other than redemptions of bearer obligations.
(d) Awaiting-TIN certificate.
(e) Form for certificate.
(f) Examples.

§31.3406(h)-1 Definitions.

(a) Taxpayer identification number
(1) In general.
(2) Obviously incorrect number.
(b) Examples.
(c) Broker.
(d) Readily tradable instrument.

§31.3406(h)-2 Special rules.

(a) Special rule for joint payees.
(1) In general.
(2) Special rule with respect to joint foreign persons.
(3) Examples.
(b) Withholding from an alternative source.
(1) In general.
(2) Payments made in property.
(3) Barter exchanges.
(4) Examples.
(c) Special rules for trusts.
(1) In general.
(2) Grantor trust with ten or fewer grantors.
(3) Grantor trust with more than ten grantors.
(d) Conditions for a trustee of a grantor trust with more than ten grantors to impose backup withholding.
(e) Examples.
(f) Adjustment of prior withholding.
(1) In general.
(2) Example.
(g) Conversion of amounts paid in foreign currency into United States dollars.
(1) Convertible foreign currency.

(2) Nonconvertible foreign currency. [Reserved]

(h) Coordination with other sections.

(i) Penalties.

(j) To whom a payor is liable for amount withheld.

§31.3406(h)–3 Certificates.

(a) Prescribed form.

(b) Prescribed form to furnish a noncertified taxpayer identification number.

(c) Forms prepared by payors or brokers.

(1) Substitute forms; in general.

(2) Taxpayer identification number.

(3) Notified payee underreporting.

(4) Substitute form for both certifications.

(5) Form for exempt recipients.

(d) Special rule for brokers.

(e) Reasonable reliance on certificate.

(f) Who may sign the certificate.

(1) In general.

(2) Notified payee underreporting.

(g) Retention of certificate.

(1) Accounts or instruments that are not pre-1984 accounts or instruments and brokerage relationships that are post-1983 brokerage accounts.

(2) Accounts or instruments that are pre-1984 accounts or instruments and brokerage relationships that are not post-1983 brokerage accounts.

§31.3406(i)–1 Transitional rules.

§31.3406(a)–1 Withholding requirement on reportable payments made after December 31, 1983.

Except as provided in section 3406(g) and §§31.3406(g)–1, 31.3406(g)–2, and 31.3406(g)–3, every payor (as defined in section 3406(h)(4) and §31.3406(a)–2) is required to deduct and withhold 20 percent of—

(a) Any reportable payment as defined in section 3406(b) and §31.3406(b)(1)–1 made after December 31, 1983, if—

(1) The payee does not furnish a taxpayer identification number (as defined in §31.3406 (h)–1(a)) in the manner required to the person required to file an information return with respect to such payment (as described in section 3406(a)(1)(A) and §31.3406(d)–1), or

(2) The Internal Revenue Service or a broker (as defined in section 3406(h)(5) and §31.3406(h)–1(c)) notifies such payor that the taxpayer identification number that the payee furnished is incorrect (as described in section 3406(a)(1)(B) and §31.3406(d)–5, or

(b) Any reportable interest or dividend payment (as defined in section 3406(b)(2) and §31.3406(b)(1)–1(b)) made after December 31, 1983, if—

(1) The Internal Revenue Service or a broker notifies the payor that there has been payee underreporting (as described in section 3406(a)(1)(C) and §31.3406(c)–1), or

(2) The payee fails to provide a certification to the person required to file a return with respect to the payment (as described in section 3406(a)(1)(D) and §31.3406(d)–2).

Persons required to file an information return with respect to reportable payments subject to backup withholding are considered payors for purposes of backup withholding. Paragraph (a)(2) of this section provides a definition of persons considered payors for purposes of backup withholding and who therefore have an obligation to backup withhold if one of the conditions for imposing backup withholding exists with respect to a reportable payment. The payments which are subject to backup withholding are described in section 3406(b) and §31.3406(b)(1)–1. See §31.3406(d)–1 for the rules regarding how a payee may furnish a taxpayer identification number in the manner required and certify that he is not subject to backup withholding due to notified payee underreporting. The period for which backup withholding under section 3406 is required is described in section 3406(e) and §31.3406(e)–1. Exemptions from and exceptions to backup withholding are described in §§31.3406(g)–1, 31.3406(g)–2, and 31.3406(g)–3. Sections 31.3406(h)–1, 31.3406(h)–2, and 31.3406(h)–3 provide certain definitions and special rules relating to backup withholding.

§31.3406(a)–2 The obligation of payors to backup withhold.

(a) *In general.* A payor of an instrument or account is required to deduct and withhold the tax imposed by section 3406. The term "payor" means any person who is required to make an information return with respect to any reportable payment under section 6041, 6041A(a), 6042, 6044, 6045, 6049, 6050A, or 6050N as described in §31.3406(b)(1)–1(a), including any middleman payor as described in paragraph (b) of this section. Thus, for example, with respect to reportable payments under section 6045, the payor is the broker having the closest contact with the payee (in terms of payments or crediting of gross proceeds) because that broker is required to file an information return with respect to reportable payments made to the payee.

(b) *Middlemen treated as payors.* Except as provided in paragraph (c) of this section, any person who receives or collects a reportable payment on behalf of or for the account of any other person shall be treated as the payor with respect to such payment. Such persons include—

(1) A custodian of a payee's account, such as a bank, financial institution or brokerage firm acting as custodian of an account,

(2) A nominee, including the joint owner of an account or instrument, except if such joint owners are husband and wife or if the payment is actually owned by another person whose name is also shown on the information return filed with respect to such payment,

(3) A broker holding a security (including stock) for a customer in "street name",

(4) A grantor trust with more than ten grantors,

(5) A common trust fund,

(6) Any partnership or S corporation that makes a reportable payment, and

(7) Any other person making a reportable payment and who is required to make an information return under the applicable information reporting section with respect to such payments.

(c) *Exceptions.* The following persons are not treated as payors for purposes of section 3406 if the person is not treated as a middleman, payor, or otherwise does not have a reporting obligation under the section on information reporting to which the payment relates:

(1) An agent of the payor which is acting on behalf of the payor in making the payment and who has not entered into an agreement with the payor pursuant to Revenue Procedure 84-33, 1984-1 C.B. 502, such as a bank that acts as a paying agent in making a payment of dividends on behalf of a corporation (although payments made by the agent are considered to be payments made by the payor, and thus are subject to backup withholding, reporting, and the depositing requirements pertaining to section 3406 as if they were made by the payor itself),

(2) A trust (other than a grantor trust with ten or more grantors) that files a Form 1041 and furnishes a beneficiary a Form K-1 containing information required to be shown on an information return, including amounts withheld under section 3406, or shown on an information return, including amounts withheld under section 3406, or

(3) A partnership making a distributive share to a partner of the partnership.

(d) *Examples.* The application of the provisions of this section may be illustrated by the following examples:

Example (1). Individual A presents a United States savings bond to be cashed at Bank M and fails to provide a social security number to M. Bank M is required to make an information return under section 6049. M is considered the payor with respect to such interest and is required to withhold under section 3406 because A has failed to provide M with a social security number.

Example (2). Bank N pays interest on a savings account held by Trust O which is an irrevocable trust required to include its items of income, deduction, and credit on a Form 1041. O is not an exempt recipient described in §1.6049-4(c)(1)(ii). N is required to make an information return under section 6049. N is considered the payor and is required to withhold if any condition for imposing backup withholding exists with respect to O. O as record owner is required to file a fiduciary return and furnishes a Schedule K-1 to each beneficiary. Therefore, O is not required to make an information return under §1.6049-4(c)(2). Thus, O is not considered a payor and is not required to withhold when O distributes income to a beneficiary because the payment does not constitute a reportable payment.

Example (3). In 1984, Corporation P pays dividends to Broker Q, a dealer in securities and registered as such under the laws of the United States. Q holds stock as nominee for Individual B. Q is considered an exempt recipient under section 6042(b)(2) and does not provide its employer identification number to P. Thus, P is not required to make an information return under section 6042 showing the amount of dividends P pays Q. B has not furnished a social security number to Q. When Q pays or credits B's account with the dividends, Q is required to make an information return under section 6042 and §1.6042-2(a)(1)(ii). Q is considered the payor and is required to withhold under section 3406 since B failed to provide Q with a social security number.

Example (4). Individual C instructs Broker R to sell securities. C is a customer of R and has furnished R with an obviously incorrect social security number. R instructs Broker S to sell the securities. R is required to make an information return under section 6045 since R is the initiating broker who receives the instructions from C to sell the securities. Thus, R is considered the payor and is required to withhold on the gross proceeds under section 3406.

Example (5). Issuer T pays interest to Bank V with respect to obligations that Bank V holds in a custodial account for Individual D who has failed to furnish a social security number to V. T is not required to make an information return under section 6049 because it is making payment to an exempt recipient described in §1.6049-4(c)(1)(ii). Consequently, T is not considered a payor. V is required to make an information return under section 6049 with respect to the interest it receives for D's custodial account. V is considered the payor and is required to withhold under section 3406 since D failed to provide a social security number to V.

Example (6). W, a partnership, holds debentures of Corporation X. On June 30, 1984, X makes a payment of stated interest on the bonds held by W. X is required to make an information return under section 6049 showing the interest paid to W. X is considered a payor and is required to withhold if any of the four conditions for imposing backup withholding exists with respect to W. W makes a distribution of partnership income to its partners on December 31, 1984. W is not required to make an information return under section 6049. Thus, W is not considered a payor and is not required to withhold when W distributes each partner's distributive share of income on December 31, 1984, because the distribution does not constitute a reportable payment.

Example (7). Individual E owns property that Individual F leases. E has an agreement with Bank Y which provides that Y will collect the rental payments from F on behalf of E and will credit E's account with those amounts. Y's functions are limited solely to the receipt and crediting of those payments to E's account. Y is not required to make an information return under §1.6041-3(p); thus, Y is not considered a payor. F is required to make an information return under section 6041 showing the rental payments made to E if F makes the rental payments in the course of F's trade or business. Accordingly, F would be considered a payor and would be required to withhold if one of the two conditions for imposing backup withholding on the reportable payment exists with respect to E (as described in §31.3406(b)(3)-1).

Example (8). Assume the same facts as in *Example (7)* except that Y not only collects the payment for E but pays other expenses for taxes, repairs, commissions, etc., and credits the net amount to E's account. Y's responsibilities are greater than the performance of a collection agent. Thus, Y is required to make an information return under section 6041 if F's payments to E are made in the course of F's trade or business. Y is considered the payor and is required to withhold if one of the two conditions for imposing backup withholding exists with respect to E (as described in §31.3406(b)(3)-1).

Example (9). G and H own real estate and hire Z to manage the property. Z is a real estate agent for G and H. Lessees I, J, and K make rental payments to Z, and Z pays costs incidental to the property and pays commissions to L, an independent agent who locates tenants. Z pays the net amount of the rental payments to G and H. I, J, and K are not required to make an information return under §1.6041-3(e) with respect to the rental payments to Z because Z is a real estate agent; but Z is required to make an information return under section 6041 showing payment to G and H. Thus, Z is considered a payor and is required to withhold if one of the two conditions for imposing backup withholding exists with respect to G or H (as described in §31.3406(b)(3)-1). Z's payment of commissions to L also is subject to reporting under section 6041, withholding, and the depositing requirements under section 3406 (as described in §31.3406(a)-2(c)(1)).

§31.3406(a)-3 Accounts subject to backup withholding.

A payor who is required to backup withhold under §31.3406(a)-1 is required to impose backup withholding on the specific account subject to withholding under §31.3406(a)-1(a)(1) or (b)(2) and, with respect to withholding under §31.3406(a)-1(a)(2) or (b)(1), on the accounts and according to the manner described respectively under §31.3406(d)-5 (relating to notification of incorrect TIN) or §31.3406(c)-1 (relating to notified payee underreporting).

§31.3406(a)-4 Time when payments are considered to be paid and subject to backup withholding.

(a) *Reportable interest or dividend payments.* With respect to a reportable interest or dividend payment (as defined in section 3406(b)(2) and §31.3406(b)(1)-1)b)), backup withholding under section 3406 shall apply when the payor pays interest, dividends, patronage dividends, or original issue discount to an account that is subject to backup withholding. Amounts are paid when they are credited to the account of, or set apart for, the payee. Amounts are not considered paid solely because they are posted (e.g., an informational notation on the payee's passbook) or because they may be withdrawn by the payee, so long as they are not actually credited to the payee's account. They are paid, however, upon withdrawal or crediting to the payee's

account. When bonds are sold between interest payment dates, the portion of the sales price representing interest accrued to the date of sale is not considered to be a payment of interest for purposes of section 6049, but is considered as a portion of a reportable payment of gross proceeds under section 6045 (provided that the accrued interest is not tax-exempt as described in section 103(a), relating to certain governmental obligations). In the case of stock for which the record date is earlier than the payment date, the dividends are considered paid on the payment date. In the case of a corporate reorganization, if a payee is required to exchange stock held in the former corporation for stock in the new corporation before the dividends which have been paid with respect to the stock in the new corporation will be provided to the payee, the dividend is considered paid on the date the payee actually exchanges the stock and receives the dividend.

(b) *Other reportable payments.* With respect to any other reportable payment (as defined in section 3406(b)(3) and §31.3406(b)(1)-1(c)), except amounts reportable under section 6045, backup withholding under section 3406 shall apply at the time the payment is made. In the case of a transaction reportable under section 6045, except in the case of forward contracts, regulated futures contracts, foreign currency contracts, and security short sales, the obligation to backup withhold arises on the date the sale is entered on the books of the broker or the date the exchange occurs as provided in §1.6045-1(f)(3). However, a broker is not required to satisfy its backup withholding liability until payment is made. See §31.3406(b)(3)-2(c) for special rules applicable to forward contracts, regulated futures contracts, foreign currency contracts, and security short sales.

(c) *Middleman payor*—(1) *In general.* Any middleman payor (as described in §31.3406(a)-2(b)) shall withhold under section 3406 at the time the reportable payment is received by or credited to the middleman payor. If the middleman payor makes or credits the reportable payment to the payee prior to the middleman payor's receipt of the corresponding payment, the middleman payor may withhold at the time the reportable payment is made or credited to the payee.

(2) *Special rule for common trust funds.* A common trust fund, as defined in section 584, shall withhold at the time the reportable payment is received by or credited to the common trust fund as provided in paragraph (c)(1) of this section, on the date on which the assets of the common trust fund are valued, or at the time the common trust fund pays or credits the reportable payment to the beneficiary of the common trust fund.

(d) *Special rule for certain grantor trusts.* With respect to certain grantor trusts (as described in §31.3406(h)-2(c)(3)), reportable amounts (except gross proceeds subject to reporting under section 6045) are treated as paid to the grantor on the date that the distribution is made to the grantor by the trustee. Paragraph (b) of this section applies to a grantor trust with respect to when gross proceeds subject to reporting under section 6045 are subject to withholding.

(e) *Examples.* The application of the provisions of this section may be illustrated by the following examples in which it is assumed that the payee may be subject to backup withholding under section 3406(a)(1)(A):

Example (1). Bank P computes interest on savings account deposits by compounding the interest on a daily basis but credits the amount of interest that has accrued during a calendar quarter to the savings account on the last day of the quarter. Backup withholding under section 3406 applies at the time P credits interest to the accounts (*i.e.*, the end of each quarter).

Example (2). Credit Union Q computes dividends on regular share accounts by compounding the dividends on a daily basis. It credits the amount of dividends accrued during a calendar quarter on the last day of the quarter unless the account is closed, in which case it credits accrued dividends on the date the account is closed. A, an individual, opens a regular share account at Q on July 1, 1984. Backup withholding under section 3406 applies when Q credits accrued dividends to the account on September 30, 1984. If A closes the account on October 21, 1984, a payment would be considered to be made on October 2l when Q credits accrued dividends to A's account and A withdraws the dividends. Thus, backup withholding will apply on October 2l.

Example (3). Corporation R declares a dividend on September 1, 1984, to its record holders as of September 15, 1984. The dividend on its stock is payable on October 1, 1984. Trust Company S holds stock of R in trust for Individual B. S credits the dividend to the account of the trust for B on October 1, even though in the normal course of business S may not receive the money until several days thereafter. At the discretion of S, backup withholding under section 3406 will apply when S credits the dividend on October 1, or when the money is actually received by S. See §31.3406(a)-4(c)(1).

Example (4). Money Market Fund T declares dividends on its shares daily and credits the dividends to the investor's account on the last day of the month regardless of whether any shares have been redeemed during the month. Backup withholding under section 3406 applies to a reportable dividend payment made on the last day of the month when T credits the investor's account.

Example (5). The facts are the same as in *Example (4)* except that T credits the dividends to the investor's account daily. Backup withholding under section 3406 applies daily when T credits the investor's account.

Example (6). On January 1, 1984, Individual C buys a 10-year corporate bond with attached semiannual interest coupons of $500 that may be cashed on January 1 and July 1 of each year. C sells the bond for $12,250 on April 1, 1984, to Bank U. Although $250 of the purchase price is attributable to accrued interest, it is not considered to be a reportable interest payment for purposes of section 6049. If U is a broker required to make an information return under 6045 with respect to a sale of a security, the gross proceeds of $12,250 (including the $250 accrued interest) are subject to backup withholding on April 1, 1984.

Example (7). On April 1, 1984, Bank U sells the bond it purchased in *Example (6)* to Individual D. On July 1, 1984, D cashes the interest coupon for that date at U. Backup withholding under section 3406 applies on July 1 (the date the interest coupon is presented) to the $500 reportable interest payment.

Example (8). Bank V credits interest to its checking accounts on a quarterly basis. On August 3, 1984, Bank V accepts for payment a check which has been drawn on the account of E. E does not have sufficient funds posted in the account to pay the amount of the check. However, E's account has accrued interest since V's last crediting date which, net of withholding, is sufficient to pay the amount of the check. V pays the check after posting the interest that has accrued since V's last crediting date to E's account. Backup withholding under section 3406 applies on August 3, 1984, when V posts the accrued interest to E's account and before V pays the check. If the interest, net of withholding, were insufficient to pay the amount of the check, V would be required to impose backup withholding prior to paying the check, provided the interest is credited to E's account.

Example (9). F presents a Series E savings bond to Bank W to be cashed on July 1, 1984. Backup withholding under section 3406 applies on that date.

Example (10). On December 1, 1970, G purchases a $500 Series E savings bond. The amount paid for the bond is $375. On August 1, 1985, the bond is reissued by the Bureau of Public Debt by deleting G's name and inserting the name of G's child. At the time of reissue, the redemption value of the bond is $1,015.80. The accrued interest is $640.80 (i.e., $1,015.80—$375). The reissue is a taxable transaction, and G must include in income the accrued interest at the time of reissue. Backup withholding under section 3406 applies on the date of the reissuance (August 1, 1985) to $640.80 (the amount of accrued interest).

Example (11). Assume the same facts as in *Example (10)* except that G exchanges the bond for a Series HH savings bond in the amount of $1,000 issued in G's name. The exchange is tax-deferred under section 1037. A check in the amount of $15.80 is delivered to G. Backup withholding under section 3406 applies on the date of the exchange but only to the extent of $15.80, the amount subject to information reporting under §1.6049-4(d)(9).

Example (12). Assume the same facts as in *Example (11)* except that the Series HH savings bond is reissued in the name of G's child. Accordingly, the exchange is not a tax-deferred exchange under section 1037 and backup withholding under section 3406 applies to $640.80 (the amount of accrued interest) on the date that the bond is exchanged.

Example (13). Broker H sells stock for Individual I and enters the transaction on H's books on September 24, 1990. Payment is made on September 28, 1990. The sale occurs on the date the sale is entered on the books. Accordingly, the obligation to backup withhold arises on September 24, 1990. However, H is not required to satisfy its backup withholding liability until September 28, 1990.

Example (14). Individual K is the trustee of Trust M, which is not a grantor trust as described in §31.3406(h)-2(c)(3) or an exempt recipient as described in §1.6049-4(c)(1)(ii) . The corpus of the trust is stock of Corporation N. On August 31, 1984, N pays a dividend to M and is required to withhold 20 percent of the payment. On September 30, 1984, K makes a distribution of M's income to the beneficiaries of M. K is not required to withhold the tax under section 3406 on September 30, 1984, when K distributes M's income, because the payment is not a reportable payment and the trust is not a payor as described in §31.3406(a)-2.

Example (15). L, an individual trustee of a grantor trust with 150 grantors, holds stock of Corporation T. L has provided the taxpayer identification number of L to T. B, a grantor of the trust, fails to provide a taxpayer identification number to L. T pays dividends on July 1 and is not required to withhold under section 3406 because no condition for imposing backup withholding exists with respect to L. L is required to withhold under section 3406, however, on the date that L distributes the reportable payment to B.

Example (16). O, a partnership, holds bonds of Corporation P. On July 1, 1984, P makes a payment of stated interest on the bonds held by O and is required to withhold 20 percent of the payment. O makes a distribution of income to its partners on December 31, 1984. O is not required to withhold under section 3406 on July 1, 1984, when it receives the payment of interest from P since O is not a middleman payor with respect to any reportable payment; O is the payee. In addition, O is not required to withhold under section 3406 on December 31, 1984, when O distributes income to its partners because the distribution is not a reportable payment.

Example (17). On February 28, 1985, Corporation R declares a dividend on its stock payable on April 1, 1985, to holders of record as of March 3, 1985. On March 1, 1985, Broker Q sells stock in Corporation R which it held in "street name" on behalf of B to Broker S. S purchases the stock on behalf of Individual C. R's stock transfer agent does not record the transfer until March 4, 1985. Accordingly, on April 1, 1985, R's paying agent pays the dividend declared by R to Q. R does not withhold under section 3406 since Q is an exempt recipient described in section 6042(b)(2)(B). Because Q is not able to identify immediately the owner of the dividend, Q places the dividend in a suspense account. On the same date, S credits C's account with the amount of the dividend payable by R on that date. On April 30, 1985, S makes a claim on Q for the amount of the dividend Q received on R's stock and Q pays the dividend to S. Q does not withhold under section 3406 since S is an exempt recipient. Unless C furnishes his social security number to S, S is required to withhold under section 3406 when it receives the dividend from Q on April 30, 1984, or, in its discretion, at the time it credits the dividend to C's account on April 1, 1984.

Example (18). On January 2, 1992, individual D signs an agreement with Insurance Company Z. The agreement specifies that D will make one initial payment on the date the agreement is signed and Z will pay all future premiums when due by using a portion of D's previous payment including interest Z agrees to pay under the agreement. D does not furnish his social security number to Z. The yearly premiums are payable every July 1. Z credits the interest accruing during the year on the policy's anniversary date (July 1). Z is required to withhold 20 percent of the annual increase in value of the "prepaid premium" on July 1 (the date that the interest is credited to pay the premium due).

§31.3406(b)(1)-1 Reportable payment.

(a) *In general.* For purposes of backup withholding under section 3406, the term "reportable payment" means—

(1) Any reportable interest or dividend payment (as defined in section 3406(b)(2) and paragraph (b) of this section), and

(2) Any other reportable payment (as defined in section 3406(b)(3) and paragraph (c) of this section).

The determination of whether a payment is reportable and thus subject to withholding under section 3406 is made without regard to the amount of the payment. A payor may elect under §31.3406(b)(4)-1, however, not to withhold from certain minimal payments.

(b) *Reportable interest or dividend payment defined.* The term "reportable interest or dividend payment" means—

(1) Interest subject to reporting under section 6049 (as described in §31.3406(b)(2)-1),

(2) Original issue discount subject to reporting under section 6049 (as described in §31.3406(b)(2)-2),

(3) Window transactions subject to reporting under section 6049 (as described in §31.3406(b)(2)-3),

(4) Dividends subject to reporting under section 6042 (as described in §31.3406(b)(2)-4), and

(5) Certain patronage dividends subject to reporting under section 6044 (as described in §31.3406(b)(2)-5).

(c) *Other reportable payment defined.* The term "other reportable payment" means—

(1) Rents, commissions, nonemployee compensation, and other payments subject to reporting under section 6041 or 6041A(a)(as described in §31.3406(b)(3)-1),

(2) Barter exchange or broker transactions subject to reporting under section 6045 (as described in §31.3406 (b)(3)-2),

(3) Certain payments by certain fishing boat operators subject to reporting under section 6050A (as described in §31.3406(b)(3)-3), and

(4) Payments of royalties subject to reporting under section 6050N (as described in §31.3406(b)(3)-4).

§31.3406(b)(2)-1 Reportable interest payment.

(a) *Interest subject to withholding*—(1) *In general.* Backup withholding under section 3406 is required with respect to any payment of a kind, and to a payee, that is required to be reported under section 6049 (relating to returns regarding interest and original issue discount), subject to the special rules of §31.3406(b)(2)-2 (relating to original issue discount), and §31.3406(b)(2)-3 (relating to window transactions). If the payment is not of a kind subject to reporting because the payment is not defined as "interest" in section 6049(b) and in §1.6049-5(a) and (b), then the payment is not subject to backup withholding. Additionally, if the payment is not to a payee subject to reporting under section 6049 because it is made to a person described in section 6049(b)(4) or §1.6049-4(c)(1)(ii), the payment is not subject to backup withholding. After a determination is made under section 6049 that an information return is required, the payor is required to deduct and withhold the tax under section 3406 if any of the four conditions for imposing backup withholding exists with respect to a payee (as described in §31.3406(a)-1(a) and (b)). The amount subject to backup withholding under section 3406 is described in

paragraph (b) of this section. Notwithstanding the provisions of this section, a payor is not required to withhold on any payment described in §31.3406(g)-1.

(2) *Special rule for tax-exempt interest.* When an issuer is required to make an information return under §1.6049-4(d)(8) because a payee incorrectly provided a signed written statement on the envelope or "shell" claiming that the interest was exempt from taxation under section 103(a) (as described in §1.6049-5(b)(2)), the issuer is not required to impose backup withholding under section 3406.

(3) *Examples.* The application of the provisions of this paragraph (a) may be illustrated by the following examples:

Example (1). Bank M pays interest to A, an individual, on a deposit that A maintains with M. Since the payment is of a kind that is subject to reporting under section 6049 and §1.6049-5(a)(3) and the payee is not an exempt recipient as defined in §31.3406(g)-1, M is required to withhold under section 3406 if any of the four conditions for imposing backup withholding exists with respect to A.

Example (2). Assume the same facts as in *Example (1)* except that Bank M pays such interest to Corporation X. The payment to X is not subject to information reporting under section 6049 since M is making payment to a person described in §1.6049-4(c)(1)(ii)(A). Accordingly, M is not required to withhold even if one of the four conditions for imposing backup withholding under section 3406 exists with respect to X.

Example (3). Individual B presents an interest coupon from a tax-exempt obligation to Bank N. B properly completes the "shell" used for processing the coupon (*i.e.*, he includes his name, address, and taxpayer identification number on the shell) and claims that the interest is exempt from taxation (as required by §1.6049-5(b)(2)). N is not required to make an information return under section 6049 because the payment is not of a kind subject to reporting under section 6049 (as described in §1.6049-5(b)(2)). Accordingly, N is not required to withhold even if one of the four conditions for imposing backup withholding under section 3406 exists with respect to B. In addition, under paragraph (a)(2) of this section, the issuer who receives the shell is not required to withhold even if the interest is not exempt from taxation. If, however, B did not properly complete the shell, by including his taxpayer identification number, N may not treat the interest as tax-exempt and N is required to withhold because B did not include his taxpayer identification number on the shell.

Example (4). Credit Union O pays "dividends" that are considered interest under section 6049 to nonresident alien individual C on a deposit C has with O. C certifies on Form W-8 (or other permissible form as described in §1.6049-5(g)) that he is not a United States citizen or resident. If O is required to make an information return under section 6049 with respect to the payment to C as required by §1.6049-5(e)(2), O is not required to withhold under section 3406 as provided in §31.3406(g)-1(d).

Example (5). Individual D places money in escrow with P to guarantee performance on a contract. P is not a financial institution that pays interest subject to reporting under section 6049(b)(1)(B) or (C) and §1.6049-5(a)(2) or (3). P is not required to make an information return under section 6049 because the payment is not of a kind subject to reporting under section 6049 (as described in §§1.6049-5(b)(3) or 1.6049-5(b)(5)). Accordingly, P is not required to withhold even if one of the four conditions for imposing backup withholding under section 3406 exists with respect to D. If, however, P is a financial institution that pays interest described in section 6049(b)(1)(B) or (C) and §1.6049-5(a)(2) or (3), P would be required to withhold under section 3406 if any of the four conditions for imposing backup withholding exists.

(b) *Amount subject to withholding*—(1) *In general.* The amount of interest subject to withholding under section 3406 is the amount subject to reporting under section 6049 except as provided in paragraph (b)(2) of this section.

(2) *Withholding adjustment for penalty for premature withdrawal*—(i) *Special rule.* Solely for purposes of computing the amount subject to backup withholding, the payor may elect not to withhold from the portion of any interest payment that is not received by the payee because of the imposition of a penalty for premature withdrawal of funds deposited in a time savings account, certificate of deposit, or similar class of deposit.

(ii) *Examples.* The application of the provisions of this paragraph (b)(2) may be illustrated by the following examples:

Example (1). A, an individual, deposits $10,000 in a 4-year savings account with Bank M on January 2, 1985, which earns 10.75 percent interest per annum payable quarterly. A does not provide M with a social security number. A must pay a penalty equal to the previous 3 months' interest if the funds are withdrawn prior to January 2, 1989. On March 31, 1985, A's funds earn $268.75 in interest. Backup withholding under section 3406 will apply to the amount of interest ($268.75) paid on that date. The fact that M may impose a penalty on A after the interest is paid and the tax is withheld should A prematurely withdraw the funds is irrelevant because M has not, in fact, imposed a penalty.

Example (2). Assume the same facts as in Example (1) except that A withdraws the funds on September 30, 1985. A penalty in the amount of $280.43 (*i.e.*, an amount equal to the previous 3 months' interest earned by A) is imposed on A. M is not required to withhold any amount on that date since the penalty imposed on A is equal to the interest earned by A that quarter. At M's option, however, M may withhold 20 percent of the $280.43 payment of interest. In either event, M is not relieved of the requirement under section 6049 to report the $280.43 of quarterly interest payment made to A.

§31.3406(b)(2)-2 Original issue discount.

(a) *Original issue discount subject to withholding.* Under section 6049(d)(6) and §1.6049-5(k), original issue discount is treated as a payment of interest. The amount of original issue discount subject to backup withholding under section 3406 is the amount subject to reporting under section 6049, but is limited to the amount of cash paid. In addition, if an original issue discount obligation, subject to reporting under section 6045, is sold prior to maturity and a condition exists for imposing backup withholding on such gross proceeds, then backup withholding under §31.3406(b)(3)-2 applies to the gross proceeds of the sale reportable under section 6045.

(b) *Time and amount subject to backup withholding with respect to short-term obligations*—(1) *No payment prior to maturity.* In the case of an obligation with a fixed maturity date not exceeding 1 year from the date of issue (a "short-term obligation") with respect to which there is no interest payable prior to maturity, backup withholding under section 3406 applies to the amount of original issue discount which is includible in the gross income of the holder. Backup withholding applies at the maturity of the obligation when the face amount of the obligation is paid.

(2) *Payment prior to maturity.* In the case of a short-term obligation with respect to which there is interest payable prior to maturity, backup withholding under section 3406 applies only to the actual interest payments made prior to maturity and not to any amount of original issue discount. Backup withholding shall be computed on the stated interest payment, and 20 percent of the actual interest payment shall be withheld at the time the interest is paid. At maturity, the amount subject to backup withholding shall be the sum of any interest payment made at that time and the total original issue discount that is includible in gross income of the holder and shall be withheld upon at that time.

(c) *Transferred short-term obligations*—(1) *Subsequent holder may establish purchase price.* At maturity of

a short-term obligation, a subsequent holder (*i.e.*, any person who purchased the obligation after the obligation was issued to the original holder) may establish the price at which the subsequent holder purchased the obligation. The purchase price paid by such a subsequent holder shall then be treated as the original issue price for purposes of computing the amount of original issue discount subject to backup withholding under section 3406. The purchase price of an obligation may be established by confirmation receipt or other record of a similar type or, if the obligation is redeemed by or through the person from which the obligation was purchased, by the records of the person from which or through which the obligation was purchased. The subsequent holder is not required to certify under penalties of perjury that the purchase price is correct.

(2) *If subsequent holder is unable to establish purchase price.* If a subsequent holder fails to establish the purchase price of the obligation (as provided in paragraph (c)(1) of this section), then the person redeeming the obligation shall determine the amount subject to backup withholding under section 3406 as though the obligation had been purchased by the holder on the date of issue. If the person redeeming the obligation is the issuer of the obligation, then the issuer shall determine the amount subject to backup withholding through its records. If the person redeeming the obligation is a person other than the issuer of the obligation, then the person shall determine the amount subject to backup withholding by using the issue price indicated in the Internal Revenue Service publication of publicly-traded original issue discount obligations or in standard financial sources. (See §1.6049-5(k)). In the case of a Treasury bill, the purchase price shall be assumed to be the noncompetitive price of a Treasury bill having the earliest issue date of all Treasury bills with the same CUSIP number and the same maturity date as the bill being redeemed.

(3) *If obligation is transferred.* If a short-term obligation is transferred, no part of the purchase price is considered a reportable interest payment under section 6049. Backup withholding under section 3406 applies, however, to the gross proceeds of the sale of the obligation if the transfer is subject to reporting under section 6045 and a condition exists for imposing backup withholding. For the rules regarding backup withholding where an amount is subject to reporting under section 6045, see §31.3406(b)(3)-2.

(d) *Time and amount subject to withholding with respect to long-term obligations*—(1) *No payments prior to maturity.* In the case of an obligation with a fixed maturity date that is more than 1 year from the date of issue (a "long-term obligation") with respect to which there are no cash payments (whether consisting of interest or principal) prior to maturity, backup withholding applies only at maturity and only with respect to the original issue discount includible in the income of the holder during the calendar year in which the obligation matures. For purposes of this section, the term "cash payments" includes checks and other monetary media of exchange.

(2) *Registered long-term obligations with payments prior to maturity.* In the case of a long-term obligation that is in registered form and that provides for cash payments (whether consisting of interest or principal) prior to maturity, the amount subject to backup withholding under section 3406 shall be the sum of the amount of stated interest paid and the amount of original issue discount that is includible in the gross income of the holder for that calendar year in which the cash payments are made. Backup withholding applies at the time the cash payments are made. The amount required to be withheld at the time of any cash payment, however, shall not exceed the amount of the cash payment made. If more than one payment is made during a calendar year, the tax that is required to be withheld with respect to original issue discount shall be allocated among all the cash payments in the ratio that each cash payment bears to the total of the cash payments. Thus, if two equal cash payments of stated interest are made during the calendar year, one-half of the original issue discount includible in gross income of the holder for that calendar year shall be taken into account in computing the tax which must be withheld from each cash payment.

(3) *Bearer long-term obligations*—(i) *Payments prior to maturity.* In the case of a long-term obligation that is in bearer form and with respect to which there is stated interest payable prior to maturity, backup withholding applies only to the stated interest payment and not to any amount of original issue discount. Backup withholding applies to the stated interest payment at the time the stated interest is paid.

(ii) *Payments at maturity.* Backup withholding applies to the sum of any stated interest payment made at maturity and the total amount of original issue discount that is includible in the gross income of the holder during the calendar year of maturity.

(e) *Transferred long-term obligations*—(1) *Subsequent holder.* In the case of a long-term obligation that is transferred after its issuance from the original holder, the amount subject to backup withholding is the amount of original issue discount includible in the gross income of all holders during the calendar year (without regard to any amount paid by a subsequent holder at the time of transfer). If the person redeeming the obligation at maturity is the issuer of the obligation, then the issuer shall determine the amount subject to backup withholding through its records by treating the holder as if he were the original holder. If the person redeeming the obligation at maturity is a person other than the issuer of the obligation, then the person shall determine the amount subject to backup withholding by using the original issue price indicated in the Internal Revenue Service publication of publicly-traded original issue discount obligations or in standard financial sources. (See §1.6049-5(k)).

(2) *If obligation is transferred.* If a long-term obligation is transferred after original issuance, no part of the purchase price is considered a reportable interest payment under section 6049. Backup withholding under section 3406 applies, however, to the gross proceeds of the sale of the obligation if the transfer is subject to reporting under section 6045 and a condition exists as described in §31.3406(a) for imposing backup withholding on such gross proceeds.

For the rules regarding backup withholding where an amount is subject to reporting under section 6045, see §31.3406(b)(3)-2.

(f) *Examples.* The application of the provisions of this section may be illustrated by the following examples:

Example (1). On January 1, 1980, Individual A purchases at original issue, for $7,000 cash, X Corporation's 5-year bond which has a stated redemption price at maturity of $10,000. A does not furnish a social security number to X. The bond does not provide for any interest or principal payments prior to maturity. The ratable monthly portion of original issue discount determined under section 1272(a)(1) is $50. If A holds the bond for 12 months of his taxable year, A must include $600 (*i.e.*, $50 x 12 months) in his gross income for that year and in each subsequent year that he holds the bond for the entire 12 months. No amount of the $600 of original issue discount includible in A's gross income each year is subject to backup withholding under section 3406 since no amount of cash has been paid. Assume that A holds the bond until maturity on December 31, 1984, and the bond is redeemed for $10,000 on that date. Since A has not furnished a social security number to X, backup withholding applies to the amount of original issue discount includible in A's gross income during the calendar year ($600). X is not required to make an information return under section 6045 (*i.e.*, the retirement is described in §5f.6045-1(c)(3)-(x)). X is required to withhold only on the $600 (the amount of original issue discount includible in A's gross income).

Example (2). Assume the same facts as in *Example (1)* except that A does not hold the bond until maturity but rather sells it to B on January 1, 1984, for $9,540. The gross proceeds of the sale are subject to backup withholding if the sale is required to be reported under section 6045. See §31.3406(b)(3)-2. When X redeems the bond at maturity, the amount subject to backup withholding is the $600 of original issue discount accrued during 1984 even though B paid more for the bond than the sum of the original issue price and the amount of the original issue discount includible in A's gross income. Under paragraph (e)(1) of this section, B, as a subsequent holder, is treated the same as the original holder for purposes of determining the amount subject to withholding on redemption.

Example (3). Assume the same facts as in *Example (2)* except that the sale occurs on March 1, 1984, and B provides a social security number to X. Even though $100 (*i.e.*, $50 x 2 months) of original issue discount has accrued with respect to A (who has not provided a social security number to X) during 1984, no amount of original issue discount is subject to backup withholding at maturity since B has provided a social security number to X.

Example (4). On January 1, 1984, Individual D purchases a Treasury bill with a maturity of 52 weeks at the original issue price of $8,736. At maturity on December 31, 1984, D redeems the bill for $10,000 but fails to furnish a social security number. The amount subject to backup withholding on the date of maturity is $1,264 (the difference between the stated redemption price at maturity, $10,000, and D's purchase price for the obligation, $8,736).

Example (5). Assume the same facts as in Example (4) except that D sells the Treasury bill on March 1, 1984, to Individual E through Broker Y. E does not furnish a social security number to Y. E pays $8,940 for the bill. Although no part of the purchase price is a reportable interest payment under section 6049, Y is required to report the sales proceeds under section 6045. Consequently, Y is required to withhold 20 percent of the $8,940 gross proceeds paid to D under §31.3406(b)(3)-2 if D does not furnish a social security number to Y. E redeems the Treasury bill through Y at maturity. E establishes through Y's records that E paid $8,940 for the Treasury bill on March 1, 1984. The amount subject to backup withholding at maturity is $1,060 (the difference between the stated redemption price at maturity, $10,000, and E's purchase price of $8,940).

Example (6). On January 1, 1985, F, an individual, purchases at original issue, for $7,500 cash, Z Corporation's 30-year bond which has a stated redemption price at maturity of $10,000. The bond provides for annual interest payments of $1,000. F does not furnish Z with a social security number. Assuming F holds the bond for all of calendar year 1985, the amount of original issue discount which is includible in F's gross income during 1985 is $7.83. On December 31, 1985, Z makes its $1,000 interest payment to F. Z must withhold $201.56 (i.e., 20 percent of $1,007.83) on that date.

Example (7). Broker G acquires a bond issued in 1960 by the United States Treasury through the Bureau of Public Debt. Broker G sells interests in the bond to the public after December 31, 1982. A purchaser may acquire an interest in any interest payment falling due under the bond or an interest in the principal of the bond. Under section 1273, each bond component is treated as an obligation issued with original issue discount equal to the excess of the stated redemption price at maturity over the purchase price of the bond component. The interests sold by G are obligations of a type offered to the public. The bond is held by Custodian H for the benefit of the persons acquiring these interests. On receipt of interest and principal payments under the bond, Custodian H transfers the amount received to the person whose ownership interest corresponds to the bond component giving rise to the payment. On January 1, 1984, Individual J, a calendar year taxpayer, purchases from G, for $826.45 cash, a $1,000 interest coupon payable on December 31, 1985. J does not provide G or H with a social security number. During 1984, J must include $82.65 in income (i.e., the amount of original issue discount accruing during 1984). No amount, however, is subject to backup withholding under section 3406 since no cash payment is made. During 1985, J must include $90.90 in income (i.e., the amount of original issue discount accruing during 1985). On December 31, 1985, H is required to withhold $18.18 (20 percent of $90.90) and then pays J $981.82 ($1,000 minus $18.18).

§31.3406(b)(2)-3 Window transactions.

(a) *Requirement to withhold.* Backup withholding under section 3406 applies to a "window transaction" as defined in section 3406(b)(7) and paragraph (b) of this section only where the payee does not furnish a taxpayer identification number to the payor in the manner required in paragraph (c) of this section. Backup withholding does not apply to a "window transaction" when the Internal Revenue Service notifies the payor of an incorrect taxpayer identification number or notified payee underreporting. The payee in a window transaction also is not required to certify under penalties of perjury that the payee is not subject to backup withholding due to notified payee underreporting (as described in §31.3406(d)-2(b)(2)).

(b) *Window transaction defined.* The term "window transaction" means a payment of interest with respect to any of the following obligations:

(1) An interest coupon which is subject to taxation (*i.e.*, other than interest described in §1.6049-5(b)(2)),

(2) A United States savings bond, or

(3) A discount obligation having a maturity at issue of 1 year or less, including commercial paper and bankers' acceptances that are in definitive form (*i.e.*, evidenced by a paper document other than a confirmation receipt) but not including short-term government obligations (as defined in section 1271(a)(3)(B)).

(c) *Manner of furnishing taxpayer identification number in the case of a window transaction.* A payee must furnish his taxpayer identification number to the payor with respect to a window transaction either orally or in writing. The payee is not required to certify, under penalties of perjury, that the taxpayer identification number provided is correct. The number must be furnished at the time that the window transaction occurs. See §31.3406(g)-3(c)(1)(i), which provides that a payee may not claim he is awaiting receipt of a taxpayer identification number with respect to a window transaction. Thus, a payor is required to withhold 20 percent of a reportable interest payment paid in a window transaction as described in this paragraph only if the payee fails to furnish a taxpayer identification number or furnishes an obviously incorrect number as described in §31.3406(h)-1(a)(2).

(d) *Examples.* The application of the provisions of this section may be illustrated by the following examples:

Example (1). Individual A presents five Series EE savings bonds to Bank X for payment on January 3, 1984. Bank X is required to make an information return under section 6049 if $10 or more of interest is paid. A provides orally to X a social security number containing nine digits. A does not certify under penalties of perjury that the number provided is his correct social security number. X is not required to withhold on such payment because payments of interest on United States savings bonds are window transactions and A has furnished a taxpayer identification number to X.

Example (2). Assume the same facts as in *Example (1)* except that A has other accounts with X and the Internal Revenue Service has notified X that the taxpayer identification number that A furnished on a savings account A maintains with X is incorrect (pursuant to section 3406(a)(1)(B)). X is not required to withhold on the payment on the savings bonds. X is not required to check its records to determine whether A has provided the taxpayer identification number which it has been notified is incorrect. X is only required to withhold if A does not provide a taxpayer identification number or provides an obviously incorrect number.

Example (3). Individual B presents a taxable interest coupon to Bank Y for payment. Bank Y is required to make an information return under section 6049 if the coupon represents $10 or more of interest. B maintains other accounts with Y and requests Y to deposit the amount of the interest coupon to his account. The Internal Revenue Service has notified Y that B is subject to backup withholding pursuant to section 3406(a)(1)(C). B furnishes a social security number to Y at the time of the window transaction. Because payments on interest coupons are window transactions, B is not required to certify that his taxpayer identification number is correct or that he is not subject to backup withholding due to notified payee underreporting. Y is also not required to check its records to see whether B is subject to backup withholding. Consequently, Y is not required to withhold on the coupon because B furnished his social security number in the manner required in paragraph (c) of this section.

Example (4). Partnership M requests that Bank Z redeem an interest coupon at maturity that Z is holding as a custodian for M and deposit the funds into M's account. Z is required to make an information return under section 6049 if $10 or more of interest is paid. Z asks M for its employer identification number, and M provides a nine-digit number. M does not certify its taxpayer identification number or certify that it is not subject to backup withholding due to notified payee underreporting. Z is not required to withhold since M has furnished its taxpayer identification number to Z. The payment on the interest coupon is considered a window transaction even though M does not present the interest coupon at a bank window for payment.

§31.3406(b)(2)-4 Reportable dividend payment.

(a) *Dividends subject to withholding.* Except as provided in paragraph (c) of this section, backup withholding under section 3406 is required with respect to any payment of a kind, and to a payee, that is required to be reported under section 6042 (relating to returns regarding payments of dividends and corporate earnings and profits). If the payment is not of a kind subject to reporting under section 6042 because it is not defined as a "dividend" under section 6042(b) or §1.6042-3, then the payment is not subject to backup withholding. Additionally, if the payment is not to a payee subject to reporting under section 6042 because, for example, it is made to a payee that is excluded from the definition of a person (as described in §1.6042-2(a)(2)) to whom a payment is subject to reporting under section 6042, the payment is not subject to backup withholding. After the determination is made under section 6042 that an information return is required, the payor is required to deduct and withhold the tax under section 3406 if any of the four conditions for imposing backup withholding exists (as described in §31.3406(a)-1(a) and (b)). The amount subject to backup withholding under section 3406 is described in paragraph (d) of this section. Notwithstanding the provisions of this section, a payor is not required to withhold on any payment made to a payee described in §31.3406(g)-1(a) (relating to exempt recipients).

(b) *Examples.* The application of the provisions of paragraph (a) of this section may be illustrated by the following examples:

Example (1). Corporation Z makes a distribution to individual shareholder E who has not furnished a social security number to Z. The distribution is a dividend as defined in section 316 and is subject to reporting under section 6042(b)(1)(A) and §1.6042-3(a)(1). Since Z is required to make an information return under section 6042 and E has not provided a social security number, Z is required to withhold under section 3406.

Example (2). Assume the same facts as in *Example (1)* except that Z makes payment to State Q. State Q is not a person (as defined in §1.6042-2(a)(2)) a payment to whom is subject to reporting under section 6042. Since Z is not required to make an information return under section 6042, Z also is not required to withhold under section 3406 even if one of the four conditions for imposing backup withholding under section 3406 exists with respect to Q.

Example (3). Assume the same facts as in *Example (1)* except that the distribution is not from current or accumulated earnings and profits but rather a return of capital. Because the distribution is not a dividend subject to reporting under section 6042, Z is not required to make an information return under section 6042. Accordingly, Z is not required to withhold even if one of the four conditions for imposing backup withholding under section 3406 exists with respect to E.

Example (4). Corporation S makes payment to foreign Corporation T. The payment is subject to withholding under section 1442 or would be subject to withholding under section 1442 but for the provisions of a treaty. The payment is not subject to reporting under section 6042 because it is excepted from the definition of a dividend subject to reporting under §1.6042-3(b)(2). Because S is not required to make an information return under section 6042, S is not required to withhold even if one of the four conditions for imposing backup withholding under section 3406 exists.

(c) *Dividends not subject to withholding.* Except as provided in §31.3406(b)(3)-2 (relating to transactions reportable under section 6045), backup withholding under section 3406 shall not apply to—

(1) Any amount treated as a taxable dividend by reason of section 302 (relating to redemptions of stock);

(2) Any amount treated as a taxable dividend by reason of section 306 (relating to disposition of certain stock);

(3) Any amount treated as a taxable dividend by reason of section 356 (relating to receipt of additional consideration in connection with certain reorganizations);

(4) Any amount treated as a taxable dividend by reason of section 1081(e)(2) (relating to certain distributions pursuant to an order of the Securities and Exchange Commission);

(5) Any exempt-interest dividend, as defined in section 852(b)(5)(A), paid by a regulated investment company;

(6) Any amount paid or treated as paid during a year by a regulated investment company provided that the payor reasonably estimates, as provided in paragraph (d)(2) of this section, that 95 percent or more of all dividends paid or treated as paid during the year are exempt-interest dividends; or

(7) Effective for distributions before 1986, any dividend that is reinvested pursuant to a qualified plan in stock of a public utility. For this purpose, the amount of the reinvested dividend paid to any person, the identity of the recipient, and whether the recipient makes the election required by section 305(e)(2)(B) are irrelevant.

(d) *Amount subject to withholding*—(1) *In general.* The amount of a dividend subject to withholding under section 3406 is generally the amount subject to reporting under section 6042, including any dividend which is reinvested pursuant to a plan under which a shareholder may elect to receive stock as a dividend instead of property. Except as otherwise provided in this paragraph (d), backup withholding applies to the entire amount of the distribution.

(2) *Reasonable estimate of amount of dividend subject to withholding.* Pursuant to section 6042(b)(3) and §1.6042-3(c), if the payor is unable to determine the portion of a distribution that is a dividend, the entire amount of the distribution shall be treated as a dividend for information reporting under section 6042. Hence, backup withholding applies to the entire amount of the distribution. If a payor is able reasonably to estimate under section 6042 and §1.6042-3(c) the portion of a distribution that is not a dividend, however, the payor shall not withhold on that portion (which is not considered a dividend). A payor making a payment, all or a portion of which may not be a dividend, may use previous experience to estimate the portion of the payment which is not a dividend. An estimate of the portion of a distribution that is not a dividend shall be considered reasonable if—

(i) The estimate does not exceed the proportion of the distributions made by the payor during the most recent calendar year for which Form 1099 was required to be filed which was not reported by the payor as a dividend, and

(ii) The payor has no basis to expect that the proportion of the distribution that is not a dividend will be substantially different for the current year.

(3) *Reinvested dividends.* In the case of a dividend paid pursuant to a dividend reinvestment plan (other than a dividend described in paragraph (c)(7) of this section), backup withholding under section 3406 shall apply, pursuant to §31.3406(a)-4(a), at the time the dividend is made available to the shareholder or credited to the shareholder's account. Backup withholding applies to the amount made available to the shareholder or credited to the shareholder's account. At the discretion of the payor, backup withholding under section 3406 need not be applied to any excess of the fair market value of the shares of stock received by the shareholder or credited to the shareholder's account over the purchase price of such shares (including shares acquired by the shareholder at a discount in connection with the dividend distribution) or to any fee that is paid by the payor in the nature of a broker's fee for purchase of the stock or service charge for maintenance of the shareholder's account. Thus, the payor is not required to impose backup withholding on any amount in excess of the actual cash value of the dividend declared that the payee would have received had the payee not been a participant in the dividend reinvestment plan. The payor must, however, treat any excess amounts and fees on a consistent basis for each calendar year.

§31.3406(b)(2)-5 Reportable patronage dividend.

(a) *Patronage dividends subject to withholding.* Except as otherwise provided in paragraph (c) of this section, backup withholding under section 3406 is required with respect to any payment of a kind, and to a payee, that is required to be reported under section 6044 (relating to returns regarding patronage dividends). If the payment is not of a kind subject to reporting under section 6044 because it is not described in section 6044(b) and §1.6044-3, then such payment is not subject to backup withholding. Additionally, if the payment is not subject to reporting under section 6044 because it is made to a payee that is excluded from the definition of a person (as described in §1.6044-2(a)(2)) to whom a payment is subject to reporting under section 6044, the payment is not subject to backup withholding. After the determination is made under section 6044 that an information return is required, the payor is required to deduct and withhold the tax under section 3406 if any of the four conditions for imposing backup withholding exists with respect to the payee (as described in §31.3406(a)-1(a) and (b)). The amount subject to withholding under section 3406 is described in paragraph (c) of this section. Notwithstanding the provisions of this section, a payor is not required to withhold on any payment made to a payee described in §31.3406(g)-1(a) (relating to exempt recipients).

(b) *Examples.* The application of the provisions of paragraph (a) of this section may be illustrated by the following examples:

Example (1). Cooperative K pays Individual F a patronage dividend (as defined in section 1388(a)). The payment is an amount subject to reporting under section 6044 and §1.6044-3(a)(1)(i). Since K is required to make an information return under section 6044, K is required to withhold 20 percent of the amount described in paragraph (c) of this section if any of the four conditions for imposing backup withholding exists with respect to F.

Example (2). Assume the same facts as in *Example (1)* except that the payment is made to a political subdivision of the United States, which is not a person (as defined in §1.6044-2(a)(2)) a payment to whom is subject to reporting under section 6044. K is not required to make an information return under section 6044 because K does not make payment to a payee subject to reporting. Accordingly, K is not required to withhold under section 3406 even if one of the four conditions for imposing backup withholding exists with respect to the political subdivision.

(c) *Amount subject to withholding*—(1) *Failure to provide taxpayer identification number or notification of incorrect taxpayer identification number.* Except as provided in paragraph (c)(2) of this section, the amount of a payment of a kind and to a payee that is subject to withholding under section 3406 is the amount subject to reporting under section 6044, but only to the extent such payment is made in money. For purposes of this paragraph, money includes cash or a qualified check (as defined in section 1388(c)(4)). Thus, the payor shall, when required, withhold 20 percent of the amount required to be reported under section 6044, but only if it is paid in cash or by qualified check.

(2) *Notified payee underreporting or payee certification failure.* For purposes of section 3406(a)(1)(C) and (D), the amount of a payment that is subject to backup withholding under section 3406 is the amount subject to withholding under paragraph (c)(1) of this section, but only if 50 percent or more of that reportable amount is paid in money. Therefore, in the case where there has been a notified payee underreporting described in section 3406(c) or §31.3406(c)-1 or there has been a payee certification failure described in section 3406(d) or

§31.3406(d)-2 and the payor makes a payment subject to reporting under section 6044 of which 50 percent or more is made in cash or by qualified check, the payor is required to withhold 20 percent of the cash or qualified check. If less than 50 percent of the payment is made in cash or by qualified check, no amount is subject to backup withholding.

(3) *Examples.* The application of the provisions of paragraph (c) of this section may be illustrated by the following examples:

Example (1). Cooperative L pays Individual G a $500 patronage dividend consisting of $100 in cash and $400 in a qualified written notice of allocation (as defined in section 1388(c)(1)(B)). G does not furnish his taxpayer identification number to L. L is required to withhold $20 (20 percent of $100, the amount paid in cash or by qualified check).

Example (2). Assume the same facts as in *Example (1)* except that Individual G fails to certify with respect to a membership established on or after January 1, 1984, that he is not subject to backup withholding due to notified payee underreporting. In the case where there has been a payee certification failure, L is not required to withhold under section 3406 because less than 50 percent of the reportable payment is made in cash or by qualified check.

Example (3). Assume the same facts as in *Example (1)* except that G receives a $500 per-unit retain (as defined in section 1388(f)) as a qualified per-unit retain certificate (as defined in section 1388(g)) instead of cash or a qualified written notice of allocation. L is not required to withhold even though G failed to furnish his taxpayer identification number because backup withholding is limited to the amount paid in cash or by qualified check.

Example (4). Cooperative M pays Individual H a patronage dividend consisting of $350 in cash, $250 by a qualified check, and $400 in a qualified written notice of allocation. H fails to certify with respect to a membership established on or after January 1, 1984, that he is not subject to backup withholding due to notified payee underreporting. Accordingly, M is required to withhold $120 (20 percent of $600, the amount paid in cash or by qualified check).

Example (5). Assume the same facts as in *Example (4)* except that the patronage dividend consists of $100 in cash, $250 by a qualified check, and $650 in a qualified written notice of allocation. M is not required to withhold even though there is a payee certification failure because less than 50 percent of the patronage dividend is paid in cash or by qualified check.

§31.3406(b)(3)-1 Reportable payments of rents, commissions, nonemployee compensation, etc.

(a) *Section 6041 and 6041A(a) payments subject to withholding.* Backup withholding under section 3406 is required with respect to any payment of a kind, and to a payee, that is required to be reported under section 6041 (relating to information reporting of rents, salaries, commissions, etc.) or with respect to any payment of a kind, and to a payee, that is required to be reported under section 6041A (a) (relating to information reporting of payments to nonemployees for services). If the payment is not subject to reporting under section 6041A(b) (relating to information reporting of direct sales), the payment is not subject to backup withholding. If the payment is not of a kind subject to reporting under section 6041 as described in §1.6041-3, then the payment is not subject to backup withholding. Additionally, if the payment is not to a payee that is subject to reporting under section 6041 or 6041A(a), then the payment is not subject to backup withholding. See §31.3406(g)-1(a)(3) for provisions relating to how a payor determines that a payee is exempt from information reporting under section 6041 or 6041A(a). Except as provided in paragraph (b)(2) of this section, after the determination is made that an information return is required under section 6041 or 6041A(a), the payor is required to deduct and withhold the tax under section 3406 if the payee does not furnish his taxpayer identification number to the payor in the manner required in §31.3406(d)-1 or the Internal Revenue Service notifies the payor that the taxpayer identification number that the payee furnished the payor is incorrect as described in §31.3406(d)-5. The amount subject to withholding under section 3406 is described in paragraph (b) of this section. Notwithstanding the provisions of this section, a payor is not required to withhold on any payment made to a payee described in §31.3406(g)-1(a) (relating to exempt recipients).

(b) *Amount subject to withholding*—(1) *In general.* Except as otherwise provided in paragraph (b) of this section, the amount subject to backup withholding under section 3406 is the amount subject to reporting under section 6041 or section 6041A(a). For purposes of this paragraph, any amount that is specifically excluded from information reporting under section 6042(a)(1), 6047(a), 6049(a), or 6050N(a) and the regulations issued thereunder is not thereby subject to backup withholding under §31.3406(b)(3)-1.

(2) *Special rule with respect to payments aggregating $600 or more for the calendar year.* In making the determination of whether an information return is required to be made under section 6041 or 6041A(a), the payor shall determine whether the aggregate amount of the current payment and all previous payments to the payee during the calendar year aggregate $600 or more. See paragraph (b)(3) of this section for determining whether reportable payments aggregate $600. If payments to any person that are subject to reporting under section 6041 or 6041A(a) aggregate $600 or more during the calendar year, the payor is required to make an information return and correspondingly may be required to deduct and withhold 20 percent under section 3406. The amount subject to withholding is the entire amount of the payment that causes the total amount paid to the payee to equal $600 or more and the amount of any subsequent payments made to the payee until the payee furnishes or corrects the taxpayer identification number. If, however, the payor was required to make an information return under section 6041 or 6041A(a) for the preceding calendar year with respect to payments to the payee or the payor was required to withhold under section 3406 during the preceding calendar year with respect to payments to the payee that were reportable under section 6041 or 6041A(a), then the payor shall deduct and withhold 20 percent of any payment made to the payee during the calendar year, regardless of whether the payor's payments to the payee equal or exceed $600 for the year, until the payee furnishes or corrects the taxpayer identification number. See §31.6051-4 for the requirement to furnish a statement to the recipient in all cases where tax is withheld under section 3406. The $10 minimal payment exception described in §31.3406(b)(4)-1 does not apply with respect to payments subject to reporting under section 6041 or 6041A(a). This paragraph (b)(2) does not apply to gambling winnings (as provided in §31.3406(g)-2(e)(1)).

(3) *Determination of whether payments aggregate $600 or more.* In making the determination of whether payments to a payee aggregate $600 or more during a calendar year for purposes of backup withholding, the payor must aggregate only payments

of the same kind made to the same payee. For this purpose, payments are of the same kind if they are of the same type, not if they are reportable under the same section. For example, a payor is not required to aggregate rental payments to a payee with premium payments to the same payee even though both payments are reportable under section 6041. In addition, a payor with different paying departments making reportable payments of the same kind is not required to aggregate payments made by all the departments unless it is the payor's customary method to aggregate those payments. A payor may, in its discretion, aggregate—

(i) Payments not of the same kind to the same payee, reportable under either section 6041 or 6041A(a), and/or

(ii) Payments reportable under section 6041 with payments reportable under section 6041A(a).

(4) *Exceptions.* Backup withholding does not apply to net commissions paid to unincorporated special agents with respect to insurance policies that are subject to reporting under section 6041, provided that no cash is actually paid by the payor to the special agent.

(5) *Examples.* The application of the provisions of this paragraph (b) may be illustrated by the following examples:

Example (1). A, in the course of his trade or business, pays rent to B, an individual who is not a real estate agent. A pays B $200 on June 30, 1984, and $200 on December 31, 1984. B does not furnish his taxpayer identification number to A. A has not made any rental payments to B in the preceding year. A is not required to make an information return under section 6041 since the aggregate payments to B do not exceed $600 during the calendar year. A is not required to withhold 20 percent of the payments under section 3406 because A is not required to make an information return under section 6041 and A did not make any payments to B in the preceding year that would have required A to withhold in 1984.

Example (2). Assume the same facts as in *Example (1)* except that A also pays $400 to B during 1984 as nonemployee compensation which is reportable under section 6041A(a). A is not required to aggregate the payments made to B under section 6041 with the payments made to B under section 6041A(a). Thus, the result is the same as in Example (1) because A did not pay B $600 or more during 1984 in payments of a type which are reportable under the same section. A may, however, aggregate the payments. If A aggregates the payments, A would be required to withhold under section 3406.

Example (3). Assume the same facts as in *Example (1)* except that A paid B over $600 of rental payments during 1983 (the preceding calendar year). A was required to make an information return for 1983. Even though A did not pay B $600 or more during calendar year 1984, A is required under section 3406 to withhold 20 percent of each $200 payment made to B in 1984 because A did not receive B's taxpayer identification number. A is required to continue to withhold on the rental payments made to B, including payments made in the subsequent calendar year, until A receives B's taxpayer identification number. A is required to file an information return with respect to the payments made to B in 1984 (even though such payments do not equal or exceed $600) because A backup withheld on those amounts.

Example (4). C, in the course of his trade or business, pays D $200 for machine hire on January 1, $100 on February 1, $50 on March 1, $75 on April 1, $115 on May 1, $60 on June 1, and $150 a month on the first day of each month from July through December of 1984. D does not furnish a taxpayer identification number to C at any time during 1984. C did not make any machine hire payments to D in the preceding calendar year. C is required to withhold 20 percent of the $60 payment made on June 1 (i.e., the payment that causes the aggregate payments to D to equal or exceed $600) and of every payment made thereafter until C receives D's taxpayer identification number.

Example (5). Assume the same facts as in Example (4) except that C receives D's taxpayer identification number on March 19, 1984. C is not required to withhold 20 percent of the payments made during the year since C receives D's taxpayer identification number before C paid $600 of machine hire payments to D.

Example (6). Assume the same facts as in *Example (4)* except that C receives D's taxpayer identification number on June 15, 1984. C is required to withhold 20 percent of the payment on June 1 because D does not receive D's taxpayer identification number prior to the time that C's payments to D equal $600 for the calendar year. C is not required to withhold under section 3406 on any subsequent payments to D during the calendar year.

§31.3406(b)(3)–2 Reportable barter exchanges and gross proceeds of sales of securities or commodities by brokers.

(a) *Transactions subject to withholding.* Backup withholding under section 3406 is required with respect to any amount of a kind, and to a payee, that any broker (as defined in section 6045(c) and §1.6045–1(a)(1)) or any barter exchange (as defined in section 6045(c) and §1.6045–1(a)(4)) is required to report under section 6045. If the amount is not of the kind subject to reporting under section 6045 (as described in §1.6045–1(c)(3)), then that amount is not subject to backup withholding. Additionally, if the amount is not subject to reporting under section 6045 because it is made with respect to an exempt recipient (as described in §5f.6045–1(c)(3)(i)) or it is made with respect to an exempt foreign person (as described in §1.6045–1(g)), that amount is not subject to backup withholding. After the determination is made under section 6045 that an information return is required, the broker or barter exchange is required to deduct and withhold the tax under section 3406 if the payee does not furnish his taxpayer identification number to the broker or the barter exchange in the manner required in §31.3406(d)–1 or the Internal Revenue Service notifies the broker or barter exchange that the taxpayer identification number the payee furnished to the broker or barter exchange is incorrect as described in §31.3406(d)–5. The amount subject to withholding under section 3406 is described in paragraph (c) of this section. See §31.3406(i)–1 for a special rule regarding the furnishing of taxpayer identification numbers after January 1, 1984, with respect to certain accounts.

(b) *Examples.* The application of the provisions of paragraph (a) of this section may be illustrated by the following examples:

Example (1). Broker M effects the sale of a security for Individual E who is M's customer. M is required to make an information return under section 6045 showing the gross proceeds of the sale because E is a payee with respect to whom an information return is required. Since M is required to make an information return under section 6045, M is required to withhold 20 percent of the gross proceeds under section 3406 if E does not furnish a taxpayer identification number to M in the manner required in §31.3406(d)–1 or the Internal Revenue Service notifies M that E's taxpayer identification number is incorrect.

Example (2). Assume the same facts as in *Example (1)* except that M effects a sale for Corporation O which is M's customer. M is not required to make an information return under section 6045 showing the gross proceeds since O is an exempt recipient for purposes of broker reporting under §5f.6045–1(c)(3)(i). Because M is not required to make an information return under section 6045, M is not required to withhold 20 percent of the gross proceeds even if one of the conditions for imposing backup withholding under section 3406 exists.

Example (3). Assume the same facts as in *Example (1)* except that Individual E is a person who has signed a statement as required in §1.6045–1(g)(3)(i), effective for the calendar year in question, that he is an exempt foreign person. M is not required to make an information return under section 6045 because the amount is not paid to a payee subject to information reporting. Because M is not required to make an information return under section 6045, M is not required to withhold 20 percent of the gross proceeds even if one of the conditions for imposing backup withholding under section 3406 exists.

Example (4). Broker N retires a Treasury bill (*i.e.*, a short-term government discount obligation as defined in section 1271(a)(3)(B)) for Individual F. N is not required to make an information return under section 6045 showing the gross proceeds because that amount is a kind of payment excepted from broker reporting under §5f.6045-1(c)(3)(vi)(C). The amount of the original discount included in the income of the holder is subject to reporting at maturity, however, under section 6049. See §31.3406(b)(2)-2 for the requirement to withhold on the amount subject to reporting at maturity under section 6049.

Example (5). Assume the same facts as in *Example (4)* except that F instructs Broker N to sell F's Treasury bill before maturity for $9,800. Broker N is required to make an information return under section 6045 showing $9,800 as the gross proceeds of the sale since that amount is of a kind subject to reporting under section 6045. Because N is required to make an information return under section 6045, N is required to withhold 20 percent of $9,800 (the gross proceeds) under section 3406 if F does not furnish a taxpayer identification number to N in the manner required in §31.3406(d)-1 or the Internal Revenue Service notifies N that F's taxpayer identification number is incorrect.

Example (6). Individual G asks Broker O to redeem shares of a mutual fund (other than a redemption at issue price described in §5f.6045-1(c)(3)(v)). O is required to make an information return under section 6045 and, accordingly, is required to withhold 20 percent of the gross proceeds if G does not furnish a taxpayer identification number to O in the manner required in §31.3406(d)-1 or the Internal Revenue Service notifies O that G's taxpayer identification number is incorrect.

Example (7). Individual H asks Broker P to redeem a tax-exempt municipal bond at maturity with a redemption value of $10,000. A $500 interest coupon is also attached to the bond that is payable on the date of maturity. P is required to make an information return under section 6045 showing gross proceeds of $10,000. Correspondingly, P is required to withhold 20 percent of the gross proceeds ($10,000) if a condition for imposing backup withholding exists with respect to the gross proceeds under paragraph (a) of this section. If H properly completes the "shell" or envelope (i.e., he includes his name, address, and taxpayer identification number) used for processing the coupon and states that the interest is exempt from taxation under section 103(a) (as provided in §1.6049-5(b)(2)), P is not required to make an information return showing the tax-exempt interest portion ($500) of the gross proceeds because that amount is not required to be reported under either section 6045 or 6049. Accordingly, P is not required to withhold 20 percent of the $500 tax-exempt interest payment.

Example (8). Individual I instructs Broker Q to transfer a corporate debenture to J for $15,000 (of which $2,000 represents accrued interest). Q is required to make an information return under §1.6045-1(d)(5) on Form 1099-B showing $13,000 of gross proceeds. Q is also required to make an information return under §1.6045-1(d)(3) on Form 1099-INT showing $2,000 of interest. Both the $13,000 of gross proceeds and the $2,000 of interest are subject to backup withholding if I does not furnish his taxpayer identification number to Q or the Internal Revenue Service notifies Q that I's taxpayer identification number is incorrect. Because the accrued interest element is not a reportable interest payment under section 6049, Q is not required to withhold if the Internal Revenue Service notifies Q under section 3406(a)(1)(C) relating to notified payee underreporting or if I fails to make the certification required in §31.3406(d)-2. The interest component of the gross proceeds is reportable as interest pursuant to §1.6045-1(d)(3) but in the manner and at the time required by Form 1099 and section 6049.

Example (9). Individual K requests Bank R to redeem a nontransferable certificate of deposit issued by R. The certificate of deposit is a book entry obligation with respect to which the relevant books and records indicate that no interim transfers have occurred. R is not required to make an information return under §5f.6045-1(c)(3)(x), and, accordingly, R is not required to withhold on the gross proceeds at maturity. R, however, is required to make an information return under section 6049 with respect to the interest on the obligation and is required to withhold on the reportable interest payment if any of the four conditions for imposing backup withholding under section 3406 exists (as described in §31.3406(a)-1(a) and (b)).

Example (10). Depositary Trust S, which regularly acts as an escrow agent in corporate acquisitions, is the agent for Corporation W in a tender offer by W for the stock of Corporation T. Partnership L tenders T stock to S and is paid the tender offer price by S. Under section 6045, S is required to make an information return showing the gross proceeds paid by S to L for T stock. Consequently, S is required to withhold 20 percent of the gross proceeds under section 3406 if L does not furnish a taxpayer identification number in the manner required in §31.3406(d)-1 or the Internal Revenue Service notifies S that L's taxpayer identification number is incorrect.

Example (11). Issuer A arranges for Transfer Agent X to act as its disbursing agent with respect to dividends paid on its stock under its dividend reinvestment plan. The issuer has the reporting obligation for the dividends paid to the plan because it has the legal obligation to make those payments and hence any backup withholding liability that might exist. Thus, upon the reinvestment of the dividends to the plan by the holder, X has no reporting obligation under section 6042. Nor does X have a reporting obligation under section 6045. Although X is a broker under §1.6045-1(a)(1) of the regulations, since it stands ready to purchase or redeem shares of Issuer A's stock, there is no "sale" with respect to the holder of Issuer A's stock on the reinvestment of the dividends. However, if Issuer A's stock is redeemed by instruction from the holder to X and X will pay the holder redeemed, then X must report the gross proceeds under section 6045.

Example (12). Individual AA instructs Broker V to redeem shares of a qualified dividend reinvestment plan of a public utility. Although reinvested dividends of that plan are not subject to backup withholding under §31.3406(b)(2)-4(c)(7) (with respect to distributions before 1986), V is required to make an information return under section 6045 showing the gross proceeds of the shares redeemed. Correspondingly, V is required to withhold 20 percent of the gross proceeds if AA does not furnish a taxpayer identification number to V in the manner required in §31.3406(d)-1 or the Internal Revenue Service notifies V that AA's taxpayer identification number is incorrect.

(c) *Amount subject to withholding*—(1) *In general.* Except as provided in paragraph (c)(2), (3), (4), and (5) of this section and §31.3406(b)(4)-1, the amount subject to withholding under section 3406 is the amount subject to reporting under section 6045. The amount subject to withholding with respect to broker reporting is the amount of gross proceeds (as determined under §1.6045-1(d)(5)). The amount subject to withholding with respect to barter exchanges is the amount received by any member or client (as determined under §1.6045-1(f)(4)).

(2) *Foreign currency contracts, forward contracts, or regulated futures contracts.* If a customer is subject to backup withholding with respect to foreign currency contracts (as defined in section 1256(g) and reportable under §1.6045-1(c)(5)) or with respect to an account through which forward contracts or regulated futures contracts are disposed of or acquired, the broker must withhold 20 percent of both of the following amounts:

(i) All cash or property withdrawn from the account by the customer during the relevant year. A withdrawal includes the use of money (including both gross proceeds and variation margin) or property in the account to purchase any property other than property acquired in connection with the closing of a contract. For this purpose, the acceptance of a warehouse receipt or other taking of delivery to close a contract is in connection with the closing of a contract only if the property acquired is disposed of by the close of the seventh trading day following the trading day that the customer takes delivery under the contract. In addition, making delivery to close a contract is in connection with the closing of a contract only if the broker is able to determine that the property used to close the contract was acquired no earlier than the seventh trading day prior to the trading day on which delivery is made. Withdrawals do not include repayments of debt incurred in connection with making or taking delivery that meets the requirements of this paragraph (c)(2). Withdrawals

also do not include payments of commissions, fees, transfers of cash from the account to another futures account that is subject to this paragraph (c)(2) or cash withdrawals traceable to dispositions of property other than futures (not including profit on the contract separately reportable under §1.6045-1(c)(5)(i)(b)); and

(ii) The amount of cash in the account available for withdrawal by the customer at the relevant year-end (including both gross proceeds and variation margin).

The determination of whether the customer is subject to backup withholding with respect to an account containing forward contracts or regulated futures contracts shall be made at the time of the cash or property withdrawals or the relevant year-end, whichever is applicable.

(3) *Security sales made through a margin account.* The amount subject to backup withholding in the case of a security sale made through a margin account (as defined in 12 CFR section 220 (Regulation T)) is the gross proceeds (as defined in §1.6045-1(d)(5)) of such sale. The amount required to be withheld with respect to such a sale, however, is limited to the amount of cash available for withdrawal by the customer immediately after the settlement of the sale. For this purpose, the amount available for withdrawal by the customer does not include amounts required to satisfy margin maintenance under: Regulation T, rules and regulations of the National Association of Securities Dealers and national securities exchanges, and generally applicable self-imposed rules of the margin account carrier.

(4) *Security short sales*—(i) *Amount subject to backup withholding.* The amount subject to backup withholding with respect to a short sale of securities is the gross proceeds (as defined in §1.6045-1(d)(5)) of such short sale. At the option of the broker, however, the amount subject to backup withholding may be the gain upon the closing of the short sale (if any); consequently, the obligation to withhold would be deferred until the closing transaction. A broker may use this alternative method of determining the amount subject to backup withholding with respect to a short sale only if at the time the short sale is initiated the broker expects that the amount of gain realized upon the closing of the short sale will be determinable from the broker's records. If, due to events unforeseen at the time the short sale was initiated, the broker is unable to determine the basis of the property used to close the short sale, the property shall be assumed to have a basis of zero.

(ii) *Time of withholding.* The determination of whether a short seller is subject to backup withholding shall be made on the date of the initiation or closing, as the case may be, or on the date that the initiating or closing, as the case may be, is entered on the broker's books and records.

(5) *Fractional shares.* A broker is not required to withhold under section 3406 with respect to a sale of a fractional share of stock resulting in less than $20 of gross proceeds (as described in §5f.6045-1(c)(3)(ix)).

(6) *Examples.* The application of the provisions of this paragraph (c) may be illustrated by the following examples in each of which it is assumed that the payee failed to provide a taxpayer identification number in the manner required by §31.3406(d)-1:

Example (1). A instructs Broker M to sell 200 shares of Corporation X's stock for $100 per share. The amount of gross proceeds subject to reporting under section 6045 and thus subject to backup withholding under section 3406 is $20,000.

Example (2). B instructs Broker N to retire a long-term bond at maturity where the stated redemption price at maturity is $10,000. The amount of gross proceeds subject to reporting under section 6045 and thus subject to backup withholding under section 3406 is $10,000.

Example (3). Assume the same facts as in *Example (2)* except that the bond has a $50 final interest coupon attached. The amount of gross proceeds subject to reporting under section 6045 and thus subject to withholding under section 3406 is $10,000. The $50 interest coupon is subject to reporting under section 6049 and, accordingly, is subject to backup withholding as described in §31.3406(b)(2)-1.

Example (4). On March 1, 1984, C enters into a futures contract through O, a futures commission merchant. C deposits initial margin with O in the form of a $10,000 Treasury bill. The futures contract is closed on September 1, 1984, at a net profit of $5,000. In addition, on October 1, 1984, the Treasury bill matures, and O credits C's account with $10,000. C seeks to withdraw the $15,000 from the account on November 1, 1984. The amount subject to backup withholding is $5,000 (i.e., the amount which is a withdrawal under paragraph (c)(2)(i) of this section). The $10,000 proceeds from the redemption of the Treasury bill is not considered a withdrawal because the proceeds are traceable to the disposition of property other than futures contracts. The amount paid with respect to the maturity of the Treasury bill is subject to reporting under section 6049. See §31.3406(b)(2)-2 for the amount subject to backup withholding at maturity of the Treasury bill.

Example (5). Assume the same facts as in *Example (4)* except that the futures contract is not closed on September 1. On December 31, 1984 (the end of C's taxable year), the cash available for C's withdrawal from the account is $2,000 due to a positive balance in the variation margin account. The amount subject to backup withholding is $2,000 under paragraph (c)(2)(ii) of this section.

Example (6). D maintains an account with Broker P through which D enters into forward contracts. D authorizes P to withdraw $50,000 cash from the account on April 1, 1984, in order to take delivery to close a forward contract. The amount subject to backup withholding is $50,000 under paragraph (c)(2)(i) of this section if the property delivered pursuant to the contract is not disposed of by the close of the seventh trading day following the trading day that the customer took delivery under the contract. Thus, for example, in a case where the property delivered pursuant to the contract is not disposed of until the tenth trading day following the trading day that the customer took delivery under the contract, Broker P must withhold $10,000 (20 percent of $50,000, the amount subject to backup withholding). If, however, property was disposed of by the close of the seventh trading day following the trading day that the customer took delivery under the contract, the total amount withdrawn would not have been subject to backup withholding.

Example (7). E maintains an account with Broker Q through which E engages in margin transactions. In order to satisfy the applicable margin requirements, Q sells $500 worth of stock for E's account. No amount of the $500 proceeds is subject to backup withholding under paragraph (c)(3) of this section since the entire amount of the proceeds is necessary to meet the margin requirement. Q would be required to withhold, however, to the extent, if any, that the proceeds of such a forced sale exceeded the amount needed to meet the margin requirements.

Example (8). F enters into a short sale through Broker R with respect to 100 shares of Corporation Y's stock for $50 a share. The amount subject to backup withholding is $5,000 under paragraph (c)(4) of this section. R may elect, however, to defer withholding until the short sale is closed, if at the time the short sale was initiated, R expected that the gain realized from the sale would be determinable from R's records. If R elects and R's records show the amount of the gain, the amount subject to backup withholding would be the gain realized on closing. If the amount of the gain cannot be determined from R's records at the time of closing, the property used to close the short sale must be assumed to have a basis of zero. Consequently, the amount of gain subject to backup withholding is $5,000.

§31.3406(b)(3)-3 Reportable payments by certain fishing boat operators.

(a) *Payments subject to withholding.* Backup withholding under section 3406 is required with respect to any amount of a kind, and to a payee, that is required to be reported

under section 6050A (relating to information reporting by certain fishing boat operators). If the payment is excepted from the definition of wages subject to wage withholding under section 3402, then that payment is subject to reporting under section 6050A and backup withholding. If the payment is not subject to reporting under section 6050A because the payee is treated as an employee performing services described in section 3121(b)(20) and §31.3121(b)(20)-1, that payment is not subject to backup withholding because the payment is wages subject to wage withholding under section 3402. After the determination is made under section 6050A that an information return is required, the fishing boat operator is required to deduct and withhold the tax under section 3406 if the payee does not furnish his taxpayer identification number to the fishing boat operator in the manner required in §31.3406(d)-1 or the Internal Revenue Service notifies the fishing boat operator that the taxpayer identification number that the payee furnished to the fishing boat operator is incorrect. The amount subject to withholding under section 3406 is described in paragraph (c) of this section.

(b) *Examples.* The application of the provisions of paragraph (a) of this section may be illustrated by the following examples:

Example (1). K, an owner of a fishing boat, normally operates the boat with a captain and eight others performing services as crew members of the boat solely for cash representing a share of the catch. K is required to make an information return under section 6050A. Accordingly, K is required to withhold 20 percent of the amount described in paragraph (c) of this section if a crew member does not furnish his taxpayer identification number to the fishing boat operator in the manner required in §31.3406(d)-1 or the Internal Revenue Service notifies the fishing boat operator that the taxpayer identification number that the crew member furnished the fishing boat operator is incorrect.

Example (2). Assume the same facts as in *Example (1)* except that K does not pay the crew members a share of the catch but rather pays them cash remuneration as wages for services performed. The payment is subject to income tax withholding under section 3402. Thus, K is not required to make an information return under section 6050A and, accordingly, K is not required to withhold under section 3406. K may be required to file a statement under section 6051(d).

(c) *Amount subject to withholding*—(1) *In general.* The amount subject to withholding under section 3406 is the amount subject to reporting under section 6050A, but only to the extent the amount is paid in money and represents a share of the proceeds of the catch. Thus, while the fair market value of the share of the catch that the payee receives generally must be reported under section 6050A, the fishing boat operator shall withhold under section 3406 only on the dollar amount the individual receives as his share of the proceeds of the catch (*i.e.*, the amount required to be included on Form 1099 under section 6050A and §1.6050A-1(a)(5)).

(2) *Examples.* The application of the provisions of paragraph (c)(1) of this section may be illustrated by the following examples:

Example (1). L, an owner of a fishing boat, normally employs nine people to work as the crew members of the boat. The only remuneration that L pays each crew member is his respective share of the catch in kind. L is required to make an information return under section 6050A showing the type and weight of the crew member's share of the catch and, if ascertainable, the fair market value of the catch. L is not required to withhold under section 3406, however, because backup withholding is limited to the extent of the cash received with respect to amounts subject to reporting under section 6050A.

Example (2). Assume the same facts as in example (1) except that L pays each crew member his share of the proceeds of the catch. L is required to make an information return under section 6050A showing the dollar amount paid to each crew member. L is required to withhold under section 3406 on the dollar amount paid to a crew member who does not furnish a taxpayer identification number to L or with respect to whom the Internal Revenue Service has notified L that an incorrect taxpayer identification number has been furnished.

Example (3). Assume the same facts as in example (1) except that, in addition to receiving a share of the catch, each crew member is entitled to receive $3 per hour for repairing nets, constructing new nets, splicing cable, and other incidental work while in port. Since each crew member is entitled to receive payment other than a share of the catch, he is considered an employee and thus subject to wage withholding under section 3402. Accordingly, none of L's payments to the crew members are reportable under section 6050A. Thus, L is not required to withhold under section 3406.

§31.3406(b)(3)-4 Reportable payments of royalties.

(a) *Royalty payments subject to withholding.* Backup withholding under section 3406 is required with respect to any payment of a kind, and to a payee, that is required to be reported under section 6050N (relating to information reporting of payments of royalties). If the payment is not of a kind subject to reporting under section 6050N, then the payment is not subject to backup withholding. Additionally, if the payment is not to a payee that is subject to reporting under section 6050N, then the payment is not subject to backup withholding. See section 6050N(c) for those payees that are not subject to information reporting under section 6050N and thus are not subject to withholding under this paragraph. After the determination is made that an information return is required under section 6050N, the payor is required to deduct and withhold the tax under section 3406 if the payee does not furnish his taxpayer identification number in the manner required in §31.3406(d)-1 or the Internal Revenue Service notifies the payor that the taxpayer identification number that the payee furnished the payor is incorrect as described in §31.3406(d)-5. The amount subject to withholding under section 3406 is described in paragraph (b) of this section. Notwithstanding the provisions of this section, a payor is not required to withhold on any payment made to a payee described in §31.3406(g)-1(a) (relating to exempt recipients).

(b) *Amount subject to withholding.* The amount subject to backup withholding under section 3406 is the amount subject to reporting under section 6050N.

§31.3406(b)(4)-1 Exemption for certain minimal payments.

(a) *In general.* A payor is required to withhold under section 3406 with respect to any payment that is of a kind and to a payee that is subject to information reporting if any condition for imposing backup withholding exists (as described in §31.3406(a)-1). A payor of reportable interest or dividends (as defined in §31.3406(b)-(1)-1(b)) may elect, however, not to withhold from a payment which does not exceed $10 and which on an annualized basis does not exceed $10 (as computed in paragraph (c) of this section). In addition, a broker or barter exchange may elect not to withhold on gross proceeds of $10 or less. The broker or barter exchange is not required to annualize the amount of the gross proceeds. If a payor, broker, or barter exchange elects to withhold on amounts of $10 or less, the payor, broker, or barter exchange is required to make an information return under §31.6051-1. A payment

of more than $10 is subject to withholding under this section, regardless of the period for which the payment is made if any relevant condition for imposing backup withholding under section 3406 exists (as described in §31.3406(a)-1). Therefore, the annualization computation of paragraph (c) of this section should not be performed for any payment exceeding $10.

(b) *Manner of making the election.* The election not to withhold from payments that do not exceed $10 can be made only for a reportable interest or dividend payment (as defined in §31.3406(b)(1)-1(b)), for a royalty payment (as defined in §31.3406(b)(3)-4), or by a broker or barter exchange with respect to gross proceeds (as described in §31.3406(b)(3)-2). Thus, a payor of any other reportable payment (as defined in §31.3406(b)(1)-1(c)) except royalty payments is required to withhold regardless of the amount except as provided in §31.3406(b)(3)-1 with respect to amounts subject to reporting under section 6041 or 6041A(a). The minimal payment election is made with respect to a particular payment by complying with all the requirements of this section. The election not to withhold on payments that do not exceed $10 need not be made consistently, but may be made on a payment-by-payment basis.

(c) *Annualization*—(1) *Reportable interest or dividend payment.* Except as provided in paragraph (c)(2) of this section, with respect to any reportable interest or dividend payment (other than an amount paid in a window transaction or an amount that is original issue discount), the payor shall annualize the payments made. With respect to a payor who maintains records which reflect multiple holdings of one payee and the payor makes an aggregate payment with respect to all the payee's holdings (such as a dividend check that reflects payment on all stock owned by the payee), the payor shall annualize the aggregate payment made. To annualize a reportable interest or dividend payment, the payor shall calculate what the amount of the payment would be if it were paid for a 1-year period (instead of the period for which it actually is paid). The annualized amount shall be determined by dividing the amount of the payment by the number of days in the period for which it is being paid and then multiplying that result by the number of days in the year. If the annualized amount is $10 or less, the payor may elect not to apply backup withholding to that payment regardless of whether more than $10 may be or has been paid to the payee in other reportable payments during the calendar year. Conversely, if the annualized amount is more than $10, backup withholding applies even if $10 or less is actually paid to the payee during the calendar year. For purposes of computing the annualized amount, the payor may assume either that February always consists of 28 days and that the year consists of 365 days or that each month always consists of 30 days and that the year consists of 360 days. For amounts that are deposited with a payor in a new account or certificate between the dates on which the payor customarily pays or credits interest, the payor may assume that the period for which the interest is paid is the payor's customary period for paying or crediting interest.

(2) *Window transactions, original issue discount, and broker reporting.* No annualization is required for window transactions (as defined in §31.3406(b)(2)-3(b)), original issue discount, or a broker reporting gross proceeds under section 6045. With respect to a window transaction, however, the payor is required to aggregate all payments made in the same transaction (*e.g.*, payments made with respect to coupons or obligations presented for payment at the same time as described in §1.6049-4(e)(4)). A payor is not required to annualize any amount that is original issue discount on an obligation regardless of the period of time for which the payment is made. Thus, original issue discount (as described in §31.3406(b)(2)-2) is subject to withholding under section 3406 only if it exceeds $10.

(d) *Examples.* The application of the provisions of this section may be illustrated by the following examples:

Example (1). A, an individual to whom payments are subject to backup withholding, maintains a savings account at Bank M. M credits interest on the account at the end of each calendar quarter. M credits $2.60 of interest to A's account on March 31, and $2.00 of interest on June 30, September 30, and December 31. The annualized amount for the payment credited on March 31 exceeds $10 determined for a 1-year period (*i.e.*, $2.60 (actual payment) divided by 90 (number of days in the quarter) multiplied by 360 is $10.40). Consequently, the payment to A is not a minimal payment, and M may not elect not to impose backup withholding on the payment. Therefore, M must withhold 52 cents ($2.60 multiplied by 20 percent) from the amount credited to A on March 31. M is not required to withhold on June 30, September 30, or December 31, because the annualized amount for each of the payments does not exceed $10 ($2.00 divided by 90 multiplied by 360 is $8.00).

Example (2). Assume the same facts as in *Example (1)* except that the payments on September 30 and December 31 are $3.00 each. The result is the same as in *Example (1)* with respect to the payments on March 31 and on June 30. M is required to withhold on the payments made on September 30 and December 31 since the annualized amount credited on each date exceeds $10 (*i.e.*, $3.00 divided by 90 multiplied by 360 is $12.00). Even though the total payments made to B during the 1-year period exceed $10, M is not required to withhold on June 30. M is not required to withhold more than 20 percent from the third or fourth quarterly payment to compensate for the earlier payment that was not subject to withholding.

Example (3). Individual C presents two Series EE savings bonds at Bank N to cash, on each of which $3 of interest has accrued. C also presents an interest coupon for a corporate bond on which $10 of interest is payable. Thus, the total amount of interest paid to C in the transaction is $16. N is required to withhold if C does not furnish a taxpayer identification number. If only the two savings bonds were presented, however, N would not be required to withhold since not more than $10 would be paid to C in the transaction. N is not required to annualize the payment under paragraph (b) of this section because it is a window transaction (as defined in §31.3406(b)(2)-3).

Example (4). Corporation X pays quarterly dividends on shares owned by Individual D. Each quarter X pays D $2.75 of dividends for all the shares D owns. X is required to withhold on each quarterly dividend because the annualized amount of each quarterly dividend exceeds $10 (*i.e.*, $2.75 divided by 90 multiplied by 360 is $11).

Example (5). Individual E opens a new savings account at O Bank on February 2, 1984, and fails to make the certifications required in §31.3406(d)-1 or §31.3406(d)-2. O customarily credits interest to accounts of this type at the end of each calendar quarter. On March 31, O credits $2.00 of interest to D's account. O may annualize the payment by dividing $2 by 59 (the number of days in the period for which the interest actually is paid) and multiplying that amount by 360. In that event, the annualized amount would be $12.20, and O would be required to withhold. Alternatively, O may treat the payment as made for the entire calendar quarter. Accordingly, O would annualize the payment by dividing $2 by 90 and multiplying that amount by 360, in which case the annualized amount would be $8.00 and O could elect not to withhold.

Example (6). Q is a middleman payor (as defined in §31.3406(a)-2(b)(3)) with respect to dividends that are paid quarterly. Q maintains separate records for each instrument of the same issue owned by Individual F, who fails to furnish a social security number. Q pays $9 of dividends to F with respect to Y company stock

and $2 of dividends to F with respect to Z company stock. While Q is not required to aggregate the two payments, Q is required to annualize each payment. Thus, Q must withhold on the quarterly dividend of $9 paid with respect to Y stock since the annualized amount exceeds $10 (i.e., $9 divided by 90 multiplied by 360 is $36). Q is not required to withhold on the quarterly dividend of $2 paid with respect to Z stock since the annualized amount does not exceed $10 ($2.00 divided by 90 multiplied by 360 is $8).

Example (7). Assume the same facts as in *Example (6)* except that Q maintains records which reflect F's multiple holdings in Y and Z issues and Q makes an aggregate payment of $11.00 to C. Since the payment is more than $10, backup withholding applies.

§31.3406(c)-1 Notified payee underreporting of reportable interest or dividend payments.

(a) *Requirement to withhold*—(1) *In general.* Backup withholding under section 3406(a)(1)(C) is required with respect to any reportable interest or dividend payment (as defined in section 3406(b)(2) and §31.3406(b)(1)-1(b)) made to a payee if the Internal Revenue Service or a broker (as defined in section 3406(h)(5) and §31.3406(h)-1(c) and pursuant to section 3406(d)(2)(B)(ii)(III)) notifies a payor (as defined in section 3406(h)(4) and §31.3406(a)-2) that the payee is subject to backup withholding due to a notified payee underreporting (as defined in paragraph (a)(2) of this section). The payor is required under section 3406(c)(4) and paragraph (c)(1) of this section to inform the payee that backup withholding under section 3406(a)(1)(C) has begun. The requirements for the notice that a payor must send to a payee are set forth in paragraph (c)(2) and (3) of this section. The period for which backup withholding is required due to a notified payee underreporting is described in section 3406(e)(3)(A) and in paragraph (e)(1) of this section. See section 3406(c)(3) and paragraph (g) of this section for the rules regarding how a payee may obtain a determination from the Internal Revenue Service that withholding under section 3406(a)(1)(C) be stopped or not started.

(2) *Definition of notified payee underreporting.* The term "notified payee underreporting" means that the Internal Revenue Service has—

(i) Determined that there was a payee underreporting as defined in paragraph (a)(3) of this section,

(ii) Mailed at least four notices to the payee (over a period of at least 120 days) with respect to the underreporting as prescribed in paragraph (f)(1) of this section, and

(iii) Assessed any deficiency attributable to the underreporting in the case of any payee who has filed a return.

(3) *Definition of a payee underreporting.* The term "payee underreporting" means that the Internal Revenue Service has determined, for a taxable year, that—

(i) A payee failed to include in his return of tax under chapter 1 of the Internal Revenue Code for such year any portion of a reportable interest or dividend payment required to be shown on such tax return, or

(ii) A payee may be required to file a return for such year and to include a reportable interest or dividend payment in such return, but failed to file such return.

Reportable minimal payments (*i.e.*, small payments described in section 3406(b)(5) to the extent reported on an information return), patronage dividends, original issue discount, and window payments shall be taken into account in determining whether underreporting as defined in paragraph (a)(3) of this section has occurred, even though such payments may not be defined as reportable interest or dividend payments under section 3406(b)(2) and §31.3406(b)(1)-1(b) or even though backup withholding under section 3406(a)(1)(C) may not apply to such payments.

(b) *Notice to payors and brokers regarding backup withholding*—(1) *Notice from the Internal Revenue Service.* The Internal Revenue Service will notify—

(i) Payors to begin backup withholding on reportable interest or dividend payments due to a notified payee underreporting pursuant to section 3406(a)(1)(C); and

(ii) Brokers pursuant to section 3406(c)(5) that a payee is subject to backup withholding under section 3406(a)(1)(C).

(2) *Notice from a broker.* A broker who receives a notice from the Internal Revenue Service that a payee is subject to backup withholding due to a notified payee underreporting and through whom the payee subsequently acquires a readily tradable instrument (as defined in section 3406(h)(6)) with respect to which the broker is not the payor is required to notify the payor of that instrument that the payee is subject to backup withholding under section 3406(a)(1)(C) in the time and manner provided in §31.3406(d)-4(a).

(3) *Accounts subject to backup withholding*—(i) *Existing accounts.* After receiving notice from the Internal Revenue Service or from a broker, as provided in section 3406(d)-(2)(B) and paragraphs (b)(l)(i) and (2) of this section, that a payee is subject to backup withholding under section 3406 (a)(l)(C), payors are required to withhold 20 percent of all reportable interest or dividend payments subject to backup withholding made with respect to all existing accounts of the payee (and all subsequent accounts that are thereafter opened by the payee which the payor treats as under one primary account) with that payor (i.e., with the payor's Taxpayer Identification Number).

(ii) *New accounts; reliance on certification.* If paragraph (b)(3)(iii) of this section does not apply to a new account of a payee, then a payor may rely on a certification made by a payee under penalties of perjury as described in section 3406(a)(1)(D) and §31.3406(d)-2 that he is not subject to backup withholding due to notified payee underreporting. A payor, however, may not rely on the certification if in the course of processing the certification or in administering the account to which the certification relates, the payor discovers that such certification is false (because the payor was notified by the Internal Revenue Service that the payee is subject to backup withholding under section 3406(a)(1)(C) and no notice was received to stop backup withholding pursuant to section 3406(c)(3) and §31.3406(c)-1(d)(1) prior to the time the new account is opened). See §31.3406(d)-2. After discovering that the certification is false, the payor must commence backup withholding on the next interest or dividend payment to the account that is subject to backup withholding. Backup withholding is required under section 3406(a)(1)(C) on the account until the payor receives a notice from the Internal Revenue Service or a copy of the certification provided to the payee pursuant to section 3406(c)(3).

(iii) *Joint accounts.* Payors are required to withhold on joint accounts

if the payee subject to backup withholding under section 3406(a)(1)(C)—

(A) Is the first person listed on the account for tax purposes on the date that the payor receives the notice to begin backup withholding,

(B) Effective [DATE THAT IS 60 DAYS AFTER THE DATE THIS DOCUMENT IS PUBLISHED AS A TREASURY DECISION], was the first person listed on the account at any time during the 120-day period prior to the day the payor received the notice described in paragraph (b)(1) or (2) of this section to begin backup withholding, or

(C) Effective [DATE THAT IS 60 DAYS AFTER THE DATE THIS DOCUMENT IS PUBLISHED AS A TREASURY DECISION], should be the first person listed on the account for tax purposes on the date that the payor receives the notice to begin backup withholding and the payor has actual knowledge that the payee should be so listed.

Backup withholding shall apply to reportable interest and dividend payments made to a joint account, if required, even if the order of the names on the account is subsequently changed, so long as the name of the payee subject to backup withholding remains on the account.

(iv) *Withholding exception.* Payors are not required to withhold on reportable interest or dividend payments made with respect to an account of the payee that could not be located with reasonable care. The payor will be considered to have exercised reasonable care—

(A) If the payor uses the name and taxpayer identification number or names and taxpayer identification numbers (if a joint return was filed by the payees) provided on the notice from the Internal Revenue Service or from a broker as prescribed in paragraph (b)(1)(i) and (2) of this section and in certain circumstances identified in this paragraph (b)(3)(iv) any account numbers provided by the Internal Revenue Service in locating all accounts of a payee or payees;

(B) If the payor, using records kept in the ordinary course of business, can associate another surname with the name of the payee provided on the notice and the payor uses both surnames of a payee to locate accounts of a payee (*i.e.*, when the payee uses a different name on the account from the names stated in the notice from the Internal Revenue Service or from a broker, for instance due to marriage or adoption);

(C) If the payor uses any account numbers provided by the Internal Revenue Service or a broker to identify the payee and the payee's taxpayer identification number when the taxpayer identification number is not provided to the payor by the Internal Revenue Service or broker, or when the taxpayer identification number provided by the Internal Revenue Service or a broker does not match the taxpayer identification number of the payee on the records that the payor maintains in the ordinary course of business. The name of the payee and the payee's taxpayer identification number obtained as described in the preceding sentence must be used by the payor to locate other accounts of the payee and by the broker to locate the payors with respect to whom the payee subsequently acquires a readily tradable instrument through the broker; and

(D) If a payor that has several branches or divisions, each of which uses the same Taxpayer Identification Number for information reporting purposes, searches for the accounts of the payee pursuant to the rules described in paragraph (b)(3)(iv)(A), (B), or (C) of this section at all branches or divisions of the payor within a reasonable geographic area of the mailing address of the payee (*e.g.*, if the payor lives in a city, all branches or divisions within the metropolitan area).

(v) *Examples.* The provisions of this paragraph (b) may be illustrated by the following examples:

Example (1). Corporation X declares a reportable dividend on its common stock and uses Bank A as its paying agent in making the dividend payments. The Internal Revenue Service notifies X to commence backup withholding under section 3406(a)(1)(C) due to notified payee underreporting of reportable interest and dividend payments by several of its payees. The notice contains X's employer identification number (EIN) to further identify the payor who has the obligation to impose backup withholding under section 3406(a)(1)(C). X sends the notice to its paying agent, A, and instructs A to commence backup withholding on the named payees. The payees subject to withholding also maintain savings accounts with A that pay reportable interest. A was not notified by the Internal Revenue Service with respect to the named payees. In determining which accounts are subject to backup withholding, A must review all the accounts it maintains for X with X's EIN. A does not have to review any of its accounts on which it is the payor or other accounts for which it acts as a paying agent.

Example (2). Assume the same facts in *Example (1)* except that A receives the notice to begin backup withholding due to payee underreporting from the Internal Revenue Service and the notice contains A's EIN. In determining which accounts are subject to backup withholding, A must review all of its accounts containing the EIN specified on the notice. A does not have to review other accounts it maintains as a paying agent.

Example (3). Bank B received notice from the Internal Revenue Service to begin backup withholding due to payee underreporting with respect to all accounts of C making reportable interest or dividend payments. The notice specifies C's name, taxpayer identification number, address, and an account number. While searching for other accounts, B discovers that C has a joint account with D, an individual. The account lists D's name first, but contains C's taxpayer identification number. If the account information reflects that C is the primary owner of the account and his name is reported first on information returns filed with the Internal Revenue Service, then B must withhold on that account. If, however, C's name is not reported first for information reporting, then, absent actual knowledge that C should, in fact, be the person listed first on the account, B should not withhold on that account because the name and taxpayer identification number information set forth in the notice from the Internal Revenue Service and such information set forth for the first named person on the account are not the same.

Example (4). Assume the same facts as in *Example (3)* except that the account number specified on the Internal Revenue Service notice concerns the joint account mentioned above. D's name is listed first on the account on B's records, and it is listed first for information reporting. B must withhold on the specified account but review its business records to determine whether the taxpayer identification number corresponds with D's or C's name and then use that information (name and taxpayer identification number) in locating other accounts that should be subject to backup withholding.

(c) *Notice from payors of backup withholding due to a payee underreporting*—(1) *In general.* A payor is required under section 3406(c)(4) to notify the payee in accordance with paragraph (c)(2) of this section that backup withholding has begun because of a notified payee underreporting. Payors who are notified by a broker that a payee is subject to backup withholding under section 3406(a)(1)(C) are also required to send the notice in accordance with paragraph (c)(2) of this section. As a result, the notice requirements provided in §31.3406(d)-4(b)(2) shall not apply to those payors notified by a broker that a payee is subject to backup withholding under section 3406(a)(1)(C). The payor must send the notice required by paragraph

(c)(2) of this section to the payee no later than 15 days after the date that the payor makes the first payment subject to backup withholding under section 3406(a)(1)(C). The payor must send the notice of backup withholding by first-class mail to the payee at his last known address.

(2) *Form of the notice to the payee with respect to notified payee underreporting.* The notice to the payee required by paragraph (c)(1) of this section must state—

(i) That the Internal Revenue Service has given notice that the payee has underreported reportable interest or dividends;

(ii) That, as a result of such underreporting, the payor is required under section 3406(a)(1)(C) of the Internal Revenue Code to withhold 20 percent of reportable interest and dividend payments made to the payee no later than the close of the day 30 days after the date that the payor received the notice;

(iii) The date that the payor received the notice to begin backup withholding under section 3406(a)(1)(C);

(iv) Effective [DATE THAT IS SIXTY DAYS AFTER THIS DOCUMENT IS PUBLISHED AS A TREASURY DECISION], the account number(s) that will be subject to backup withholding due to notified payee underreporting;

(v) That the payee must obtain a determination from the Internal Revenue Service in order to stop the backup withholding under section 3406(a)(1)(C); and

(vi) That while the payee is subject to backup withholding due to payee underreporting, the payee may not certify to a payor making reportable interest or dividend payments (or to a broker acquiring a readily tradable instrument for the payee) that the payee is not subject to backup withholding under section 3406(a)(1)(C). (See section 3406(a)(1)(D) and §31.3406(d)-2 for the backup withholding rules with respect to a payee's failure to make the certification under section 3406(a)(1)(D)).

(3) *Exceptions.* A notice provided to a payee on or before April 23, 1987, will be deemed to satisfy the provisions of paragraph (c)(2) of this section if it informs the payee that the payor has been instructed by the Internal Revenue Service to start backup withholding on reportable interest or dividend payments to the payee. If a payor who has started backup withholding due to notified payee underreporting on or before April 23, 1987, has not provided adequate notice to the payee on or before April 23, 1987, then the payor must provide notice to the payee in the manner prescribed in paragraph (c)(2) of this section by June 8, 1987.

(4) *Penalty for failure to provide notice.* A payor who fails to provide the notice required under section 3406(c)(4) to a payee (as described in paragraph (c)(2) of this section) may be subject to civil or criminal penalties as a result of that failure.

(d) *Notice to stop backup withholding*—(1) *In general.* The Internal Revenue Service will provide written certification to a payee that backup withholding is to stop and will notify payors who were contacted pursuant to paragraph (b) of this section to stop withholding after the Internal Revenue Service has made a determination under paragraph (g) of this section that backup withholding with respect to a payee should stop. The Internal Revenue Service will also notify brokers who were contacted pursuant to paragraph (b) of this section that the payee is no longer subject to backup withholding under section 3406(a)(1)(C) and that the brokers are no longer obligated to provide notices to payors under paragraph (b)(2) of this section. A broker who receives a notice from the Internal Revenue Service or a copy of the certification provided to a payee by the Internal Revenue Service is not required to notify any payors to whom the broker has previously provided the notice required under paragraph (b)(2) of this section that the payee is no longer subject to backup withholding under section 3406(a)(1)(C).

(2) *Date notice to stop withholding will be provided*—(i) *Underreporting corrected or bona fide dispute.* If the Internal Revenue Service makes a determination as set forth in paragraph (g)(1)(ii) or (iv) of this section during the 12-month period ending on October 15 of any calendar year, the Internal Revenue Service will provide the certification and notice required by paragraph (d)(1) of this section no later than December 1 of such calendar year.

(ii) *No underreporting or undue hardship.* If the Internal Revenue Service makes a determination as set forth in paragraph (g)(1)(i) or (iii) of this section, the Internal Revenue Service will provide the notices required by paragraph (d)(1) of this section no later than the 45th day after the day on which the Internal Revenue Service makes its determination.

(e) *Period during which withholding is required*—(1) *In general.* Upon receiving notice from the Internal Revenue Service after April 23, 1987, to begin backup withholding under section 3406(a)(1)(C) or notification from a broker stating that the payee is subject to backup withholding under section 3406(a)(1)(C), the payor must impose backup withholding on all reportable interest and dividend payments made to the payee during the period beginning after the close of the 30th day after the day on which the payor receives the notice provided in paragraph (b)(1)(i) or (2) of this section and ending as of the close of the day before the stop date (as described in paragraph (e)(2) of this section). Pursuant to section 3406(e)(5)(C), the payor may elect to begin backup withholding at any time during the 30-day period described in this paragraph.

(2) *Stop date*—(i) *Underreporting corrected or bona fide dispute.* In the case of a determination that the underreporting has been corrected or that a bona fide dispute exists (as defined in paragraph (g)(1)(ii) or (iv) of this section), the stop date is—

(A) January 1 following the 12-month period ending on October 15th of any calendar year in which the determination has been made or, if later,

(B) The day that is 30 days after the earlier of—

(*1*) The date on which the payor receives written notification from the Internal Revenue Service (under paragraph (d)(2) of this section) that withholding is to stop, or

(*2*) The date on which the payor receives a copy of the written certification provided to the payee by the Internal Revenue Service that withholding is to stop.

(ii) *No underreporting or undue hardship.* In the case of a determination that no payee underreporting occurred or that an undue hardship exists or could exist (as defined in

paragraph (g)(1)(i) or (iii) of this section), the stop date is the date specified in paragraph (e)(2)(i)(B) of this section.

(iii) *Payor election to shorten or eliminate grace period.* The payor with respect to any payee may elect to determine the stop date without regard to the grace period provided in section 3406(e)(5)(B) (i.e., without regard to the words "the day that is 30 days after" in paragraph (e)(2)(i)(B) of this section) or by substituting a shorter grace period.

(iv) *Examples.* The provisions of this paragraph (e)(2) may be illustrated by the following examples:

Example (1). The Internal Revenue Service makes a determination by October 15, 1987, that any underreporting with respect to A has been corrected. X, a payor who has been notified to backup withhold on payments of interest to A due to notified payee underreporting, receives written notice from the Internal Revenue Service on December 1, 1987, informing X that A is no longer subject to backup withholding under section 3406(a)(1)(C) and that X must stop backup withholding as of the close of December 31, 1987, or, if later, the earlier of the close of the day 30 days after receipt of the notice from the Internal Revenue Service or receipt of the copy of the written certification provided to the payee by the Internal Revenue Service. The stop date, as provided in paragraph (e)(2)(i)(A) of this section, is January 1, 1988, and the payor must stop backup withholding as of the close of December 31, 1987.

Example (2). Assume the same facts as in *Example (1)* except that X, due to a change of address or for other reasons, does not receive the notice from the Internal Revenue Service to stop backup withholding until December 15, 1987. In addition, A does not provide X with a copy of the certification that was provided to A by the Internal Revenue Service until December 15, 1987. The stop date, as provided in paragraph (e)(2)(i)(B) of this section, is January 14, 1988 (30 days after December 15, 1987), because that date is later than January 1, 1988. However, if a payor elects pursuant to section 3406(e)(5)(C) and paragraph (e)(2)(iii) of this section to determine the stop date without regard to that 30-day grace period, the stop date is January 1, 1988.

Example (3). Assume the same facts as in *Example (2)* except that on December 10, 1987 (rather than on December 15, 1987), A provides X with a copy of the certification from the Internal Revenue Service. The stop date, as provided in paragraph (e)(2)(i)(B) of this section, is January 9, 1988 (30 days after December 10, 1987), because that date is earlier than January 14, 1988 (30 days after the day X received notice from the Internal Revenue Service), but later than January 1, 1988. However, if a payor elects pursuant to section 3406(e)(5)(C) and paragraph (e)(2)(iii) of this section to determine the stop date without regard to that 30-day grace period, the stop date is January 1, 1988.

(f) *Notice to payees from the Internal Revenue Service*—(1) *Notice period.* After the Internal Revenue Service determines that a payee underreporting exists as defined in paragraph (a)(3) of this section, the Internal Revenue Service, pursuant to section 3406(c)(1)(B), will mail to the payee at least four notices over a period of at least 120 days (the "notice period") before payors and brokers will be notified that the payee is subject to backup withholding due to a notified payee underreporting as provided in paragraph (b)(1) of this section. The notices may be incorporated with other notices provided to the payee by the Internal Revenue Service.

(2) *Payee subject to withholding.* After the Internal Revenue Service provides the notices described in paragraph (f)(1) of this section, the Internal Revenue Service will send the notices required by paragraph (b) of this section unless—

(i) A payee obtains a determination under paragraph (g) of this section, or

(ii) In the case of a payee who has filed a tax return, the Internal Revenue Service has not assessed the deficiency attributable to the underreporting.

(3) *Disclosure of names of payors and brokers.* The Internal Revenue Service pursuant to section 3406(c)(5) may require a payee subject to backup withholding due to a notified payee underreporting to disclose the names of all of his payors of reportable interest or dividend payments and the names of all of the brokers with whom the payee has accounts which may involve reportable interest or dividend payments. To the extent required in the request from the Internal Revenue Service, the payee shall also provide his account numbers and other information necessary to identify the payee's accounts.

(4) *Backup withholding certification.* After a payee receives a final notice from the Internal Revenue Service notifying him that his reportable interest or dividend payments are subject to backup withholding due to notified payee underreporting under section 3406(a)(1)(C), the payee shall not certify to any payor or broker, under penalties of perjury, that he is not subject to backup withholding under section 3406(a)(1)(C). See paragraph (k)(2) of this section for the penalties that will apply to a payee who makes a false certification. The payee may not make the certification until the payee receives the certification provided in paragraph (d)(1) of this section from the Internal Revenue Service advising the payee that he is no longer subject to backup withholding under section 3406(a)(1)(C) (as provided in §31.3406(h)-3(f)(2)). See §31.3406(d)-2 for the rule applicable to a payor who makes reportable interest or dividend payments to a payee who fails to certify that he is not subject to backup withholding due to notified payee underreporting.

(g) *Determination by the Internal Revenue Service that backup withholding should not start or should be stopped*—(1) *In general.* A payee may prevent backup withholding from starting or stop it once it has started if, for the taxable year with respect to which there is a notified payee underreporting and any other taxable years for which there is any payee underreporting, the payee—

(i) Shows that there was no payee underreporting (as provided in paragraph (g)(2) of this section);

(ii) Corrects any payee underreporting (as provided in paragraph (g)(3) of this section);

(iii) Shows that backup withholding will cause or is causing an undue hardship (as defined in paragraph (g)(4) of this section) and that it is unlikely that the payee will underreport interest or dividend payments again; or

(iv) Shows that a bona fide dispute exists as to whether any underreporting has occurred (as provided in paragraph (g)(5) of this section).

(2) *No underreporting.* A payee may show that no underreporting of interest or dividends exists by presenting receipts or other satisfactory documentation to the Internal Revenue Service showing that all taxes relating to such payments were reported or evidence showing that the payee did not have to file a return for the taxable year in question or that the underreporting determination is based upon a factual, clerical, or other mistake.

(3) *Correcting any payee underreporting*—(i) *Before issuance of a statutory notice of deficiency.* Before a statutory notice of deficiency is issued to a payee pursuant to section 6212, the payee may correct underreporting—

(A) By filing a return if one was not previously filed,

(B) By filing an amended return in the event a return was filed, or

(C) By consenting to the additional assessment according to applicable notices and forms sent to the payee by the Internal Revenue Service with respect to such underreporting, and paying taxes, penalties, and interest due with respect to any underreported interest or dividend payments.

(ii) *After issuance of a statutory notice of deficiency.* After a statutory notice of deficiency is issued to a payee, the payee may correct underreporting—

(A) At any time by filing a return if one was not previously filed and paying the entire deficiency and any other taxes including penalties and interest attributable to any payee underreporting of interest or dividend payments, or

(B) After the mailing of the statutory notice of deficiency but before the expiration of the 90-day or 150-day period described in section 6213(a), or, if a petition is filed with the United States Tax Court, before the decision of the Tax Court is final by making a remittance to the Internal Revenue Service of the amounts described in paragraph (g)(3)(ii)(A) of this section specifically designating in writing that the remittance is a "deposit in the nature of a cash bond." The payee will not be deemed to have corrected the payee underreporting under this paragraph (g)(3)(ii)(B) after the remittance is returned to the payee as described in subparagraph 2 of section 4.01 of Rev. Proc. 84-58, 1984-2 C.B. 501. Once the remittance is returned to the payee, the procedures under §31.3406(c)-1 will apply. However, if the Internal Revenue Service previously contacted payors of the payee to commence backup withholding with respect to the payee underreporting, the Internal Revenue Service will recontact such payors to commence backup withholding under section 3406(a)(1)(C) and §31.3406(c)-1(b) with respect to such payee underreporting without regard to section 3406(c)(1) and §31.3406(c)-1(f) of this section.

For example, under paragraph (g)(3)(ii)(A) of this section a payee may correct underreporting after assessment of a deficiency by paying the entire assessment of all taxes, penalties, and interest with respect to that deficiency for the taxable year and any other taxes including penalties and interest attributable to any payee underreporting of interest or dividend payments for other taxable years.

(4) *Undue hardship.* A determination of undue hardship will be based on the overall impact to the payee of having 20 percent of reportable interest and dividend payments withheld. Factors that will be considered in determining whether backup withholding causes undue hardship include, but are not limited to, the following:

(i) Whether estimated tax payments, and other credits for current tax liabilities, or amounts withheld on employee wages or pensions, in addition to backup withholding, would cause significant over-withholding;

(ii) The payee's health, including the payee's ability to pay foreseeable medical expenses;

(iii) The extent of the payee's reliance on interest and dividend payments to meet necessary living expenses and the existence, if any, of other sources of income;

(iv) Whether other income of the payee is limited or fixed (e.g., social security, pension, and unearned income);

(v) The payee's ability to sell or liquidate stocks, bonds, bank accounts, trust accounts, or other assets, and the consequences of doing so;

(vi) Whether the payee reported and timely paid the most recent year's tax liability, including interest and dividend income; and

(vii) Whether the payee has filed a bankruptcy petition with the United States Bankruptcy Court.

In addition to the above factors, the Internal Revenue Service must conclude that it is unlikely that any payee underreporting will occur again.

(5) *Bona fide dispute.* The Internal Revenue Service may make a determination under this paragraph if there is a dispute between the payee and the Internal Revenue Service on a question of fact or law that is material to a determination under paragraph (g)(1)(i) and, based upon all the facts and circumstances, the Internal Revenue Service finds that the dispute is asserted in good faith by the payee and there is a reasonable basis for the payee's position. See the example provided in paragraph (j)(2)(ii) of this section for an illustration of this provision.

(h) *Requests for determinations*—(1) *In general.* A payee may request a determination under one or more of the provisions of paragraph (g) of this section. Following its review of a request for a determination under paragraph (g) of this section, the Internal Revenue Service will either provide the payee with a written certification as prescribed in paragraph (d) of this section if the evidence presented warrants the requested determination or will provide the payee with a written notice informing him that a determination was not made.

(2) *Determinations made during the notice period.* In general, if a determination is made during the notice period as defined in paragraph (f)(1) of this section, then the payee will not be subject to backup withholding due to a notified payee underreporting with respect to any taxable year for which a determination was made.

(3) *Determinations made after the notice period.* If a determination is made after the notice period, as defined in paragraph (f)(1) of this section, the Internal Revenue Service will provide a notice to payors and brokers, and a certification to the payee as provided in paragraph (d)(1) of this section.

(i) [Reserved].

(j) *Payees filing a joint return*—(1) *In general.* For purposes of section 3406(a)(1)(C), if payee underreporting is found to exist with respect to a joint return then the provisions of this section shall apply to both payees (i.e., the husband and wife). As a result, both payees will be subject to backup withholding on accounts in their individual names as well as accounts in their joint names. Either or both payees may satisfy the criteria for a determination that no payee underreporting exists, that the underreporting has been corrected, or that a bona fide dispute exists (as provided in paragraph (g)(1)(i), (ii), or (iv) of this section). Both payees, however, must satisfy the criteria for a determination that backup withholding will cause or is causing undue hardship (as provided in paragraph (g)(1)(iii) of this section).

(2) *Exceptions*—(i) *Innocent spouse.* A spouse who files a joint

return may obtain a determination that withholding should stop or not start with respect to payments made to his or her individual accounts, if the spouse—

(A) Shows that he or she did not underreport income because he or she is an innocent spouse as described in section 6013(e), or

(B) Shows that there is a bona fide dispute as to whether he or she is an innocent spouse and hence did not underreport income.

(ii) *Example.* The provisions of paragraph (j)(2)(i) may be illustrated by the following example:

Example. H and W filed a joint return in 1986 on which H failed to include $2,000 of interest income. In 1987, the Internal Revenue Service determined that a payee underreporting exists with respect to H and W for the 1986 tax year. After properly notifying H and W of the underreporting and assessing the tax, the Internal Revenue Service sent notices to payors to begin backup withholding on the joint and individual accounts of H and W and to brokers informing them that H and W are subject to backup withholding under section 3406(a)(1)(C) on their joint and individual accounts. W claims that she is an innocent spouse and requests a determination that she did not underreport interest or dividend income so that her individual accounts will not be subject to backup withholding.

The Internal Revenue Service questions her status as an innocent spouse. If the Internal Revenue Service determines, based upon all the facts and circumstances, that there is a reasonable basis for W's claim to be an innocent spouse and that the claim is made in good faith, W will have a bona fide dispute with the Internal Revenue Service. Consequently, the individual accounts of W will not be subject to further backup withholding due to a notified payee underreporting as provided in paragraph (g)(5) of this section.

The Internal Revenue Service will notify W's payors to stop backup withholding under section 3406(a)(1)(C) and will notify brokers that W is no longer subject to backup withholding under section 3406(a)(1)(C) on W's individual accounts. Backup withholding will not restart on those accounts unless the Internal Revenue Service ultimately determines that W is not an innocent spouse. In that event the Internal Revenue Service will notify the payors to start backup withholding under section 3406(a)(1)(C) and will notify the brokers that W is subject to backup withholding under section 3406(a)(1)(C) with respect to the individual accounts of W.

(iii) *Divorced or legally separated payee.* A payee who, at the time of the request for a determination under paragraph (g) of this section, is divorced or separated under State law may obtain a determination that undue hardship exists (or would exist) under paragraph (g)(1)(iii) of this section with respect to reportable interest and dividend payments made to his or her individual accounts if the divorced or legally separated payee satisfies the criteria for a determination under paragraph (g)(4) of this section.

(k) *Penalties*—(1) *Failure to withhold.* See §31.3406(h)-2(i) for the penalties applicable to a payor who fails to withhold on reportable interest and dividend payments made to a payee subject to backup withholding.

(2) *False certification*—(i) *Criminal penalty under section 7205(b).* If any individual willfully makes a false certification under section 3406(d)(1) or (2), then that individual shall, in addition to any other penalty provided by law, upon conviction thereof, be fined not more than $1,000, or imprisoned not more than 1 year, or both.

(ii) *Civil penalty under section 6682*—(A) *In general.* In addition to any criminal penalty provided by law, if any individual makes a statement under section 3406 which results in a decrease in the amounts deducted and withheld under chapter 24 of the Internal Revenue Code and, as of the time the statement was made, there was no reasonable basis for the statement, the individual shall pay a penalty of $500 for the statement. The penalty is due upon notice and demand and pursuant to section 6682 collection is not subject to the deficiency procedures of subchapter B of chapter 63 of the Internal Revenue Code. See section 6682.

(B) *Waiver of penalty.* The payee may obtain a waiver (in whole or part) of the penalty imposed under section 6682(a) and paragraph (k)(2)(ii)(A) of this section if it is established to the satisfaction of the Internal Revenue Service that the taxes imposed under subtitle A of the Internal Revenue Code with respect to the payee for the taxable year in which the false certification was made are equal to or less than the sum of—

(*1*) The credits against taxes allowed by part IV of subchapter A of chapter 1 of the Internal Revenue Code, and

(*2*) The payments of estimated tax which are considered payments on account of such taxes.

(C) *Procedure for seeking a waiver.* To request a waiver under section 6682(b) and paragraph (k)(2)(ii)(B) of this section, the payee must submit to the Internal Revenue Service a written statement with supporting documents to establish all the facts necessary in order to obtain the waiver. The statement must be signed by the person who otherwise would be subject to the penalty imposed by section 6682(a) and paragraph (k)(2)(ii)(A) of this section and must contain a declaration that it is made under penalties of perjury.

(3) *Delay of assessment.* If a payee institutes or maintains a suit with the United States Tax Court primarily to delay assessment and the payee's position is frivolous or groundless, or the payee unreasonably failed to pursue available administrative remedies, the court may award up to $5,000 in damages under section 6673. The damages will be assessed against and collected from the payee in the same manner as the underlying tax.

§31.3406(d)-1 Manner required for furnishing a taxpayer identification number.

(a) *Requirement to withhold.* Backup withholding under section 3406(a)(1)(A) is required with respect to any reportable payment (as defined in §31.3406(b)(1)-1(a)) if the payee does not furnish his taxpayer identification number to the payor in the manner required by this section. The period for withholding is described in §31.3406(e)-1(c). See §31.3406(d)-3(a) for special rules when an account is established directly with, or an instrument is acquired directly from, the payor by means of electronic or mail communication or an instrument is sold through a broker by means of electronic transmission (*i.e.*, telephone or wire instruction), and see §31.3406(d)-4 for special rules relating to the acquisition of a readily tradable instrument through a broker. See also §31.3406(g)-3 for rules as to when a payee is awaiting receipt of a taxpayer identification number. See the applicable information reporting sections and section 6109 and the regulations thereunder to determine whose taxpayer identification number should be provided.

(b) *Reportable interest or dividend account*—(1) *Manner required for furnishing a taxpayer identification number with respect to a pre-1984 account or instrument.* A payee shall furnish his taxpayer identification number to the payor with respect to any obligation, deposit, certificate, share, membership, contract, account, or other relationship or instru-

ment established or acquired on or before December 31, 1983 (a "pre-1984 account"). The manner of determining whether an account or an instrument is a pre-1984 account is described in paragraph (b)(2) of this section. The payee of a pre-1984 account may furnish his taxpayer identification number to the payor orally or in writing. The payee is not required to certify under penalties of perjury that the taxpayer identification number is correct.

(2) *Determination of pre-1984 account or instrument*—(i) *In general.* An account that is in existence before January 1, 1984, will be considered a pre-1984 account, regardless of whether additional deposits are made to the account on or after January 1, 1984. Accounts established as an expansion of a credit union prime account in existence prior to January 1, 1984, shall constitute a pre-1984 account. If funds taken from one account in existence prior to January 1, 1984, are used to create a new account on or after such date, however, the new account so created does not constitute a pre-1984 account except as provided in the preceding sentence. For example, with respect to a disposition of shares in a mutual fund and the purchase of shares of another fund within a group of mutual funds which occurs after December 31, 1983, the shares acquired in the second fund may not be treated as a pre-1984 account unless the payee owned shares in the second fund prior to January 1, 1984. An instrument acquired prior to January 1, 1984, is a pre-1984 account. An instrument negotiated in a window transaction as defined in §31.3406(b)(2)-3(b) after December 23, 1987, is treated as an instrument acquired after December 31, 1983. However, an obligation in bearer form, whenever acquired, that is redeemed after December 31, 1983, and subject to reporting under section 6045, is not a pre-1984 account. Any instrument, whenever acquired, that is held in a brokerage account shall be considered a pre-1984 account if the brokerage account is not a post-1983 brokerage account (as described in paragraph (c)(1) of this section). If shares of a corporation are held before January 1, 1984 (or considered held before such date by operation of this rule), and additional shares are acquired by the holder, irrespective of whether such shares are received by reason of a stock dividend, investing new cash, or otherwise, the new shares, in the discretion of the payor, may be considered a pre-1984 account. In the case of a qualified employee trust that distributes instruments in kind, any instrument distributed from the trust will be considered a pre-1984 account with respect to employees who were participants in the trust before 1984. Similarly, when a payor offers participants in a plan the opportunity to purchase stock of the payor after a specified time, using the money that the payee invested during that period of time, the stock so purchased after December 31, 1983, shall be considered a pre-1984 account with respect to participants in the plan who either owned shares or invested money in the plan before January 1, 1984.

(ii) *Account or instrument automatically acquired on the maturity or termination of an account.* When an account is opened, or an instrument is acquired, automatically on the maturity or termination of an account that was in existence or an instrument that was held before January 1, 1984 (or considered to have been in existence or held before such date by operation of this rule), without the participation of the payee, the new account or instrument will be considered to be a pre-1984 account, in the discretion of the payor. For purposes of the preceding sentence, a payee shall not be considered to have participated in the acquisition of the new account or instrument solely because the payee failed to exercise a right to withdraw funds at the maturity or termination of the old account or instrument.

(iii) *Special rule for short-term discount instruments acquired before January 1, 1985.* Where a discount instrument with a maturity not exceeding one year (a "short-term instrument") is acquired from the same payor immediately upon the maturity of the short-term instrument, the participation of the payee in the acquisition of the newly-acquired instrument shall not be taken into account, and the new instrument shall be considered to have been acquired automatically, unless the new instrument is acquired after December 31, 1984.

(iv) *Insurance policies.* In the case of insurance policies in effect on December 31, 1983, the election of a dividend accumulation option pursuant to which interest is paid (as defined in §1.6049-5(a)(4)), or the creation of an "account" in which proceeds of a policy are held for the policy beneficiary, may, in the payor's discretion, be treated as a pre-1984 account.

(v) *Acquisitions and mergers.* In the case of any acquisition or merger including a tax-free reorganization under section 368, the acquiring-payor shall treat those persons who (A) held accounts or instruments in another payor immediately before the acquisition or merger of such payor and who (B) receive an account or instrument in the acquiring payor immediately after such acquisition or merger, as having the same status in the acquiring payor for information reporting, backup withholding, and related tax provisions as existed with respect to the payor whose accounts or instruments were acquired. In the event that the acquiring payor cannot determine the status of the acquired accounts or instruments from the business records of the payor from whom the accounts or instruments were acquired, then the acquiring payor shall treat such accounts or instruments as pre-1984 accounts or instruments.

(3) *Manner required for furnishing a taxpayer identification number with respect to an account or instrument that is not a pre-1984 account.* Except as provided in (b)(4) of this section, a payee is required to certify under penalties of perjury that the taxpayer identification number the payee furnishes to the payor is the payee's correct taxpayer identification number with respect to any account or instrument that is not a pre-1984 account as described in paragraph (b)(2) of this section. The certificate on which the certification shall be made is described in §31.3406(h)-3. With respect to an account or instrument that is not a pre-1984 account, see §31.3406(d)-2 for the requirement that the payee must certify under penalties of perjury that the payee is not subject to backup withholding due to notified payee underreporting. See also the special rule in §31.3406(d)-3(a) with respect to an account established directly with, or

an instrument acquired directly from, the payor by electronic or mail communication. See also the rules in §31.3406(d)-4 applicable to readily tradable instruments acquired through a broker.

(4) *Special rule with respect to the acquisition of a readily tradable instrument in a transaction between parties unrelated to the payor if the parties act without the assistance of a broker.* When a readily tradable instrument is at any time acquired by a payee without the assistance of a broker, and the payee is unrelated to the payor of reportable payments on the instrument, the payee must furnish his taxpayer identification number to the payor prior to the time reportable payments are made on the instrument, but the payee is not required to certify under penalties of perjury that the number is correct. A broker shall be considered to be involved in the transaction if the person effecting the transaction would be required to make an information return under section 6045 if the instrument were sold. See §31.3406(d)-4 for the rules relating to an acquisition of a readily tradable instrument when a broker is involved.

(5) *Examples.* The application of the provisions this paragraph (b) may be illustrated by the following examples:

Example (1). Individual A maintains an interest bearing account with Bank Q that has been in existence since 1981. Because the account was in existence before January 1, 1984, the account is a pre-1984 account under paragraph (b)(2) of this section. A furnishes a taxpayer identification number to Q but does not certify under penalties of perjury that the number is his correct taxpayer identification number. A has furnished his taxpayer identification number in the manner required in paragraph (b)(1) of this section. Thus, withholding under section 3406(a)(1)(A) does not apply to any reportable interest payment on that account.

Example (2). Individual B, a shareholder of Corporation X, enrolls before January 1, 1984, in X's dividend reinvestment program to purchase additional shares of X stock and orally furnishes his taxpayer identification number to X at that time. The shares that B receives after December 31, 1983, may be considered payable to a pre-1984 account, in X's discretion. X decides to treat the account as a pre-1984 account as described in paragraph (b)(2)(i) of this section. Even if B does not certify his number, B has furnished his taxpayer identification number in the manner required in paragraph (b)(1) of this section with respect to a pre-1984 account. Thus, withholding under section 3406(a)(1)(A) does not apply to any reportable payment made with respect to the account.

Example (3). Assume the same facts as in *Example (2)* except that X does not treat the new shares as a pre-1984 account. B has not furnished his taxpayer identification number in the manner required in paragraph (b)(3) of this section with respect to accounts or instruments that are not a pre-1984 account. Thus, withholding under section 3406(a)(1)(A) applies to any reportable payment on the new shares until B certifies that the taxpayer identification number is correct. See §31.3406(d)-4(c)(2) for rules applicable to aggregate payments made with respect to certain accounts.

Example (4). Individual C purchased 100 shares of Y Corporation stock directly from Y in 1982. Y did not receive C's certified taxpayer identification number at the time the stock was acquired. On April 16, 1984, C furnished the number orally to Y and did not certify under penalties of perjury that the number is correct. Since the 100 shares of stock are considered a pre-1984 account under paragraph (b)(2) of this section, C has furnished his taxpayer identification number in the manner required. Thus, Y is not required to withhold under section 3406(a)(1)(A) on reportable payments made after April 16, 1984, as described in §31.3406(e)-1.

Example (5). Public Utility Company Z offers an investment program to consumers to invest in Z's stock. Under the plan, a consumer will invest $100 a month. At the end of the year, the money invested in the plan will be used to purchase shares of Z stock. Individual D participates in the plan during 1983. The shares acquired by D are considered a pre-1984 account under paragraph (b)(2) of this section. Accordingly, D is not required to certify his taxpayer identification number to Y. If D does not provide a taxpayer identification number to Z, however, withholding under section 3406(a)(1)(A) applies to reportable payments made with respect to the account until C furnishes his taxpayer identification number.

Example (6). E, an individual, transfers a bond issued by Corporation N to Individual F without the assistance of a broker (as defined in §1.6045-1(a)). F furnishes his taxpayer identification number to N, but does not certify under penalties of perjury that it is his correct number. L, a transfer agent for N, is instructed to register the bond in F's name. Since the transaction is effected without the assistance of a broker and the parties are unrelated to the payor, F is not required to certify his taxpayer identification number. Thus, F has furnished his taxpayer identification number in the manner required in paragraph (b)(4) of this section. Consequently, N is not required to withhold under section 3406(a)(1)(A) on reportable payments made on the bond to E.

Example (7). Assume the same facts as in *Example (6)* except that E maintains a custodial account with Bank K that is not a pre-1984 account under paragraphs (b)(2)(i) and (c)(1) of this section. E instructs K to transfer the bond in the custodial account to F. K effects the transfer and instructs L to register the bond in F's name. K is considered a broker under section 6045. Since the transaction is effected with the assistance of a broker, F is required to certify his taxpayer identification number to K who is required to notify L if F fails to certify his number (as described in §31.3406(d)-4). If F does not furnish his taxpayer identification number in the manner required in paragraph (c) of this section, L is required to withhold under section 3406(a)(1)(A).

(c) *Brokerage account*—(1) *Manner required for furnishing a taxpayer identification number with respect to a brokerage relationship that is not a post-1983 brokerage account*—(i) *In general.* With respect to any instrument, investment, or deposit made through a brokerage account that is not a post-1983 brokerage account, the payee shall furnish his taxpayer identification number to the broker either orally or in writing. The payee is not required to certify under penalties of perjury that the taxpayer identification number is correct. See §31.3406(d)-1(b)(2)(i) for the rule that any instrument, whenever acquired, that is held in a brokerage account that is not a post-1983 brokerage account, shall be considered held in such account.

(ii) *Definition of a brokerage account that is not a post-1983 brokerage account.* A brokerage account that was established by a payee before January 1, 1984, through which during 1983 the broker either bought or sold securities for the payee or held securities on behalf of the payee as a nominee, is an account that is not a post-1983 brokerage account.

(iii) *Definition of a post-1983 brokerage account.* A brokerage account established after December 31, 1983, (or before January 1, 1984, and through which during 1983 the broker neither bought nor sold securities nor held securities on behalf of the payee in street name) is a post-1983 brokerage account.

(2) *Manner required for furnishing a taxpayer identification number with respect to a post-1983 brokerage account.* Except as provided in §31.3406(d)-3(b), the payee is required to certify under penalties of perjury that the taxpayer identification number furnished to a broker is correct with respect to a post-1983 brokerage account as described in paragraph (c)(1) of this section.

(3) *Examples.* The application of the provisions of this paragraph (c) may be illustrated by the following examples:

Example (1). Individual D established an account with Broker K before January 1, 1984, in which K held readily tradable securities in street name for D during 1983. The account is not a post-1983 brokerage account under paragraph (c)(1)(ii) of this section and instruments held in the account, whenever acquired, are pre-1984 accounts under paragraph (b)(2)(i) of

this section. D furnishes his taxpayer identification number orally to K before January 1, 1984. D is treated as furnishing his taxpayer identification number in the manner required in paragraphs (c)(1) and (b)(1) of this section. Thus, withholding under section 3406(a)(1)(A) shall not apply to any sale of any instrument in the account that is subject to reporting under section 6045 nor shall withholding apply to any reportable interest or dividend payment made with respect to any instrument in the account.

Example (2). Individual E established an account with Broker L before January 1, 1984, and furnished his taxpayer identification number to L. L neither bought nor sold instruments for E nor did L act as nominee for E anytime during 1983. The account is a post-1983 account under paragraph (c)(1)(iii) of this section. Although E furnished a taxpayer identification number to L, E did not certify under penalties of perjury that it was his correct taxpayer identification number. E has not, therefore, furnished his taxpayer identification number to L in the manner required in paragraph (c)(2) of this section. Thus, withholding under section 3406(a)(1)(A) shall apply to any sale of an instrument through that account that is subject to reporting under section 6045 unless E certifies to L prior to the sale of any instrument that E's taxpayer identification number is correct. (See §31.3406(d)-3(b) for the special rule if the instruction to sell was by means of telephone or wire instruction.) Since L did not act as nominee for E, L would not be making any reportable interest or dividend payments to E that would be subject to withholding under section 3406(a)(1)(A) because E did not furnish his taxpayer identification number to L in the manner required in paragraphs (b)(1) and (c)(1) of this section. If any instrument was placed in the account after December 31, 1983, i.e., L holds the instrument in street name, the instrument would not be a pre-1984 account under paragraph (b)(2)(i) of this section. Thus, payments made with respect to the instrument would be subject to withholding under section 3406(a)(1)(A) because E did not furnish his taxpayer identification number to L in the manner required in paragraph (b)(3) of this section.

Example (3). F opens a brokerage account with Broker M on August 1, 1984. F does not certify under penalties of perjury that his taxpayer identification number furnished is correct. The account is a post-1983 brokerage account under paragraph (c)(1)(iii) of this section. F has not furnished his taxpayer identification number in the manner required in paragraph (c) of this section, and withholding under section 3406(a)(1)(A) shall apply to any gross proceeds that are subject to reporting under section 6045. Thus, if Broker M sold securities for F through the account on August 1, 1984, the gross proceeds would be subject to withholding. (See §31.3406(d)-3(b) for the special rule if the instruction to sell was by means of telephone or wire instruction.)

Example (4). Assume the same facts as in *Example (3)* except that F opens the account and purchases readily tradable instruments. M holds the instruments in street name for F. The instruments will pay reportable dividends on September 30, 1984. Since M is holding the instruments in street name for F, M is considered the payor of the reportable dividends (as defined in §31.3406(a)-2). Because the account is a post-1983 brokerage account described in paragraph (c)(1)(iii) of this section, the instruments held in the account are not considered a pre-1984 account under paragraph (b)(2)(i) of this section regardless of when the instrument was acquired. Consequently, if F does not certify under penalties of perjury that his taxpayer identification number is correct before September 30, 1984, M is required to withhold under section 3406(a)(1)(A) on the reportable dividend payment on such date. (See §31.3406(d)-3(a) for the special rule if the acquisition is effected by telephone, wire, or mail.)

(d) *Rents, commissions, nonemployee compensation, and certain fishing boat operators, etc.*—(1) *Manner required for furnishing a taxpayer identification number.* With respect to accounts, contracts, or relationships where the payor is required to make an information return under section 6041 (relating to information reporting at source on rents, royalties, salaries, etc.), section 6041A(a) (relating to information reporting of payments for nonemployee services), section 6050A (relating to information reporting by certain fishing boat operators), or section 6050N (relating to information reporting of payments of royalties), the payee shall furnish his taxpayer identification number to the payor either orally or in writing. The payee is not required to certify under penalties of perjury that the taxpayer identification number is correct regardless of when the account, contract, or relationship is established.

(2) *Example.* The application of the provisions of this paragraph (d) may be illustrated by the following example:

Example. E performs services as a nonemployee to Y who pays $1,000 to E. Y's payment to E is reportable under section 6041A(a). E furnishes his taxpayer identification number to Y but does not certify under penalties of perjury that it is his correct number. E has furnished his taxpayer identification number in the manner required in paragraph (d) of this section. It is not relevant whether the relationship is or is not a pre-1984 account. Thus, withholding under section 3406(a)(1)(A) does not apply to the reportable payment to E.

§31.3406(d)-2 Payee certification failure.

(a) *Requirement to withhold.* Except as provided in paragraph (b) of this section, §31.3406(d)-3(a), and §31.3406(d)-4, backup withholding under section 3406(a)(1)(D) (relating to a payee certification failure) is required with respect to a reportable interest or dividend payment (as defined in section 3406(b)(2) and §31.3406(b)(1)-1(b)) if, and only if, the payee fails to certify to the payor, under penalties of perjury, that the payee is not subject to backup withholding due to notified payee underreporting under section 3406(a)(1)(C). Special rules are provided in §31.3406(d)-3(a) when an account is established directly with, or an instrument is acquired directly from, the payor through electronic or mail communication. See §31.3406(c)-1(b)(3)(ii) for rules with respect to a payor's reliance on a payee certification for a new account following notified payee underreporting. See §31.3406(d)-4 for rules applicable to readily tradable instruments acquired through a broker. The certificate on which the certification should be made is described in §31.3406(h)-3. The period for which withholding is required is described in §31.3406(e)-1(d).

(b) *Exceptions.* Backup withholding under section 3406(a)(1)(D) and paragraph (a) of this section does not apply in the case of—

(1) A reportable interest or dividend payment with respect to a pre-1984 account (as defined in §31.3406(d)-1(b)(1));

(2) A reportable interest payment made in a window transaction (as defined in §31.3406(b)(2)-3(b)); or

(3) A reportable interest or dividend payment made with respect to a readily tradable instrument that is described in §31.3406(d)-4(a)(2).

§31.3406(d)-3 Special 30-day rules for certain reportable payments.

(a) *Accounts or readily tradable instruments acquired directly from the payor (including a broker who holds an instrument in street name)*—(1) *Account or instrument acquired directly from the payor by electronic means.* In the case of an account established directly with, or a readily tradable instrument acquired directly from, the payor by means of electronic transmission (*e.g.*, telephone or wire), the payor may permit the payee to furnish the certifications required in §31.3406(d)-1(b)(3) (relating to certification that the payee's taxpayer identification number is correct) and §31.3406(d)-2 (relating to certification of notified payee underreporting) within 30 days after the establishment or acquisition, provided that the payee furnishes a taxpayer identification number to the payor at the time of the acquisition or establishment and the payee does not make any with-

drawals before the certifications are received. For purposes of this section, an account or instrument shall be considered "acquired directly from the payor" if the instrument was acquired by the payee without the assistance of a broker or the instrument was acquired directly from a broker who holds the instrument as nominee for the payee (*i.e.*, in street name) and who is considered a payor under §31.3406(a)-2. If the payee makes any withdrawals before the certifications are received, the payor must withhold 20 percent of the amounts withdrawn to the extent of any reportable interest or dividend payments made to the payee during the 30-day period. In addition, the payor must commence withholding on all reportable interest or dividend payments made with respect to the account or instrument on and after the 31st day following acquisition or establishment if the payee has not provided the required certifications to the payor by that date. The rules of this paragraph (a)(1) also apply with respect to a payee from whom the payor is required to obtain a Form W-8 or substitute form (as described in §1.6049-5(g)) or is to obtain other evidence of foreign status (as described in §1.6049-5(h)), provided the payee represents to the payor, orally or otherwise, before or at the time of the acquisition or establishment that the payee is not a United States citizen or resident. A payee described in the preceding sentence is not required to furnish a taxpayer identification number at the time of establishment of the account or acquisition of the instrument in order for the special rule under this paragraph to apply.

(2) *Accounts or readily tradable instruments acquired directly from payor by mail communication.* The rules of paragraph (a)(1) of this section also apply to accounts established with, or instruments acquired directly from, the payor that are effected by mail before January 1, 1985. With respect to accounts established directly with, or instruments acquired directly from, the payor by mail on or after January 1, 1985, the payor is required to impose backup withholding on the reportable interest or dividend payments if the payee has not provided the required certifications by the time that a reportable payment is made (as described in §31.3406(a)-4).

(3) *Examples.* The application of the provisions of this paragraph (a) may be illustrated by the following examples:

Example (1). G opens a new interest bearing account at Bank N on March 7, 1984, by appearing at N in person. Bank N will pay interest on the account at the end of each month. G provides his taxpayer identification number at the time that G opens the account but fails to certify under penalties of perjury that he is not subject to backup withholding due to notified payee underreporting as required in §31.3406(d)-2. N is required to withhold 20 percent of the payment made on March 31, 1984.

Example (2). Assume the same facts as in *Example (1)* except that G opens the account by calling Bank N and wiring the initial deposit by electronic funds transfer. G provides his taxpayer identification to N during the telephone call. N is not required to withhold on the March 31 payment date since G provided his taxpayer identification number on the date of acquisition (as provided in paragraph (a)(1) of this section). G provides the required certifications on April 6. Thus, N also is not required to withhold on the April 30 payment date since N received G's certifications within 30 days of opening the account and prior to the payment.

Example (3). Assume the same facts as in *Example (2)* except that G closes the account on April 2 and does not provide any certification before withdrawal. Under paragraph (a)(1) of this section, N is required to withhold 20 percent of the reportable interest payment made on March 31 as well as any reportable payment made at the time the account is closed and the funds are withdrawn (April 2).

Example (4). H purchases new shares in Mutual Fund O on February 14, 1984, that will pay reportable dividends daily. H acquires the shares by wiring money from his bank account to the mutual fund. H does not provide his taxpayer identification number at the time of acquisition. O is required to withhold 20 percent of any reportable amounts paid after February 14 until O receives H's certifications. Even if O receives H's taxpayer identification number after February 14, 1984, O is required to withhold from payments made to H because H did not furnish his taxpayer identification number at the time of acquisition as required in paragraph (a)(1) of this section. O may stop withholding only when O receives the required certifications from H.

Example (5). Assume the same facts as in *Example (4)* except that H provides his taxpayer identification number on February 14 (date of acquisition). On March 1, before providing the required certifications, H withdraws $5000. Two hundred dollars of dividends have been paid prior to that date. Four thousand eight hundred dollars are gross proceeds for the shares redeemed. O is required to withhold 20 percent of the reportable amount ($5000) on March 1, the date of withdrawal. The $200 is reportable under section 6042 and the $4800 is reportable under section 6045. O is required to withhold on the $200 under paragraph (a)(1) of this section since the $200 is assumed to be a reportable interest or dividend payment. O is also required to withhold on the $4800 since that amount is subject to reporting under section 6045 and H has not furnished his taxpayer identification number in the manner required in §31.3406(d)-1(c)(2).

(b) *Special rule with respect to the sale of an instrument for a customer pursuant to a telephone or wire instruction*—(1) *Special rule.* In the case of a sale of an instrument through a post-1983 brokerage account (as described in §31.3406(d)-1(c)(1)) by means of electronic transmission (*e.g.*, telephone or wire), a broker who is required to report the gross proceeds of the sale under section 6045 (as described in §31.3406(b)(3)-2) may permit the customer to furnish the certification described in §31.3406(d)-1(c)(2) (relating to certification that the customer's taxpayer identification number is correct) within 30 days after the sale, provided that the customer furnishes his taxpayer identification number to the broker before the sale and the customer does not withdraw or reinvest more than 80 percent of the proceeds of the sale before the required certification is provided. Thus, if at all times at least 20 percent of all gross proceeds reportable under section 6045 are held in cash by the broker, the gross proceeds of the sale will not be subject to backup withholding for 30 days. If the customer desires to withdraw or reinvest more than 80 percent of the proceeds of the sale before the 31st day and before the certification is received, the broker is required to withhold 20 percent of the reportable gross proceeds at the time of the withdrawal or reinvestment (or, if later, the time the proceeds are paid). If the customer does not provide the required certification within 30 days of the date of the sale, the broker must withhold 20 percent of the reportable gross proceeds on the 31st day after the date of the sale. The rules of this paragraph (b)(1) also apply with respect to a customer from whom the broker is required to obtain a Form W-8 (or substitute form) in accordance with §1.6045-1(g)(1)(i)-(A) or is required to obtain other evidence of foreign status in accordance with §1.6045-1(g)(1)(i)(B) or (C) provided the customer represents to the broker before the sale, orally or otherwise, that the customer is not a United States citizen or resident.

(2) *Examples.* The application of the provisions of this paragraph (b)

may be illustrated by the following examples:

Example (1). Individual G establishes an account with Broker N on August 1, 1984, by calling N and wiring money to the account. N purchases shares of Y Corporation stock that N will hold in street name for G. G provides his taxpayer identification number but does not certify under penalties of perjury that it is his correct taxpayer identification number. The account is a post-1983 brokerage account under §31.3406(d)-1(c)(2). On October 12, 1984, G telephones N and instructs N to sell all of the Y stock for $10,000 and to send him a check for $5,000. N is required to make an information return under section 6045 showing the $10,000 of gross proceeds. N, at its option, is not required to withhold $2,000 on October 12, 1984, even though G has not provided a certified taxpayer identification number. Under paragraph (b)(1) of this section, N may permit G to furnish the certification within 30 days since G has furnished his taxpayer identification number and G did not withdraw more than 80 percent of the proceeds of the sale. If N does not receive the certification by November 12, N is required to withhold $2,000 from G's account on November 13.

Example (2). Assume the same facts as in *Example (1)* except that G does not provide his taxpayer identification number prior to, or on October 12 (the date of the sale). Because G did not furnish his taxpayer identification number, N is not permitted under paragraph (b)(1) of this section to give G 30 days to furnish the certification. Thus, N is required to withhold $2,000 on October 12.

Example (3). Assume the same facts as in *Example (1)* except that G instructs N to sell the Y stock and reinvest $9,000 of the proceeds in stock of Z Corporation. Even though G has furnished his taxpayer identification number, N is required to withhold on October 12 because under paragraph (b)(1) of this section N may only permit G to furnish the required certification within 30 days of the sale if G does not withdraw more than 80 percent of the proceeds. The reinvestment is a withdrawal under paragraph (b)(1) of this section. Because G desired to withdraw (in the form of reinvestment) more than 80 percent of the gross proceeds, N is required to withhold $2,000 before purchasing Z stock for G. If G desired to withdraw (or reinvest) only $8,000 of the gross proceeds, N would not be required to withhold on October 12.

§31.3406(d)-4 Special rules for readily tradable instruments acquired through a broker.

(a) *Readily tradable instruments acquired through a broker who is not a payor*—(1) *Instruments acquired through post-1983 brokerage accounts.* When a readily tradable instrument is acquired through a post-1983 brokerage account (as defined in §31.3406(d)-1(c)(2)) and the broker is not the payor of the instrument (as defined in §31.3406(a)-2(b)(3)), the broker must—

(i) Obtain the certifications described in §31.3406(d)-2(a) and §31.3406(d)-1(b)(3) and (c)(2) from the payee (relating to certification of payee underreporting and taxpayer identification number, respectively), but the broker is required to obtain the certifications only once with respect to each account;

(ii) Furnish the payee's taxpayer identification number to the payor; and

(iii) Notify the payor to impose backup withholding if the payee fails to make either of the required certifications to the broker or if the broker has been notified by the Internal Revenue Service before the acquisition of the instrument that the payee is subject to backup withholding due to notified payee underreporting under section 3406(a)(1)(C) or that the payee is subject to backup withholding because the payee's taxpayer identification number is incorrect (as described in §31.3406(d)-5).

The broker is required to give the information required by paragraph (a)(1)(ii) and (iii) of this section to the payor in connection with the transfer instructions for the acquisition. The term "transfer instructions" includes the "fanfold" documents and account registration instructions transmitted by a broker in the case of acquisitions of shares in a mutual fund. A notice including the information described in paragraph (b)(1) of this section shall satisfy the broker's requirement to give notice to the payor. Once the broker transmits the transfer instructions containing the information required by this section, the broker has no further responsibility to obtain a missing taxpayer identification number or missing certification or to provide additional notices to the payee or payor with respect to the acquisition of the instrument. Upon receiving the notice from a broker, the payor must impose backup withholding on the account pursuant to §31.3406(a)-1.

(2) *Transactions entered into through a brokerage account that is not a post-1983 brokerage account.* When a readily tradable instrument is acquired through a brokerage account that is not a post-1983 brokerage account (as defined in §31.3406(d)-1(c)(1)) and the broker is not the payor of the instrument (as defined in §31.3406(a)-2(a)), the broker is required to furnish the payee's taxpayer identification number to the payor. In addition, if the broker has been notified by the Internal Revenue Service that the payee is subject to backup withholding under section 3406 either because of an incorrect taxpayer identification number (as described in §31.3406(d)-5) or due to notified payee underreporting under section 3406(a)(1)(C), the broker must notify the payor (in connection with the transfer instructions) to impose backup withholding with respect to that payee. A notice that contains the information described in paragraph (b)(1) of this section shall satisfy the broker's requirement to give notice to the payor. After a payor receives a notice from a broker pursuant to section 3406(d)(2)(B) and this paragraph, the payor must impose backup withholding on any accounts of the payee paying reportable interest or dividends as defined in §31.3406(b)(1)-1(b) in accordance with §31.3406(a)-1.

(3) *Payor must notify payee*—(i) *Failure to provide certifications.* If a payor is notified by a broker, as required in paragraph (a) of this section, that a payee is subject to backup withholding because the payee failed to provide the certifications, as described in §31.3406(d)-2(a) and §31.3406(d)-1(b)(3) and (c)(1), then the payor is required to notify the payee that backup withholding has commenced (or will commence) no later than 15 days after the payor makes the first payment to the payee that is subject to backup withholding under section 3406. A notice that contains the information described in paragraph (b)(2) of this section shall satisfy the payor's requirement to give notice to the payee. If the broker notifies the payor that the payee failed to make a required certification and the payor has received the certification from the payee, the payor may disregard the the notice from the broker.

(ii) *Notified payee underreporting and incorrect taxpayer identification number.* The payor is also required to notify the payee under this section when the Internal Revenue Service or a broker notifies the payor to withhold either because of an incorrect taxpayer identification number under section 3406(a)(1)(B) (as described in §31.3406(d)-5) or due to notified payee underreporting under section 3406(a)(1)(C) (as described in

§31.3406(c)-1). Whenever there is notification including notification from the Internal Revenue Service through a broker with respect to a readily tradable instrument, the payor may not ignore the notice even if the payor has received the required certification from the payee. See §31.3406(d)-5(c)(1) and (2) and (f)(2) for requirements of the notice that a payor must provide to a payee when a payor is notified by the Internal Revenue Service or a broker that a payee is subject to backup withholding under section 3406(a)(1)(B) because the payee has furnished an incorrect taxpayer identification number as described in §31.3406(d)-5(a)(4). See §31.3406(c)-1(c)(2) for the requirements of the notice that a payor must provide to a payee when a payor is notified by the Internal Revenue Service or a broker that a payee is subject to backup withholding under section 3406(a)(1)(C) due to a notified payee underreporting.

(b) *Notices*—(1) *Form of notice by broker to payor.* A broker who is required under paragraph (a)(1)(iii) and (2) of this section to notify the payor with respect to a readily tradable instrument shall include in the notice—

(i) The payee's name, address, and taxpayer identification number (if provided to the broker), and

(ii) A statement that the payee is subject to backup withholding under section 3406(a)(1)(A), (B), (C), or (D) of the Internal Revenue Code, whichever section applies, and

(iii) When applicable, a statement that the broker was notified by the Internal Revenue Service that the payee is subject to backup withholding under section 3406(a)(1)(B) or (C). The broker may notify the payor in connection with the transfer instructions by means of magnetic media, machine readable document, or any other medium, provided that the notice includes the information described in the preceding sentence.

(2) *Form of notice by payor to payee.* A payor who receives notice from the broker or the Internal Revenue Service that the payee is subject to backup withholding shall notify the payee as required in paragraph (a)(3) of this section. The notice to the payee shall be substantially similar to the following:

(i) For a notification concerning a failure to provide a taxpayer identification number in the required manner under section 3406(a)(1)(A) or a failure to make the certifications described in section 3406(a)(1)(D):

Recently, you purchased (identify security acquired). Because of the existence of one or more of the following conditions, payments of interest, dividends, and other reportable amounts that are made to you will be subject to backup withholding of tax at a 20 percent rate: (specify the condition or conditions, described below, that are applicable)

(1) You failed to provide a taxpayer identification number, or failed to provide such number under penalties of perjury, in connection with the purchase of the acquired security. (An individual's taxpayer identification number is his or her social security number.)

(2) You failed to certify, under penalties of perjury, that you are not subject to backup withholding due to notified payee underreporting as required under section 3406(a)(1)(D) of the Internal Revenue Code.

If condition (1) applies, you may stop withholding by providing your taxpayer identification number on the enclosed Form W-9, signing the form, and returning it to us. If you do not have a taxpayer identification number, but have (or will soon) apply for one, you may so indicate on the Form W-9. Backup withholding may apply during the 60-day period you are awaiting for your taxpayer identification number. You must provide us with your taxpayer identification number promptly after you receive it in order to avoid withholding after the end of the 60-day period or to stop backup withholding if it has already begun. Certain persons, described on the enclosed Form W-9, are exempt from withholding. Follow the instructions on that form if applicable to you. If condition (2) applies, you may stop withholding by certifying on the enclosed Form W-9 that you are not subject to backup withholding due to notified payee underreporting, signing the form, and returning it to us.

If more than one condition applies, you must remove ALL applicable conditions to stop withholding.

Please address any questions concerning this notice to: [Insert Payor Identifying Information].

(Do not address questions to the broker who purchased the securities for you.)

(ii) For the form of the notice concerning imposition of backup withholding due to an incorrect taxpayer identification number under section 3406(a)(1)(B), see §31.3406(d)-5 and (f)(2).

(iii) For the form of the notice concerning the imposition of backup withholding due to a notified payee underreporting, see §31.3406(c)-1(c)(2).

(c) *Payors' reliance on information from broker*— (1) *In general.* A payor of an instrument acquired by a payee through a broker may rely on the information that the payor receives from the broker pursuant to paragraphs (a) and (b) of this section. Thus, if the broker's transfer instructions to the payor include a taxpayer identification number and do not inform the payor that the payee failed to make a required certification, the payor is not required to impose backup withholding. If the broker's notice informs the payor that the payee failed to make a required certification, however, and the payor has not received the certification from the payee, the payor is required to impose backup withholding. In addition, if the broker's notice informs the payor that the payee is subject to backup withholding due to notification from the Internal Revenue Service, the payor is required to withhold during the period described in §31.3406(c)-1(e) and (f).

(2) *Amount subject to withholding.* The payor is required to withhold depending on the payor's customary method of making payment on an instrument or instruments owned by a payee. For example, if it is the practice of a payor to combine in one account all readily tradable instruments of the same issue owned by a payee and if certain of those instruments are subject to backup withholding and others are not subject to backup withholding, the payor is required to withhold 20 percent of the aggregate payment made with respect to all the instruments in the account. If it is not the practice of the payor to combine in one account all readily tradable instruments of the same issue owned by a payee, the payor is required only to withhold 20 percent of the payment made on the instrument or instruments with respect to which the payee is subject to backup withholding.

(3) *Examples.* The application of the provisions of this paragraph (c) may be illustrated by the following examples:

Example (1). Individual A owns 100 shares of X Corporation stock which were purchased directly from X in 1983. On July 1, 1985, A instructs Broker M to purchase 200 additional shares of X stock and have the shares registered in A's name. The 200 shares are acquired through a post-1983 brokerage account with M. X has received A's social security number, but A has not certified under penalties of perjury that the number provided is correct or certified that A is not subject to backup withholding due to notified payee under-reporting. A fails to make the required certifications to M, and M notifies X of that fact as required in paragraph (a)(1)(iii) of this section. X, in accordance with its customary practice, com-

bined in one account all 300 shares owned by A and made an aggregate payment with respect to all the instruments. X is required to withhold 20 percent of all reportable amounts under paragraph (c)(2) of this section.

Example (2). Assume the same facts as in *Example (1)* except that X, in accordance with its customary practice, separates the shares into two accounts. Under paragraph (c)(2) of this section, X is only required to withhold 20 percent of the reportable payments made with respect to the 200 shares of stock that A acquired through M because the 100 shares of X stock were acquired before January 1, 1984, directly from X.

Example (3). Assume the same facts as in *Example (1)* except that X received A's certifications that A's social security number was correct and that A was not subject to backup withholding due to notified payee underreporting. Even though M notified X that A failed to make the required certifications, X is not required to withhold since X has received the necessary certifications from A (as described in §31.3406(d)-2(a)). Under paragraph (a)(3) of this section, because X has received the required certifications from A, X is not required to notify A.

Example (4). Assume the same facts as in *Example (1)* except that M does not notify X that A failed to make any certifications nor does M include A's taxpayer identification number. Since X already has A's taxpayer identification number, X is not required to withhold assuming no other condition for imposing backup withholding exists with respect to A.

§31.3406(d)-5 Backup withholding when the Service or a broker notifies the payor to withhold because the payee's taxpayer identification number is incorrect.

(a) *Requirement that a payor backup withhold due to notification of an incorrect taxpayer identification number*—(1) *In general.* Except as otherwise provided in paragraph (a)(2)(ii) of this section, backup withholding under section 3406(a)(1)(B) applies to any reportable payment (as defined in section 3406(b) and paragraph (a)(2) of this section) made to an account (as defined in paragraph (a)(5) of this section) of a payee if, after December 31, 1989, the Internal Revenue Service or a broker notifies a payor that the payee's taxpayer identification number is incorrect (as defined in paragraph (a)(4) of this section) and such incorrect taxpayer identification number is used with respect to such account of the payee. The payor is required under section 3406(h)(8) and paragraph (c) of this section to send a copy of the notice received by the payor (from the Internal Revenue Service or a broker) to inform the payee that he has furnished an incorrect taxpayer identification number and that, as a result, he may be subject to backup withholding under section 3406(a)(1)(B). The requirements for the notice that a payor must send to a payee are set forth in paragraph (c)(3) of this section. An example of the notice required by paragraph (c)(3) is set forth in the Appendix to this section. The period for which backup withholding applies due to notification of an incorrect taxpayer identification number is described in paragraph (d) of this section. See paragraph (e) of this section for the rules regarding how a payee may prevent backup withholding from starting or to stop it once it has begun. See paragraph (f) of this section for the applicable rules when the Internal Revenue Service or a broker notifies a payor twice within 3 calendar years that a payee has furnished an incorrect taxpayer identification number. See section 6721 for the penalty that may be imposed on a payor for providing an incorrect taxpayer identification number on an information return filed with the Internal Revenue Service unless there is reasonable cause for the error.

(2) *Definition of reportable payment*—(i) *In general.* See section 3406(b) and §31.3406(b)(1)-1 for the definition of reportable payments.

(ii) *Exceptions.* For the payments that are not "reportable payments" for purposes of section 3406(a)(1)(B), see §31.3406(b)(2)-1 through §31.3406(b)(4)-1. Also see §31.3406(g)-1 through §31.3406(g)-3 for other exceptions.

(3) *Transitional exclusion for payments to a fiduciary or nominee account.* Reportable payments to a fiduciary or nominee account are not subject to backup withholding for purposes of section 3406(a)(1)(B). For purposes of this paragraph (a)(3), a fiduciary or nominee account means an account with respect to which at least one person named in the registration is identified as acting in the capacity as nominee or of administrator, conservator, custodian, receiver, tutor, curator, committee, executor, guardian, trustee, or other fiduciary capacity recognized under governing law. This paragraph (a)(3) does not apply with respect to a notice from the Internal Revenue Service or a broker under paragraph (b)(1) or (2) of this section that is received by a payor after [THE DATE THAT THIS DOCUMENT IS PUBLISHED AS A TREASURY DECISION.]

(4) *Definition of incorrect taxpayer identification number.* An incorrect taxpayer identification number is any number that, at the time the Internal Revenue Service makes a determination that the taxpayer identification number is incorrect—

(i) Is not assigned under section 6109 to any surname of the payee, or

(ii) Is not assigned by the Internal Revenue Service to the name of a non-individual such as a corporation, estate, partnership, or trust, and that was provided on an information return filed with respect to a payee.

(5) *Definition of account.* The term "account" means any account, instrument, or other relationship with a payor.

(b) *Notice regarding an incorrect taxpayer identification number*—(1) *Notice from the Internal Revenue Service to payors and brokers.* The Internal Revenue Service will notify—

(i) Payors that a payee's taxpayer identification number is incorrect and that the payor must commence backup withholding as required under section 3406(a)(1)(B) and paragraphs (d) and (f) of this section on reportable payments made to accounts of the payee as defined in paragraph (a)(5) of this section that contain such incorrect taxpayer identification number, and

(ii) Brokers that a payee's taxpayer identification number is incorrect and that the broker must notify a payor that the payee is subject to backup withholding under section 3406(a)(1)(B) on accounts of the payee as defined in paragraph (a)(5) of this section that contain that incorrect taxpayer identification number.

The Internal Revenue Service will furnish the payor or broker with a copy of the notice and the payor shall furnish such copy, or an acceptable substitute copy, to the payee as described in paragraph (c) of this section.

(2) *Notice from a broker to a payor.* A broker who receives a notice from the Internal Revenue Service pursuant to paragraph (b)(1)(ii) of this section that a payee has furnished an incorrect taxpayer identification number and through whom the payee subsequently acquires a readily tradable instrument with respect to which the broker is not the payor must

notify the payor of that instrument of the following information:

(i) The fact that the broker was notified by the Internal Revenue Service that the payee furnished an incorrect taxpayer identification number and the date set forth on such notice from the Internal Revenue Service,

(ii) The name and taxpayer identification number of the payee with respect to whom the broker was notified, and

(iii) The fact that the named payee is subject to backup withholding under section 3406(a)(1)(B).

The broker is required to provide this information to the payor of the instrument in the time and manner provided in §31.3406(d)-4. See paragraph (b)(5)(ii) of this section for accounts of the payee with respect to which the broker is required to notify a payor under this paragraph (b)(2).

(3) *Accounts subject to backup withholding.* After receiving notice from the Internal Revenue Service or from a broker, as provided in paragraph (b)(1) and (2) of this section, the payor is required to notify the payee in accordance with paragraph (c) of this section and to institute backup withholding as prescribed in paragraph (d) of this section on all reportable payments subject to backup withholding that are made to the account or accounts of the payee containing the incorrect taxpayer identification number. See paragraph (f) of this section for the rules that apply when a payor has received two notifications of an incorrect taxpayer identification number with respect to an account of the payee from the Internal Revenue Service or a broker within 3 calendar years. See paragraph (b)(5) of this section for the determination of the account or accounts of the payee containing the incorrect taxpayer identification number.

(4) *Joint accounts*—(i) *In general.* Generally, payors are required to backup withhold on reportable payments made to the account of joint payees if the payee subject to backup withholding under section 3406(a)(1)(B) is the first person listed on the account at the time the payor receives the notice under paragraph (b)(1) or (2) of this section.

(ii) *Exception.* In the case where the first person listed on the account is an exempt foreign person for information reporting purposes under the applicable information reporting provisions and the account contains the names of persons who are not foreign persons, the payor is required to backup withhold on the account if the incorrect taxpayer identification number matches the name and number combination of the person on the account used for information reporting.

(iii) *Change in order of names.* If the account of a payee may be subject to backup withholding as described in paragraph (b)(4) of this section, backup withholding shall apply, if required, even though the order of the names on the account is subsequently changed, provided that the incorrect taxpayer identification number giving rise to backup withholding remains on the account.

(5) *Payor determination of the account or accounts of the payee that contain the incorrect taxpayer identification number*—(i) *Payors.* If an account number or designation is provided in the notice received under paragraph (b)(1) or (2) of this section, the payor need only determine whether the account or accounts corresponding to that number or designation contain the same name and incorrect taxpayer identification number provided in the notice. If no account number or designation is provided in the notice received under paragraph (b)(1) or (2) of this section, the payor must locate, using reasonable care, all accounts of the payee containing the same name and incorrect taxpayer identification number provided in the notice. A payor who satisfies the following two-part facts-and-circumstances test will be considered to have exercised reasonable care.

(A) Part one of the test is satisfied if a payor identifies and uses the appropriate computer or other record system on which to locate accounts of the payee subject to backup withholding under section 3406(a)(1)(B). A payor with a centralized and fully integrated computer system containing all product lines of the payor that pay reportable payments will have identified and used the appropriate system if the payor searches on such system for all accounts of the payee described in paragraph (a)(5) of this section that are subject to backup withholding. A payor whose product lines paying reportable payments are on separate computer or records systems will have identified and used the appropriate system if the payor searches for accounts of the payee on the computer or record system that contains the product line with respect to which the payor received a notification of an incorrect taxpayer identification number pursuant to paragraph (b)(1) or (2) of this section.

(B) Part two of the test is satisfied if the payor uses or inputs the appropriate data or criteria into the system that is correctly identified under paragraph (b)(5)(i)(A) of this section. In general, a payor who uses or inputs the name and taxpayer identification number, provided on the notice from the Internal Revenue Service or a broker as described in paragraph (b)(1) or (2) of this section will satisfy part two of the test. In some cases the system of a payor cannot utilize the data enumerated in the preceding sentence for locating all accounts of the payee subject to backup withholding under section 3406(a)(1)(B). In such cases the payor must use or input the appropriate data or criteria, as determined by the capability of the payor's computer or record system.

(ii) *Brokers.* Brokers are required to use the information and follow the procedures described in paragraph (b)(5)(i) to locate accounts of the payee with respect to which a broker is required to notify a payor pursuant to paragraph (b)(2) of this section.

(c) *Notice from payors of backup withholding due to an incorrect taxpayer identification number*—(1) *In general.* If the name and taxpayer identification number listed on the notice from the Internal Revenue Service or a broker as described in paragraph (b)(1) or (2) of this section matches the name and taxpayer identification number used on the payee's account at the time the payor receives the notification of an incorrect taxpayer identification number—

(i) The payor who receives a notice from the Internal Revenue Service is required under section 3406(h)(8) to send a copy of the notice required by paragraph (b)(1) of this section or a substitute notice as described in paragraph (c)(3) of this section to the payee of the account in accordance with paragraph (c)(2) of

this section (an example of the notice from the Internal Revenue Service required by section 3406(h)(8) and paragraph (b)(1) of this section is set forth in the Appendix to this §31.3406(d)-5), and

(ii) The payor who receives notification of an incorrect taxpayer identification number from a broker as described in paragraph (b)(2) of this section must send a substitute notice as described in paragraph (c)(3) of this section to the payee in accordance with paragraph (c)(2) of this section.

However, a payor is not required to send a notice as described in this paragraph (nor backup withhold under paragraph (d) of this section) with respect to any account of a payee where, due to an error of the payor, the taxpayer identification number on such account is not the number that was provided to the payor on the applicable Form W-9 (or acceptable substitute form) because, for example, the payor transposed the taxpayer identification number when incorporating it into its business records. If a payor sends a substitute notice, such notice must include all the information set forth in paragraph (c)(3) of this section, or must be identical to the notice set forth in the appendix to this §31.3406(d)-5, or must be an acceptable substitute of the notice set forth in the Appendix to this §31.3406(d)-5. In addition to the copy of the notice required by paragraph (b)(1) of this section or the substitute notice described in paragraph (c)(3) of this section, the payor must include a Form W-9 or an acceptable substitute form (as described in §31.3406(h)-(3)(c)(2)) with the notice for the payee to use to provide his name and taxpayer identification number and to certify that the taxpayer identification number is correct, or to provide his name and taxpayer identification number that was originally furnished and to certify that such taxpayer identification number is correct. The payor is required to include a reply envelope (self-addressed) with the notice to the payee which may be, but is not required to be, postage prepaid. The envelope containing the notice and the Form W-9 (or an acceptable substitute form) must state on the outside in a bold and conspicuous manner: "Important Tax Document Enclosed". The mailing may not include any material other than the notice, the Form W-9 (or an acceptable substitute form), any documents of the payor that are necessary to change the name or taxpayer identification number (or both) on the account of the payee, and the reply envelope of the payor. The notice required by paragraph (c) of this section shall also apply to those payors notified by a broker that a payee is subject to backup withholding under section 3406(a)(1)(B). For purposes of this section, the date set forth on the notice from the Internal Revenue Service (or a broker) shall be considered the date of receipt by and of notification to the payor. However, in the case of a dispute, if the payor demonstrates to the satisfaction of the Internal Revenue Service that the date of actual receipt of the notice is later than the date on the notice, the actual date shall be considered the date of receipt by and of notification to the payor.

(2) *Procedures*—(i) *In general.* The payor must send the notice described in paragraph (c) of this section to the payee within 15 business days after the date that the Internal Revenue Service or a broker notifies the payor pursuant to paragraph (b)(1) or (2) of this section. The payor must mail the notice to the payee's last known address by first-class mail. If it is the customary practice of the payor not to mail any correspondence to a payee, the payor may furnish the notice by personal delivery, by intra-office mail, or by any other means reasonably expected to furnish the notice to the payee promptly. A payor is not required to send the notice to the payee if there is currently a "do not mail" or a "stop mail hold" instruction with respect to the payee's account subject to backup withholding under section 3406(a)(1)(B). However, the payor must handle the notice in the same manner that the payor handles other correspondence of the payee.

(ii) *Two or more notices for a payee in the same calendar year.* A payor who receives, under the same payor employer identification number (or social security number), two or more notices described in paragraph (b)(1) or (2) of this section in a calendar year with respect to a payee may satisfy the requirements of this paragraph (c) with respect to such notices by sending one notice to the payee that satisfies the requirements of paragraph (c)(3) of this section.

(3) *Requirements of substitute notice to the payee.* If the payor does not send a copy of the notice received from the Internal Revenue Service pursuant to paragraph (b)(1) of this section or if the payor is notified by a broker as described in paragraph (b)(2) of this section that the payee provided an incorrect taxpayer identification number, the payor may send a substitute notice as provided for in this paragraph (c)(3). A notice to the payee will satisfy the requirements of section 3406(h)(8) and paragraph (c)(1) of this section if the notice is identical to the one set forth in the appendix to this §31.3406(d)-5, is an acceptable substitute thereof, or if the notice—

(i) Informs the payee that the payor has been notified that the taxpayer identification number furnished by the payee is an incorrect taxpayer identification number (as defined in paragraph (a)(4) of this section);

(ii) Advises the payee of the name and taxpayer identification number combination that the Internal Revenue Service has determined to be incorrect;

(iii) Informs the payee that the payee must either—

(A) Correct the surname (or business name) or taxpayer identification number (or both) and certify, under penalties of perjury, that the newly provided taxpayer identification number is correct, or

(B) State—

(*1*) Under penalties of perjury that the taxpayer identification number originally furnished to the payor is correct and provide that number and the corresponding listed surname (or business name),

(*2*) That the Social Security Administration (or the local office of the Internal Revenue Service in the case of an incorrect employer identification number) has been contacted by the payee to resolve the problem giving rise to the notification of an incorrect taxpayer identification number, or

(C) In the case of a notification of an incorrect taxpayer identification number of an individual payee due to a name change by the payee when the

payee has not communicated the change of name to the Social Security Administration—

(*1*) Contact the Social Security Administration and reassign the taxpayer identification number to the surname that is used on the account with the payor, certify under penalties of perjury, that the existing taxpayer identification number shown on the account is correct (and provide the corresponding surname used with that number), and provide a statement that the Social Security Administration has been contacted to reassign the taxpayer identification number to the surname shown on the account, or

(*2*) Use both surnames on the account with the payor (the surname currently shown on the account and the surname shown on the payee's Social Security Administration card if the payee is unable to contact the Social Security Administration at this time), provide the surnames, and certify under penalties of perjury that the furnished taxpayer identification number is correct, and

(*3*) Follow either paragraph (c)(3)(iii)(C)(*1*) or (*2*) of this section consistently with respect to all accounts with the payor;

(iv) Advises the payee of other necessary documentation (*i.e.*, account creation documents) that the payee must provide to the payor in order to change the name or taxpayer identification number (or both) on the account and how to provide such information and the information described in paragraph (c)(3)(iii) of this section to the payor;

(v) Advises the payee to contact the Social Security Administration to obtain a social security card if the payee was never assigned a social security number or to obtain a replacement social security card if the payee lost his card and does not remember his social security number;

(vi) Advises the payee that as a result of providing an incorrect taxpayer identification number, the payor is required under section 3406(a)(1)(B) of the Internal Revenue Code to begin backup withholding 20 percent of the reportable payments made to the account of the payee no later than after the close of the day 30 business days after the date that the payor is notified of the incorrect taxpayer identification number by the Internal Revenue Service or a broker if the payor has not received the required Form W-9 (or an acceptable substitute form) as described in paragraph (e) of this section;

(vii) Gives the payee the date that the payor received the notice that the payee provided an incorrect taxpayer identification number; and

(viii) States that the payee must complete and return the enclosed Form W-9 (or an acceptable substitute form), and, if necessary, other documents of the payor as described in paragraph (c)(3)(iv) of this section, and the statement that the payee contacted the Social Security Administration (or the Internal Revenue Service) before the time described in paragraph (c)(3)(vi) of this section in order to prevent backup withholding under section 3406(a)(1)(B) from starting, or after the time described in paragraph (c)(3)(vi) of this section to stop backup withholding once it has begun and to avoid the imposition of the penalty for failure to provide a correct taxpayer identification number.

(4) *Payor must use newly provided certified number.* If the payor receives a certified Form W-9 (or an acceptable substitute form) from the payee in the manner required in paragraph (e) of this section before the end of a calendar year, the payor shall use the name and certified taxpayer identification number on the Form W-9 (or acceptable substitute form) on information returns that the payor is required to file for reportable payments made with respect to the payee for that year and subsequent calendar years. A payor who uses the name and certified taxpayer identification number on an information return as described in this paragraph will satisfy the requirement to provide this information to the Internal Revenue Service as prescribed in section 3406(h)(9).

(d) *Period during which backup withholding is required due to notification of an incorrect taxpayer identification number*—(1) *In general.* Except as provided in paragraph (d)(2) of this section, upon receiving a notice described in paragraph (b)(1) or (2) of this section, the payor must impose backup withholding on all reportable payments made to the account of the payee that are subject to backup withholding after the close of the 30th business day after the date the payor receives the notice described in paragraph (b)(1) or (2) of this section and on or before the close of the 30th calendar day after the day the payor receives from the payee the certified Form W-9 (or acceptable substitute form) as described in paragraph (e) of this section.

(2) *Grace periods*—(i) *Starting backup withholding.* Pursuant to section 3406(e)(5)(A), the payor may elect, on a payee-by-payee basis or in general, to begin backup withholding at any time during the 30-business-day period described in paragraph (d)(1) of this section.

(ii) *Stopping backup withholding.* Pursuant to section 3406(e)(5)(B), the payor may elect, on a payee-by-payee basis or in general, to treat the certified Form W-9 or acceptable substitute form described in paragraph (e) of this section as having been received at any time within 30 calendar days after it is provided by the payee and to stop backup withholding at any time within such 30-day period. See section 3406(e)(5)(B) and §31.3406(e)-1(b) for the application of the rules contained in this paragraph (d)(2).

(e) *Manner required for payee to furnish certified taxpayer identification number.* A payee with respect to whom the payor has been notified (as described in paragraph (b) of this section) that the payee's taxpayer identification number is incorrect is required to provide his name and taxpayer identification number and to certify, under penalties of perjury, that the taxpayer identification number being provided to the payor on a Form W-9 (or acceptable substitute form) is correct in order to prevent backup withholding from starting or to stop it once it has begun. Additionally, the payee may be required to state on the notice provided to the payor, as described in paragraph (c)(3)(iii)(C)(*1*) of this section, that the Social Security Administration (or the Internal Revenue Service) was contacted by the payee within 30 calendar days from the date of the notice from the payor. In general, the payee is require to provide the information described in this paragraph for each account, including any pre-1984 account or instrument (as defined in §31.3406(d)-1(b)(2) and (c)(1)(ii)) that contains the incorrect taxpayer identification number identi-

fied by the Internal Revenue Service pursuant to paragraph (b)(1) or (2) of this section unless §31.3406(h)(3)(a) applies with respect to the accounts of a payee. See §31.3406(h)-3(a), (c), and (f) which respectively provide that the Form W-9 is the prescribed form for the payee to make the certification, permit the use of substitute forms, and explain who may sign the form. See paragraph (f)(1) of this section for the rules on obtaining a certified taxpayer identification number after a payor is notified twice within 3 calendar years that a payee's taxpayer identification number is incorrect.

(f) *Notification of two incorrect taxpayer identification numbers within a 3-year period*—(1) *In general.* If a payor receives a notification as described in paragraph (b)(1) or (2) of this section twice within 3 calendar years, and in each case the payor pursuant to paragraph (b)(5) of this section identifies the same account as containing the incorrect taxpayer identification number, then the payor shall—

(i) Disregard any future certifications (described in paragraph (e) of this section) furnished by the payee with respect to the account;

(ii) Send the notice described in paragraph (f)(2) of this section to the payee (and not the notice required under paragraph (c) of this section) within 15 business days after the date that the payor receives the second notice described in this paragraph (f), and

(iii) Impose backup withholding on the account containing the incorrect the taxpayer identification number for the period described in paragraph (f)(3) of this section.

For purposes of this paragraph (f), a payor shall not count any notice as a first notice unless the payor was required to notify the payee about the incorrect taxpayer identification number pursuant to paragraph (c)(1) of this section. Additionally, a payor shall treat the receipt of two or more notices in a calendar year as described in paragraph (b)(1) or (2) of this section with respect to the same payee as the receipt of one notice for purposes of this paragraph. The preceding sentence applies only with respect to a payor who received such two or more notices under the same payor employer identification number (or social security number). The payor who receives such two or more notices may satisfy the requirements of this paragraph (f) by sending one notice to the payee that contains all the information described in paragraph (f)(1) of this section. The payor shall maintain sufficient records to determine whether the payor has received notices described in this paragraph and paragraph (b)(1) or (2) of this section twice within 3 calendar years with respect to a payee as described in this paragraph (f). The envelope containing the notice must state on the outside in a bold and conspicuous manner: "Important Tax Document Enclosed". The payor is not required to include a Form W-9, nor is the payor required to include a reply envelope in the mailing of the notice to the payee. The payor may not include any material in the mailing of the notice described in this paragraph (f). The notice requirements provided in this paragraph (f) shall apply to a payor notified by a broker that a payee is subject to backup withholding under section 3406(a)(1)(B). The mailing procedure described in paragraph (c)(2) of this section shall apply to the mailing of the notice described in paragraph (f) of this section. A payor is not required to send a notice described in paragraph (f)(2) of this section (nor backup withhold under paragraph (f)(3) of this section) with respect to any account of a payee where, due to an error of the payor, the taxpayer identification number on such account is not the number that was provided to the payor on the applicable Form W-9 (or acceptable substitute form) because, for example, the payor transposed the taxpayer identification number when incorporating it into its business records.

(2) *Notice to payee who has provided two incorrect taxpayer identification numbers within 3 years.* The notice to the payee required by paragraph (f)(1) of this section must list, in a bold and conspicuous manner, the date the payor was notified of the second incorrect taxpayer identification number, the payee's name, address (including street, city, state (or country), and zip (or mailing) code), and such other information that may be required by revenue procedures and revenue rulings. In addition the notice must state that—

(i) The payor has been notified that the taxpayer identification number furnished by the payee is incorrect, setting forth the name and taxpayer identification number that the Internal Revenue Service has determined to be incorrect and the specific account number that contains the incorrect taxpayer identification number;

(ii) The payor has been notified twice within 3 calendar years that the payee has furnished an incorrect taxpayer identification number on the account with the payor;

(iii) The payor is required to disregard any future taxpayer identification numbers, whether or not certified under penalties of perjury, received from the payee with respect to the account unless the Internal Revenue Service has notified the payor that such taxpayer identification number is correct;

(iv) As a result of providing an incorrect taxpayer identification number, the payor is required under section 3406(a)(1)(B) to begin backup withholding 20 percent of reportable payments made to the account of the payee no later than after the close of the day 30 business days after the date that the payor is notified of the incorrect taxpayer identification number if the Internal Revenue Service has not notified the payor that the payee provided a correct taxpayer identification number to the Internal Revenue Service as described in paragraph (h) of this section; and

(v) The payee must contact the Internal Revenue Service Center where the payee is required to file his income tax return in order to prevent backup withholding under section 3406(a)(1)(B) from starting or to stop it once it has begun.

(3) *Period during which backup withholding is required due to a second notification of an incorrect number within 3 years.* Upon receiving the second notice of an incorrect taxpayer identification number from the Internal Revenue Service or a broker as described in paragraph (f)(1) of this section, the payor must backup withhold on all reportable payments subject to backup withholding made to the account of the payee after the close of the 30th business day after the day on which the payor receives a notice described in paragraph (b)(1) or (2) of this section and on or before

the close of the 30th calendar day after the payor receives the notification from the Internal Revenue Service as described in paragraph (h) of this section.

(4) *Grace periods*—(i) *Starting backup withholding.* Pursuant to section 3406(e)(5)(A), the payor may elect, on a payee-by-payee basis or in general, to begin backup withholding at any time during the 30-business-day period described in paragraph (f)(3) of this section.

(ii) *Stopping backup withholding.* Pursuant to section 3406(e)(5)(B), the payor may elect, on a payee-by-payee basis or in general, to treat the notification from the Internal Revenue Service as described in paragraph (h) of this section as having been received at any time within 30 calendar days after such notification is provided by the Internal Revenue Service and to stop backup withholding at any time within 30 calendar days of receiving such notice. See §31.3406(e)-1(b) for the application of the rule contained in this paragraph (f)(4)(ii).

(g) *Procedure for furnishing a correct taxpayer identification number to the Internal Revenue Service.* The procedure that a payee must follow after the Internal Revenue Service or a broker has notified a payor twice within 3 calendar years that the payee provided an incorrect taxpayer identification number with respect to the same account as described in paragraph (f)(1) of this section will be provided in a revenue procedure published by the Internal Revenue Service.

(h) *Notice from the Internal Revenue Service to stop backup withholding.* A payor who received a notice pursuant to paragraph (f) of this section will be notified by the Internal Revenue Service to stop backup withholding after the Internal Revenue Service receives a correct taxpayer identification number from the payee. A broker who received a notice pursuant to paragraph (b) of this section will be notified by the Internal Revenue Service that the payee is no longer subject to backup withholding under section 3406(a)(1)(B) and that the broker is no longer required to provide notices to payors under paragraph (b)(2) of this section. A broker who receives a notice under this paragraph (h) from the Internal Revenue Service is not required to provide the notice to any payor to which the broker has previously provided the notice required under paragraph (b)(2) of this section. The Internal Revenue Service will notify a payor or a broker pursuant to this paragraph by providing the payee with a Form W-9 on which the payee has certified, under penalties of perjury, that his taxpayer identification number is correct. The Form W-9 will bear an official stamp of the Internal Revenue Service verifying that the taxpayer identification number on the Form W-9 is correct as associated with the listed surname or business name. A payee may provide a copy of the Form W-9 to his payors or brokers in order to prevent backup withholding under paragraph (f)(3) of this section from beginning or to stop it under paragraph (f)(4)(ii) once it has begun. In lieu of receiving a copy of the Form W-9 described in this paragraph, in its discretion, a payor or broker may require the payee to set forth his name and certify, under penalties of perjury, that his taxpayer identification number is correct (as set forth on the Form W-9 verified by the Internal Revenue Service) on the payor's or broker's substitute Form W-9 in order to prevent backup withholding under paragraph (f)(3) from beginning or to stop it under paragraph (f)(4)(ii) once it has begun.

(i) [Reserved]

(j) *Examples.* The application of the provisions of this section may be illustrated by the following examples:

Example (1). D opened an account with Bank O prior to 1984 and furnished a taxpayer identification number to O at the time he opened the account. O is open for business Monday through Friday. O pays interest on the account at the end of each calendar month, and the account is a pre-1984 account as described in §31.3406(d)-1(b)(2) and (c)(1)(ii). On October 1, 1990, the Internal Revenue Service notifies Bank O that the taxpayer identification number provided by D is incorrect. O timely sends the notice information to D as required in paragraph (c)(1) of this section. O does not receive a certified Form W-9 or an acceptable substitute form (hereinafter "certification") from D as described in paragraph (e) of this section. O is required to backup withhold 20 percent of all reportable payments made after November 14, 1990 (which is 30 business days after the date the Internal Revenue Service notified O). Therefore, O is not required to backup withhold on the reportable payment made on October 31, 1990, but is required to backup withhold on the reportable payment made on November 30, 1990. O is required to continue to backup withhold under section 3406(a)(1)(B) until O receives the certification described in paragraph (e) of this section from D.

Example (2). Assume the same facts as in *Example (1)* except that D furnishes a new taxpayer identification number to O on November 1, 1990, but does not certify, under penalties of perjury, that it is his correct taxpayer identification number as required in paragraph (e) of this section. Even though the account is a pre-1984 account, O is required to withhold 20 percent of all reportable payments made after November 14, 1990 (which is 30 business days after the date the Internal Revenue Service notified O), and before the date O receives the certification as described in paragraph (e) of this section from D.

Example (3). Assume the same facts as in *Example (2)* except that D provides O with the certification described in paragraph (e) of this section on November 20, 1990. D elects pursuant to paragraph (d)(2)(ii) of this section to treat the certification as received on November 20, 1990. Even though D did not provide the certification to O within 30 business days after the Internal Revenue Service notified O that D provided an incorrect taxpayer identification number, O is not required to backup withhold under section 3406(a)(1)(B) because O did not make any reportable payment to D after 30 business days after notification of an incorrect taxpayer identification number and before O received D's certification in the manner required in paragraph (e) of this section. Pursuant to section 3406(e)(5)(B), O may elect to treat the certification as having been received at any time within the 30 calendar days after it is provided by D.

Example (4). Individual F has two post-1983 accounts with Bank R that pay reportable interest: a savings account and a money market account. The money market account was opened in 1986, and the savings account was opened on February 1, 1991. R treats each of these accounts as a separate account with the Bank. F provided R with the certifications as described under §31.3406(a)-1 at the time each account was opened. On October 1, 1990, the Internal Revenue Service notified R pursuant to paragraph (b)(1) of this section that F furnished an incorrect taxpayer identification number with respect to the money market account. R timely sends F the notice required under paragraph (b)(1) of this section and receives the certification required under paragraph (e) of this section from F on November 1, 1990. On October 1, 1991, the Internal Revenue Service notifies R that F furnished an incorrect taxpayer identification number with respect to the money market account. Further, R determines from its business records that two notifications of an incorrect taxpayer identification number have been received with respect to the money market account within 3 calendar years. R must send F the notice required under paragraph (f)(2) of this section and must commence backup withholding on reportable interest paid on the money market account pursuant to paragraph (f)(3) of this section after November 14, 1991, which is 30 business days after R received the second notice. R must continue to backup withhold on the money market account until R receives from the payee a copy of the notice that was provided to the payee by the Internal Revenue Service as described in paragraph (h) of this section. R is not required to backup withhold on the savings account until it receives notice under paragraph (b)(1) or (2) of this section with respect to the savings account.

Appendix to §31.3406(d)-5

A notice required by paragraph (c)(3) of this section shall be substantially similar in content to the following.

Date _____

IMPORTANT TAX INFORMATION—PLEASE READ CAREFULLY

YOU MUST PROVIDE US WITH A FORM W-9 (EVEN IF WE ALREADY HAVE ONE ON FILE FOR YOU)

Notice of Backup Withholding

We received a notice from the Internal Revenue Service (IRS) stating that the taxpayer identification number (TIN) on your account with us is incorrect. A TIN is incorrect if either the name or number shown on an account does not match a name and number combination shown on the records of the Social Security Administration (SSA) or IRS. You must act to correct this problem within 30 calendar days from the date shown above. Otherwise, we may be required to withhold 20% of the interest, dividends, and certain other payments that we make to your account.

Section 3406 of the Internal Revenue Code requires that we withhold 20% in tax, called backup withholding, when you do not give us your correct TIN. Further, you may be subject to a $50 penalty by the IRS under section 6723 of the Internal Revenue Code for failing to provide us with your correct TIN. This notice provides you with instructions to correct your account record in order to avoid backup withholding and the possible imposition of the penalty.

INSTRUCTIONS FOR INDIVIDUALS

For individuals, the TIN is the social security number (SSN). Very often a TIN is incorrect because of a name change due to marriage, divorce, adoption or some other reason that has not been communicated to the Social Security Administration (SSA) and recorded on its records. Alternatively, the account may not contain the correct SSN of the actual owner. For example, an account in a child's name may contain a parent's SSN. An account should be titled in the name of the actual owner of the account with that person's SSN.

What to Do

To determine what actions you should take to correct your TIN, compare the name and SSN on your account with us (listed on page (insert the correct page number)) with the name and SSN shown on your social security card and then follow the chart below to determine what action you should take. (If you have never been assigned an SSN by SSA or if you lost your card and do not know your SSN, contact your local SSA office to apply for an original or a replacement SSN card, whichever is required. Also, if you have never been assigned an SSN, *read* the enclosed Form W-9, write the words "applied for" on the form according to its instructions, and return the form to us. You do not need to follow the chart below. You must send us your name and SSN, as shown on the SSN card that you get from SSA, on a Form W-9 within 60 days.)

IF—	*THEN—*
1. The last name and SSN on your account agree with the last name and SSN on your social security card—	1. Contact your local SSA office to ascertain why the information on SSA's records is different from that on your social security card and to resolve that problem. Also, put your name and SSN on the enclosed Form W-9 according to its instructions. Sign the Form W-9 and the statement below that you contacted SSA. Send both forms to us.
2. The SSN on your account is different from the SSN on your social security card, but the last name is the same—	2. Put your name and SSN, as shown on your social security card, on the enclosed Form W-9 according to its instructions, sign it and send it to us. No contact with SSA is necessary.
3. The last name on your account is different from the last name on your social security card, but the SSN is the same on both—	3. Take one of the following steps (but not all): If the last name on your account is correct, (a) Contact SSA to correct the name on your social security card. Put your SSN and name shown on your account on the enclosed Form W-9 according to its instructions, sign it and the statement that you contacted SSA. Send both forms to us. (b) If you are not able to contact SSA at this time, you can provide us with both last names. Put your SSN and the name shown on your social security card plus the last name shown on your account (in that order) on the enclosed Form W-9 according to its instructions, sign it, and return it to us. For example, if your social security card lists your maiden name, you can provide us with your SSN and your name in the following order: First/maiden/married name. Please note, however, that you should contact SSA as soon as possible. If the last name on your social security card is correct,

IF—	THEN—
4. Both the last name and SSN on your account are different from the last and SSN on your social security card—	(c) Put that name and your SSN on the enclosed Form W-9 according to its instructions, sign it, and return it to us. No contact with SSA is necessary. 4. If the last name and SSN on your social security card name are correct, (a) put that name and SSN on the enclosed Form W-9 according to its instructions, sign it, and send it to us. No contact with SSA is necessary. If the last name on your account and the SSN on your social security card are correct, (b) Follow procedures in section 3(a) or (b) above. Be sure to put the name shown on your social security card on the Form W-9.

You must be consistent with the name and number (SSN) that you furnish (1) to us for all of your accounts and (2) to your other payors in order to avoid a problem in the future. If you must visit SSA, take this notice, your social security card, and other relevant documents with you. You should call SSA first so they can explain to you what other documents you need to bring to the SSA office.

Instructions for Nonindividuals

For most nonindividuals (such as trusts, estates, partnerships, and similar entities), the taxpayer identification is the employer identification number (EIN). The EIN on your account may be incorrect because it does not contain the number of the actual owner of the account. For example, an account of an investment club or bowling league should reflect the organization's own EIN and name, rather than the SSN of a member. (The account of a sole proprietor who may have both an EIN and an SSN should reflect the individual name of the sole proprietor and his or her SSN.) Please put the name and EIN on the enclosed Form W-9, sign it, and send it to us.

Remember

YOU MUST SEND US A SIGNED FORM W-9 WITHIN 30 CALENDAR DAYS FROM THE DATE SHOWN AT THE TOP OF PAGE 1 even if the name and number (SSN or EIN) on your account with us match the name and number (SSN or EIN) on your social security card or the document issuing you an EIN. If we do not receive your Form W-9, any other documents that are necessary for us to change the name or TIN (or both) on your account to reflect the name and number on the newly provided Form W-9, and, if necessary, the statement that you contacted SSA or IRS within the 30-day period, we may be required to withhold 20% from any reportable payment that we pay to your account until we receive the necessary documents.

Please complete the form below if you are required to contact SSA or the IRS.

Detach and Return to Us

Statement of SSA or IRS Contact

I hereby state that I have contacted the Social Security Administration concerning my social security number (SSN) or the Internal Revenue Service concerning my employer identification number (EIN) to resolve the problem with my name or number which resulted in my being notified of an incorrect taxpayer identification number.

_____
(Print Name)

_____
(Signature)

By _____
(For Nonindividuals and Agents Only)

Date _____

(The portion below must be completed by the payor.)

Account Number _____

Current TIN on Account _____

Current Name on Account _____

§31.3406 (e)-1 Period during which withholding is required.

(a) *In general.* A payor shall withhold 20 percent of any reportable payment (as defined in §31.3406(b)(1)-1(a)) made to a payee during the period described in this section. A payor shall continue to withhold until no condition for imposing backup withholding exists with respect to the payee. A payor shall not withhold more than 20 percent of any reportable payment irrespective of the number of conditions for imposing backup withholding that exist with respect to the payee.

(b) *Special rule for determining when the payor receives a taxpayer identification number or certificate from a payee.* In determining whether a payee has failed to provide a taxpayer identification number or any certification to a payor (including a Form W-8 or substitute form), a payor is required to process the taxpayer identification number or certification within 30 days after the payee or broker furnishes the taxpayer identification number or certification to the payor. Thus, the payor may take up to 30 days to treat the number or certificate as having been received. The payor, at its option, may treat the taxpayer identification number or certificate as having been received at any time within 30 days after the payee or broker furnishes the number or certification to the payor.

(c) *Failure to furnish taxpayer identification number in the manner required.* A payor is required to withhold 20 percent of any reportable payment (as defined in §31.3406(b)(1)-1(a)) made to a payeeif—

(1) The payor has not received the payee's taxpayer identification number in the manner required in §31.3406(d)-1, or

(2) The payor has received notice from a broker (as required by §31.3406(d)-4(a)(1)(iii)) with respect to a readily tradable instrument that the payee did not furnish a taxpayer identification number to the broker in the manner required in §31.3406(d)-1 and the payor has

not received the taxpayer identification number from the payee in such manner.

The payor shall continue to withhold 20 percent of any reportable payments made to the payee until the payor receives the taxpayer identification number from the payee in the manner required in §31.3406(d)-1. Once the payor receives the taxpayer identification number in the manner required, the payor must stop withholding under section 3406(a)(1)(A) within 30 days after receiving the taxpayer identification number.

(d) *Payee certification failure.* A payor is required to withhold 20 percent of any reportable interest or dividend payment (as defined in §31.3406(b)(1)-1(b)) made to a payee if—

(1) The payor has not received the certification required in §31.3406(d)-2, or

(2) The payor has received notice from a broker (as required in §31.3406(d)-4(a)(1)(iii)) that the payee did not make the required certification and the payor has not received the required certification from the payee.

The payor shall continue to withhold 20 percent of any reportable payments made to the payee until the payor receives the required certification from the payee. Once the payor receives the required certification from the payee, the payor must stop withholding under section 3406(a)(1)(D) within 30 days after the certification is received.

(e) *Notification of an incorrect taxpayer identification number.* See §§31.3406(d)-5(d) and (f)(3) for the period for which backup withholding is required in the case of notification of an incorrect taxpayer identification number.

(f) *Notified payee underreporting.* See §31.3406(c)-1(e) for the period for which backup withholding is required in the case of Internal Revenue Service notification of payee underreporting.

(g) *Examples.* The application of the provisions of this section may be illustrated by the following examples:

Example (1). Individual A has maintained an interest bearing account with Bank M since 1981. M credits interest on the account on the first day of each month. A furnished a taxpayer identification number to M at the time that A opened the account, but A has not certified under penalties of perjury that the number is correct. Because the account is a pre-1984 account (as defined in §31.3406(d)-1(b)(2)(i)), A has provided his taxpayer identification number in the manner required by §31.3406(d)-1. Moreover, no other condition for imposing backup withholding exists. Consequently, M is not required to withhold under section 3406 on payments made to A with respect to this account.

Example (2). Assume the same facts as in Example (1) except that A did not furnish a taxpayer identification number to M when A opened the account. A does not furnish his social security number to M until February 24, 1984. Under paragraph (b) of this section, M has up to 30 days in which to treat the number as having been received. M is required to withhold 20 percent of the reportable payment made on February 1. If M does not treat the number as having been received by March 1, M may withhold 20 percent of the reportable payment made on March 1. M may not, however, withhold 20 percent of the payment made on April 1.

Example (3). Individual B opens an interest bearing checking account with Bank N on January 9, 1984. N will pay interest on the account quarterly. B does not furnish his taxpayer identification number to N and also does not certify that he is awaiting receipt of a taxpayer identification number (as described in §31.3406(g)-3). N is required to withhold under section 3406 on payments made to B until N receives B's taxpayer identification number and certification under penalties of perjury that B's taxpayer identification number is correct and that B is not subject to backup withholding due to notified payee underreporting. N is required to withhold only 20 percent under section 3406 on any reportable payments made to B even though two conditions for imposing backup withholding exist.

Example (4). Assume the same facts as in *Example (3)* except that B furnishes his taxpayer identification number and the required certifications to M on March 15, 1984. Under paragraph (b) of this section, M has up to 30 days to treat the certifications as having been received. If N treats the number and certifications as received before March 31, N is not required to withhold under section 3406 on the March 31 quarterly interest payment. If N does not treat the certifications as received before March 31, however, N is required to withhold on the March 31 interest payment. See §31.6413(a)-3(a) which provides that N may treat the amount withheld on March 31 as erroneously withheld and may refund the withheld amount to B. N is required to withhold only 20 percent of any reportable payments made to B even though two conditions for imposing backup withholding exist.

Example (5). Assume the same facts as in Example (4) except that B furnishes his taxpayer identification number and certifies, under penalties of perjury, that it is his correct number, but B does not certify that he is not subject to backup withholding due to notified payee underreporting as required under §31.3406(d)-2. N treats the number as having been received on March 15, 1984. Even though B furnished his taxpayer identification number in the manner required in §31.3406(d)-1 and N has received the number, N is required to withhold 20 percent of the March 31 interest payment because M has not received certification from B that B is not subject to backup withholding due to notified payee underreporting. N is required to continue to withhold until N receives such a certification from B.

Example (6). C opens a new account with Broker P on March 19, 1984, to purchase a readily tradable instrument of Corporation Z. P holds the instrument in street name for C. Payments of $1000 of stated interest on the instrument will be made on June 30 and December 31. C does not certify his taxpayer identification number or that C is not subject to backup withholding due to notified payee underreporting until July 1, 1984. Because the instrument is held in street name, P is the payor of the interest to C (as defined in §31.3406(a)-2). Under paragraph (b) of this section, P treats the certifications as having been received on July 31, 1984. P is required to withhold $200 (20 percent of $1000 paid on June 30) under section 3406 even though two conditions for imposing backup withholding under section 3406 exist with respect to C. P is not required to withhold under section 3406 on the December 31 interest payment because P has received C's certifications and no other condition for imposing backup withholding exists.

Example (7). Assume the same facts as in *Example (6)* except that P does not hold the instrument in street name for C. Thus, P is not the payor of the reportable interest payment (as defined in §31.3406(a)-2). P is required under §31.3406(d)-4(a)(l)(iii) to notify Z in connection with the transfer instructions that C failed to make the required certifications. Z is required to notify C as described in §31.3406(d)-4(a)(3), is required to seek the missing certifications, and is required to withhold 20 percent of any reportable payments made to C until Z receives C's certifications.

Example (8). Assume the same facts as in *Example (7)* except that C furnishes the required certifications to Z on June 1, 1984. Under paragraph (b) of this section, Z has up to 30 days to treat the certifications as having been received. If Z treats the certifications as having been received before June 30, 1984, Z is not required to withhold on the June 30 interest payment. If Z does not treat the certifications as having been received before June 30, Z is required to withhold 20 percent of the June 30 interest payment.

Example (9). Assume the same facts as in *Example (7)* except that before P's notification Z had already received the required certifications from C because C had acquired other instruments directly from Z. Z is not required to withhold due to P's notification since Z has received the required certifications from C.

Example (10). Assume the same facts as in *Example (7)* except that in addition to acquiring the Z instrument through P, C subsequently acquired additional Z instruments through Broker Q. Q does not hold the instruments in street name for C so Q is not the payor as defined in §31.3406(a)-2. Q is required under §31.3406(d)-4 to notify Z in connection with the transfer instructions if C fails to make any required certifications. Q's transfer instructions to Z include C's taxpayer identification number and do not inform Z of any payee certification failure. Unless Z has received the certifications

from C, Z may not assume that there is no reason to solicit the certifications required by P's notification even though Q's transfer instructions did not inform Z of any certification failure. Z is required to seek the missing certifications (based on P's transfer instructions to Z), and Z is required to withhold 20 percent of any reportable payments made to C until Z receives C's certifications. Another broker's transfer instructions to a payor do not relieve the payor's responsibility with respect to an earlier broker's transfer instructions. Once one broker notifies the payor that there is a payee certification failure, the payor must withhold until the payor receives the certification from the payee. See §31.3406(d)-4(c)(2) which provides that if Z makes an aggregate payment with respect to all Z Corporation instruments owned by C, Z is required to withhold 20 percent of the aggregate reportable payment.

§31.3406(f)-1 Confidentiality of information.

(a) *Confidentiality and liability for violation—In general.* No person may use any information obtained under section 3406 for any purpose except for the purpose of complying with the requirements of section 3406 or for purposes permitted under section 6103 (subject to the safeguards of section 6103). See section 7431 for civil damages for violating the confidential use of such information.

(b) *Permissible use of information*—(1) *In general.* A payor or broker may transmit information on a Form W-9 or other acceptable form relating to backup withholding to the department, institution, or firm (or to any employee therein) that is responsible for withholding or processing of taxpayer identification numbers, certifications described in §31.3406(h)-3, or other substitute forms. In addition, a broker may notify the payor with respect to a readily tradable instrument of the requirement to withhold and the condition or conditions for imposing backup withholding (as described in §31.3406(d)-4) that exist with respect to the payee. A payor or broker may, without violating the Internal Revenue Code, close an account of, refuse to open an account for, or issue an instrument to, or redeem an instrument for, a person who fails to furnish his taxpayer identification number in the manner required in §31.3406(d)-1.

(2) *Window transactions.* In the case of a window transaction (as defined in §31.3406(b)(2)-3(b)), a payor may, without violating the Internal Revenue Code, refuse to redeem or may refuse to make payment if the payee fails to provide a taxpayer identification number regardless of when the obligation was issued or acquired.

(c) *Specific restrictions on the use of information.* A payor or broker is not permitted to refuse to open an account or to issue an instrument if the person fails to certify, under penalties of perjury, that the person is not subject to withholding under section 3406(a)(1)(C) (relating to notified payee underreporting). A payor or broker is not permitted to use information obtained under section 3406, including a payee's failure or inability to certify that he is not subject to backup withholding due to notified payee underreporting or the fact that the account is subject to backup withholding, to surcharge an account, to open or close an account, to issue or redeem an instrument, or in deciding whether to extend credit to the payee. A payor or broker has surcharged an account if the payor or broker charged an account more than the fee charged a similar account that was not subject to backup withholding. If a payor or broker in good faith reasonably believes use of the information is permissible under this section, the payor or broker will not be liable under section 7431.

(d) *Examples.* The application of the provisions of this section may be illustrated by the following examples:

Example (1). A, an individual, attempts to open a savings account at Bank M on January 1, 1988. A fails to certify that he is not subject to backup withholding due to notified payee underreporting under section 3406(a)(1)(D) and §31.3406(d)-2. M refuses to open an account for A. A has a cause of action against M under section 7431 for an unauthorized use of information obtained under section 3406.

Example (2). Corporation N receives a notice from the Internal Revenue Service, pursuant to section 3406(a)(1)(B) and §31.3406(d)-5, concerning an incorrect taxpayer identification number provided by B, a shareholder of N. N imposes backup withholding on reportable dividends paid to B and imposes a surcharge of $10 to cover the cost of backup withholding on B's account. B has a cause of action against N under section 7431 for an unauthorized use of information obtained by N under section 3406.

Example (3). Credit Union O receives a notice from the Internal Revenue Service, pursuant to section 3406(a)(1)(C), that C, a depositor of O, is subject to backup withholding due to notified payee underreporting. Based on this information, O refuses to approve C's credit application. C has a cause of action against O under section 7431 for an unauthorized use of information obtained pursuant to section 3406.

Example (4). Cooperative P receives a notice from the Internal Revenue Service, pursuant to section 3406(a)(1)(C), notifying P to withhold on payments made to E due to notified payee underreporting. P, pursuant to section 3406(c)(4), then provides notice to E of withholding at the time P begins withholding. E does not have a cause of action against P under section 7431, because this notice to E is an authorized use of information obtained pursuant to section 3406.

Example (5). Corporation Q receives notice from Broker R of the requirement to withhold with respect to F, a shareholder, who failed to certify that his taxpayer identification number was correct. Q provides notice to F of such withholding (as required in §31.3406(d)-4(a)(3)). F does not have a cause of action against either Q or R for an unauthorized use of information obtained pursuant to section 3406.

§31.3406(g)-1 Exception for payments to certain payees and certain other payments.

(a) *Exempt recipients*—(1) *In general.* A payor of any reportable payment (as defined in §31.3406(b)(1)-1(a)) shall not withhold under section 3406 if the payee is—

(i) A tax exempt organization as described in §1.6049-4(c)(1)(ii)(B),

(ii) An individual retirement plan as described in §1.6049-4(c)(1)(ii)(C),

(iii) The United States as described in §1.6049-4(c)(1)(ii)(D),

(iv) A State as described in §1.6049-4(c)(1)(ii)(E),

(v) A foreign government as described in §1.6049-4(c)(1)(ii)(F), or

(vi) An international organization as described in §1.6049-4(c)(1)(ii)(G).

(2) *Payments subject to reporting under section 6041 or 6041A(a).* In determining whether a payment is not reportable under section 6041 and 6041A(a) because it is made to a payee that is not subject to reporting under section 6041 or 6041A(a), the payor shall use the procedures provided in §1.6049-4(c)(1)(ii) to determine whether an information return is required.

(3) *Determination of whether person is described in paragraph (a)(1) of this section.* The determination of whether a person is described in paragraph (a) of this section shall be made as provided in the applicable provision of §1.6049-4(c)(1)(ii). A payor, even if permitted to treat a person as an exempt recipient without requiring a certificate under the provisions of §1.6049-4(c)(2)(ii), may require a payee not required to file a certificate as to its exempt status to file a certificate and may treat a payee who fails to file such a certificate as a person who is not an exempt recipient. See §31.3406(h)-3 for a description of the form or a substitute

form prescribed under section 3406 for a person to claim exempt status.

(4) *Prepaid or advance premium life-insurance contracts.* A payor of a reportable payment (as defined in §31.3406(b)(1)-1(a)) may, but is not required to withhold under section 3406 on reportable payments made from January 1, 1984, to December 31, 1991, on prepaid or advance premium life-insurance contracts to a payee who is the owner for tax purposes of the prepaid or advance premium life-insurance contract. However, a payor, at its discretion, may withhold on such payments. For purposes of this exception from backup withholding, a prepaid or advance premium life-insurance contract is one entered into on or before June 30, 1984, by the payee and under which the increment in value of the prepaid or advance premium is used for the payment of premiums during the period in which the exception from backup withholding applies.

(5) *Examples.* The application of the provisions of this paragraph (a) may be illustrated by the following examples:

Example (1). Corporation M pays $1000 to Broker N for services N performs for M. M's payment to N is in the course of M's trade or business. M is required to make an information return under section 6041 or 6041A(a) because the payment is of a kind (*i.e.*, nonemployee compensation paid in the course of a payor's trade or business) and to a payee subject to reporting (*i.e.*, payments to registered securities dealers are not excepted under §1.6041-3 from information reporting under section 6041 or 6041A(a)). Thus, M is required to withhold under section 3406 if any of the two conditions for imposing backup withholding exists with respect to N as described in §31.3406(b)(3)-1. N is also not an exempt recipient from backup withholding because N is not described in paragraph (a)(1) of this section.

Example (2). Assume the same facts as in *Example (1)* except that M pays the nonemployee compensation to P Co. While a payment to a corporation is excepted from information reporting under section 6041 or 6041A(a) and §1.6041-3(c), M may not treat P Co. as exempt from information reporting without receiving a Form W-9 or substitute form from P Co. certifying that it is an exempt recipient. Because a payor may not treat a payee with "Co." in its name as an exempt recipient under §1.6049-4(c)(1)(ii) without receiving a Form W-9 or substitute form from the payee, M, as payor of payments subject to reporting under section 6041 or 6041A(a), may not treat a payee with "Co." in its name as exempt from backup withholding without receiving a Form W-9 certifying as to its exempt status (as provided in paragraph (a)(2) of this section). If M does not receive a Form W-9 or acceptable substitute from P Co., M is required to make an information return under section 6041 or 6041A(a) and would be required to withhold under section 3406 if any condition for imposing backup withholding exists with respect to P (as described in §31.3406(b)(3)-1) because P is not an exempt recipient described in paragraph (a) (1) of this section.

Example (3). Assume the facts as in *Example (2)* except that P's name is P Corp. M may treat P as an exempt recipient under section 6041 or 6041A(a) and §1.6041-3(c) because P can be treated as a person described in §1.6049-4(c)(1)(ii) without filing a certificate as to its exempt status. Since the payment to P Corp. is not subject to information reporting under section 6041 or 6041A(a), M is not required to withhold under section 3406 even though P is not described in paragraph (a)(1) of this section.

Example (4). Assume the same facts as in *Example (3)* except that P Corp. is a corporation engaged in providing medical and health care services or engaged in the billing and collection of payments in respect of medical and health care services (other than certain tax-exempt or governmental facilities described in §1.6041-3(c)(1) and (2)). Notwithstanding paragraph (a)(2) of this section, M is required to make an information return under section 6041 because payments to such corporations are not excepted from information reporting under section 6041 or 6041A(a). Moreover, M would be required to backup withhold on the payments to P if P failed to provide its taxpayer identification number because P is not described in paragraph (a)(1) of this section.

Example (5). Corporation Q becomes a member of Barter Exchange R in 1984. Q provides goods for another member of R and receives a credit on the books of R for such goods. During 1984 members of R engage in more than 100 similar barter transactions. Consequently, R is required to make an information return with respect to the transaction engaged in by Q. Q fails to furnish its taxpayer identification number to R, under penalties of perjury, as required in §31.3406(d)-1. Q is not exempt from information reporting under section 6045 as provided in §1.6045-1(e). Q is also not exempt from backup withholding under section 3406 because Q is not described in paragraph (a)(1) of this section.

(b) *Middleman.* The transfer by a middleman (as defined by §1.6049-4(f)(4)(i)) from within the United States of an interest coupon or discount obligation on behalf of a payee for presentation, payment, or collection outside the United States, although subject to information reporting under §1.6049-4(b)(3)(ii), shall not be subject to backup withholding under section 3406. Thus, the middleman is not required to withhold under section 3406 with respect to the transfer.

(c) *International organizations.* An international organization as described in §1.6049-4(c)(1)(ii)(G) (or a paying, transfer or other agent that is not also a payee's agent) is not required to withhold under section 3406 on interest or principal paid with respect to an obligation issued by the international organization, provided the international organization is an organization of which the United States is a member and which enjoys immunity or exemption from any liability or obligation to pay, withhold, or collect tax pursuant to an international agreement having full force and effect in the United States.

(d) *United States deposits and accounts of foreign payees.* A payor of a reportable payment (as defined in §31.3406(b)(1)-1(a)) is not required to withhold under section 3406 on amounts described in §1.6049-5(e)(2).

(e) *Certain reportable payments made outside the United States by foreign persons, foreign offices of United States banks and brokers, and others.* A payor of a reportable payment (as defined in §31.3406(b)(1)-1(a)) is not required to withhold under section 3406 if the reportable payment is made outside of the United States, the payor does not have actual knowledge that the payee is a United States person, and the payment is of—

(1) Interest described in §1.6049-5(e)(1) (regarding interest payments made or collected by a person in the commercial banking business with respect to an account or deposit maintained at an office of such person outside the United States);

(2) Dividends that would be described in §1.6042-3(b)(2) (regarding dividends from sources outside the United States that are distributed or paid outside the United States) but for the fact that they are actually owned by a United States person;

(3) Amounts that would be described in §1.6045-1(g)(1)(i)(B) (regarding sales effected by a broker at an office of the broker outside the United States) but for the fact that the customer is a United States person; or

(4) Interest described in §1.6049-5(f)(1) (regarding payments outside the United States by a middleman that, as an agent of the payee, collects the amount for or on behalf of the payee).

§31.3406(g)-2 Exception for reportable payments for which withholding is otherwise required.

(a) *In general.* A payor of a reportable payment (as defined in §31.3406(b)(1)-1(a)) shall not withhold under section 3406 if tax is

actually withheld from the payment under any other provision of the Code.

(b) *Payment of wages.* A payor who is required to make an information return under section 6041 with respect to a payment of wages (as defined in section 3401) because the employee makes a certification under section 3402(n) (relating to employees incurring no income tax liability) shall not withhold 20 percent of the wages under section 3406.

(c) *Distribution from a pension, annuity, or other plan of deferred compensation*—(1) *In general.* For payments prior to December 31, 1984, a payor who is required to make an information return under section 6041 with respect to a distribution from or under a pension, annuity, or other deferred compensation arrangement shall not withhold 20 percent of the distribution under section 3406 if tax is actually withheld from the distribution under section 3405 because the payee did not make an election under section 3405(a)(2) (relating to an election with respect to periodic distributions) or under section 3405(b)(3) (relating to an election with respect to nonperiodic distributions). Additionally, if tax is not actually withheld from the distribution under section 3405 because the payee made an applicable election or because the amount of the distribution is less than the minimum amount subject to withholding under section 3405 and if the payee does not provide a taxpayer identification number to the payor, then, except as provided in paragraph (c)(2) of this section, backup withholding shall apply to the distribution if any of the two conditions for imposing backup withholding exist (as described in §31.3406(b)(3)-1).

(2) *Special rule.* If the annual distributions subject to reporting under section 6041 to a payee total $5,400 or less (in which case withholding on periodic payments under section 3405 generally is not required), and if the payor has no taxpayer identification number for the payee, the payor shall not impose backup withholding until the first payment made after June 30, 1984. If the payee does not provide a taxpayer identification number by that date backup withholding applies as described in §31.3406(b)(3)-1 to distributions made after June 30, 1984.

(3) *Distributions not subject to backup withholding.* Backup withholding applies only to distributions from a pension, annuity, or other plans of deferred compensation that are subject to reporting under section 6041 and does not apply to distributions that are not reportable under section 6041. Thus, backup withholding does not apply to—

(i) Distributions from an individual retirement account (subject to reporting under sections 408(i) and 6047(d)),

(ii) Distributions from an owner-employee plan (subject to reporting under section 6047(b)),

(iii) Certain surrenders of life insurance contracts (subject to reporting under section 6047(e)), and

(iv) Distributions from a qualified bond purchase plan (subject to reporting under section 6047(c)).

(4) *Examples.* The application of the provisions of this paragraph (c) may be illustrated by the following examples:

Example (1). Corporation X maintains a qualified retirement plan for its employees and their beneficiaries. Distributions to retirees and beneficiaries are made by an employees' trust described in section 401(a) that is exempt under section 501(a). Individual A is an employee of Corporation X who has accrued substantial pension benefits. In June 1983, A dies and her beneficiary, Individual B, elects to receive the pension benefits from the retirement plan accrued on behalf of A in the form of an annuity, beginning January 1, 1984. The payments to B that are includible in B's gross income will aggregate approximately $10,000 per calendar year. In accordance with the requirements of section 3405 (relating to withholding from pensions, annuities, and other deferred income), X provided a notice to B of the right to elect out of withholding under section 3405. B returned the election form indicating that he did not want income tax withheld from his distributions, but B did not furnish his taxpayer identification number to X. Consequently, X is required to withhold 20 percent from all reportable payments made to B after December 31, 1983, under section 3406 until B furnishes a taxpayer identification number to X.

Example (2). Assume the same facts as in *Example (1)* except that the payments to B from the retirement plan that are includible in B's gross income will aggregate only $5000 per calendar year. In addition, assume that B did not return the form to elect out of withholding under section 3405. Under section 3405(a)(4), if no exemption certificate electing out of withholding is filed, the amount withheld is determined by treating the payee as a married individual claiming three withholding exemptions. Therefore, for 1984, the payments to B are not subject to withholding under section 3405 since the payments aggregate less than $5400 per year. Because B has not furnished X a taxpayer identification number, however, X must withhold 20 percent of the payments made after June 30, 1984, under section 3406 until B furnishes a taxpayer identification number to X. If B provides his taxpayer identification number to X before July 1, 1984, however, no withholding under section 3406 is required (as described in paragraph (c)(2) of this section).

Example (3). Bank Y sponsors an individual retirement account (as defined under section 408(a)) on behalf of Individual C. C has attained the age of 59 1/2 and requests scheduled payments from his IRA of $500 per month (or $6000 per year) beginning on January 1, 1984. Y reports such distributions under section 408(i) and section 6047(d). Because these distributions are not reportable under section 6041, Y is not required to withhold 20 percent of each payment under section 3406, even if C elects out of withholding under section 3405 and does not furnish a taxpayer identification number to Y.

(d) *Payment with respect to an oil or gas interest.* A payor who is required to make an information return under section 6041 with respect to a calendar year ending before January 1, 1987, or under section 6050N with respect to a calendar year ending after December 31, 1986, with respect to an oil or gas payment (including payments for working interests, delayed rental, or lease bonuses) shall not withhold 20 percent of such payment under section 3406 if the payor actually withholds windfall profit tax under section 4986. If windfall profit tax is not actually withheld from the payment (because, for example, payment is made with respect to "exempt royalty oil" (as defined in section 4994(f)), the payment is subject to backup withholding if any of the two conditions for imposing backup withholding exists (as described in §31.3406(b)(3)-1). The amount subject to backup withholding under section 3406 is the net amount the payee receives (*i.e.*, the gross proceeds less production related taxes such as State severance tax). If the payor customarily makes an aggregate payment with respect to both an oil and gas payment to a payee, and windfall profit tax is actually withheld only upon the portion representing the oil interest, the aggregate payment is *not* subject to backup withholding. The payor shall not be liable to any person other than the United States for the amount of tax withheld as described in §31.3406(h)-2(h).

(e) *Gambling winnings*—(1) *In general.* A payor of a reportable gambling winning shall not withhold 20

percent of the gambling winning under section 3406 if tax is actually withheld from the gambling winning under section 3402(q) (relating to the extension of withholding to certain gambling winnings). See paragraph (e)(2) of this section for the determination of a reportable gambling winning. If the reportable gambling winning is not withheld upon under section 3402(q), backup withholding shall apply to the gambling winning if, and only if, the payee does not furnish a taxpayer identification number to the payor. Section 31.3406(b)(3)-1(b)(2) does not apply to a reportable gambling winning. Thus, the payor of a reportable gambling winning is not required to aggregate all such winnings made to a payee during a calendar year, nor is the payor required to determine whether an information return was required to be made with respect to such payee for the preceding calendar year.

(2) *Definition of a reportable gambling winning and determination of amount subject to backup withholding.* For purposes of backup withholding, a reportable gambling winning is any gambling winning subject to information reporting under section 6041. The amount of a reportable gambling winning is—

(i) The amount paid with respect to the amount of the wager reduced, at the option of the payor, by

(ii) The amount of the wager.

Amounts paid with respect to identical wagers are treated as paid with respect to a single wager for purposes of calculating the amount paid with respect to the wager. The determination of whether wagers are identical shall be made under §31.3402(q)-1(c)(1)(ii). In addition, until further regulations are issued under section 6041 or section 3406, a gambling winning (other than a winning from bingo, keno, or slot machines) is a reportable gambling winning only if the amount paid with respect to the wager is in excess of $600 and is based on betting odds of 300 to 1, or higher. See §7.6041-1 to determine whether a winning from bingo, keno, or slot machines is a reportable gambling winning and thus subject to backup withholding.

(f) *Certain real estate transactions.* A real estate reporting person (the so-called "broker") as defined in section 6045(e)(2) shall not withhold under section 3406 on a payment made with respect to a real estate transaction that is subject to reporting under section 6045(a) and (e) and §1.6045.

(g) *Limited exception for certain payments after a merger or an acquisition of accounts.* A payor who acquires accounts or instruments of another payor by acquisition or merger and who is unable to determine from the business records of the merged payor or of the payor whose accounts or instruments were acquired whether any or all of such accounts or instruments are pre-1984 or post-1983 accounts or instruments may treat such accounts as pre-1984 accounts or instruments and may commence backup withholding under section 3406(a)(1)-(A) and §31.3406(d)-1 on any such accounts or instruments for which the payor does not have a taxpayer identification number from the payee or has an obviously incorrect taxpayer identification number as defined in §31.3406(h)-1(a)(2) no later than sixty days following the date of the merger or acquisition of such accounts or instruments.

(h) *Certain gross proceeds.* No backup withholding is required with respect to any portion of the original issue discount on an instrument or security that is subject to backup withholding as reportable gross proceeds of such instrument or security under section 6045.

§31.3406(g)-3 Exemption while payee is waiting for a taxpayer identification number.

(a) *In general*—(1) *Withholding not required for 60 days.* Except as provided in paragraphs (b) and (c) of this section, a payor shall not withhold for 60 days if the payee is awaiting receipt of a taxpayer identification number unless the payee (or a joint payee in the case of a joint account) makes a withdrawal from an account described in paragraph (a)(2) of this section during the 60-day period. In order to qualify for the exemption, the payee must comply with paragraph (d) of this section which requires the payee to provide the payor a certification signed under penalties of perjury (an "awaiting-TIN certificate"). The payor must withhold under section 3406 from 60 days after the date that the payor receives an "awaiting-TIN certificate" described in paragraph (d) of this section if the payor has not received a taxpayer identification number from the payee in the manner required in §31.3406(d)-1 by that date. Regardless of whether the payee provides an awaiting-TIN certificate to a payor, the payor is required to withhold on reportable interest or dividend payments as described in §31.3406(d)-2 if the payee fails to certify, under penalties of perjury, that the payee is not subject to backup withholding due to notified payee underreporting as required in §31.3406(d)-2.

(2) *Withholding during 60-day period on accounts paying reportable interest or dividends*—(i) *Effective for awaiting-TIN certificates received after December 31, 1987, and before July 1, 1988.* A payor is required to withhold on reportable interest and dividend payments made during the 60-day period after the receipt of an awaiting-TIN certificate (which receipt occurs after December 31, 1987, and before July 1, 1988) if the payee made a withdrawal from the account after the close of 7 business days after the date the awaiting-TIN certificate is received and before the earlier of—

(A) The date that the payor receives a certified Form W-9 from the payee or an acceptable substitute form,

(B) The date the account is closed, or

(C) After the expiration of the 60-day exemption period when backup withholding applies.

For purposes of this paragraph (a)(2), a payor is also required to backup withhold on any reportable interest or dividend payment made at the time the account or relationship is closed or at a time of the sale or redemption of an instrument. For purposes of this paragraph (a)(2), all cash withdrawals, in an amount up to the reportable payments, made from the day after the date of receipt of an awaiting-TIN certificate to the date of withdrawal are treated as reportable payments.

(ii) *Effective for awaiting-TIN certificates received on or after July 1, 1988.* On a payee-by-payee basis or in general, a payor may withhold on reportable interest or dividends—

(A) As described in paragraph (a)(2)(i) of this section, or

(B) As described in such paragraph but limiting the definition of cash to currency or a check issued to close out the account of a payee (For purposes of this paragraph (a)(2)(ii)-(B) the term does not include a cash disbursement from an automatic teller machine or an electronic transfer.), or

(C) On the account no later than 7 business days after the date that the payor receives the awaiting-TIN-certification on reportable interest and dividend payments thereafter made to the account whether or not the payee makes a cash withdrawal and before the earliest of—

(*1*) The date that the payor receives a certified Form W-9 from the payee or an acceptable substitute form,

(*2*) The date the account is closed, or

(*3*) After the expiration of the 60-day exemption period when backup withholding applies.

Effective August 16, 1988, a payor who has elected to withhold under paragraph (a)(2)(ii)(C) of this section must refund the amounts withheld during the 60-day period in accordance with and to the extent permitted by the procedures described in §31.6413(a)-3 if the payor receives the certified taxpayer identification number from the payee on or after August 16, 1988, and within the 60-day period provided that the payee is not subject to backup withholding under section 3406(a)(1)(C) or (D) during any part of such period. For purposes of the preceding sentence, amounts withheld are deemed to be withheld erroneously as described in §31.6413(a)-3. If a certified taxpayer identification number is not received by the payor within the 60-day period, the amounts withheld shall not be refunded unless the amounts are erroneously withheld without regard to paragraph (a)(2)(ii)(C) of this section. The payor is also required to backup withhold after the 60-day period until a certified taxpayer identification number is received from the payee or the account is closed.

(b) *Special rule for readily tradable instruments.* The 60-day awaiting-TIN exemption described in paragraph (a)(1) of this section applies to payments made with respect to readily tradable instruments only if the payee provides an awaiting-TIN certificate directly to the payor. Thus, the payee does not qualify for the exemption by providing an awaiting-TIN certificate to a broker who effects a purchase of a readily tradable instrument for a payee (unless the instrument is held in street name). If a broker acquires a readily tradable instrument through a post-1983 brokerage account (as described in §31.3406(d)-1(c)(2)) for a payee who has no taxpayer identification number, the broker must advise the payor as required in §31.3406(d)-4(a)(1) that the payee failed to provide a taxpayer identification number under penalties of perjury, regardless of whether the payee provides an awaiting-TIN certificate to the broker. Once a payor is notified by a broker that a payee failed to provide a taxpayer identification number in the required manner, or that the payee is subject to backup withholding under section 3406(a)(1)(B) or (C), the payor must impose backup withholding for the appropriate period described in §31.3406(e)-1.

(c) *Exceptions*—(1) *In general.* The 60-day awaiting-TIN exemption described in paragraph (a) of this section does not apply to—

(i) Window transactions (as defined in §31.3406(b)(2)-3(b)),

(ii) Redemptions of bearer obligations that are subject to reporting under section 6045 after September 27, 1990), or

(iii) Other amounts that are subject to reporting under section 6045 (except as described in paragraph (c)(2) of this section).

(2) *Special rule for amounts subject to reporting under section 6045 other than proceeds of redemptions of bearer obligations.* In any case in which a broker's customer does not provide a taxpayer identification number to the broker and the broker effects a sale that is subject to reporting under section 6045 (other than a redemption of a bearer obligation), §31.3406(d)-3(b)(1) shall apply, whether or not the sale is pursuant to a telephone or wire instruction, if the customer provides an awaiting-TIN certificate to the broker before the sale, except that the 30-day period provided in §31.3406(d)-3(b)(1) shall be a 60-day period.

(d) *Awaiting-TIN certificate.* A payee qualifies for the 60-day awaiting-TIN exemption provided in paragraph (a) of this section if the payee furnishes a written statement to the payor, signed under penalties of perjury, that the payee has not been issued a taxpayer identification number, that the payee has applied for a taxpayer identification number or intends to apply for a number in the near future, and that the payee understands that if the payee does not provide a number to the payor within 60 days, the payor is required to withhold 20 percent of any reportable payment thereafter made to the payee until the payor receives a number, or 20 percent of any withdrawal to the extent of reportable payments made to the payee during the 60-day period, as described in paragraph (a)(2) of this section. Language that is substantially similar to the following will satisfy the requirements of this paragraph: "I certify, under penalties of perjury, that a taxpayer identification number has not been issued to me, and that I mailed or delivered an application to receive a taxpayer identification number to the appropriate Internal Revenue Service Center or Social Security Administration Office (or I intend to mail or deliver an application in the near future). I understand that if I do not provide a taxpayer identification number to the payor within 60 days, the payor is required to withhold 20 percent of all reportable payments thereafter made to me or 20 percent of any withdrawal to the extent of reportable payments made to me during the 60 day period, until I provide a number."

(e) Form for awaiting-TIN certificate. A payor may use Form W-9 for the awaiting-TIN certificate, or a payor may include the language described in paragraph (d) of this section on any other document for the awaiting-TIN certification. See §31.3406(h)-3 which provides that Form W-9 is the prescribed form but permits use of substitute forms, and specifies how long the payor is required to retain the form. If Form W-9 is used, the payee should write "Applied For" in the space reserved for the taxpayer identification number.

(f) *Examples.* The application of the provisions of this section may be illustrated by the following examples:

Example (1). Individual A opens a new account at Bank M on January 7, 1984, that pays reportable interest. A furnishes an awaiting-TIN certificate to M on January 7 (the date that he opened the account) and A also certifies, under penalties of perjury, that

he is not subject to backup withholding due to notified payee underreporting as required in §31.3406(d)-2(a). M treats the awaiting-TIN certificate as though received on such date as permitted in §31.3406(e)-1(b). If M does not receive a taxpayer identification number from A within 60 days (March 7), M is required to withhold on payments made to A on or after such date until M receives a taxpayer identification number from A in the manner required in §31.3406(d)-1.

Example (2). Assume the same facts as in *Example (1)* except that A does not certify, under penalties of perjury, that he is not subject to backup withholding due to notified payee underreporting as required in §31.3406(d)-2(a). Notwithstanding that A provided an awaiting-TIN certificate to M, M is required to withhold because A failed to make the payee certification required in §31.3406(d)-2(a).

Example (3). Individual B establishes a brokerage relationship with Broker O that is not a post-1983 brokerage account (as described in §31.3406(d)-1(c)(1)). B has never furnished his social security number to O. No reportable payments have been made with respect to any instruments in B's brokerage account until August 13, 1984, when B instructs O to sell stock of Z Corporation for $30,000. On that date B states that he is awaiting receipt of a social security number. Under paragraph (c)(2) of this section, B will be exempt from backup withholding for a 60-day period provided O receives an awaiting-TIN certificate from B (as described in paragraph (d) of this section). O receives B's awaiting-TIN certificate on August 13, 1984, as permitted in §31.3406(e)-1(b). If B desires to withdraw or reinvest more than 80 percent of the proceeds of the sale (i.e., $24,000) during the 60 days after the sale and before B certifies under penalties of perjury that his social security number furnished to O is correct, O is required to withhold 20 percent of the reportable gross proceeds on the date of withdrawal. (See §31.3406(d)-3(b) for whether reinvestment will be considered a withdrawal.)

Example (4). Assume the same facts as in *Example (3)* except that, on October 12, 1984, B instructs O to send him a check for $10,000. Under paragraph (c)(2) of this section, B is exempt from withholding from August 13 to October 13 (60 days) provided B does not withdraw or reinvest more than 80 percent of the gross sale proceeds. Because B has not withdrawn more than 80 percent of the gross proceeds, O may not withhold on October 12 when B withdraws $10,000 (as provided in paragraph (a) of this section).

Example (5). Assume the same facts as in *Example (4)* except that, on September 12, 1984, B instructs O to reinvest all the gross proceeds of the sale in stock of R Corporation. Under §31.3406(d)-3(b) the reinvestment is considered a withdrawal. Because B has not furnished his social security number certified under penalties of perjury before withdrawing more than 80 percent of the gross proceeds, O is required to withhold $6,000 (*i.e.*, 20 percent of $30,000) on October 12 (the date of withdrawal) even though within the 60-day exemption period described in paragraph (a) of this section.

Example (6). Individual C presents a taxable interest coupon on a corporate bond to Bank P after December 31, 1983. The payment is defined as a window transaction in §31.3406(b)(2)-3(b). C furnishes an awaiting-TIN certificate to P at the time of the transaction. Under paragraph (c) of this section, the 60-day awaiting-TIN exemption does not apply with respect to the window transaction. Thus, P is required to withhold 20 percent of the payment made to C.

Example (7). Partnership D instructs Broker N to purchase Corporation Y's debentures on April 15 and instructs N to have them registered in D's name. Stated interest on the debentures will be paid on June 30 and December 31. D provides N on April 15 an awaiting-TIN certificate and certification that it is not subject to backup withholding due to notified payee underreporting. Under §31.3406(d)-4(a) and paragraph (b) of this section, N is required to notify Y that D failed to furnish a taxpayer identification number. If Y does not receive either a taxpayer identification number in the manner required by §31.3406(d)-1 or an awaiting-TIN certificate directly from D by June 30, Y is required to withhold 20 percent of the payment made on June 30.

Example (8). Assume the same facts as in *Example (7)* except that Y receives an awaiting-TIN certificate directly from D on May 1. Y must not withhold on June 30 because reportable payments made to D with respect to the instrument are exempt from backup withholding during the period from May 1 to June 30 (60 days). If Y does not receive a taxpayer identification number in the manner required by §31.3406(d)-1 from D after June 30 and before December 31, however, Y is required to withhold 20 percent of the payment made on December 31.

§31.3406(h)-1 Definitions.

(a) *Taxpayer identification number*—(1) *In general.* The term "taxpayer identification number" shall mean the identifying number assigned to a person under section 6109 (relating to identifying numbers). Thus, the number for an individual is generally his social security number and the number for a corporation, estate, trust, or partnership is generally an employer identification number. The proper number of digits is nine for both the social security number and the employer identification number. An obviously incorrect number shall not be considered to be a taxpayer identification number. Thus, a payor shall treat the payee as having failed to furnish a taxpayer identification number if the payee furnishes an obviously incorrect number. See §§31.6011(b)-2 and 301.6109-1 for provisions relating to obtaining a taxpayer identification number.

(2) *Obviously incorrect number.* The term "obviously incorrect number" means a number that does not contain nine digits or a number that includes an alpha character as one of the nine digits.

(b) *Examples.* The application of the provisions of paragraph (a) of this section may be illustrated by the following examples:

Example (1). Individual A provides Bank O with a social security number as 605-62-599. The number provided by A, because it does not contain nine digits, is an obviously incorrect number. Consequently, A is treated as not furnishing a taxpayer identification number.

Example (2). Individual B provides Bank P with a social security number as 605-6W-6599. The number provided by B, because it contains an alpha character, is an obviously incorrect number. Consequently, B is treated as not furnishing a taxpayer identification number.

Example (3). Partnership X provides its employer identification number as 12-2764. The number provided by X, because it does not contain nine digits, is an obviously incorrect number. Consequently, X is treated as not furnishing its taxpayer identification number.

Example (4). Individual C provides Bank Q with a social security number as lll-ll-llll. The number provided by C, because it contains nine digits, is not an obviously incorrect number. Consequently, C is treated as furnishing a taxpayer identification number.

Example (5). Company Y provides Bank P with a employer identification number as 12-3456789. The number provided by Y, because it contains nine digits, is not an obviously incorrect number. Consequently, Y is treated as furnishing its taxpayer identification number.

(c) *Broker.* The term "broker" shall have the meaning given to such term by section 6045(c)(1) and §1.6045-1(a)(1). If there could be more than one broker with respect to any acquisition, only the broker having the closest contact with the payee shall be treated as a broker. The rules of §5f.6045-1(c)(3)(ii) and (iii) shall apply to determine the broker with the closest contact with the payee. In the case of any instrument, the term "broker" shall not include any person who is the payor with respect to such instrument as described in §31.3406(a)-2.

(d) *Readily tradable instrument.* The term "readily tradable instrument" means—

(1) Any instrument which is part of an issue any portion of which is traded on an established securities market (within the meaning of section 453(f)(5)), or

(2) Any instrument which is regularly quoted by brokers or dealers making a market.

Thus, the term may include, but is not limited to, bonds, debentures, notes, certificates, and other evidences of indebtedness regardless of how denominated, repurchase agreements, stocks, shares in a mutual fund, United States government securities, State and local government obligations, and deposits with persons carrying on

the banking business and persons that are mutual savings banks, cooperative banks, building and loan associations, homestead associations, credit unions, or similar organizations.

§31.3406(h)-2 Special rules.

(a) *Special rule for joint payees—*(1) *In general.* Except as provided in paragraph (a)(2) of this section, for purposes of information reporting and backup withholding, any payment made to joint payees shall be treated as if the entire payment were made to the first person listed on the account or instrument giving rise to the payment. Therefore, except as provided in paragraph (a)(2) of this section, for purposes of information reporting and backup withholding, the taxpayer identification number that is required to be furnished is the number for the first person listed on the account or instrument. However, if the payor knows that the first person listed on the account is not the owner of the account for tax purposes and the payor does not treat such payee as the owner of the account, then the taxpayer identification number required to be provided is that of the owner (identified by the payor) listed on the account even though such owner is not listed first on that account. The requirement to provide the taxpayer identification number of the actual owner (as described in the immediately preceding sentence) is effective for accounts for which backup withholding under this section would begin [DATE THAT IS 60 DAYS AFTER THIS DOCUMENT IS PUBLISHED AS A TREASURY DECISION].

Payors are required to withhold on joint accounts if the payee subject to backup withholding is the first person listed on the account at the time the payor determines that the payee is required to provide a taxpayer identification number on the certificates described in §31.3406(d)-2 to the payor and in the case where the payor is notified under section 3406(a)(1)(B) or (C), if the payee is the first person on the account at the time of such notification. Thus, for example, if the first person listed on the account or instrument does not provide a taxpayer identification number to the payor in the manner required in §31.3406(d)-1, the payor shall withhold 20 percent of the payment under section 3406. A payor is required to withhold even if the order of the names on the account is subsequently changed, provided the name of the payee subject to backup withholding remains on the account.

(2) *Special rule with respect to joint foreign payees.* If the first payee listed on an account or instrument provides the penalties of perjury statement as to its foreign status (as described in §1.6049-5(g) with respect to interest and original issue discount and §1.6045-1(g)(3)(i) with respect to brokers), backup withholding shall apply unless—

(i) Every joint payee provides the statement as to foreign status, or

(ii) Any one of the joint payees who has not established foreign status provides a taxpayer identification number to the payor in the manner required in §31.3406(d)-1.

If any one of the joint payees who has not established foreign status provides a taxpayer identification number under paragraph (a)(2)(ii), such number is the taxpayer identification number that is required to be furnished for purposes of information reporting and backup withholding.

(3) *Examples.* The application of the provisions of paragraph (a) of this section may be illustrated by the following examples:

Example (1). G and H, United States citizens, jointly own an instrument of Corporation X. G is the first person listed on the account giving rise to the payment and does not provide a taxpayer identification number to X. X is required to withhold 20 percent of any reportable payment with respect to such instrument even if H provided a taxpayer identification number in the manner required in §31.3406(d)-1 to X.

Example (2). Assume the same facts as in *Example (1)* except that G is a foreign person and provides a written certification to that effect on Form W-8. In order for backup withholding not to apply to the jointly held instrument, X must receive H's taxpayer identification number or awaiting-TIN certification.

(b) *Withholding from an alternative source*—(1) *In general.* Except with respect to a payment in property (as described in paragraph (b)(2) of this section) or a barter exchange (as described in paragraph (b)(3) of this section), a payor may not withhold from a source maintained by the payor other than the source with respect to which there exists a liability to withhold with respect to the payee. See section 3403 and §31.3403-1 that provides that the payor is liable for the amount required to be withheld regardless of whether the payor withholds.

(2) *Payments made in property.* (i) In the case of a payment that is made in property (other than money), the payor is required under section 3406 to withhold 20 percent of the fair market value of the property determined immediately before or on the date of payment. The payor may withhold from the principal amount being deposited with the payor, or the payor may withhold from another source maintained by the payee with the payor. The source from which the tax is withheld must be payable to at least one of the persons listed on the account subject to backup withholding. If the account or source is not payable to, and only to, the same person or persons listed on the account subject to backup withholding, then the payor must obtain a written statement from all other persons to whom the account or source is payable authorizing the payor to withhold from the alternative account or source. A payor that elects to withhold from an alternative source may determine the account or source from which the tax is to be withheld, or, in its discretion, the payor may allow the payee to designate the alternative source. However, a payee may not require a payor to withhold from a specific alternative source.

(ii) If the payor cannot locate, using reasonable care, an alternative source of cash out of which the payor may satisfy its withholding obligation pursuant to paragraph (b)(2)(i) of this section, the payor may elect to defer its obligation to withhold until the payor makes a cash payment to the account subject to backup withholding or cash is otherwise deposited in the account. For purposes of this paragraph (b)(2)(ii), a payor is considered to exercise reasonable care in locating an alternative source of cash if the payor follows procedures substantially similar to those set forth in §31.3406(d)-5(b)(5)(i)(A) and (B). This paragraph (b)(2)(ii) does not apply to reportable payments of property made in connection with prizes, awards, or gambling winnings.

(3) *Barter exchanges.* In the case of a barter exchange that issues scrip to, or credits the account of, a member or client of the exchange in payment for property or services, the barter

exchange may withhold from the credit or scrip, or, alternatively, the barter exchange may withhold from any other source maintained by the exchange for the member or client. If the barter exchange elects to withhold from the credit or scrip, such credit or scrip must be converted to cash in order to satisfy the deposit requirements of section 6302 and §31.6302(c)-1(a)(1). In the case of a barter exchange that does not provide for payment for property or services by means of a credit on the books of the barter exchange or scrip issued by the barter exchange, the barter exchange may withhold from an alternative source in the manner described in paragraph (b)(1) of this section.

(4) *Examples.* The application of the provisions of paragraph (b) of this section may be illustrated by the following examples:

Example (1). Individuals A and B maintain a joint checking account at Bank M. A also maintains a savings account at M. Payments to A are subject to backup withholding under section 3406. On December 31, 1984, M credits A's savings account with a $50 interest payment. Because the payment giving rise to the liability to withhold was not made in property, M may not withhold the tax imposed by section 3406 on the amount credited to A's savings account from A's and B's joint checking account. M is liable under section 3403 and §31.3403-1 for the tax required to be withheld from the savings account under section 3406 regardless of whether M withholds from accounts maintained by A.

Example (2). Individual C opens an interest-bearing savings account in 1984 at Bank N with respect to which C will receive property in lieu of interest. C has a joint checking account at N with Individual D. C and D are not foreign persons. C is the first person listed on the checking account. When C opens the interest-bearing savings account and receives the property, C fails to certify that his taxpayer identification number is correct or that he is not subject to backup withholding due to notified payee underreporting. N is required to withhold under section 3406 at the time the reportable payment is made to C (*i.e.*, the time that N pays C the "interest" as described in §31.3406(a)-2(a)). N may elect to withhold the tax from the principal C has deposited with N in the interest-bearing savings account, or N may elect to withhold the tax imposed by section 3406 from C's and D's joint checking account, provided that N obtains a written statement from D permitting N to withhold the tax from C's and D's joint checking account. N is liable under section 3403 and §31.3403-1 for the tax required to be withheld under section 3406 regardless of whether N withholds.

Example (3). Broker O provides a payment of property as a dividend to Individual D whose stock has been borrowed in connection with a short sale. D does not provide O with a social security number. O may elect to withhold the tax imposed by section 3406 by creating a liability on the margin account that D maintains with O, or O may withhold from any alternative source D maintains with O. O is liable under section 3403 and §31.3403-1 for the tax required to be withheld under section 3406 regardless of whether O withholds.

Example (4). Corporation E, a member of Barter Exchange P, provides goods for another member of P and receives a credit on the books of P for such goods. During the same calendar year, members of P engage in over 100 similar barter transactions. Consequently, P is required to make an information return (Form 1099-B) with respect to the transaction engaged in by E. Corporation E fails to provide its taxpayer identification number to P. See §§1.6045-1(e) and 31.3406(g)-1(a) which provides that corporate members of barter exchanges are not exempt from backup withholding. Accordingly, P is required to withhold 20 percent of the fair market value of the credit received by E. P may elect to withhold from the credit or from any alternative source maintained by P for E. If P elects to withhold on the credit, the credit must be converted to cash. P is liable under section 3403 and §31.3403-1 for the tax required to be withheld under section 3406 regardless of whether P withholds.

Example (5). Individual F, an independent travel agent, receives an airline ticket as an award for performing nonemployee services for Company X. F is not an employee of X as defined in section 3121(d). X is required to make an information return under section 6041 showing the fair market value of the airline ticket under §1.6041-1(d)(3) and (e). F does not furnish a social security number to X. Because the reportable payment is made in property, X may elect to withhold from an alternative source with F under paragraph (b)(1) of this section. X is liable under section 3403 and §31.3403-1 for the tax required to be withheld under section 3406 regardless of whether X withholds. If F does not maintain another account with X, X may withhold by reducing the amount of the award by the 20 percent tax required to be withheld.

(c) *Special rules for trusts*—(1) *In general.* Backup withholding shall apply to a payment to a trust if any of the conditions for imposing backup withholding apply to the trust. Generally, a trust is not a payor. Therefore, except as provided in paragraph (3) of this section, a trust will not be required to withhold on reportable payments that the trust makes to a beneficiary who is subject to backup withholding. In addition, the trustee of a trust may certify that the trust's taxpayer identification number is correct and that the trust is not subject to backup withholding due to notified payee underreporting, without regard to the status of the individual beneficiaries of the trust.

(2) *Grantor trusts with ten or fewer grantors.* Backup withholding will apply to a reportable payment to a grantor trust with ten or fewer grantors that was established on or after January 1, 1984, if one of the conditions for imposing backup withholding exists with respect to the trust. The trustee of a grantor trust with ten or fewer grantors may not certify either that the trust is not subject to backup withholding due to notified payee underreporting or that the trust's taxpayer identification number provided by the trustee is correct unless each grantor has furnished the trustee with certifications, signed under penalties of perjury, that the grantor is not subject to backup withholding due to notified payee underreporting and that the grantor's taxpayer identification number provided to the trustee is correct, and the trustee uses such taxpayer identification numbers provided by the grantors on the Form 1041 that is filed by the trustee pursuant to section 671. A trustee of a grantor trust with ten or fewer grantors is not considered a payor as provided in §31.3406(a)-2(a). Therefore, distributions by the trust of amounts to beneficiaries will not be considered payments of reportable amounts subject to backup withholding.

(3) *Grantor trust with more than ten grantors.* Trustees of a grantor trust with more than ten grantors are considered payors of reportable payments received by such trust for purposes of backup withholding. Payments of all reportable amounts (except gross proceeds reportable under section 6045) made to such trust are considered payments of the same kind made by the trust, as payor, to each grantor, as payee, in proportion to each grantor's ownership of the trust. Each grantor of such a trust is treated as having received his or her proportionate share of the reportable payment on the day the payment is received by the trust. Accordingly, any reportable payment made to the trust is treated as a reportable payment made by the trust to the grantor or grantors and is subject to backup withholding if one of the conditions specified in paragraph (d) of this section exists with respect to a grantor. If the reportable amount of the distribution is greater than the amount distributed, the trustee may, in its discretion, withhold on the entire reportable amount.

(d) *Conditions for a trustee of a grantor trust with ten or more grantors to impose backup withholding.* The trustee is required to withhold under section 3406 on the amount of

any reportable payment (except gross proceeds reportable under section 6045) received by a trust attributable to a grantor if—

(1) The grantor fails to provide a taxpayer identification number to the trustee in the manner required in §31.3406(d)-1,

(2) The grantor fails to certify to the trustee with respect to reportable interest or dividend payments (as defined in §31.3406(b)(1)-1(b)) that he is not subject to backup withholding due to notified payee underreporting when required under §31.3406(d)-2,

(3) The trustee is required to impose backup withholding under the rules applicable to readily tradable instruments which were not purchased from the issuer and are not held in "street name" by a broker, or

(4) The Internal Revenue Service notifies the trustee that the grantor provided an incorrect taxpayer identification number or that the grantor is subject to backup withholding due to notified payee underreporting.

The trustee of a grantor trust having more than ten grantors may certify that the trust's taxpayer identification number is correct and that the trust is not subject to backup withholding due to notified payee underreporting without regard to the status of, or certifications provided by, the grantors of the trust.

(e) *Examples.* The application of the provisions of paragraph (d) of this section may be illustrated by the following examples:

Example (1). Grantor Trust R has 100 grantors. R holds debentures of Corporation X that will pay stated interest. M is the trustee. A, one grantor of the trust, fails to provide the required certification to M that A's taxpayer identification number is correct and that A is not subject to backup withholding due to notified payee underreporting. Even though an individual grantor of the trust has failed to make the required certification, M certifies to X as described in paragraph (d) of this section as to R's taxpayer identification number and that R is not subject to backup withholding due to notified payee underreporting. X pays $100,000 of interest to R on July 1, 1984, and does not withhold. On September 30, 1984, M distributes $900 to each grantor (after deducting certain expenses). On September 30, 1984, M is required to withhold 20 percent of the $900 payment to A and any other grantor who is subject to backup withholding. M may withhold 20 percent of the amount reportable ($1,000).

Example (2). Assume the same facts in *Example (1)* except that R is a trust with 10 or fewer grantors. Under paragraph (c)(2) of this section, M may not certify that R's taxpayer identification number is correct or that the trust is not subject to backup withholding due to notified payee underreporting because the trustee has not received such certification from each grantor. Thus, X is required to withhold 20 percent of $100,000 payment on July 1, 1984. Because R has 10 or fewer grantors, R is not a payor under §31.3406(a)-2, and M is not required to impose backup withholding on payments to A or any other grantor.

Example (3). Grantor Trust S is an oil royalty trust with 100 grantors. N is the trustee of the trust and B, a grantor of the trust, fails to furnish B's taxpayer identification number to N. On August 1, 1987, S receives a $1,000,000 oil royalty payment from X, an oil producer, subject to reporting under section 6050N. X does not withhold on the payment because N provided a taxpayer identification number to X. N distributes $8,000 to each grantor on December 31, 1984 (after deducting certain production-related taxes and expenses). On December 31, 1987, N is required to withhold 20 percent of the $8,000 payment made to B and to any other grantor who does not provide a taxpayer identification number to N.

Example (4). Trust T has 50 beneficiaries none of whom are grantors. Trust T maintains a savings account with Bank O that pays reportable interest. T has provided its taxpayer identification number to O. On August 16, 1987, Bank O makes a reportable interest payment to T. T has no information reporting obligation with respect to the interest it distributes to its beneficiaries because T is not a payor as described in §31.3406(a)-2.

(f) *Adjustment of prior withholding by middlemen*—(1) *In general.* A middleman payor (as defined in §31.3406(a)-2(b)) who receives a payment from which tax has been erroneously withheld under section 3406 may seek a refund of the tax withheld by the payor from whom the middleman payor received the payment (referred to as the "upstream payor"). Alternatively, the middleman payor may obtain a refund of the tax by claiming a credit for the amount of tax withheld by the upstream payor against the deposit of any tax imposed by this chapter which the middleman payor is required to withhold and deposit (as described in section 6413 and §31.6413(a)-2). In either case, the middleman payor shall pay or credit the gross amount of the payment (including the tax withheld) to its payee as though it had received the gross amount of the payment from the upstream payor and shall withhold the tax imposed by section 3406 only if one of the conditions for imposing backup withholding exists with respect to its payee. If its payee is not subject to backup withholding under section 3406, the middleman payor shall pay or credit the full amount of the payment to the payee. See §31.6413(a)-3 regarding repayment by a payor of tax erroneously collected from a payee.

(2) *Example.* The application of the provisions of this paragraph (f) may be illustrated by the following example:

Example. Broker M holds stock in Corporation N in "street name" for Individual A, who is not subject to backup withholding. M does not certify to N that M is not subject to backup withholding under section 3406 as N requires in order to treat M as an exempt recipient. Accordingly, N withholds 20 percent of its dividend payment to M. Rather than seek a refund of the erroneously withheld tax from N, M elects to credit the amount of tax withheld by N against any tax that M is required to withhold and deposit under section 6413 and §31.6413(a)-2. Because A is not subject to backup withholding under section 3406, M pays the gross amount of the dividend payment to A.

(g) *Conversion of amounts paid in foreign currency into United States dollars*—(1) *Convertible foreign currency.* In the event that an amount is paid in convertible foreign currency, the amount shall be converted into United States dollars and the amount subject to withholding under section 3406 shall be computed on *that* amount expressed in United States dollars as of the date of the payment or crediting. The amount withheld shall be deposited in United States dollars. For purposes of this paragraph (g)(1), the term "convertible foreign currency" means currency of a foreign country that either is readily convertible into United States dollars or, effective from the date specified in a rule-related notice published in the Federal Register, is of a type the Secretary determines is to be treated as convertible foreign currency.

(2) *Nonconvertible foreign currency.* [Reserved]

(h) *Coordination with other sections.* For purposes of section 31, chapter 24 (other than section 3402(n)) of subtitle C of the Code (relating to employment taxes and collection of income tax at source) and so much of subtitle F (other than section 7205) of the Code (relating to procedure and administration) as relates to this chapter, and the regulations thereunder—

(1) An amount required to be withheld under section 3406 shall be treated as a tax required to be withheld under section 3402;

(2) An amount withheld under section 3406 shall be treated as an

amount withheld under section 3402. Thus, an amount withheld under section 3406 shall be allowed to the payee of a reportable payment as a credit under section 31 against the tax imposed by subtitle A of the Code;

(3) The term "wages" includes the gross amount of any reportable payment (as defined in §31.3406(b)(1)-1)) except for purposes of section 6014 (relating to election by the taxpayer not to compute the tax on his annual return);

(4) The term "employer" includes a payor who is required to withhold the tax under section 3406 (as defined in §31.3406(a)-2(a)) with respect to any reportable payment (as defined in §31.3406(b)(1)-1);

(5) The term "employee" includes a payee of any reportable payment; and

(6) The term "payroll period" includes the period described in §31.3406(e)-1 during which the payor is required to withhold the tax imposed by section 3406.

Thus, the general procedures for withholding, deposit, payment, and reporting of Federal tax withheld shall apply to reportable payments and amounts withheld under section 3406. For example, section 6205 provides that an employer (payor) who makes an undercollection of income tax required to be withheld shall correct such error for the return period in which the undercollection is discovered. Section 6205 thus requires a payor to withhold amounts from subsequent payments to a payee that should have been withheld from prior payments, whether or not the subsequent payments are subject to backup withholding under section 3406. Accordingly, a payor who does not impose backup withholding under section 3406 when required must withhold from a subsequent payment to the payee even though the conditions for imposing backup withholding may not exist at the time the subsequent payment is made to the payee. See §31.6302(c)-1 for the rules relating to the timing for depositing withheld amounts.

(i) *Penalties.* A payor is subject to the same penalties for failing to impose backup withholding under section 3406 as an employer making a payment of wages. Consequently, under section 3403 and §31.3403-1, a payor is liable for the tax required to be withheld whether or not the payor withholds the tax from a payee who is subject to backup withholding. A payor may be relieved of liability for an amount that was required to be withheld if the payor proves that the tax has been paid by the payee, as provided in section 3402(d) and §31.3402(d)-1. The fact that a payor may be relieved of the liability for an amount that was required to be withheld will not relieve the payor of liability for any civil or criminal penalty. Additionally, a payor may be subject to civil and criminal penalties, including penalties under section 6651 (addition to the tax for failure to file certain tax returns and to pay any tax), section 6721 (failure to file certain information returns), section 6656 (failure to make deposit of taxes), section 6672 (failure to collect and pay over tax), section 6676 (failure to supply identifying numbers), section 6722 (failure to furnish certain statements), 6682 (false information with respect to withholding), section 7201 (willfully attempting to evade or defeat any tax or the payment of any tax), section 7202 (willful failure to collect or pay over any tax), section 7203 (willful failure to pay tax), section 7206(2) (aid or assistance of fraud or false statement), section 7207 (fraudulent returns, statements, or other documents), and section 7215 (offenses with respect to collected taxes). In addition, a broker is subject to the penalty under section 6705 (failure of a broker to provide notice to a payor).

(j) *To whom payor is liable for amount withheld.* The payor is not liable to any person for any withheld amount under section 3406. The payor shall be liable only to the United States for an amount that was required to be withheld as provided in §313403-1.

§31.3406(h)-3 Certificates.

(a) *Prescribed form to furnish information under penalties of perjury.* Except as provided in paragraph (c) of this section, Form W-9 is the form prescribed under section 3406 on which the payee may certify, under penalties of perjury, that—

(1) The taxpayer identification number furnished to the payor is correct (as required in §31.3406(d)-1 and §31.3406(d)-5),

(2) The payee is not subject to backup withholding due to notified payee underreporting (as required in §31.3406(d)-2), (3) The payee is an exempt recipient (as described in §31.3406(g)-1), or (4) The payee is awaiting receipt of a taxpayer identification number (as described in §31.3406(g)-3).

The Form W-9 shall be prepared in accordance with the instructions applicable thereto and shall set forth fully and clearly the data called for therein. A valid Form W-9 shall include the name, address, and taxpayer identification number of the payee. An obviously incorrect number shall not be considered to be a taxpayer identification number (see §31.3406(h)-1(a)). Except as provided in paragraph (b) of this section, the payee must sign under penalties of perjury and date Form W-9 in order to satisfy the requirements of this section. Blank copies of Form W-9 will be supplied to payors, payees, and brokers upon request to the district director. A payor or broker may require a payee to furnish a separate Form W-9 for each obligation, deposit, certificate, share, membership, contract, or other instrument. Alternatively, a payor or broker may require a payee to furnish one Form W-9 for all the payee's obligations or relationships with the payor or broker. For example, a bank may permit a payee to file one Form W-9 for all savings, interest-bearing checking, or other accounts the payee has with the bank. In addition, a payee of a mutual fund that has a common investment advisor or common principal underwriter with other mutual funds may be permitted, in the discretion of the mutual fund, to provide one Form W-9 with respect to shares acquired or owned in any of the funds.

(b) *Prescribed form to furnish a noncertified taxpayer identification number.* With respect to accounts or other relationships where the payee is not required to certify, under penalties of perjury, that the taxpayer identification number being furnished is correct, the payor or broker may use Form W-9 or a substitute form, but the payee is not required to sign the form. Alternatively, the payor or broker may use any other document or may obtain the taxpayer identification number orally.

(c) *Forms prepared by payors or brokers*—(1) *Substitute forms; in general.* A payor or broker may prepare and use a form that contains provisions which are substantially similar to those of the official Form W-9 as described in paragraph (c)(2) and (3) of this section. A payor or broker may use any document relating to the transaction, such as the signature card for an account, so long as the certifications are clearly set forth. A payor or broker who uses a substitute form may furnish orally or in writing the instructions for Form W-9 that relate to the account. A payor or broker may refuse to accept certifications (including the official Form W-9) that are not made on the form or forms provided by the payor or broker. A payor or broker may refuse to accept a certification provided by a payee only if the payor or broker furnishes the payee with an acceptable form immediately upon receipt of an unacceptable form or within 5 business days of receipt of an unacceptable form. An acceptable form for this purpose must contain a notice that the payor or broker has refused to accept the form submitted by the payee and that the payee must submit the acceptable form provided by the payor in order for the payee not to be subject to backup withholding. If the payor or broker requires the payee to furnish a form for each account of the payee, the payor or broker is not required to furnish an acceptable form until the payee furnishes the payor or broker with the payee's account numbers. A payor or broker may use separate substitute forms to have a payee certify under penalties of perjury that—

(i) The payee's taxpayer identification number is correct, and

(ii) The payee is not subject to backup withholding due to notified payee underreporting, provided the language is substantially similar to the language in paragraph (c)(2) and (3) of this section or paragraph (c)(4) of this section if the payor or broker uses a single substitute form for both certifications.

(2) *Taxpayer identification number.* A payor or broker may use a substitute form for the payee to certify, under penalties of perjury, that the taxpayer identification number being furnished is correct, provided the language of the certification is substantially similar to the following: "Under penalties of perjury, I certify that the taxpayer identification number furnished on this form is my correct taxpayer identification number."

(3) *Notified payee underreporting.* A payor or broker may use a substitute form for the payee to certify, under penalties of perjury, that such payee is not subject to backup withholding due to notified payee underreporting under section 3406(a)(1)(C), provided the language of the certification is substantially similar to the following: "Under penalties of perjury, I certify that I am not subject to backup withholding either because I have not been notified that I am subject to backup withholding as a result of a failure to report all interest or dividends, or because the Internal Revenue Service has notified me that I am no longer subject to backup withholding."

(4) *Substitute form for both certifications.* A payor or broker may use a substitute form for both certifications described in paragraph (c)(2) and (3) of this section, provided the language of the certification is substantially similar to the following: "Under penalties of perjury, I certify that the taxpayer identification number shown on this form is my correct taxpayer identification number and that I am not subject to backup withholding either because I have not been notified that I am subject to backup withholding as a result of a failure to report all interest or dividends, or because the Internal Revenue Service has notified me that I am no longer subject to backup withholding." If a payor or broker uses a single substitute form for both certifications which does not follow the Form W-9 format, the substitute form must contain an instruction to the payee to strike out the language certifying that the payee is not subject to backup withholding due to notified payee underreporting if the payee has been notified that he or she is subject to backup withholding due to notified payee underreporting, and if the payee has not received a notice from the Internal Revenue Service advising the payee that backup withholding due to notified payee underreporting has terminated.

(5) *Form for exempt recipients.* A payor or broker may use a substitute form for the payee to certify, under penalties of perjury, that the payee is an exempt recipient (described in §31.3406(g)-1 or described in the respective reporting section), provided the form contains provisions that are substantially similar to those of the official Form W-9 relating to exempt recipients. A certificate shall be prepared in accordance with the instructions applicable to exempt recipients on Form W-9, and shall set forth fully and clearly the data called for therein. If a payor will treat the payee as an exempt recipient only if the payee files a certificate as to its exempt status, the certificate is valid only if it contains the payee's taxpayer identification number. Thus, a payee must include his taxpayer identification number on a certificate that a payor requires to be made in order to treat the payee as an exempt recipient.

(d) *Special rule for brokers.* A broker may act as the payee's agent for purposes of furnishing a taxpayer identification number or certification to a payor with respect to any readily tradable instrument (as defined in §31.3406(h)-1(d)) provided the payee provides a taxpayer identification number or Form W-9 or other acceptable substitute form to the broker. The payor may rely on a taxpayer identification number provided by the broker unless the broker notifies the payor that the number was not certified when certification is required (as described in §31.3406(d)-4).

(e) *Reasonable reliance on certificate.* A payor shall not be liable for the tax imposed under section 3406 if the payor's failure to deduct and withhold the tax is due to reasonable reliance on the taxpayer identification number provided by the payee or a broker which is in effect with respect to the payee at the time such tax is required to be deducted and withheld under section 3406. A payor or broker may reasonably rely on a Form W-9 or other acceptable substitute form only if the form contains a name and taxpayer identification number (or contains a name and states that the payee is awaiting receipt of a taxpayer identification number (*i.e.*, "an awaiting-TIN certificate") and is signed and dated by a payee. A payor or broker is not required to determine whether the statements made on the form are

true. Any deletion of the jurat or other similar provisions of the statement by which the payee certifies or affirms the correctness of the information contained on the form that relates to the payee means, however, that the form may not be reasonably relied upon by the payor or broker. If a payor or broker receives a form that cannot be reasonably relied upon, the payor or broker shall treat the payee as if no form were provided.

(f) *Who may sign the certificate*—(1) *In general.* A Form W-9 or other acceptable form may be signed by any person who is authorized to sign a declaration under penalties of perjury on behalf of the payee as provided in section 6061 and the regulations thereunder (relating to who may sign generally for an individual, which includes certain agents who may sign returns and other documents), section 6062 and the regulations thereunder (relating to who may sign corporate returns), and section 6063 and the regulations thereunder (relating to who may sign partnership returns).

(2) *Notified payee underreporting.* Any payee who has not been notified that he is subject to backup withholding as a result of notified payee underreporting can make the certification related to notified payee underreporting. In addition, a payee who was subject to backup withholding due to notified payee underreporting may certify that he is not subject to backup withholding due to notified payee underreporting if the Internal Revenue Service has provided the payee with written certification that backup withholding due to notified payee underreporting has terminated.

(g) *Retention of certificate*—(1) *Accounts or instruments that are not pre-1984 accounts and brokerage relationships that are post-1983 brokerage accounts.* With respect to an account or instrument that is not a pre-1984 account (as described in §31.3406(d)-1(b)(3)) or with respect to a brokerage relationship that is a post-1983 brokerage account (as described in §31.3406(d)-1(c)(2)), the payor or broker who receives a Form W-9 or other acceptable substitute form related to backup withholding shall retain the form in its records for the same period of time that the payor or broker retains other account-creation or instrument-purchase agreements. The form may be retained on microfilm or microfiche in accordance with any applicable revenue procedures.

(2) *Accounts or instruments that are pre-1984 accounts and brokerage relationships that are not post-1983 brokerage accounts.* With respect to a pre-1984 account (as described in §31.3406(d)-1(b)(1)) or with respect to a brokerage relationship that is not a post-1983 brokerage account (as described in §31.3406(d)-1(c)(1)), the payor or broker is not required to retain any Form W-9 or other acceptable substitute form on which—

(i) The payee has certified the correctness of the payee's taxpayer identification number,

(ii) The payee has certified that he is awaiting receipt of a taxpayer identification number ("an awaiting-TIN certificate" as described in §31.3406(g)-3), or

(iii) The payee has certified that the payee is an exempt recipient described in §31.3406(g)-1, provided the payor or broker can establish the existence of procedures that are reasonably calculated to ensure that a payee who has so certified is accurately identified in the payor's or broker's records. If, however, the payor or broker requires the payee to file only one Form W-9 or substitute form for all accounts or instruments of the payee, the payor or broker must retain the single form in the manner and for the period of time described in paragraph (g)(1) of this section if that form relates to any account or instrument that is not a pre-1984 account or relates to a post-1983 brokerage account.

§31.3406(i)-1 Transitional rules.

In general, the following transitional rules apply for the 1984 calendar year. In this connection, Question and answer 1 concerns certain payees of pre-1984 accounts or relationships who did not furnish a taxpayer identification number before January 1, 1984. Question and answer 2 concerns payments of gross proceeds before April 1984 and other similar payments.

Q-1. Did a special rule exist with respect to a payee who had not furnished a taxpayer identification number to a payor before January 1, 1984, with respect to a pre-1984 account (as described in §31.3406(d)-1(b)(l)), a brokerage account that is not a post-1983 brokerage account (as described in §31.3406(d)-1(c)(1)), or other relationships established (as described in §31.3406(d)-1(d)) before January 1, 1984?

A-1. Yes. All payees of such accounts, instruments or relationships were treated as if they were waiting for receipt of a taxpayer identification number, without any action on their part, until January 16, 1984. The payor was required to withhold 20 percent of any payment made after January 16, 1984, unless (1) the payee had certified that the payee was waiting for receipt of a taxpayer identification number (as provided in §31.3406(g)-3) or (2) the payor received a taxpayer identification number from the payee. If, however, a payor had been provided with a Form W-9 (or substitute form) with an "Applied For" designation by a payee on an account, instrument, or relationship established before January 1, 1984, the form was valid for 60 days notwithstanding the fact that the supplemental instruction referred to in §31.3406(h)-3 was not provided to the payee.

Assume, for example, that the payee of an account established before January 1, 1984, delivered an awaiting-TIN certification to the payor on December 30, 1983, and the payor processed the certification that day as permitted in §31.3406(e)-1(b). The payor should not impose backup withholding on payments made to the payee prior to February 29, 1984, because the payee is treated under this paragraph as having provided a taxpayer identification number during that period. If the payor did not receive a number in the manner required in §31.3406(d)-1 from the payee prior to February 29, 1984, the payor would be required to withhold 20 percent of any payment made to the payee on or after February 29, and before the payee provided a number. As another example, assume that a payee of an account established before January 1, 1984, delivered an awaiting-TIN certification to the payor on January 12, 1984, and processed it that day. The payor should not impose backup withholding on payments made between January 1 and 12 because the payee would be treated during that period as if he had provided a taxpayer identification number under the rule set forth

above. Moreover, backup withholding would not apply to payments made during the 60 days following January 12, because the payee on that date delivered an awaiting-TIN certification. Backup withholding would begin only if the payor had not received a taxpayer identification number within that 60-day period. (See §31.3406(e)-1(b), however, for the rules relating to the dates on which the payor may be treated as having received the certificate or the taxpayer identification number.)

Q-2. Did transition rules apply to backup withholding on gross proceeds reportable by brokers under section 6045 (as described in §31.3406(b)(3)-2)?

A-2. Yes. The following transition rules applied until April 1, 1984. First, for purposes of backup withholding on gross proceeds reportable by brokers, the penalties of perjury certification required by §31.3406(d)-1(c)(2) (for post-1983 accounts) may be waived at the broker's option until April 1, 1984. A customer who opens an account after December 31, 1983, and who consummates a sale prior to April 1, 1984, will not be subject to backup withholding provided that the customer furnishes a taxpayer identification number to the broker prior to the sale. The gross proceeds from sales made through post-1983 accounts after March 31, 1984, however, will be subject to backup withholding if the customer does not provide a taxpayer identification number certified under penalties of perjury. See §31.3406(d)-3(b) for special rules applicable when a sale is made pursuant to a telephone or wire instruction.

Second, until April 1, 1984, the gross proceeds from a sale made through a pre-1984 account (as described in §31.3406(d)-1(c)(1)) by a customer who has not provided a taxpayer identification number will not be subject to backup withholding at the broker's option provided that (1) the customer furnishes his number to the broker within 30 days after the date of the sale and (2) the customer does not withdraw the proceeds of the sale prior to the time his taxpayer identification number is furnished to the broker (or backup withholding is applied). For purposes of the preceding sentence, an investment of the cash proceeds in other property shall not be considered a withdrawal by the customer if, at all times during the 30-day period, at least 20 percent of all gross proceeds reportable under section 6045 are held in cash within the customer's account by the broker. If the customer does not furnish his taxpayer identification number within 30 days after the date of sale, the broker must withhold 20 percent of all reportable gross proceeds on the 31st day after the date of the sale.

If, with respect to forward contracts, regulated futures contracts, security short sales, or issuer payment of debt securities, the broker applies backup withholding on a date other than the sale date (see §31.3406(b)(3)-2(c)) the rules of this paragraph shall apply as if any date on which the broker determines whether backup withholding applies were the sale date.

Par. 8. Section 31.601(a)-5(a) is amended by adding the phrase "or §31.6011(a)-11" immediately after the phrase "§31.6011(a)-1 or §31.6011(a)-(4)" wherever the latter phrase appears, and by adding the phrase "or payor" immediately after the term "employer" wherever it appears.

Par. 9. Section 31.6011(a)-6 is amended by revising the heading and the first and third sentences of paragraph (a)(1) to read as follows:

§31.6011(a)-6 Final returns.

(a) *In general*—(1) *Federal Insurance Contributions Act; income tax withheld from wages and certain reportable payments.* An employer or payor who is required to make a return on a particular form pursuant to §31.6011(a)-1, §31.6011(a)-4, §31.6011(a)-5, or §31.6011(a)-11, and who in any return period ceases to pay wages or other reportable payments in respect of which he is required to make a return on such form, shall make such return for such period as a final return. * * * Every such person filing a final return (other than a final return on Form 942 or Form 943) shall furnish information showing the date of the last payment of wages, as defined in section 3121(a) or section 3401(a), and, if appropriate, the date of the last payment of certain reportable payments as defined in section 3406.***

* * * * *

Par. 10. A new §31.601(a)-11 is added to read as follows:

§31.6011(a)-11 Returns of income tax withheld from any reportable payment.

(a) *Quarterly returns.* Except as otherwise provided in §31.6011(a)-5, every payor or broker required to withhold taxes from any reportable payment pursuant to section 3406 shall make a return on Form 941 or Form 941E, whichever is the prescribed form regarding those taxes, for the first calendar quarter in which the payor or broker is required to deduct and withhold such tax and for each subsequent calendar quarter (whether or not the payor or broker is required to deduct and withhold the tax imposed by section 3406 during the quarter) until it has filed a final return in accordance with §31.6011(a)-6.

(b) Information returns on Form 1099. See sections 6041, 6041A, 6042, 6044, 6045, 6049, and 6050A for requirements regarding information returns on Form 1099 with respect to any reportable payment.

(c) *Time and place for filing returns.* For provisions relating to the time and place for filing returns required under this section, see §31.6071(a)-1 and §31.6091-1, respectively.

(d) *Monthly returns.* The provisions of §31.6011(a)-5 regarding monthly returns shall apply, as appropriate, to a payor or broker.

(e) *Final returns.* The provisions of §31.6011(a)-6(a)(1) regarding final returns shall apply, as appropriate, to a payor or broker.

Par. 11. A new §31.6051-4 is added to read as follows:

§31.6051-4 Statements required in case of backup withholding.

(a) *Statements required from payor.* Every payor of any reportable payment (as defined in section 3406(b) and §§31.3406(b)(1)-1) who is required to deduct and withhold tax under section 3406 shall furnish to the payee a written statement containing the information required by paragraph (c) of this section.

(b) *Prescribed form.* The prescribed form for the statement required by this section shall be Form 1099. In the case of any reportable interest or dividend payment as de-

fined in §31.3406(b)(1)-1(b), the prescribed form shall be the official Form 1099 required in §1.6042-5 (relating to payments of dividends), §1.6044-6 (relating to payments of patronage dividends), or §1.6049-6(e) (relating to payments of interest or original issue discount). Statements required to be furnished by this section shall be treated as statements required by the respective sections with respect to any reportable payment, except that the statement required under this section shall include the amount of tax withheld under section 3406. In no event shall a statement be required under this section if a statement with the same information is required to be furnished to the recipient under another section. Thus, a payor is not required to furnish two statements of the same information to a recipient.

(c) *Information required.* Each statement on Form 1099 shall show the following:

(1) The name, address, and taxpayer identification number of the person receiving any reportable payment;

(2) The amount subject to reporting under section 6041, 6041A(a), 6042, 6044, 6045, 6049, 6050A, or 6050N whether or not the amount of the reportable payment is less than the amount for which an information return is required, if tax is withheld under section 3406 relating to backup withholding. If tax is withheld under section 3406, the statement shall show the amount of the payment withheld upon;

(3) The amount of tax deducted and withheld under section 3406;

(4) The name and address of the person filing the form;

(5) A legend stating that such amount is being reported to the Internal Revenue Service; and

(6) Such other information as is required by the form.

(d) *Time for furnishing statements.* The statement shall be furnished to the payee no later than January 31 of the year following the calendar year in which the payment was made.

(e) *Aggregation.* The payor or broker may combine the information required to be shown under this section with information required to be shown under another section even if they do not relate to the same type of reportable payment.

(f) *Cross references.* For provisions relating to the failure to file certain statements, see section 6722. For provisions relating to the penalties provided for the willful furnishing of a false or fraudulent statement, or for the willful failure to furnish a statement, see sections 6656, 6682 and 7215. For additional provisions relating to the inclusion of identification numbers and account numbers in statements on Form 1099, see §§31.6109-1 and 301.6109-1. For provisions relating to the penalty for failure to report an identification number or an account number, as required by §31.6109-1 or §301.6109-1, see section 6676 for statements required for 1988 or earlier calendar years and section 6721 for statements required for 1989 or later calendar years.

Par. 12. Section 31.6071(a)-1 is amended by revising the heading of paragraph (a) and the first sentence of paragraph (a)(1) to read as follows:

§31.6071(a)-1 Time for filing returns and other documents.

(a) *Federal Insurance Contributions Act and income tax withheld from wages and certain reportable payments*—(1) *Quarterly or annual returns.* Except as provided in paragraph (a)(4) of this section, each return required to be made under §31.6011(a)-1 in respect of the taxes imposed by the Federal Insurance Contributions Act, or required to be made under §31.6011(a)-4 in respect of income tax withheld from wages, or required to be made under §31.6011(a)-11 in respect of income tax withheld from certain reportable payments, shall be filed on or before the last day of the first calendar month following the period for which it is made.***

* * * * *

Par. 13. Section 31.6302(c)-1 is amended by adding a new paragraph (a)(1)(i)(*d*), removing the term "and" at the end of paragraph (a)(1)(iii)(*b*), by adding the term ", and" at the end of paragraph (a)(1)(iii)(*c*), and by adding new paragraph (a)(1)(iii)(d). The added provisions read as follows:

§31.6302(c)-1 Use of Government depositaries in connection with taxes under Federal Insurance Contributions Act and income tax withheld.

(a) *Requirement*—(1) *In general.* *(i)****

* * * * *

(*d*) A payor who withholds income tax with respect to reportable payments under section 3406 may elect, in accordance with the instructions provided with Form 941, to deposit such taxes under the rules of paragraphs (a)(1)(i)(*a*) or (*b*) of this section without taking into account the undeposited taxes described in paragraphs (a)(1)(iii)(*a*), (*b*), or (*c*) of this section for purposes of determining when taxes withheld under section 3406 must be deposited. A payor who makes this election shall not take tax withheld under section 3406 into account for purposes of determining when taxes described in paragraphs (a)(1)(iii)(*a*), (*b*), or (*c*) of this section must be deposited under paragraphs (a)(1)(i)(*a*) or (*b*) of this section.

* * * * *

(iii) ***

(*d*) The income tax withheld under section 3406, relating to backup withholding with respect to reportable payments. (See paragraph (a)(1)(i)(*d*) of this section concerning the election payors may make regarding deposits of tax withheld under section 3406).

Par. 14. A new §31.6413(a)-3 is added to read as follows:

§31.6413(a)-3 Repayment by payor of tax erroneously collected from payee.

(a) *In general.* If a payor or broker withholds from a payee in error or withholds more than the proper amount of the tax under section 3406, the payor or broker may refund the amount erroneously withheld as provided in section 6413 and this section. A payor or broker shall be considered to have withheld erroneously only if the amount is withheld because of an error by the payor or broker (*e.g.*, an error in "flagging" or identifying an account that is subject to backup withholding under section 3406) or the Internal Revenue Service directs the payor to refund an amount withheld pursuant to section 3406(a)(1)(C). If the payor or broker requires a payee described in §31.3406(g)-1(a) or the respective reporting section (*e.g.*, a corporation)

to certify that it is an exempt recipient, the payee fails to make the required certification, and the payor or broker subsequently withholds the tax imposed by section 3406 from a payment to such payee, the payor or broker may, in its discretion, treat the amount withheld as an amount erroneously withheld and refund it to the payee. The same rule applies if the payor or broker does not require such a payee to certify concerning its exempt status and the payor or broker withholds. If a payor or broker withholds from a payee after the payee provides a taxpayer identification number or required certification (including the certification relating to foreign status described in §1.6049-5(g) or §1.6045-1(g)(3)(i)) to the payor, but before the payor or broker treats the number or required certification as having been received under §31.3406(e)-1(b), the payor or broker may, in its discretion, treat the amount withheld as an amount erroneously withheld and refund it to the payee. If a payor or broker withholds, however, because the payor or broker has not received a taxpayer identification number or required certification and the payee subsequently provides a taxpayer identification number or a required certification to the payor, the payor or broker may not refund the amount to the payee because the payor or broker has not erroneously withheld under section 3406.

(b) *Manner of refunding amounts erroneously withheld.* If a payor or broker withholds from a payee in error or withholds more than the correct amount under section 3406 as described in paragraph (a) of this section, the payor or broker may refund the amount erroneously withheld to the payee so long as the refund is made prior to the end of the calendar year and prior to the time the payor or broker furnishes a Form 1099 to the payee with respect to the payment for which the erroneous withholding occurred. If the amount of the erroneous withholding is refunded to the payee, the payor or broker shall keep as part of its records a receipt showing the date and amount of refund and the payor or broker must provide a copy or such receipt to the payee. For this purpose, a cancelled check or an entry in a statement is sufficient provided that the check or statement contains a specific notation that it is a refund of tax erroneously withheld. If the payor or broker has not deposited the amount of the tax prior to the time that the refund is made to the payee, the payor or broker shall not deposit the amount erroneously withheld. If the amount erroneously withheld has been deposited prior to the time that the refund is made to the payee, the payor or broker may adjust any subsequent deposit of the tax collected under chapter 24 of the Code which the payor or broker is required to make in the amount of the tax which has been refunded to the payee. A payor or broker shall not report on a Form 1099 as tax withheld any amount which the payor or broker has refunded to a payee.

(c) *Examples.* The application of the provisions of this section may be illustrated by the following examples:

Example (1). A, an individual, maintains an interest-bearing checking account with Bank M. A has not furnished a social security number to M. On March 31, 1984, M credits a payment of interest to A's account and withholds 20 percent of the payment pursuant to section 3406. On April 7, 1984, A receives a quarterly statement from M showing the tax withheld, provides M with a social security number, and requests that M refund the tax withheld. Since M did not have A's social security number on the date M made a payment to A, M has not erroneously withheld the tax imposed by section 3406 and may not refund the tax to A.

Example (2). B, an individual, has an interest-bearing share account with Credit Union N. Although B has provided a social security number to N, N has failed to associate B's number with the account B maintains with N. N credits a payment of interest to B's account on February 1, 1984, and withholds 20 percent of the payment. When B receives a quarterly statement from N showing the tax withheld, B requests that N refund the amount of tax withheld. Upon examining its records, N determines that the tax was withheld because of its error in associating B's social security number with B's account. Accordingly, N may treat the amount as erroneously withheld under paragraph (a) of this section and refund the amount withheld to B as provided in section 6413 and paragraph (b) of this section.

Example (3). State C maintains an investment account with Bank O. C does not have a taxpayer identification number on file with O. Although O requires persons who are exempt from backup withholding under section 3406 to certify their exempt status to O, C fails to do so. O credits a payment of interest to C's account on January 31, 1984, and withholds 20 percent of the payment. On February 2, 1984, O realizes it has withheld the tax imposed by section 3406 from a payment to C. O may treat the amount withheld from C as an amount erroneously withheld under paragraph (a) of this section and refund the amount withheld to C as provided in section 6413 and paragraph (b) of this section.

Par. 15. Section 31.6682-1 is amended by revising the first sentence and by adding two new sentences after the second sentence of paragraph (a) to read as follows:

§31.6682-1 False information with respect to withholding.

(a) *Civil penalty.* If any individual makes a statement under section 3402 (relating to income tax collected at source) or section 3406 (relating to backup withholding) which results in a lesser amount of income tax actually deducted and withheld than is properly allowable under section 3402 or section 3406 and, at the time the statement was made, there was no reasonable basis for the statement, the individual shall pay a penalty of $500 for the statement. *** There was a reasonable basis for a statement on a Form W-9 if the person included his correct taxpayer identification number assigned under section 6109 and, with respect to a reportable interest or dividend payment (as defined in §31.3406(b)(1)-1)(b), that person had a reasonable basis to certify under penalties of perjury that he was not subject to backup withholding if, prior to the time that the person made the statement, he had not been notified that he was subject to backup withholding as a result of notified payee underreporting. Additionally, a person who was subject to backup withholding due to notified payee underreporting had a reasonable basis to certify that he was not subject to backup withholding due to notified payee underreporting if, prior to the time that the person made the statement, the Service provided him with written certification that backup withholding due to notified payee underreporting had terminated. ***

* * * * *

PART 301—PROCEDURE AND ADMINISTRATION

Par. 16. The authority citation for Part 301 is amended by adding the following citation:

Authority: 26 U.S.C. 7805 *** §301.6109-1 also issued under 26 U.S.C. 6109.

Par. 17. Section 301.6109-1 is amended by revising paragraphs (a)(1) and (g), by redesignating paragraph (h) as paragraph (i), and by adding a new paragraph (h) to read as follows:

§301.6109-1 Identifying numbers.

(a) *In general*—(1) *Social security numbers and employer identification numbers.* Generally, there are two types of taxpayer identifying numbers: social security numbers and employer identification numbers. Social security numbers take the form 000-00-0000, while employer identification numbers take the form 00-0000000. Social security numbers identify individual persons while employer identification numbers identify corporations, partnerships, nonprofit associations, trusts, estates of decedents, and similar nonindividual persons. Both types of taxpayer identifying numbers are used by individuals who are employers or who are engaged in trade or business as sole proprietors, as required by returns, statements or other documents and their related instructions. Such documents often require an individual's own social security number in connection with his individual taxes, and his employer identification number in connection with his business taxes. See paragraph (g) of this section for the rules with respect to the use of a taxpayer identification number for nonresident aliens.

* * * * *

(g) *Nonresident aliens.* In general, nonresident aliens who are treated as residents under section 6013(g) or (h) must obtain a taxpayer identification number in the same form and manner that is required of U.S. residents. However, nonresident aliens with income effectively connected with a U.S. trade or business, or nonresident aliens who do not have such income but who must file a Form 1040NR to obtain a refund of tax withheld, must obtain a taxpayer identification number that takes the form 9xx-xx-xxxx. This number may be obtained from the Internal Revenue Service Center located in Philadelphia, Pennsylvania. Other nonresident aliens are not required to obtain a taxpayer identification number.

(h) *Other foreign persons.* A foreign corporation, foreign partnership, or foreign private foundation is not required to obtain a taxpayer identification number if it does not have income effectively connected with the conduct of a trade or business within the United States and does not have an office or place of business or fiscal or paying agent in the United States.

* * * * *

Par. 18. A new §301.6676-2 is added to read as follows:

§301.6676-2 Due diligence defense.

For purposes of section 6676, the following questions and answers (Q/A's) concerning the actions that payors must take to establish due diligence are hereby referenced in this §301.6676-2:

(a) Q/A-1, through Q/A-29, Q/A-31, Q/A-34 through Q/A-36, Q/A-38 through Q/A-42 B, and Q/A-48 through Q/A-56 of §35a.9999-1;

(b) Q/A-1 through Q/A-9, Q/A-17 through Q/A-18, and Q/A-20 through Q/A-23 of §35a.9999-2;

(c) Q/A-1, Q/A-3 through Q/A-4, Q/A-20, Q/A-29, Q/A-33 through Q/A-37, Q/A-41, Q/A-46, Q/A-48, Q/A-51 through Q/A-97, and Q/A-99 through Q/A-104 of §35a.9999-3; and

(d) Q/A-3 and Q/A-5 of §35a.9999-4T.

Par. 18(a). Sections 35a.3406-1 and 35a.3406-2 are removed.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 19. The authority for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 20. Section 602.101(c) is amended by inserting the following in the appropriate place in the table "§31.3406 . . . 1545-0112 and 1545-0979".

Fred T. Goldberg, Jr.,
Commissioner of
Internal Revenue.

(Filed by the Office of the Federal Register on September 20, 1990, 10:53 a.m., and published in the issue of the Federal Register for September 27, 1990, 55 F.R. 39427)

Notice of Proposed Rulemaking

Economic Performance Requirement

IA-258-84

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to the requirement that economic performance occur in order for an amount to be incurred by a taxpayer using an accrual method of accounting. Changes to the applicable law were made by the Tax Reform Act of 1984. The regulations affect all taxpayers that use an accrual method of accounting, and are necessary to provide them with guidance needed to comply with these changes.

DATE: Written comments and requests for a public hearing must be delivered by August 6, 1990.

ADDRESS: Send comments and requests for a public hearing to: Internal Revenue Service, Office of Chief Counsel, Attn: CC:CORP:T:R (IA-258-84), P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044.

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR Part 1) to provide rules under section 461(h) of the Internal Revenue Code of 1986 (Code). Section 461(h) was added to the Code by section 91(a) of the Tax Reform Act of 1984 (Pub. L. 98-369, 98 Stat. 598) [1984-3 C.B. (Vol. 1) 1, 106].

Explanation of Statutory Provisions

Section 461(h) adds a third requirement to the "all events test" for determining the taxable year in which an item may be treated as incurred by a taxpayer using an accrual method of accounting. As in effect before the enactment of section 461(h), the all events test was satisfied when (1) all the events occurred that determined the fact of a liability and (2) the amount of the liability could be determined with reasonable accuracy. Section 461(h) provides that the all events test shall not be treated as met any earlier than the taxable year in which "economic performance" occurs with respect to the liability. Sec-

tion 461(h) applies to any item allowable as a cost, expense, or deduction, except for certain items for which the Code provides alternative timing rules.

Section 461(h)(2) provides that, except as otherwise provided in regulations prescribed by the Secretary, the following general principles determine when economic performance occurs. If the liability of a taxpayer arises out of the provision of property or services to the taxpayer by another person, economic performance occurs as the property or services are provided. If the liability of a taxpayer arises out of the use of property by the taxpayer, economic performance occurs as the taxpayer uses such property. If the liability of a taxpayer requires the taxpayer to provide property or services, economic performance occurs as the taxpayer provides the property or services. If the liability of a taxpayer requires payment to another person and arises under a workers' compensation act or arises out of any tort, economic performance occurs as the payments to such person are made. Finally, in the case of any other liability of a taxpayer, economic performance occurs at the time determined under regulations prescribed by the Secretary.

Although section 461(h) generally requires economic performance to occur before an item may be treated as incurred, section 461(h)(3) provides an exception to this general rule ("the recurring item exception"). Under the recurring item exception, an item may be treated as incurred in the taxable year before economic performance occurs, but only if the following four conditions are satisfied. First, the all events test, without regard to economic performance, must be satisfied with respect to the item during the taxable year. Second, economic performance must occur with respect to the item within a reasonable period (but in no event more than 8 1/2 months) after the close of the taxable year. Third, the item must be recurring in nature, and the taxpayer must, from year to year, consistently treat items of that type as incurred in the taxable year in which the all events test (without regard to economic performance) is satisfied. Fourth, either (a) the item must not be a material item, or (b) the accrual of the item in the taxable year in which the all events test (without regard to economic performance) is satisfied must result in a better matching of the item with the income to which it relates than would result from accruing the item in the taxable year in which economic performance occurs. The recurring item exception does not apply to liabilities arising under a workers' compensation act or out of any tort.

Explanation of Regulatory Provisions

Economic performance with respect to property and services

The proposed regulations modify and clarify the statutory rules concerning when economic performance occurs in the case of property, services, or the use of property provided to or by a taxpayer. First, in the case of a liability of a taxpayer arising from the provision by another person of property or services to the taxpayer, the statute provides that economic performance occurs as the property or services are provided to the taxpayer. The regulations provide rules designed to lessen the burden on a taxpayer incident to determining when property or services are provided to the taxpayer. For example, the regulations provide that a taxpayer may treat property or services as provided to the taxpayer as the taxpayer makes payment for the property or services. However, this treatment is available only if the taxpayer can reasonably expect the property or services to be provided by the other person within 3 1/2 months after the payment is made. Thus, for example, if a taxpayer pays for the cost of property or services, the taxpayer may not deduct the costs or add them to basis upon payment if economic performance is not reasonably expected to occur within 3 1/2 months of the payment. Nonetheless, the costs will be treated as incurred for purposes of determining production expenditures that attract interest required to be capitalized under section 263A(f). See §1.263A-1T(b)(2)(iv)(C).

Second, in the case of a liability of a taxpayer to provide property or services, the regulations provide that economic performance occurs as the taxpayer incurs (within the meaning of section 461(h) and the regulations thereunder) costs in connection with such a liability. Thus, for example, if an equipment manufacturer contracts to provide a machine to a corporation, the manufacturer incurs costs (i.e., economic performance occurs) as property, services, and the use of property necessary to make the machine are provided to the manufacturer, rather than as the manufacturer provides the machine to the corporation. This rule was adopted because these costs, and not the underlying "liability" to provide property or services, generally are allowable as a cost, deduction, or expense for Federal income tax purposes.

Third, the regulations provide that in the case of liabilities for property or services that are attributable to long-term contracts, economic performance occurs as the property or services are provided, or as the taxpayer makes payment for the property or services, whichever is earlier.

The Internal Revenue Service invites comments on the interaction between the economic performance requirement and employee benefit provisions including sections 83, 404, and 419.

Liabilities for which payment is economic performance

The regulations identify six types of liabilities, in addition to liabilities arising under a workers' compensation act or out of a tort, for which payment must be made in order for economic performance to occur. These liabilities are (1) liabilities arising out of a breach of contract; (2) liabilities arising out of a violation of law; (3) rebates and refunds; (4) awards, prizes, and jackpots; (5) amounts paid for insurance, warranty, and service contracts; and (6) taxes other than creditable foreign taxes. The regulations provide that creditable foreign taxes are incurred under the rules in effect before the enactment of section 461(h). This rule is provided in order to preserve the matching principles underlying the foreign tax credit provisions.

The proposed regulations also provide that if section 461(h) or the regulations thereunder do not otherwise provide economic performance rules for a liability, economic performance occurs as payment is made to the person to which the liability is owed. The vast majority of liabilities

either involve the provision of property or services by or to a taxpayer, or are specifically designated in the statute or the proposed regulations as payment liabilities. Thus, it is anticipated that few liabilities will fall into this "catch-all" category.

Payment to another person

The proposed regulations also provide guidance on what constitutes payment to another person for purposes of section 461(h). The regulations provide that whether payment has occurred is to be determined under the principles applicable to a taxpayer using the cash method of accounting. Thus, the furnishing of a note or other evidence of indebtedness of a taxpayer, or a promise of a taxpayer to provide property or services in the future, is not payment for purposes of section 461(h). In addition, a payment is not an amount transferred as a loan, deposit, or contingent payment with respect to which the taxpayer may receive a refund or credit. Finally, the regulations provide that payment has not been made to another person unless a cash basis taxpayer in the position of that person would be treated as having actually or constructively received the amount of the payment under the principles of section 451. Thus, for example, the purchase of an annuity contract or other asset does not constitute payment to another person unless the ownership of the annuity contract or other asset is transferred to that person.

Persons to which payment constitutes economic performance

In general, in the case of liabilities requiring payment, economic performance occurs when payment is made to the person to which the liability is owed. For example, in the case of a liability arising under a workers' compensation act, payment must be made to the person entitled to payment under the workers' compensation act. Generally, a payment to a trust, escrow account, fund, or any person other than the person to which a liability is owed does not constitute economic performance.

However, payments to certain third persons constitute economic performance. For example, under section 468B, payment to a designated settlement fund constitutes economic performance in the case of certain tort liabilities. The regulations essentially extend the availability of section 468B treatment to certain other payment liabilities by providing that a payment to a "qualified fund" constitutes economic performance. Provisions in the regulations relating to this qualified fund generally conform to the provisions of section 468B. The Internal Revenue Service invites comments as to additional guidance that may be appropriate with respect to the operation of qualified funds and, more generally, the manner and extent to which the Service should exercise its authority to prescribe rules under section 468B(g) (relating to the taxation of certain funds).

In addition, the regulations provide, in connection with the sale of a trade or business by a taxpayer, that if the purchaser agrees to assume a liability of the taxpayer arising out of the trade or business, the taxpayer is treated as making deemed payments on the liability for purposes of section 461(h) as the amount of the liability is included in the amount realized on the transaction by the taxpayer. The regulations define "trade or business" using principles drawn from section 355(b) and the regulations thereunder. It is expected that case law developed with respect to the relevant portions of section 355(b) and the regulations thereunder will apply for purposes of the trade or business definition of the regulations under section 461(h).

Finally, the regulations provide that qualified assignments under section 130, relating to certain personal injury liability assignments, constitute economic performance.

The Internal Revenue Service invites comments on the scope of these exceptions to the rule that payment must be made to the person to which a liability is owed, and comments that identify additional appropriate exceptions. In particular, the Service invites comments identifying the circumstances in which it would be appropriate to provide an additional exception under which economic performance with respect to a liability of a taxpayer would be deemed to occur as the taxpayer pays an unrelated party to assume legal responsibility for satisfying that liability.

Recurring item exception

The regulations modify the recurring item exception of section 461(h)(3) by requiring that economic performance occur by the earlier of (1) 8 1/2 months after the close of a taxable year as of the end of which the all events test is met (determined without regard to the economic performance requirement); or (2) the date the taxpayer files a timely return for that taxable year. However, if economic performance with respect to an item occurs after the taxpayer files the return, but within the 8 1/2 month period, the taxpayer may file an amended return treating the item as incurred under the recurring item exception. Furthermore, the regulations identify liabilities, in addition to workers' compensation and tort, to which the recurring item exception does not apply. Finally, the regulations provide that the matching requirement of the recurring item exception is deemed satisfied in the case of the following liabilities: (1) rebates and refunds, (2) awards, prizes and jackpots, (3) amounts paid for insurance, warranty, and service contracts, and (4) taxes.

Other timing rules

The proposed regulations clarify that section 461(h) and the regulations thereunder merely provide rules for determining when a liability may be treated as incurred under the all events test. Other rules determine the manner in which the liability is taken into account for Federal income tax purposes. Liabilities generally are taken into account in the taxable year incurred, whether, for example, as a deduction from gross income under section 162 in the case of deductible liabilities, or through capitalization under section 263 or section 263A in the case of liabilities that relate to the creation of a capital asset. Furthermore, liabilities required to be capitalized may later affect the computation of taxable income through depreciation or otherwise, in accordance with applicable Code sections and guidance published by the Secretary.

Taxation of amounts transferred under section 461(f)

The proposed regulations also provide rules relating to the taxation of amounts transferred to an escrowee,

trustee, or court in connection with a contested liability within the meaning of section 461(f). The Internal Revenue Service invites comments relating to the application of section 461(f) to liabilities for which the regulations designate payment as economic performance.

Subdivided real estate

Finally, because economic performance must occur in order for a liability to be taken into account, the estimated cost of future improvements to subdivided real estate may not be added to the basis of lots sold if economic performance has not occurred with respect to those costs. Therefore, the statute and regulations override Rev. Proc. 75-25, 1975-1 C.B. 720, but only for taxable years beginning after December 31, 1989, pursuant to section 7805(b).

Effective dates

In general, the regulations are proposed to apply to liabilities that would, under the law in effect before the enactment of section 461(h), be allowable as a deduction or otherwise incurred after July 18, 1984. In the case of amounts transferred to an escrowee, trustee, or court under section 461(f) to provide for the satisfaction of an asserted liability, the regulations are proposed to apply to amounts transferred on or after June 7, 1990. In the case of certain liabilities that require payment to another person in order for economic performance to occur, and in the case of liabilities to make future improvements to subdivided real estate, the regulations are proposed to apply to liabilities that would, under the law in effect before the enactment of section 461(h), be allowable as a deduction or otherwise incurred for taxable years beginning after December 31, 1989. Although portions of the proposed regulations are effective only for taxable years beginning after December 31, 1989, taxpayers are reminded that section 461(h) of the Code became effective after July 18, 1984, and that for the period beginning after July 18, 1984, taxpayers are not entitled to rely on regulations or rulings that are inconsistent with the general principles of economic performance or with the generic exception for recurring items. *See* Conf. Rep. No. 861, 98th Cong., 2d Sess. 876 (1984).

Special Analyses

It has been determined that these proposed rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. 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, an initial Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, a copy of the rules will be submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

Comments and Requests for a Public Hearing

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably eight copies) to the Internal Revenue Service. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Internal Revenue Service by any person who submits written comments. If a public hearing is held, notice of the time and place will be published in the Federal Register.

List of Subjects

26 CFR 1.61-1 through 1.281-4

Deductions, Exemptions, Income tax, Taxable income. 26 CFR 1.441-1 through 1.483-2

Income taxes, Accounting, Deferred compensation plans.

Proposed Amendments to the Regulations

For the reasons set forth in the preamble, 26 CFR Part 1 is proposed to be amended as follows:

Part 1—Income Tax Regulations [AMENDED]

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

Section 1.461-3T also issued under 26 U.S.C. 461(h).

Par. 2. The authority for Part 1 is amended by adding the following citation:

Authority: Sec. 7805, 68A Stat. 917: 26 U.S.C. 7805. * * * Section 1.446-1, §1.461-1, §1.461-2, §1.461-4, §1.461-5, §1.461-6, and §1.461-7T also issued under 26 U.S.C. 461(h). Section 1.461-2 and §1.461-6(c) also issued under 26 U.S.C. 468B(g). Section 1.461-4(d) also issued under 26 U.S.C. 460.

Par. 3. Section 1.446-1 is amended by revising paragraph (c)(1)(ii) to read as follows:

§1.446-1 General rule for methods of accounting.

* * * * *

(c) * * *

(1) * * *

(ii) *Accrual method.* (A) Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. Under such a method, a liability is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. (See paragraph (a)(2)(iii)(A) of §1.461-1 for examples of liabilities that may not be taken into account until after the taxable year incurred, and see §§1.461-4 through 1.461-6 for rules relating to economic performance.) Applicable provisions of the Code, the Income Tax Regulations, and other guidance published by the Secretary prescribe the manner in which a liability that has been incurred is taken into account. For example, section 162 provides that a deductible liability generally is taken into account in the taxable year incurred through a deduction from gross income. As a further example, under section 263 or 263A, a liability that relates to the creation of an asset having a useful life extending substantially beyond the close of the taxable year is taken into account in the taxable year incurred through capitalization (within the meaning of §1.263A-1T(a)(5)), and may later affect the computation of taxable income through depreciation or otherwise over a period including subsequent taxable years, in accord-

ance with applicable Code sections and guidance published by the Secretary.

(B) The term "liability" includes any item allowable as a deduction, cost, or expense for Federal income tax purposes. In addition to allowable deductions, the term includes any amount otherwise allowable as a capitalized cost, as a cost taken into account in computing cost of goods sold, as a cost allocable to a long-term contract, or as any other cost or expense. Thus, for example, an amount that a taxpayer expends or will expend for capital improvements to property must be incurred before the taxpayer may take the amount into account in computing its basis in the property. The term "liability" is not limited to items for which a legal obligation to pay exists at the time of payment. Thus, for example, amounts prepaid for goods or services and amounts paid without a legal obligation to do so may not be taken into account by an accrual basis taxpayer any earlier than the taxable year in which those amounts are incurred.

(C) The method used by the taxpayer in determining when income is to be accounted for will be acceptable if it accords with generally accepted accounting principles, is consistently used by the taxpayer from year to year, and is consistent with the Income Tax Regulations. For example, a taxpayer engaged in a manufacturing business may account for sales of the taxpayer's product when the goods are shipped, when the product is delivered or accepted, or when title to the goods passes to the customers, whether or not billed, depending on the method regularly employed in keeping the taxpayer's books.

* * * * *

Par. 4. New §1.461-0 is added in the appropriate place.

§1.461-0 Table of contents.

This section lists the captions that appear in the regulations under section 461 of the Code.

§1.461-1 General rule for taxable year of deduction.

(a) General rule.
  (1) Taxpayer using cash receipts and disbursements method.
  (2) Taxpayer using an accrual method.
  (3) Effect in current taxable year of improperly accounting for a liability in a prior taxable year.
  (4) Deductions attributable to certain foreign income.
(b) Special rule in case of death.
(c) Accrual of real property taxes.
  (1) In general.
  (2) Special rules.
  (3) When election may be made.
  (4) Binding effect of election.
  (5) Apportionment of taxes on real property between seller and purchaser.
  (6) Examples.
(d) Limitation on acceleration of accrual of taxes.
(e) Dividends or interest paid by certain savings institutions on certain deposits or withdrawable accounts.
  (1) Deduction not allowable.
  (2) Computation of amounts not allowed as a deduction.
  (3) When amounts allowable.

§1.461-2 Contested liabilities.

(a) General rule.
  (1) Taxable year of deduction.
  (2) Exception.
  (3) Refunds includible in gross income.
  (4) Examples.
  (5) Transfers to provide for the satisfaction of a liability described in paragraph (g) of §1.461-4 [Reserved].
(b) Contest of asserted liability.
  (1) Asserted liability.
  (2) Definition of the term "contest."
  (3) Example.
(c) Transfer to provide for the satisfaction of an asserted liability.
  (1) In general.
  (2) Examples.
(d) Contest exists after transfer.
(e) Deduction otherwise allowed.
  (1) In general.
  (2) Example.
(f) Treatment of money or property transferred to an escrowee, trustee, or court and treatment of any income attributable thereto.
(g) Effective dates.

§1.461-3 Prepaid interest.

[Reserved].

§1.461-4 Economic performance.

(a) Introduction.
(b) Exceptions to the economic performance requirement.
(c) Definitions.
  (1) Liability.
  (2) Payment.
(d) Liabilities arising out of the provision of services, property, or the use of property.
  (1) In general.
  (2) Services and property provided to the taxpayer.
  (3) Use of property provided to the taxpayer.
  (4) Services and property provided by the taxpayer.
  (5) Rules relating to the provision of services or property to a taxpayer.
  (6) Examples.
(e) Interest.
(f) Liabilities under notional principal amount contracts. [Reserved].
(g) Certain liabilities for which payment is economic performance.
  (1) In general.
    (i) Person to which payment must be made.
    (ii) Payment to person to which liability is owed.
    (iii) Person.
    (iv) Assignments.
  (2) Liabilities arising under a workers' compensation act or out of any tort, breach of contract, or violation of law.
  (3) Rebates and refunds.
  (4) Awards, prizes, and jackpots.
  (5) Insurance, warranty, and service contracts.
  (6) Taxes.
  (7) Other liabilities.
  (8) Examples.
(h) Liabilities arising under the Nuclear Waste Policy Act of 1982.
(i) [Reserved].
(j) Special effective dates and transitional rules.

§1.461-5 Recurring item exception.

(a) In general.
(b) Requirements for use of the exception.
  (1) General rule.
  (2) Amended returns.
  (3) Items that are recurring in nature.
  (4) Materiality requirement.
  (5) Matching requirement.

(c) Types of items not eligible for treatment under the recurring item exception.

(d) Time and manner of adopting the recurring item exception.

(e) Examples.

§1.461-6 Economic performance when certain liabilities are assigned or are extinguished by the establishment of a fund.

(a) Qualified assignments of certain personal injury liabilities under section 130.

(b) Section 468B.

(c) Payment to a qualified fund.

(d) Payments to other funds or persons that constitute economic performance. [Reserved].

(e) Effective dates.

§1.461-7T Questions and answers relating to the effective dates of section 461(h).

Par. 5. Section 1.461-1 is amended by revising paragraph (a)(2) and the heading and text of paragraph (a)(3) to read as follows:

§1.461-1 General rule for taxable year of deduction.

(a) * * *

(2) *Taxpayer using an accrual method*—(i) *In general.* Under an accrual method of accounting, a liability (as defined in §1.446-1(c)(1)(ii)(B)) is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. (See paragraph (a)(2)(iii)(A) of this section for examples of liabilities that may not be taken into account until a taxable year subsequent to the taxable year incurred, and see §§1.461-4 through 1.461-6 for rules relating to economic performance.) Applicable provisions of the Code, the Income Tax Regulations, and other guidance published by the Secretary prescribe the manner in which a liability that has been incurred is taken into account. For example, section 162 provides that a deductible liability generally is taken into account in the taxable year incurred through a deduction from gross income. As a further example, under section 263 or 263A, a liability that relates to the creation of an asset having a useful life extending substantially beyond the close of the taxable year is taken into account in the taxable year incurred through capitalization (within the meaning of §1.263A-1T(a)(5)), and may later affect the computation of taxable income through depreciation or otherwise over a period including subsequent taxable years, in accordance with applicable Code sections and guidance published by the Secretary. The principles of this paragraph (a)(2) also apply in the calculation of earnings and profits and accumulated earnings and profits.

(ii) *Uncertainty as to the amount of a liability.* While no liability shall be taken into account before economic performance and all of the events that fix the liability have occurred, the fact that the exact amount of the liability cannot be determined does not prevent a taxpayer from taking into account that part of the amount of the liability which can be computed with reasonable accuracy within the taxable year. For example, A renders services to B during the taxable year for which A charges $10,000. B admits a liability to A for $6,000 but contests the remainder. B may take into account only $6,000 as an expense for the taxable year in which the services were rendered. See §1.461-2 for rules that apply if a taxpayer transfers money or other property to provide for the satisfaction of certain contested liabilities.

(iii) *Alternative timing rules.* (A) If any provision of the Code requires a liability to be taken into account in a taxable year later than the taxable year provided in paragraph (a)(2)(i) of this section, the liability is taken into account as prescribed in that Code provision. See, for example, section 267 (transactions between related parties), section 404 (employee benefits), and section 464 (farming syndicates).

(B) If the liability of a taxpayer is subject to section 165 (losses), section 170 (charitable contributions), section 192 (black lung benefit trusts), section 194A (employer liability trusts), section 468 (mining and solid waste disposal reclamation and closing costs), or section 468A(a) (certain nuclear decommissioning costs), the liability is taken into account as determined under that section and not under section 461 or the regulations thereunder.

(C) Section 461 and the regulations thereunder do not apply to any amount allowable under a provision of the Code as a deduction for a reserve for estimated expenses.

(3) *Effect in current taxable year of improperly accounting for a liability in a prior taxable year.* Each year's return should be complete in itself, and taxpayers shall ascertain the facts necessary to make a correct return. The expenses, liabilities, or loss of one year generally cannot be used to reduce the income of a subsequent year. A taxpayer may not take into account in a return for a subsequent taxable year liabilities that, under the taxpayer's method of accounting, should have been taken into account in a prior taxable year. If a taxpayer ascertains that a liability should have been taken into account in a prior taxable year, the taxpayer should, if within the period of limitation, file a claim for credit or refund of any overpayment of tax arising therefrom. Similarly, if a taxpayer ascertains that a liability was improperly taken into account in a prior taxable year, the taxpayer should, if within the period of limitation, file an amended return and pay any additional tax due. However, except as provided in section 905(c) and the regulations thereunder, if a liability is properly taken into account in an amount based on a computation made with reasonable accuracy and the exact amount of the liability is subsequently determined in a later taxable year, the difference, if any, between such amounts shall be taken into account for the later taxable year.

* * * * *

Par. 6. Section 1.461-2 is amended by revising the heading, adding and reserving a new paragraph (a)(5), removing paragraphs (f), (g) and (h), and adding new paragraphs (f) and (g) to read as follows:

§1.461-2 Contested liabilities.

(a) * * *

(5) *Transfers to provide for the satisfaction of a liability described in paragraph (g) of §1.461-4. [Reserved].*

* * * * *

(f) *Treatment of money or property transferred to an escrowee, trustee,*

or court and treatment of any income attributable thereto—(1) *In general.* This paragraph (f) applies to any transfer of money or property by a taxpayer to an escrowee, trustee, or court (see paragraph (c)(1)(ii) and (iii) of this section) that is deductible under section 461(f) and paragraph (a)(1) of this section. A transfer to which this paragraph (f) applies creates a "461(f) fund," the taxation of which is governed solely by this paragraph (f). If more than one taxpayer transfers amounts to the same escrowee, trustee, or court in connection with the same contested liability, there is created for each transferor a separate 461(f) fund to which the rules of this paragraph (f) are separately applied.

(2) *Applicable rules.* The following rules apply to a 461(f) fund:

(i) Any transfer of property to a 461(f) fund is, for purposes of section 1001, a disposition of that property by the taxpayer for fair market value on the date of the transfer. Likewise, any transfer of property from a 461(f) fund to any person (including the taxpayer) is, for purposes of section 1001, a disposition of that property by the taxpayer for fair market value on the date of the transfer. For purposes of this paragraph (f)(2)(i), any money or property held by the 461(f) fund after the final resolution of the contest for the benefit of any person other than the person asserting the liability is treated as transferred to the taxpayer during the taxable year of the taxpayer in which the contest is resolved.

(ii) A taxpayer is considered the owner of any 461(f) fund created by a transfer of money or property by the taxpayer. Thus, any income, deductions, or credits of the fund are taken into account in the computation of the taxpayer's taxable income as if no transfer had occurred (except as otherwise provided in this paragraph (f)(2)).

(iii) A taxpayer is not permitted to deduct (or otherwise take into account) any income attributable to the transferred money or property ("fund income"), or the amount of any payment (including a payment of fund income) made from a 461(f) fund to the person asserting the liability.

(iv) A taxpayer must include in gross income the amount of any payment from a 461(f) fund (including a payment of fund income) made to the taxpayer or any other person except—

(A) Amounts paid to the person asserting the liability in satisfaction of the asserted liability;

(B) The amount of any taxes (other than Federal income taxes) attributable to fund income that are paid by the fund; and

(C) An amount equal to transfers to the fund that meet the requirements of a "recovery exclusion" under §1.111-1(a) (relating to recovery of tax benefit items).

(v) Any taxes (including Federal income taxes, whether paid by the taxpayer or paid by the fund and included in the taxpayer's gross income under paragraph (f)(2)(iv) of this section) that are attributable to fund income are considered transferred to the 461(f) fund, and thus deductible under paragraph (a) of this section. For any taxable year, the amount of this deduction equals the excess (if any) of—

(A) The tax that would be imposed on the taxpayer for the taxable year determined by taking into account fund income; over

(B) The tax that would be imposed on the taxpayer for the taxable year, determined without regard to fund income.

(vi) Any refund of taxes attributable to fund income is treated as a payment from the fund to the taxpayer and is included in gross income under paragraph (f)(2)(iv) of this section.

(3) *Example.* The following example illustrates the principles of this paragraph (f):

X, an accrual basis, calendar year taxpayer, contests a $9,000 liability asserted against X by Y for hazardous waste disposal services rendered by Y during 1990. In January 1991, X transfers assets having a fair market value of $9,000 and an adjusted basis of $7,000 to a trust in a transaction that satisfies the requirements of §1.461-2(c). Under section 461(f), X is allowed a $9,000 deduction for 1991. In addition, the asset transfer is considered a disposition of the assets for fair market value for purposes of section 1001. Thus, for 1991, X recognizes a $2,000 gain from the transfer and has a new basis of $9,000 in the assets.

During 1991, the fund assets earn $600, which is included in X's gross income for 1991. X pays, and takes a deduction for, taxes attributable to this amount. The only other deduction X is allowed with respect to the fund is a deduction for administrative expenses.

The fair market value of the transferred assets remains the same. In 1992, the contest is settled and assets having a fair market value of $8,000 are transferred from the fund to Y. X must include in gross income for the 1992 taxable year the $1,600 remaining in the fund. Any amounts earned by the fund in 1992 must also be included in X's gross income for 1992. The transfer to Y of assets having a fair market value of $8,000 is considered a disposition of the assets for purposes of section 1001. Because the fair market value of the assets has not changed, the disposition does not require X to recognize additional gain or loss for 1992.

(g) *Effective dates.* Paragraphs (a) through (e) of this section apply to transfers of money or property made in taxable years beginning after December 31, 1953, and ending after August 16, 1954. Paragraph (f) of this section applies to amounts transferred by a taxpayer on or after June 7, 1990.

Par. 7. Section 1.461-3T is redesignated as §1.461-7T.

Par. 8. Section 1.461(h)-4T is removed.

Par. 9. The following new sections are added immediately after §1.461-2 to read as follows:

§1.461-3 Prepaid interest.

[Reserved]

§1.461-4 Economic performance.

(a) *Introduction*—(1) *In general.* For purposes of determining whether an accrual basis taxpayer can treat the amount of any liability (as defined in §1.446-1(c)(1)(ii)(B)) as incurred, the all events test is not treated as met any earlier than the taxable year in which economic performance occurs with respect to the liability.

(2) *Overview.* Paragraph (b) of this section lists exceptions to the economic performance requirement. Paragraph (c) of this section locates the definitions of certain terms for purposes of section 461 (h) and the regulations thereunder. Paragraphs (d) through (j) of this section and §1.461-6 provide rules for determining when economic performance occurs. Section 1.461-5 provides rules relating to an exception under which certain recurring items may be incurred for the taxable year before the year during which economic performance occurs.

(b) *Exceptions to the economic performance requirement.* Paragraph (a)(2)(iii)(B) of §1.461-1 provides examples of liabilities that are taken into account under rules that operate without regard to the all events test (including economic performance).

(c) *Definitions.* The following cross-references identify certain terms defined for purposes of section 461(h) and the regulations thereunder:

(1) *Liability.* See paragraph (c)(1)(ii)(B) of §1.446-1 for the definition of "liability."

(2) *Payment.* See paragraph (g)(1)(ii) of this section for the definition of "payment."

(d) *Liabilities arising out of the provision of services, property, or the use of property*—(1) *In general.* The principles of this paragraph (d) determine when economic performance occurs with respect to liabilities arising out of the performance of services, the transfer of property, or the use of property. This paragraph (d) does not apply to liabilities described in paragraph (e) (relating to interest expense) or paragraph (g) (relating to breach of contract, worker's compensation, tort, etc.) of this section. In addition, except as otherwise provided in guidance published by the Secretary, this paragraph (d) does not apply to amounts paid pursuant to a notional principal amount contract.

(2) *Property or services provided to the taxpayer*—(i) *In general.* If the liability of a taxpayer arises out of the providing of property or services to the taxpayer by another person, economic performance occurs as the property or services are provided.

(ii) *Long-term contracts.* In the case of any liability of a taxpayer described in paragraph (d)(2)(i) of this section that is an expense attributable to a long-term contract with respect to which the taxpayer uses the percentage of completion method, economic performance occurs—

(A) As the property or services are provided; or, if earlier,

(B) As the taxpayer makes payment in satisfaction of the liability to the person providing the property or services.

(iii) *Cross-references.* See examples 5 through 9 of paragraph (d)(6) of this section. See paragraph (a)(2)(iii)(A) of §1.461-1, and example 1 of paragraph (d)(6) of this section, for illustration of the interaction between section 461(h) and employee benefit provisions including sections 404, 404A, and 419. See paragraph (d)(5) of this section for rules relating to when a taxpayer may treat property or services as provided to the taxpayer.

(3) *Use of property provided to the taxpayer.* If the liability of a taxpayer arises out of the use of property by the taxpayer, economic performance occurs ratably over the period of time the taxpayer is entitled to the use of the property. See examples 7 and 10 of paragraph (d)(6) of this section.

(4) *Services and property provided by the taxpayer*—(i) *In general.* If the liability of a taxpayer requires the taxpayer to provide services or property to another person, economic performance occurs as the taxpayer incurs costs (within the meaning of §1.446-1(c)(1)(ii)) in connection with the satisfaction of the liability. See examples 2 through 4 of paragraph (d)(6) of this section.

(ii) *Barter transactions.* If the liability of a taxpayer requires the taxpayer to provide services, property, or the use of property, and arises out of the use of property by the taxpayer, or out of the provision of property or services to the taxpayer by another person, economic performance occurs to the extent of the lesser of—

(A) The cumulative extent to which the taxpayer incurs costs (within the meaning of §1.446-1(c)(1)(ii)) in connection with its liability to provide the property or services; or

(B) The cumulative extent to which the property or services are provided to the taxpayer.

(5) *Rules relating to the provision of property or services to a taxpayer.* The following rules apply for purposes of this paragraph (d):

(i) Property and services provided to a taxpayer include property and services provided to another person at the direction of the taxpayer.

(ii) A taxpayer is permitted to treat property or services as provided to the taxpayer as the taxpayer makes payment to the person providing the property or services (as defined in paragraph (g)(1)(ii) of this section), if the taxpayer can reasonably expect the person to provide the property or services within 3 1/2 months after the date of payment.

(iii) A taxpayer is permitted to treat property as provided to the taxpayer when the property is delivered or accepted, or when title to the property passes. The method used by the taxpayer to determine when property is provided is a method of accounting that must comply with the rules of §1.446-1(e). Thus, the method of determining when property is provided must be used consistently from year to year, and cannot be changed without the consent of the Commissioner.

(iv) If different services or items of property are required to be provided to a taxpayer under a single contract or agreement, economic performance generally occurs over the time each service is provided and as each item of property is provided. However, if a service or item of property to be provided to the taxpayer is incidental to other services or property to be provided under a contract or agreement, the taxpayer is not required to allocate any portion of the total contract price to the incidental service or property. For purposes of this paragraph (d)(5)(iv), property or services are treated as incidental only if—

(A) The cost of the property or services is treated on the taxpayer's books and records as part of the cost of the other property or services provided under the contract; and

(B) The aggregate cost of the property or services does not exceed 10 percent of the total contract price.

(6) *Examples.* The following examples illustrate the principles of this paragraph (d). For purposes of these examples, it is assumed that the requirements of the all events test other than economic performance have been met, and that the recurring item exception is not used.

Example 1. X corporation, a calendar year, accrual method taxpayer, maintains a vested vacation pay plan pursuant to which the employees of X are unconditionally entitled to vacation pay based on the amount of work performed during any taxable year. During 1990 the employees of X, who all use a calendar taxable year and the cash method of accounting, earn $150,000 of vacation pay. X pays $25,000 of the vacation pay on or before March 15, 1991. The remainder of the vacation pay is paid after March 15, 1991.

Under paragraph (d)(2) of this section, economic performance with respect to the liability for vacation pay occurs as the employees provide services to X. Thus, $150,000 is incurred by X for the 1990 taxable year.

However, amounts paid after March 15, 1991, may be deferred compensation subject to section 404(a)(5), depending on the facts and circumstances (see §1.404(b)-1T, Q&A-2). Assuming that section 404(a)(5) applies, the $125,000 that X does not pay until after March 15, 1991, is not deductible until the taxable year in which the vacation pay is includible in the gross income of employees participating in the plan, even though economic performance has occurred with respect to the amount. The result would be the same if X maintained this plan for the benefit of calendar year, cash-basis

independent contractors. See section 404(d).

Example 2. X corporation, a calendar year, accrual method taxpayer, is an oil company. During March 1990, X enters into an oil and gas lease. In November 1990, X installs a platform and commences drilling. The lease obligates X to remove its offshore platform and well fixtures upon abandonment of the well or termination of the lease. During 1998, X removes the platform and well fixtures at a cost of $200,000.

Under paragraph (d)(4) of this section, economic performance with respect to X's liability to remove the offshore platform and well fixtures occurs as X incurs costs in connection with that liability. X incurs these costs in 1998 as, for example, X's employees provide X with removal services (see paragraph (d)(2) of this section). Consequently, X incurs $200,000 for the 1998 taxable year. Alternatively, assume that during 1990 X pays Z $130,000 to remove the platform and fixtures, and that Z performs these removal services in 1998. Under paragraph (d)(2) of this section, X does not incur this cost until Z performs the services. Thus, economic performance with respect to the $130,000 X pays Z occurs in 1998.

Example 3. W corporation, a calendar year, accrual method taxpayer, sells tractors under a three-year warranty that obligates W to make any reasonable repairs to each tractor it sells. During 1990, W sells ten tractors. In 1992 W repairs, at a cost of $5,000, two tractors sold during 1990.

Under paragraph (d)(4) of this section, economic performance with respect to W's liability to perform services under the warranty occurs as W incurs costs in connection with that liability. W incurs these costs in 1992 as, for example, replacement parts are provided to W (see paragraph (d)(2) of this section). Consequently, $5,000 is incurred by W for the 1992 taxable year.

Example 4. W corporation, a calendar year, accrual method taxpayer, manufactures machine tool equipment. In November 1990, W contracts to provide X corporation with certain equipment on January 1, 1993. The contract is not a long-term contract under section 460 or §1.451-3. In December 1990, W pays Y corporation $100,000 for certain parts necessary to manufacture the equipment. The parts are provided to W in May 1991. W's employees provide W with services necessary to manufacture the equipment during 1991, for which W pays $150,000 compensation in 1991. In December 1990, W pays Z corporation $50,000 to lease from Z, for the one-year period beginning on January 1, 1991, testing equipment to perform quality control tests required by the agreement with X.

Under paragraph (d)(4) of this section, economic performance with respect to W's liability to provide the equipment to X occurs as W incurs costs in connection with that liability. W incurs these costs during 1991, as services, property, and the use of property necessary to manufacture the equipment are provided to W (see paragraphs (d)(2) and (d)(3) of this section). Thus, $300,000 is incurred by W for the 1991 taxable year. See section 263A and the regulations thereunder for rules relating to the capitalization and inclusion in inventory of these incurred costs.

Alternatively, assume that the agreement with X is a long- term contract as defined in section 460(f), and that W takes into account all items with respect to such contracts under the percentage of completion method as described in section 460(b)(1). Under paragraph (d)(2)(ii) of this section, the $100,000 W pays in 1990 for parts is incurred for the 1990 taxable year, for purposes of determining the percentage of completion under section 460(b)(1)(A). W's other costs under the agreement are incurred for the 1991 taxable year for this purpose.

Example 5. LP1, a calendar year, accrual method limited partnership, owns the working interest in a parcel of property containing oil and gas. During December 1990, LP1 enters into a turnkey contract with Z corporation pursuant to which LP1 pays Z $200,000 and Z is required to provide a completed well by the close of 1992. In May 1992, Z commences drilling the well, and, in December 1992, the well is completed.

Under paragraph (d)(2) of this section, economic performance with respect to LP1's liability for drilling and development services provided to LP1 by Z occurs as the services are provided. Consequently, $200,000 is incurred by LP1 for the 1992 taxable year.

Example 6. X corporation, a calendar year, accrual method taxpayer, is an automobile dealer. On January 15, 1990, X becomes a member of N, a non-profit corporation that provides advertising and promotional activities with respect to automobiles sold by X and other member dealers. As a member of the non-profit corporation, X agrees to pay an additional $10 to Y, the manufacturer of the automobiles, for each automobile purchased by X from Y. Y, acting as an agent for the member dealers, has agreed to remit this amount to N to be used by N for advertising and promotional activities.

During 1990, X purchases from Y 1,000 new automobiles and pays to Y an additional $10,000 as provided in the membership agreement. Y, in turn, pays the $10,000 to N. N uses this $10,000 to provide advertising and promotional activities during 1992.

Under paragraph (d)(2) of this section, economic performance with respect to X's liability for advertising and promotional services provided to X by N occurs as the services are provided. Consequently, $10,000 is incurred by X for the 1992 taxable year.

Example 7. V corporation, a calendar year, accrual method taxpayer, charters aircraft. On December 20, 1990, V leases a jet aircraft from L for the four-year period that begins on January 1, 1991. The lease obligates V to pay L a base rental of $500,000 per year. In addition, the lease requires V to pay $25 to an escrow account for each hour that the aircraft is flown. The escrow account funds are to be used by L to make necessary repairs to the aircraft. Any amount remaining in the escrow account upon termination of the lease is payable to V. During 1991, the aircraft is flown 1,000 hours and V pays $25,000 to the escrow account. The aircraft is repaired by L in 1993. In 1994, $20,000 is released from the escrow account to pay L for the repairs.

Under paragraph (d)(3) of this section, economic performance with respect to V's base rental liability occurs ratably over the period of time V is entitled to use the jet aircraft. Consequently, the $500,000 rent is incurred by V for the 1991 taxable year and for each of the next three taxable years. Under paragraph (d)(2) of this section, economic performance with respect to the liability to place amounts in escrow occurs as the aircraft is repaired. Consequently, V incurs $20,000 for the 1993 taxable year.

Example 8. The facts are the same as in Example 7, except that on December 10, 1991, one of the aircraft's engines fails. On December 15, 1991, $20,000 is released from the escrow account to L in payment for repairs to the engine that V reasonably expects L to perform in January 1992. Economic performance with respect to V's liability to L for repair services occurs as L provides the services. However, under paragraph (d)(5)(ii) of this section, V is permitted to treat the repair services as provided to V as V pays L for the services. If V so treats the services as provided, V incurs $20,000 for the 1991 taxable year.

Example 9. W corporation, a calendar year, accrual method taxpayer, is an investment banking firm. W has an ongoing contract with Z, an office supply vendor, under which Z is obligated to provide office supplies to W. On December 15, 1990, W pays Z $2,000 for office supplies that W reasonably expects Z to deliver by the end of January 1991. Economic performance with respect to W's liability for property to be provided by Z occurs as Z provides the property. However, under paragraph (d)(5)(ii) of this section, W is permitted to treat the supplies as provided to W as W makes payment to Z for the supplies. If W so treats the property as provided, W incurs $2,000 for the 1990 taxable year.

Example 10. X corporation, a calendar year, accrual method taxpayer, manufactures and sells electronic circuitry. On November 15, 1990, X enters into a contract with Y that entitles X to the exclusive use of a patent owned by Y for the five-year period beginning on January 1, 1991. Pursuant to the contract, X pays Y $100,000 on December 30, 1990.

Under paragraph (d)(3) of this section, economic performance with respect to X's liability for the use of property occurs ratably over the period of time X is entitled to use the patent. Consequently, $20,000 is incurred by X for 1991 and for each of the succeeding four taxable years.

(e) *Interest.* In the case of interest, economic performance occurs as the interest cost economically accrues, in accordance with the principles of relevant provisions of the Code.

(f) *Liabilities under notional principal amount contracts.* [Reserved]

(g) *Certain liabilities for which payment is economic performance—* (1) *In general—*(i) *Person to which payment must be made.* In the case of liabilities described in paragraphs (g)(2) through (7) of this section, economic performance occurs when, and to the extent that, payment is made to the person to which the liability is owed. Thus, except as otherwise provided in §1.461-6, economic performance does not occur as a taxpayer makes payments in connection with such a liability to any other person, including a trust, escrow account, court-administered

fund, or any similar arrangement, unless the payments constitute payment to the person to which the liability is owed under paragraph (g)(1)(ii)(B) of this section. Instead, economic performance occurs as payments (including payments of investment income attributable to transferred amounts) are made from that other person or fund to the person to which the liability is owed. For example, economic performance occurs as payments are made from a court-administered fund to a plaintiff prevailing in a tort suit. For rules relating to the taxation of amounts transferred to a fund, see section 468B(g) and the regulations thereunder.

(ii) *Payment to person to which liability is owed.* Paragraph (d)(5) of this section provides that in certain cases a taxpayer may treat services or property as provided to the taxpayer as the taxpayer makes payments to the person providing the services or property. In addition, this paragraph (g) provides that in the case of certain liabilities of a taxpayer, economic performance occurs as the taxpayer makes payment to persons specified therein. For these and all other purposes of section 461(h) and the regulations thereunder:

(A) *Payment.* The term "payment" has the same meaning as for determining whether a taxpayer using the cash receipts and disbursements method of accounting has made a payment. Thus, for example, payment includes the furnishing of cash or cash equivalents. Payment does not include the furnishing of a note or other evidence of indebtedness of the taxpayer, whether or not the evidence is guaranteed by any other instrument (including a standby letter of credit) or by any third party (including a government agency). As a further example, payment does not include a promise of the taxpayer to provide property or services in the future (whether or not the promise is evidenced by a contract or other written agreement). In addition, payment does not include an amount transferred as a loan, refundable deposit, or contingent payment with respect to which the taxpayer may be, or become, entitled to receive a refund or credit.

(B) *Person to which payment is made.* Payment to another person is accomplished if paragraph (g)(1)(ii)(A) of this section is satisfied and a cash basis taxpayer in the position of that person would be treated as having actually or constructively received the amount of the payment as gross income under the principles of section 451 (without regard to section 104(a) or any other provision that specifically excludes the amount from gross income). Thus, for example, the purchase of an annuity contract or any other asset generally does not constitute payment to the person to which a liability is owed unless the ownership of the contract or other asset is transferred to that person.

(C) *Payment in the case of liabilities that are assumed in connection with the sale of a trade or business—(1) In general.* If, in connection with the sale or exchange of a trade or business by a taxpayer, the purchaser expressly assumes a liability arising out of the trade or business that the taxpayer (but for the economic performance requirement) would have been entitled to incur as of the date of the sale, the taxpayer is deemed to make payments with respect to the liability as the amount of the liability is included in the amount realized on the transaction by the taxpayer. See §1.1001-2 for rules relating to the inclusion in amount realized from a discharge of liabilities resulting from a sale or exchange.

(2) Trade or business. For purposes of this paragraph (g)(1)(ii)(C), a trade or business is a specific group of activities carried on by the taxpayer for the purpose of earning income or profit if every operation that is necessary to the process of earning income or profit is included in such group. Thus, for example, such a group of activities generally must include the collection of income and the payment of expenses.

(3) Tax avoidance. This paragraph (g)(1)(ii)(C) does not apply if the district director determines that tax avoidance is one of the taxpayer's principal purposes for the sale of a trade or business.

(iii) *Person.* For purposes of this paragraph (g), "person" has the same meaning as in section 7701(a)(1), except that it also includes any foreign state, the United States, any State or political subdivision thereof, any possession of the United States, or any agency or instrumentality of any of the foregoing.

(iv) *Assignments.* If a person that has a right to receive payment in satisfaction of a liability described in paragraphs (g)(2) through (5) of this section makes a valid assignment of that right to a second person, or if the right is assigned to the second person through operation of law, then payment to the second person in satisfaction of that liability constitutes payment to the person to which the liability is owed.

(2) *Liabilities arising under a workers' compensation act or out of any tort, breach of contract, or violation of law.* If the liability of a taxpayer requires a payment or series of payments to another person and arises under any workers' compensation act or arises out of any tort, breach of contract, or violation of law, economic performance occurs as payment is made to the person to which the liability is owed. See examples 1 and 2 of paragraph (g)(8) of this section. For purposes of this paragraph (g)(2)—

(i) A liability to make payments for services, property, or other consideration provided under a contract is not a liability arising out of a breach of that contract unless the payments are in the nature of incidental, consequential, or liquidated damages; and

(ii) A liability arising out of a tort, breach of contract, or violation of law includes a liability arising out of the settlement of a dispute in which a tort, breach of contract, or violation of law is alleged.

(3) *Rebates and refunds.* If the liability of a taxpayer is to pay a rebate or refund to another person (whether paid in property, money, or as a reduction in the price of goods or services to be provided in the future by the taxpayer), economic performance occurs as payment is made to the person to which the liability is owed. This paragraph (g)(3) applies to all rebates, refunds and payments or transfers in the nature of a rebate or refund regardless of whether they are characterized as a deduction from gross income, an adjustment to gross receipts or total sales, or an adjustment or addition to cost of goods sold. In the case of a rebate or refund made as a reduction in the price of goods or services to be provided in

the future by the taxpayer, "payment" is deemed to occur as the taxpayer would otherwise be required to recognize income resulting from a disposition at an unreduced price. For purposes of determining whether the recurring item exception of §1.461-5 applies, a liability that arises out of a tort, breach of contract, or violation of law is not considered a rebate or refund. See example 3 of paragraph (g)(8) of this section.

(4) *Awards, prizes, and jackpots.* If the liability of a taxpayer is to provide an award, prize, jackpot, or other similar payment to another person, economic performance occurs as payment is made to the person to which the liability is owed. See examples 4 and 5 of paragraph (g)(8) of this section.

(5) *Insurance, warranty, and service contracts.* If the liability of a taxpayer arises out of the provision to the taxpayer of insurance, or a warranty or service contract, economic performance occurs as payment is made to the person to which the liability is owed. See examples 6 through 9 of paragraph (g)(8) of this section. For purposes of this paragraph (g)(5)—

(i) A warranty or service contract is a contract that a taxpayer enters into in connection with property bought or leased by the taxpayer, pursuant to which the other party to the contract promises to replace or repair the property under specified circumstances.

(ii) The term "insurance" has the same meaning as for purposes of determining the deductibility of amounts paid or incurred for insurance under section 162.

(6) *Taxes*—(i) *In general.* Except as otherwise provided in this paragraph (g)(6), if the liability of a taxpayer is to pay a tax, economic performance occurs as the tax is paid to the governmental authority that imposed the tax. For purposes of this paragraph (g)(6), a tax does not include a charge collected by a governmental authority for specific extraordinary property or services provided to a taxpayer by the governmental authority. Examples of such a charge include the purchase price of a parcel of land sold to a taxpayer by a governmental authority and a charge for labor engaged in by government employees to improve that parcel. In certain cases, a liability to pay a tax is permitted to be taken into account in the taxable year before the taxable year during which economic performance occurs under the recurring item exception of §1.461-5. See example 10 of paragraph (g)(8) of this section.

(ii) *Licensing fees.* If the liability of a taxpayer is to pay a licensing or permit fee required by a governmental authority, economic performance occurs as the fee is paid to the governmental authority, or as payment is made to any other person at the direction of the governmental authority.

(iii) *Exceptions*—(A) *Real property taxes.* If a taxpayer has made a valid election under section 461(c), the taxpayer's accrual for real property taxes is determined under section 461(c). Otherwise, economic performance with respect to a property tax liability occurs as the tax is paid, as specified in paragraph (g)(6)(i) of this section.

(B) *Certain foreign taxes.* If the liability of a taxpayer is to pay an income, war profits, or excess profits tax that is imposed by the authority of any foreign country or possession of the United States and is creditable under section 901 (including a creditable tax described in section 903 that is paid in lieu of such a tax), economic performance occurs when the requirements of the all events test (as described in §1.446-1(c)(1)(ii)) other than economic performance are met, whether or not the taxpayer elects to credit such taxes under section 901(a).

(7) *Other liabilities.* In the case of a taxpayer's liability for which economic performance rules are not provided elsewhere in this section, economic performance occurs as the taxpayer makes payments in satisfaction of the liability to the person to which the liability is owed. This paragraph (g)(7) applies only if the liability cannot properly be characterized as a liability covered by rules provided elsewhere in this section. If a liability may properly be characterized as, for example, a liability arising from the provision of goods or services to, or by, a taxpayer, the determination as to when economic performance occurs with respect to that liability is made under paragraph (d) of this section and not under this paragraph (g)(7).

(8) *Examples.* The following examples illustrate the principles of this paragraph (g). For purposes of these examples, it is assumed that the elements of the all events test other than economic performance have been met and, except as otherwise provided, that the recurring item exception is not used.

Example 1. During the period 1970 through 1975, Z corporation, a calendar year, accrual method taxpayer, manufactured and distributed industrial products that contained carcinogenic substances. In 1990, a number of lawsuits are filed against Z alleging damages due to exposure to these products. In settlement of a lawsuit maintained by A, Z agrees to purchase an annuity contract that will provide annual payments to A of $50,000 for a period of 25 years. On December 15, 1990, Z pays W, an unrelated life insurance company, $491,129 for such an annuity contract. Z retains ownership of the annuity contract.

Under paragraph (g)(2) of this section, economic performance with respect to Z's liability to A occurs as each payment is made to A. Consequently, $50,000 is incurred by Z for each taxable year that a payment is made to A under the annuity contract. (Z must also include in income a portion of amounts paid under the annuity, pursuant to section 72.) The result is the same if in 1990 Z secures its obligation with a standby letter of credit.

If, instead, Z transfers ownership of the annuity contract to A, an amount equal to the fair market value of the annuity on the date of transfer is incurred by Z in the taxable year of the transfer (see paragraph (g)(1)(ii)(B) of this section).

Example 2. Assume the same facts as in Example 1, except that Z is required by court order to pay $15,000,000 to a fund that will assume sole liability for a specified class of tort claims arising out of the manufacture and distribution of Z products containing carcinogenic substances.

If Z does not (or cannot) elect the application of section 468B (designated settlement fund), then under paragraph (g)(1)(i) and (g)(2) of this section, economic performance with respect to the $15,000,000 liability occurs only as payments are made to the underlying tort claimants from the fund. Consequently, Z incurs only those amounts actually paid to the claimants from the fund during the taxable year. If Z properly elects the application of section 468B, economic performance with respect to the $15,000,000 liability occurs as Z makes payments to the fund.

Example 3. X corporation, a calendar year, accrual method taxpayer, manufactures and sells hardware products. X enters into agreements that entitle each of its distributors to a rebate (or discount on future purchases) from X based on the amount of purchases made by the distributor from X during any calendar year. During the 1990 calendar year, X becomes liable to pay a $2,000 rebate to distributor A. X pays A $1,200 of the rebate on January 15, 1991, and the remaining $800 on October 15, 1991. Assume the rebate is deductible (or allowable as an adjustment to gross receipts or cost of goods sold) when incurred.

If X does not, or is not entitled to, adopt the recurring item exception described in §1.461-5 with respect to rebates and refunds, then under

paragraph (g)(3) of this section, economic performance with respect to the $2,000 rebate liability occurs in 1991. However, if X has made a proper election under §1.461-5, and as of December 31, 1990, all events have occurred that determine the fact of the rebate liability, X incurs $1,200 for the 1990 taxable year. Because economic performance (payment) with respect to the remaining $800 does not occur until October 15, 1991 (more than 8 1/2 months after the end of 1990), X cannot use the recurring item exception (see §1.461-5). Thus, the $800 is not incurred by X until the 1991 taxable year. The result in this example would be the same if, instead of making the cash payments to A, during 1991 X adjusts the price paid by A for hardware purchased by A that is delivered to A during 1991.

Example 4. W corporation, a calendar year, accrual method taxpayer, produces and sells breakfast cereal. W conducts a contest pursuant to which the winner is entitled to $10,000 per year for a period of 20 years. On December 1, 1990, A is declared the winner of the contest and is paid $10,000 by W. In addition, on December 1 of each of the next nineteen years, W pays $10,000 to A.

Under paragraph (g)(4) of this section, economic performance with respect to the $200,000 contest liability occurs as each of the $10,000 payments is made by W to A. Consequently, $10,000 is incurred by W for the 1990 taxable year and for each of the succeeding nineteen taxable years.

Example 5. Y corporation, a calendar year, accrual method taxpayer, owns a casino that contains progressive slot machines. A progressive slot machine provides a guaranteed jackpot amount that increases as money is gambled through the machine until the jackpot is won or until a maximum predetermined amount is reached. On July 1, 1991, the guaranteed jackpot amount on one of Y's slot machines reaches the maximum predetermined amount of $50,000. On February 1, 1992, the $50,000 jackpot is paid to B.

Under paragraph (g)(4) of this section, economic performance with respect to the $50,000 jackpot liability occurs on the date the jackpot is paid to B. Consequently, $50,000 is incurred by Y for the 1992 taxable year.

Example 6. X corporation, a calendar year, accrual method taxpayer, manufactures and distributes automobiles. On December 1, 1990, X enters into a contract with Z, a property and casualty insurance company unrelated to X. Under the contract, X must pay Z $25 for each automobile manufactured by X during the 1991 calendar year. This amount is payable monthly based on the automobiles manufactured during the preceding month. In return, Z must satisfy any liability of X to a third party for damages attributable to a defect in these automobiles (a "1991 product liability loss"). X is not entitled to a refund, credit or other benefit under the contract. X manufactures 100,000 automobiles during the 1991 calendar year.

Assuming the arrangement constitutes insurance, under paragraph (g)(5) of this section economic performance occurs over the 1991 taxable year, as the premium is paid. Consequently, the $2,500,000 insurance premium is incurred by X for the 1991 taxable year.

Example 7. V corporation, a calendar year, accrual method taxpayer, manufactures toys. V enters into a contract with W, an unrelated insurance company, on December 15, 1990. The contract obligates V to pay W a premium of $500,000 before the end of 1993. The contract obligates W to satisfy any liability of V resulting from claims made during 1991 or 1992 against V by any third party for damages attributable to defects in toys manufactured by V. Pursuant to the contract, V pays W a premium of $500,000 on September 1, 1993.

Assuming the arrangement constitutes insurance, economic performance occurs as the premium is paid. Thus, $500,000 is incurred by V for the 1993 taxable year.

Example 8. Y corporation, a calendar year, accrual method taxpayer, is a common carrier. On December 15, 1990, Y contracts to pay Z, an unrelated insurance company, $360,000 in 1991. In return, Z must satisfy any liability of Y for damages that arises under a workers' compensation act or out of any tort if the event that causes the damages occurs during 1991 or 1992. Y pays $360,000 to Z during Y's 1991 taxable year.

Assume that the arrangement constitutes insurance under section 162. Economic performance with respect to a liability for insurance occurs as the premiums for the insurance are paid. Consequently, $360,000 is incurred by Y for the 1991 taxable year. The period for which the $360,000 amount is permitted to be taken into account is determined under the capitalization rules because the insurance contract is an asset having a useful life extending substantially beyond the close of the taxable year.

Example 9. Assume the same facts as in Example 8, except that Y is obligated to pay the first $5,000 of any damages covered by the arrangement with Z. Y is, in effect, self-insured to the extent of this $5,000 "deductible." Thus, under paragraph (g)(1) of this section, economic performance with respect to the $5,000 liability does not occur until the amount is paid to the person to which the tort or workers' compensation liability is owed (whether paid to that person by Y or Z).

Example 10. The laws of State A provide that every person owning personal property located in State A on the first day of January shall be liable for tax thereon and that a lien for such tax shall attach as of such date. In addition, the laws of State A provide that 60% of the tax is due on the first day of December following the lien date and the remaining 40% is due on the first day of July of the succeeding year. On January 1, 1990, X corporation, a calendar year, accrual method taxpayer, owns personal property located in State A. State A imposes a $10,000 tax on X with respect to that property on January 1, 1990. X pays State A $6,000 of the tax on December 1, 1990, and the remaining $4,000 on July 1, 1991.

Under paragraph (g)(6) of this section, economic performance with respect to $6,000 of the tax liability occurs on December 1, 1990. Consequently, $6,000 is incurred by X for the 1990 taxable year. Economic performance with respect to the remaining $4,000 of the tax liability occurs on July 1, 1991. If X has adopted the recurring item exception described in §1.461-5 as a method of accounting for taxes, and as of December 31, 1990, all events have occurred that determine the liability of X for the remaining $4,000, X also incurs $4,000 for the 1990 taxable year. If X does not adopt the recurring item exception, the $4,000 is not incurred by X until the 1991 taxable year.

(h) *Liabilities arising under the Nuclear Waste Policy Act of 1982.* Notwithstanding the principles of paragraph (d) of this section, economic performance with respect to the liability of an owner or generator of nuclear waste to make payments to the Department of Energy ("DOE") pursuant to a contract required by the Nuclear Waste Policy Act of 1982 (Pub. L. 97-425, 42 U.S.C. 10101-10226 (1982)) occurs as each payment under the contract is made to DOE and not when DOE satisfies its obligations under the contract. This rule applies to the continuing fee required by 42 U.S.C. 10222(a)(2) (1982), as well as the one-time fee required by 42 U.S.C. 10222(a)(3) (1982). For rules relating to when economic performance occurs with respect to interest, see paragraph (e) of this section.

(i) [Reserved].

(j) *Special effective dates and transitional rules.* (1) Except as otherwise provided in paragraph (j)(2) of this section, section 461(h) and this §1.461-4 apply to liabilities that would, under the law in effect before the enactment of section 461(h), be allowable as a deduction or otherwise incurred after July 18, 1984. For example, this effective date applies to liabilities arising under a workers' compensation act or out of any tort. See §1.461-7T for rules relating to the effective dates of section 461(h).

(2) Rules for liabilities contained in paragraph (g) of this section (other than liabilities arising under a workers' compensation act or out of any tort) apply to liabilities that would, under the law in effect before the enactment of section 461(h), be allowable as a deduction or otherwise incurred for taxable years beginning after December 31, 1989. Thus, there is no section 481(a) adjustment with respect to any change in the timing of when a liability is incurred that may result from compliance with paragraph (g) of this section. See §1.461-7T for an explanation of the principles of this "cut-off method." A taxpayer is permitted, however, to elect to change the timing of when a liability described in this paragraph (j)(2) is incurred through a full-year change in method of accounting pursuant to the procedures and principles of §1.461-7T, subject to the conditions of section 4 of Rev. Proc. 84-74, 1984-2 C.B. 736 (as amended). The Commissioner may provide additional published guidance relating

to these changes, including rules regarding any required adjustment under section 481(a).

§1.461-5 Recurring item exception.

(a) *In general.* Except as otherwise provided in paragraph (c) of this section, a taxpayer using an accrual method of accounting may adopt the recurring item exception described in paragraph (b) of this section as a method of accounting for one or more types of recurring items incurred by the taxpayer.

(b) *Requirements for use of the exception*—(1) *General rule.* Under the recurring item exception, a liability is treated as incurred for a taxable year if—

(i) As of the end of that taxable year, all events have occurred that establish the fact of the liability and the amount of the liability can be determined with reasonable accuracy;

(ii) Economic performance with respect to the liability occurs on or before the earlier of—

(A) The date the taxpayer files a timely (including extensions) return for that taxable year; or

(B) The 15th day of the 9th calendar month after the close of that taxable year;

(iii) The liability is recurring in nature; and

(iv) Either—

(A) The amount of the liability is not material; or

(B) The accrual of the liability for that taxable year results in a better matching of the liability with the income to which it relates than would result from accruing the liability for the taxable year in which economic performance occurs.

(2) *Amended returns.* A taxpayer may file an amended return treating a liability as incurred under the recurring item exception for a taxable year if economic performance with respect to the liability occurs after the taxpayer files a return for that year, but within 8 1/2 months after the close of that year.

(3) *Liabilities that are recurring in nature.* A liability is recurring if it can generally be expected to be incurred from one taxable year to the next. However, a taxpayer may treat such a liability as recurring in nature even if it is not incurred by the taxpayer in each taxable year. In addition, a liability that has never previously been incurred by a taxpayer may be treated as recurring if it is reasonable to expect that the liability will be incurred on a recurring basis in the future.

(4) *Materiality requirement.* For purposes of this paragraph (b):

(i) In determining whether a liability is material, consideration shall be given to the amount of the liability in absolute terms and in relation to the amount of other items of income and expense attributable to the same activity.

(ii) A liability is material if it is material for financial statement purposes under generally accepted accounting principles.

(iii) A liability that is immaterial for financial statement purposes under generally accepted accounting principles may be material for purposes of this paragraph (b).

(5) *Matching requirement.* (i) In determining whether the matching requirement of paragraph (b)(1)(iv)(B) of this section is satisfied, generally accepted accounting principles are an important factor, but are not dispositive.

(ii) In the case of a liability described in paragraph (g)(3) (rebates and refunds), paragraph (g)(4) (awards, prizes, and jackpots), paragraph (g)(5) (insurance, warranty, and service contracts), or paragraph (g)(6) (taxes) of §1.461-4, the matching requirement of paragraph (b)(1)(iv)(B) of this section shall be deemed satisfied.

(c) *Types of liabilities not eligible for treatment under the recurring item exception.* The recurring item exception does not apply to any liability of a taxpayer described in paragraph (e) (interest), paragraph (g)(2) (workers' compensation, tort, breach of contract, and violation of law), or paragraph (g)(7) (other liabilities) of §1.461-4. Moreover, the recurring item exception does not apply to any liability incurred by a tax shelter, as defined in section 461(i) and §1.448-1T(b).

(d) *Time and manner of adopting the recurring item exception.* If a taxpayer has never incurred a type of liability (as described in Q&A-3 (d) of §1.461-7T) prior to its first taxable year beginning after December 31, 1989, the taxpayer is permitted to adopt the recurring item exception as a method of accounting for that type of liability, but only for its first taxable year beginning after December 31, 1989, that the type of liability is incurred by the taxpayer. If a taxpayer has incurred a type of liability prior to its first taxable year beginning after December 31, 1989, the taxpayer is granted the consent of the Commissioner to change to the recurring item exception method of accounting for that type of liability, but only for its first taxable year beginning after December 31, 1989. In either of these cases, the recurring item exception must be adopted as prescribed in Q&A-7 (b) of §1.461-7T, applied by substituting the appropriate taxable year described above in this paragraph (d) for "the taxable year that includes July 19, 1984," and any resulting section 481(a) adjustment is taken into account ratably over a 3-year adjustment period, pursuant to the principles of Q&A-8 and Q&A-9 of §1.461-7T. In all other cases, any change to or from the recurring item exception method of accounting (for either a type of item or for all items) is a change in method of accounting subject to section 446(e) and §1.446-1(e).

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

Example 1. Y corporation, a calendar year, accrual method taxpayer, manufactures and distributes video cassette recorders. Y offers to refund the price of the recorder to any purchaser not satisfied with the recorder. During the 1990 taxable year, 100 purchasers request a refund of the $500 purchase price. Y refunds $30,000 on or before September 15, 1991, and the remaining $20,000 after such date but before the end of the 1991 taxable year.

Under paragraph (g)(3) of §1.461-4, economic performance with respect to $30,000 of the refund liability occurs on or before September 15, 1991. Assume the refund is deductible (or allowable as an adjustment to gross receipts or cost of goods sold) when incurred. If Y does not, or is not entitled to, adopt the recurring item exception with respect to rebates and refunds, $30,000 is incurred by Y for the 1991 taxable year. However, if Y has made a proper election under this section, and as of December 31, 1990, all events have occurred that determine the fact of the liability for the $30,000, Y incurs that amount for the 1990 taxable year. Because economic performance (payment) with respect to the remaining $20,000 occurs after September 15, 1991 (more than 8 1/2 months after the end of 1990), that amount is not eligible for recurring item treatment under this section. Thus, the $20,000 amount is not incurred by Y until the 1991 taxable year.

Example 2. X corporation, a calendar year, accrual method taxpayer, is a manufacturer of printing presses. Under its method of account-

ing, X recognizes sales income upon execution of the sales contract, rather than upon shipment. In December 1990, X contracts to pay C, a common carrier, $10,000 upon June 1991 delivery of 10 presses sold by X in November 1990. X generally incurs such shipping costs from one taxable year to the next. Economic performance with respect to the amount paid to C for shipping services occurs in June 1991, as C provides the shipping services (see §1.461-4(d)(2)).

Assume that all the events that fix and determine X's $10,000 liability occur in 1990. If X adopts the recurring item exception, X may deduct $10,000 for its 1990 taxable year, even though economic performance does not occur until June 1991. The $10,000 expense relates to 1990 income from the sale. Thus, better matching results from its accrual in the taxable year preceding the year during which economic performance occurs.

Example 3. Assume the same facts as in Example 2, and assume that X files its income tax return for 1990 on March 15, 1991. Under paragraph (b)(1)(ii) of this section, the costs are ineligible for recurring item exception treatment because economic performance with respect to the costs does not occur before X files a return for the taxable year for which the item would have been deducted under the exception. However, since economic performance occurs within 8 1/2 months after 1990, X may file an amended return claiming the deduction for its 1990 taxable year (see paragraph (b)(2) of this section).

§1.461-6 Economic performance when certain liabilities are assigned or are extinguished by the establishment of a fund.

(a) *Qualified assignments of certain personal injury liabilities under section 130.* In the case of a qualified assignment (within the meaning of section 130(c)), economic performance occurs as a taxpayer-assignor makes payments that are excludible from the income of the assignee under section 130(a).

(b) *Section 468B.* Economic performance occurs as a taxpayer makes qualified payments to a designated settlement fund under section 468B, relating to special rules for designated settlement funds.

(c) *Payment to a qualified fund—*(1) *In general.* In the case of a liability described in paragraph (g)(2) of §1.461-4 (other than a liability described in section 468B(d)(2)(D)), economic performance occurs as a taxpayer makes "approved payments" in satisfaction of the liability to a "qualified fund."

(2) *Qualified fund—*(i) *In general.* A qualified fund is a fund—

(A) That is established by an order described in paragraph (c)(2)(ii)(A) of this section and that extinguishes a liability of the taxpayer specified in paragraph (c)(1) of this section;

(B) That is administered by persons a majority of whom by vote are independent of the taxpayer;

(C) Under the terms of which the taxpayer or any related person cannot hold any beneficial interest in the income or corpus of the fund;

(D) To which no amounts can be transferred except approved payments;

(E) From which no amounts may be transferred to the taxpayer or any related person; and

(F) With respect to which an election has been made under this section.

(ii) *Other definitions.* For purposes of this paragraph (c)—

(A) *Approved payment.* An approved payment is any money or property, other than stock or indebtedness of the taxpayer (or any related person), irrevocably transferred to a qualified fund pursuant to an order of the United States, any State or political subdivision thereof, any possession of the United States, or any agency or instrumentality (including a court of law) of any of the foregoing. While an approved payment can include amounts received as a settlement of an insurance claim, no deduction is allowed for the transfer of those amounts to the extent the amounts are excluded from the taxpayer's gross income.

(B) *Extinguishment of liability.* [Reserved]

(C) *Related person.* "Related person" has the same meaning as in sections 267(b) and 707(b), applied by substituting 10 percent for 50 percent each place it appears.

(iii) *Exceptions.* A qualified fund does not include—

(A) A fund that is established to satisfy any contested liability of the taxpayer within the meaning of §1.461-2 (b); or

(B) A welfare benefit fund as defined in section 419.

(3) *Disqualification of fund.* If a qualified fund fails to satisfy any of the requirements of paragraph (c)(2) of this section for any taxable year—

(i) All amounts remaining in the fund shall be treated as transferred to the taxpayer in the taxable year of such failure; and

(ii) The taxpayer's tax liability for the year shall be computed without application of this paragraph (c). Thus, for example, deductions relating to a liability for which a fund is established may not be taken until the taxable year during which payments are made to the person entitled to payment (or as otherwise specified in this section).

(4) *Taxation of qualified fund.* The gross income of a qualified fund is taxed at the maximum rate in effect for the taxable year under section 1(e) of the Code. Approved payments to a fund are not treated as income to the fund. No deductions to the gross income of the fund are allowed except a deduction for any ordinary and necessary administrative or incidental costs incurred by the fund that would be deductible by a corporation.

(5) *Subtitle F.* For purposes of subtitle F (procedure and administration), a qualified fund is treated as a corporation and any tax imposed by this paragraph (c) is treated as a tax imposed by section 11 of the Code.

(6) *Time and manner of making election.* An election under this paragraph (c) is made under guidance published by the Secretary, and is revocable only with the consent of the Commissioner. See section 446(e) and §1.446-1(e).

(d) *Payments to other funds or persons that constitute economic performance.* [Reserved].

(e) *Effective dates.* The rules in paragraphs (a) and (b) of this section apply to payments after July 18, 1984. The rules in paragraph (c) of this section apply to payments in taxable years beginning after December 31, 1989.

Par. 10. Section 1.61-3 is amended by adding a new sentence at the end of paragraph (a) to read as follows:

§1.61-3 Gross income derived from business.

(a) * * * Thus, for example, an amount cannot be taken into account in the computation of cost of goods sold any earlier than the taxable year in which economic performance occurs with respect to the amount (see §1.446-1(c)(1)(ii)).

* * * * *

Par. 11. Section 1.263(a)-1 is amended by adding new text to the end of paragraph (b) to read as follows:

§1.263(a)-1 Capital expenditures; in general.

* * * * *

(b) * * * An amount referred to in paragraph (a) of this section is a capital expenditure that is taken into account through inclusion in inventory costs or a charge to capital accounts or basis no earlier than the taxable year during which the amount is incurred within the meaning of §1.446-1(c)(1)(ii). Capital expenditures are subsequently recovered through depreciation, amortization, cost of goods sold, as an adjustment to basis, or otherwise, at such time as the property to which the amount relates is used, sold, or otherwise disposed of by the taxpayer, in accordance with applicable Code sections and guidance published by the Secretary.

* * * * *

Par. 12. Section 1.263A-1T is amended by adding a new sentence to the end of paragraph (a)(5)(i) to read as follows:

§1.263A-1T Capitalization and inclusion in inventory costs of certain expenses (temporary).

(a) * * *

(5) * * *

(i) * * * However, the amount of any cost required to be capitalized may not be included in inventory or charged to capital accounts or basis beginning any earlier than the taxable year during which the amount is incurred within the meaning of §1.446-1(c)(1)(ii).

* * * * *

Par. 13. Section 1.451-3 is amended by adding a new paragraph (a) (8) to read as follows:

§1.451-3 Long-term contracts.

(a) * * *

(8) *Incurred.* For purposes of this section, the term "incurred" has the same meaning as in §1.446-1(c)(1)(ii).

* * * * *

Fred T. Goldberg, Jr.,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on June 6, 1990, 8:45 a.m., and published in the issue of the Federal Register for June 7, 1990, 55 F.R. 23235)

Notice of Proposed Rulemaking

Look-back Method for Long-term Contracts

IA-130-86

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains a notice of proposed rulemaking relating to the look-back method of section 460(b) of the Internal Revenue Code for long-term contract income reported under the percentage of completion method of accounting. The look-back method was enacted by the Tax Reform Act of 1986 (the "1986 Act"), Pub. L. No. 99-514 [1986-3 C.B. (Vol. 1) 1], and amended by the Technical and Miscellaneous Revenue Act of 1988 (the "1988 Act"), Pub. L. No. 100-647 [1988-3 C.B. 1], and the Revenue Reconciliation Act of 1989 (the "1989 Act"), Pub. L. No. 101-239 [1990-1 C.B. 210]. The purpose of the look-back method is to compensate for deferral or acceleration of contract income that results from the use of estimated, rather than actual, total contract price and contract costs in applying the percentage of completion method. Taxpayers are required to pay interest if long-term contract income is deferred, and are entitled to receive interest if long-term contract income is accelerated, under the percentage of completion method. These proposed regulations provide guidance as to how interest is computed under the look-back method, and also include simplified methods to reduce the complexity of computing interest under the look-back method.

DATES: In general, these proposed regulations are proposed to be effective with respect to contracts entered into after February 28, 1986. However, §1.460-6(d) (regarding the application of the simplified marginal impact method to domestic contracts of widely held pass-through entities) does not apply to any contract completed in a tax year for which the due date (determined with regard to extensions) of the return is before November 10, 1988, and §1.460-6(g) (regarding the application of the look-back method if there is a mid-contract change in a taxpayer reporting income from a contract) applies only to changes in the taxpayer after June 12, 1990. Written comments must be received by August 13, 1990. Outlines for persons wishing to speak at the public hearing scheduled for August 24, 1990, must be delivered by August 3, 1990. *See* the Notice of Public Hearing published elsewhere in *** [Announcement 90-84, 1990-29 I.R.B. 33]. A Treasury Decision adopting the proposed regulations with respect to the simplified marginal impact method in §1.460-6(d), and the delayed reapplication method in §1.460-6(e), is expected to be issued no later than September 17, 1990.

ADDRESSES: Send comments and requests to speak at the public hearing to: Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044, Attn: CC:CORP:T:R Room 4429 (IA-130-86). In the alternative, comments and requests may be hand-delivered to: Internal Revenue Service, Attn: CC:CORP:T:R (IA-130-86), Room 4429, Washington, D.C.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1980 (44 U.S.C. 3504(h)). Comments concerning the accuracy of the burden estimate and suggestions for reducing the burden should be directed to the Office of Management and Budget, Attention: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, D.C. 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer T:FP, Washington, D.C. 20224.

The collection of information in this regulation is in proposed §1.460-6(f) and (g). This information is required by the Internal Revenue Service to verify the amount of interest a taxpayer is required to pay or is entitled to receive under the look-back method. The likely respondents are corporations, partnerships, and individuals.

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

Estimated total annual reporting and recordkeeping burden: 69,550 hours.

The estimated average annual reporting burden per respondent is 5 hours and 32 minutes.

The estimated average annual recordkeeping burden per recordkeeper is 8 hours and 22 minutes.

Estimated number of respondents/recordkeepers: 5,000.

Estimated annual frequency of responses: 1.

Background

This document proposes to add new §1.460-6 to Part 1 of Title 26 of the Code of Federal Regulations. The proposed regulations conform the Income Tax Regulations to the requirements of section 460(b) of the Code, as enacted by section 804(a) of the 1986 Act and as amended by sections 1008(c)(2) and 5041(d) of the 1988 Act, and sections 7621(b) and 7811(e) of the 1989 Act.

Explanation of Provisions

IN GENERAL

Section 460(b) of the Code provides that, upon the completion of any long-term contract, the look-back method is applied to amounts reported under the contract using the percentage of completion method. The percentage of completion method requires the use of estimates of total contract price and total contract costs for reporting income in years prior to the year of contract completion. The look-back method is intended to offset the time-value effects of using estimates during the life of a contract that differ from the actual amounts determined upon the completion of the contract.

Under the look-back method, taxpayers are required to pay interest if tax liability is deferred as a result of underestimating the total contract price or overestimating total contract costs. Conversely, taxpayers are entitled to receive interest if tax liability is accelerated as a result of overestimating the total contract price or underestimating total contract costs. The amount of interest a taxpayer is required to pay or is entitled to receive under the look-back method is computed by applying the overpayment rate established by section 6621(a)(1), compounded daily, to the difference between the tax liability reported and the tax liability that would have been reported if the taxpayer had reported income on the basis of the actual contract price and the actual contract costs instead of the estimated contract price and costs (the "hypothetical underpayment" or "hypothetical overpayment"). Congress provided the look-back method to prevent harsh results that would otherwise be produced by the percentage of completion method if, for example, an overall loss is experienced on a contract. H.R. Rep. No. 426, 99th Cong., 1st Sess. 626 (1985), 1986-3 (Vol. 2) C.B. 626.

The look-back method involves only the computation of interest with respect to hypothetical underpayments or overpayments of tax liability attributable to the use of estimated, rather than actual, contract price and contract costs and, accordingly, has no effect on the amount of tax liability reported for a previous tax year. For example, if the tax rates in effect during the second year of a 2-year contract are lower than tax rates in effect during the first year, and if contract income was accelerated to the first year of the contract because estimated contract costs were lower than actual contract costs, interest is credited to the taxpayer on the hypothetical overpayment of tax for the first year based on the tax rate actually in effect for that year. The taxpayer would not be entitled, however, to a refund representing the amount of tax that would have been saved by applying the lower tax rate in effect for the second tax year to the amount of income accelerated to the first year of the contract. The look-back method, therefore, by design only corrects for timing differences, not permanent differences in tax liability that result from over- or underestimation of contract price and costs. Accordingly, the look-back method does not replace the requirement to properly estimate total contract price and contract costs in reporting income under the percentage of completion method for each year of a contract. For this reason, taxpayers' estimates remain subject to verification upon audit. See Notice 89-15, 1989-1 C.B. 634, Q & A 24 through Q & A 27, for rules for estimating the total contract price and total contract costs.

OPERATION OF THE LOOK-BACK METHOD

The amount of interest charged or credited to a taxpayer under the look-back method is generally computed in three steps. The first step is to reapply the percentage of completion method to completed contracts using the actual, rather than estimated, contract price and contract costs. Income from the contract is thus reallocated among prior tax years. The second step is to compare what the tax liability for each affected year would have been if income had been reported as reallocated under the look-back method with the tax liability that was previously determined. If, for any year, there is a difference between these two amounts, the difference is treated as a hypothetical underpayment or overpayment of tax. The third step is to apply the rate of interest on overpayments established by section 6621 of the Code, compounded daily, to the hypothetical underpayment or overpayment of tax, from the year of the underpayment or overpayment until the year the contract was completed. The result is the amount of interest to be paid by or credited to the taxpayer. The proposed regulations illustrate the three steps involved in applying the look-back method.

SIMPLIFIED METHOD

The proposed regulations provide a "simplified marginal impact method," which generally simplifies the application of Step Two of the look-back method by eliminating the requirement to determine what a taxpayer's tax liability would have been if income were reported on the basis of actual contract price and actual contract costs. Under the simplified marginal impact method, a taxpayer reapplies the percentage of completion method, using the actual, rather than estimated, total contract price and total contract costs, to all con-

tracts that are completed or adjusted in a particular year. The taxpayer then computes the aggregate marginal increase or decrease in income, from those contracts only, for each tax year affected by those contracts. This increase or decrease in income for each affected tax year is generally deemed to give rise to a hypothetical overpayment or underpayment of tax determined at the highest statutory tax rate in effect for that year under section 1, in the case of an individual, and section 11, in the case of a corporation (currently 28 percent and 34 percent, respectively).

In accordance with section 460(b)(4) of the Code, as added by section 5041(d) of the 1988 Act, the simplified marginal impact method must be used with respect to income from domestic long-term contracts of a widely held partnership, S corporation, or trust. With respect to this required application, the simplified marginal impact method is applied at the entity rather than at the owner level. In addition, hypothetical overpayments or underpayments of tax liability are deemed to arise at the highest statutory tax rate in effect for the majority of the entity's owners without regard to the actual tax rates or tax attributes of each of the owners.

The Internal Revenue Service has concluded that the simplified marginal impact method should be made available in the case of contracts that are not subject to the statutory simplified method. The Service is concerned about the administrative burdens that would be imposed on taxpayers in the absence of this simplified method. Considerable complexity arises because a taxpayer otherwise must fully recompute tax liability for several years at a time and, in addition, recompute tax liability multiple times for the same year when the look-back method is applied to a year for which the tax liability has previously been recomputed under the look-back method. Additional complexity results because the time period for determining the amount of interest charged or credited to a taxpayer must be adjusted when the look-back method affects tax attributes such as net operating loss or credit carryovers and carrybacks that change the time period that a hypothetical underpayment or overpayment of tax was actually available to the taxpayer or the government.

The simplified marginal impact method simplifies the computation of hypothetical overpayments and underpayments and, in some cases, the time period for charging or crediting interest. Therefore, the proposed regulations also permit C corporations, owners of widely held pass-through entities with respect to foreign contracts, owners of closely held pass-through entities, and sole proprietors to elect the simplified marginal impact method. The simplified marginal impact method is made available to these taxpayers under the authority of section 460(h), which provides that the Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of section 460.

A taxpayer that either is required to or that elects to use the simplified marginal impact method must apply the method to all of the taxpayer's completed long-term contracts. If, however, the amount of income originally reported with respect to a long-term contract for any redetermination year exceeds the amount of income reallocated under the look-back method with respect to that contract for that year (*i.e.*, using actual contract price and contract costs) by the lesser of $1,000,000 or 20 percent of the amount of income reallocated under the look-back method with respect to that contract for that year, the proposed regulations provide that the Commissioner may require a taxpayer that uses the simplified marginal impact method to apply the look-back method to that contract as if the simplified method did not apply. In determining whether to exercise this authority, the district director may take into account whether the taxpayer overreported income for a purpose of receiving interest on a hypothetical overpayment determined at the highest statutory tax rate. The district director also may take into account whether the taxpayer underreported income for the year in question with respect to other contracts. Moreover, if the Form 8697 is examined for any completion year and a year in which income was overreported is open under the statute of limitations, an adjustment to tax, rather than to look-back interest, will be made if the taxpayer did not properly estimate contract price and contract costs and the taxpayer would otherwise be permitted to obtain a permanent tax benefit. In addition, to prevent the running of interest in a taxpayer's favor on amounts in excess of the taxpayer's actual tax liability for any year, a hypothetical overpayment in the case of a taxpayer electing the simplified marginal impact method is limited to the taxpayer's actual tax liability for the year, taking into account net operating losses carried to that year.

FORM 8697

The amount of interest due or to be refunded as a result of applying the look-back method is computed and reported on Form 8697 (Interest Computation Under the Look-back Method for Completed Long-term Contracts) for any tax year in which one or more long-term contracts are completed, or in which the contract price or contract costs are adjusted for one or more long-term contracts that were previously completed. Form 8697 is due no later than the due date (including extensions) of the tax return for the year of completion or adjustment. Form 8697 is filed with the same Internal Revenue Service Center with which a taxpayer's income tax return is filed.

In general each taxpayer that reports income from a long-term contract, or adjusts amounts attributable to a completed long-term contract, is required to file Form 8697 to apply the look-back method. In the case of a pass-through entity, such as a partnership or an S corporation, however, the proposed regulations clarify that the owners or shareholders generally are required to file Form 8697 and are liable for, or entitled to receive, interest with respect to their distributive shares of income from a contract. However, widely held pass-through entities are required to apply the look-back method at the entity level with respect to income from domestic contracts.

MID-CONTRACT CHANGE IN TAXPAYER

The proposed regulations identify which taxpayer is responsible for applying the look-back method and which taxpayer is liable for paying (or is entitled to receive) interest comput-

ed under the look-back method if, prior to the completion of a long-term contract, there is a change in the taxpayer that reports income from the contract. The proposed regulations generally require the completing taxpayer to apply the look-back method with respect to all years of the contract, including tax years of a predecessor taxpayer. This approach is consistent with the assumption that a successor taxpayer reporting income from a contract, by assuming other rights and liabilities under the contract, should also be viewed as assuming the requirement to apply the look-back method upon completion. The proposed regulations reject an approach that would treat a mid-contract change in the taxpayer as a constructive completion of the contract for purposes of the look-back method. This approach would increase the complexity of the look-back method by increasing the number of times the look-back method is applied to a single contract. Moreover, a constructive completion would require the look-back method to be applied before actual completion of the contract and on the basis of estimates or, in the case of a sale of an entire business, on the basis of an allocation of the purchase price of the business, thereby producing results that may conflict with the purpose of the look-back method. For these reasons, the proposed regulations do not provide for a mid-contract application of the look- back method in the case of a change in the taxpayer and, in requiring the look-back method to be applied at the time of final completion, provide that overpayments and underpayments must be computed with respect to both pre-transaction and post-transaction years, and that interest runs on these amounts until final completion. Accordingly, only amounts paid by the customer (and not amounts transferred between the parties) are treated as contract revenue in applying the look-back method. Amounts transferred between the parties that represent gain or loss on the contract relative to the amount of income previously included under the percentage of completion method are disregarded for purposes of the percentage of completion method and the look-back method.

The proposed regulations also identify which taxpayer is required to apply the look-back method at the time of final completion and what information another taxpayer must provide to enable the responsible taxpayer to apply the look-back method. Because it could be unfair to require a taxpayer that previously reported income from a contract (the "predecessor") to pay interest based on changes in contract price and costs that are beyond its control after that taxpayer has terminated its interest in a long-term contract, the proposed regulations make the completing taxpayer primarily responsible for the payment of all interest due under the look-back method. This approach also insures that interest is ultimately paid under the look-back method with respect to all years of the contract, even if the predecessor has gone out of existence by the time the contract is completed. Secondary liability for interest due under the look-back method for the pre-transaction period is imposed on the taxpayer that has transferred or otherwise discontinued its interest in the contract, to prevent use of contract transfers to avoid the requirements of the look-back method. Since it would be unduly intrusive to require the predecessor to provide the detailed information about its tax returns that would be necessary to apply the look-back method precisely, the completing taxpayer must determine underpayments of tax in pre-transaction years under the simplified marginal impact method.

In order to prevent a related taxpayer from receiving interest on hypothetical overpayments using a tax rate that exceeds the related predecessor's actual marginal tax rate, however, the successor taxpayer is not permitted to receive interest on overpayments with respect to pre-transaction tax years, other than in a taxable sale to an unrelated party of a contract or an interest in a flow-through entity. Instead, the predecessor may apply the look-back method with respect to pre-transaction years and receive interest to the extent that the predecessor's application of the look-back method results in hypothetical overpayments for any of these tax years.

SCOPE OF LOOK-BACK METHOD

The proposed regulations describe the scope of the look-back method, which generally includes all long-term contracts entered into after February 28, 1986, that are reported under the percentage of completion method or the percentage of completion-capitalized cost method. In the case of any long-term contract reported under the percentage of completion-capitalized cost method, interest is charged or credited to the taxpayer with respect to the percentage (40, 70, or 90, whichever applies) of the contract reported under the percentage of completion method.

Section 56(a)(3) provides that, in determining the amount of the alternative minimum taxable income for any tax year, the percentage of completion method of accounting (as modified by section 460(b)) is used in lieu of the method of accounting that is used for purposes of computing the regular tax. The proposed regulations clarify that the look-back method accordingly applies to alternative minimum taxable income computed using the percentage of completion method as well as to regular taxable income.

DE MINIMIS EXCEPTION

The 1988 Act amended section 460(b) to exempt from the look-back method certain long-term contracts that are not otherwise exempt from the required use of the percentage of completion method (or the percentage of completion-capitalized cost method). Under section 460(b)(3)(B), the look-back method does not apply to any contract completed within 2 years if the gross contract price does not exceed the lesser of $1,000,000 or 1 percent of the taxpayer's average annual gross receipts. The proposed regulations clarify that this de minimis exception is mandatory, even if income from the contract was accelerated as a result of the use of inaccurate estimates of contract price and contract costs, so that the taxpayer would otherwise be entitled to receive interest on the resulting hypothetical overpayment of tax.

If the de minimis exception applies to a contract for regular taxable income, then the exception also applies for alternative minimum taxable in-

come. Because of the adjustments required for computing alternative minimum taxable income, a taxpayer's gross receipts for alternative minimum tax purposes may differ from gross receipts for regular income tax purposes. Thus, if the criteria for meeting the de minimis exception were applied separately for alternative minimum tax purposes using alternative minimum tax gross receipts, a difference between alternative minimum tax gross receipts and regular tax gross receipts could cause a contract to qualify for the de minimis exception for regular tax purposes, but not for alternative minimum tax purposes, or vice versa. To prevent this result, the proposed regulations provide that gross receipts are determined for purposes of section 460(b)(3)(B) by reference only to regular taxable income.

The de minimis exception was enacted in 1988, effective for qualifying contracts entered into after February 28, 1986, and, therefore, may apply to contracts for which a taxpayer has already applied the look-back method. Since the de minimis exception was enacted retroactively, taxpayers are permitted to file an amended Form 8697 to reverse the application of the look-back method to qualifying contracts.

TREATMENT OF LOOK-BACK INTEREST

In accordance with section 460(b)(1), interest required to be paid by a taxpayer is treated as an increase in tax for purposes of subtitle F of the Code (other than the estimated tax penalty); however, interest received by a taxpayer is not treated as a reduction in tax liability. Under the proposed regulations, the determination of whether interest computed under the look-back method is treated as tax for this purpose is determined on a "net" basis for each filing year. Thus, if a taxpayer computes for the current filing year both hypothetical overpayments and hypothetical underpayments for prior years, the taxpayer has an increase in tax only if the interest computed on the underpayments for all those prior years exceeds the interest computed on the overpayments for all those prior years.

For purposes of determining taxable income under subtitle A of the Code, however, any amount of interest required to be paid by the taxpayer under the look-back method is treated as interest expense arising from an underpayment of income tax. Thus, any look-back interest paid by an individual (determined on a net basis) is treated as personal interest in accordance with §1.163-9T(b)(2), even if that interest arises from long-term contract income that is allocated to an investment, passive, or trade or business activity. Similarly, for purposes of subtitle A, any amount of interest refunded to the taxpayer under the look-back method is taxable interest income.

The proposed regulations clarify that interest computed under the look-back method at the entity level under the simplified marginal impact method is allocated among the owners (or beneficiaries) in the same manner that interest income and interest expense are allocated to owners (or beneficiaries) and subject to the requirements of section 704 and any other applicable rules. Consequently, under the proposed regulations, look-back interest expense allocated to an individual owner (or beneficiary) is treated as personal interest expense, even though paid by the pass-through entity under the simplified marginal impact method.

TREATMENT OF CHANGE ORDERS

The proposed regulations clarify that the look-back method is applied to all amounts attributable to a single long-term contract. Section 460(f), which defines the term "long-term contract," authorizes the Secretary to prescribe regulations that require (1) two or more contracts that are interdependent (by reason of pricing or otherwise) to be treated as a single contract, and (2) a single contract that is properly severed to be treated as multiple contracts. Notice 89-15, Q & A 37 and 38, provides that the rules for severing and aggregating contracts in §1.451-3(e) determine what constitutes a single long-term contract for purposes of reporting income and allocating costs to long-term contracts under section 460. These rules apply for determining whether a change order or other similar agreement is treated as a separate contract or as part of the original contract. *Cf.* Notice 89-15, Q & A 11. Because the look-back method involves a hypothetical reapplication of the percentage of completion method (as modified by section 460), the same rules apply in determining what constitutes a single long-term contract for purposes of the look-back method. Accordingly, under the proposed regulations, if a contract change order does not constitute a separate contract under the rules for severing and aggregating contracts, the revenue and expenses attributable to the change order are allocable under the look-back method to all tax years of the underlying contract.

TIME AT WHICH LOOK-BACK METHOD IS APPLIED

Section 460(b)(1)(B) of the Code requires the look-back method to be applied upon completion of a long-term contract, and then to be reapplied in any tax year in which there are post-completion adjustments to the contract price or contract costs.

Completion

The proposed regulations define the term "completion" for this purpose to mean final completion and acceptance within the meaning of §1.451-3(b)(2). With respect to any long-term contract, therefore, the look-back method generally is applied no later than the year in which the subject matter of the contract has been delivered and is available for use by the customer, even if the taxpayer expects to incur additional contract costs in a year subsequent to the completion year.

Although §1.451-3(b)(2) determines the "time" for completion, the provisions in §1.451-3(b)(2), and §1.451-3(d) (which separate contract revenues and contract costs from a long-term contract in certain circumstances, such as in the case of a dispute or contract term relating to contingent compensation) do not apply for purposes of the look-back method. These provisions, which are designed to prevent inappropriate deferral of income and expenses by taxpayers using the completed contract method, are not relevant under the percentage of completion method. Moreover, these provisions are inconsistent with the requirement of section 460(b)(1)(B) to reapply the look-back method to

amounts taken into account after completion, since their application would otherwise permit income from a long-term contract to be accounted for under a method of accounting that is not subject to the look-back method.

In addition, section 460(b)(1) requires any portion of the contract price not previously included in income to be included in income for the year immediately following the completion year, even if the taxpayer expects to incur additional contract costs in a year subsequent to the year immediately following the completion year. This rule does not apply for purposes of the look-back method, however. Thus, to the extent that a taxpayer incurs additional costs after the year immediately following the year of completion, the taxpayer will be entitled to receive interest under the look-back method to compensate for any acceleration of income that resulted from this requirement.

Post-completion reapplications

The proposed regulations clarify that, after completion of a contract, section 460(b) generally requires the look- back method to be reapplied in any subsequent tax year in which additional contract revenues or contract costs are taken into account, or in which amounts previously taken into account as income or deductions are adjusted for any reason. In reapplying the look-back method when any amount is taken into account after completion, including when any amount of revenue that is taken into account in the year immediately following the year of completion by reason of section 460(b)(1), the proposed regulations provide that only costs actually incurred as of the reapplication year are included in the denominator of the percentage of completion ratio. Section 460(b)(2) provides that these amounts may be taken into account, for purposes of reapplying the look-back method, at a value that is discounted from the time the amount is taken into account to the time of completion. The proposed regulations clarify that amounts of contract revenue that are properly taken into account under the percentage of completion method at the time of, or prior to, contract completion are not discounted under this rule, even if received after contract completion. Although section 460(b)(2) permits taxpayers to discount adjustments on a contract-by-contract basis, if a taxpayer discounts any adjustments relating to a particular contract, the taxpayer must discount all contract price or contract cost adjustments arising from the contract. *See* H.R. Rep. No. 247, 101st Cong., 1st Sess. 1411 (1989), which provides that adjustments to costs are to be treated in the same manner as adjustments to price.

The proposed regulations provide a "delayed reapplication method" which, if elected, may reduce the number of times the look-back method is required to be reapplied for post-completion adjustments to a taxpayer's long-term contracts. Under the delayed reapplication method, taxpayers will be permitted to wait until the cumulative amount of adjustments to either the contract price or contract costs reaches a threshold of 10 percent of these amounts prior to adjustment or, if lesser, $1,000,000. To insure that all adjustments to the contract price are ultimately taken into account under the look-back method, however, the delayed reapplication method requires an electing taxpayer to reapply the look-back method no later than 5 years after the completion of the contract or the last application of the look-back method, without regard to whether the other thresholds have been met by that year. The Internal Revenue Service invites written comments and suggestions regarding the practicality of the delayed reapplication method, including its effectiveness in reducing the administrative complexity of the look-back method.

Special Analyses

It has been determined that these proposed regulations are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis 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 final Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these proposed regulations will be submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted, consideration will be given to any written comments that are submitted (preferably nine copies) to the Internal Revenue Service. All comments will be available for public inspection and copying. A public hearing is scheduled for August 24, 1990. Notice of the public hearing is published in *** [Announcement 90-84, 1990-29 I.R.B. 33].

List of Subjects

26 CFR 1.441-1 through 1.483-2

Income taxes, Accounting, Deferred compensation plans.

26 CFR 602

Reporting and recordkeeping requirements.

Amendments to the Regulations

The following amendments to 26 CFR Part 1 are adopted:

PART 1—[AMENDED]

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

Authority: Sec. 7805, 68A Stat. 917: 26 U.S.C. 7805. * * * Section 1.460-6 is also issued under 26 U.S.C. 460(h).

Par. 2. New sections 1.460-0 through 1.460-8 are added under the heading "Taxable Year for Which Items of Gross Income Included" to read as follows:

§1.460-0. Outline of regulations under section 460.

This section lists the paragraphs contained in §1.460-1 through 1.460-8.

§1.460-1. Accounting for long-term contracts in general. [Reserved.]

§1.460-2. Definition of long-term contract. [Reserved.]

§1.460-3. Percentage of completion method. [Reserved.]

§1.460-4. Percentage of completion-capitalized cost method. [Reserved.]

§1.460-5. Cost allocation rules. [Reserved.]

§1.460-6. Look-back method.
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(i) Responsible party.
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(iii) Interest on underpayments.
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(5) Alternative minimum tax.
(6) Credit carryovers.
(7) Net operating losses.
(8) Alternative minimum tax credit.
(9) Period for interest.

§1.460-7. Exempt long-term contracts. [Reserved.]

§1.460-8. Changes in method of accounting. [Reserved.]

§1.460-1. Accounting for long-term contracts in general. [Reserved.]

§1.460-2. Definition of long-term contract. [Reserved.]

§1.460-3. Percentage of completion method. [Reserved.]

§1.460-4. Percentage of completion-capitalized cost method. [Reserved.]

§1.460-5. Cost allocation rules. [Reserved.]

§1.460-6. Look-back method.

(a) *In general*—(1) *Introduction.* With respect to income from any long-term contract reported under the percentage of completion method, a

taxpayer is required to pay or is entitled to receive interest under section 460(b) on the amount of tax liability that is deferred or accelerated as a result of overestimating or underestimating total contract price or contract costs. Under this look-back method, taxpayers are required to pay interest for any deferral of tax liability resulting from the underestimation of the total contract price or the overestimation of total contract costs. Conversely, if the total contract price is overestimated or the total contract costs are underestimated, taxpayers are entitled to receive interest for any resulting acceleration of tax liability. The computation of the amount of deferred or accelerated tax liability under the look-back method is hypothetical; application of the look-back method does not result in an adjustment to the taxpayer's tax liability as originally reported, as reported on an amended return, or as adjusted on examination. Thus, the look-back method does not correct for differences in tax liability that result from over- or underestimation of contract price and costs and that are permanent because, for example, tax rates change during the term of the contract.

(2) *Overview.* Paragraph (b) explains which situations require application of the look-back method to income from a long-term contract. Paragraph (c) explains the operation of the three computational steps for applying the look-back method. Paragraph (d) provides guidance concerning the simplified marginal impact method. Paragraph (e) provides an elective method to minimize the number of times the look-back method must be reapplied to a single long-term contract. Paragraph (f) describes the reporting requirements for the look-back method and the tax treatment of look-back interest. Paragraph (g) provides rules for applying the look-back method when there is a transaction that changes the taxpayer that reports income from a long-term contract prior to the completion of a contract. Paragraph (h) provides examples illustrating the three computational steps for applying the look-back method.

(b) *Scope of look-back method—*(1) *In general.* The look-back method applies to any income from a long-term contract within the meaning of section 460(f) that is required to be reported under the percentage of completion method (as modified by section 460) for regular income tax purposes or for alternative minimum tax purposes. If a taxpayer uses the percentage of completion-capitalized cost method for long-term contracts, the look-back method applies for regular tax purposes only to the portion (40, 70, or 90 percent, whichever applies) of the income from the contract that is reported under the percentage of completion method. The requirements of section 460 also apply to income and expenses attributable to activities that benefit any long-term contract entered into by a party related to the taxpayer within the meaning of section 707(b) or 267(b), determined without regard to section 267(f)(1)(A) and by substituting "80 percent" for "50 percent" with regard to the ownership of the stock of a C corporation. Therefore, to the extent that the percentage of completion method is required to be used with respect to income and expenses that are attributable to activities that benefit a related party's long-term contract, the look-back method also applies to these amounts, even if those activities are not performed under a contract entered into directly by the taxpayer.

(2) *Exceptions from section 460.* The look-back method generally does not apply to the regular taxable income from any long-term construction contract within the meaning of section 460(e)(4) that

(i) is a home construction contract within the meaning of section 460(e)(1)(A), or

(ii) is not a home construction contract but is estimated to be completed within a 2-year period by a taxpayer whose average annual gross receipts for the 3 tax years preceding the tax year the contract is entered into do not exceed $10,000,000 (as provided in section 460(e)(1)(B)). These contracts are not subject to the look-back method for regular tax purposes, even if the taxpayer uses a version of the percentage of completion method permitted under §1.451-3, unless the taxpayer has properly changed its method of accounting for these contracts to the percentage of completion method as modified by section 460(b). The look-back method, however, applies to the alternative minimum taxable income from a contract of this type, unless it is exempt from the required use of the percentage of completion method under section 56(a)(3).

(3) *De minimis exception.* Notwithstanding that the percentage of completion method is otherwise required to be used, the look-back method does not apply to any long-term contract that (i) is completed within 2 years of the contract commencement date, and (ii) has a gross contract price (as of the completion of the contract) that does not exceed the lesser of $1,000,000 or 1 percent of the average annual gross receipts of the taxpayer for the 3 tax years preceding the tax year in which the contract is completed. This de minimis exception is mandatory and, therefore, precludes application of the look-back method to any contract that meets the requirements of the exception. The de minimis exception applies for purposes of computing both regular taxable income and alternative minimum taxable income. Solely for this purpose, the determination of whether a long-term contract meets the gross receipts test for both alternative minimum tax and regular tax purposes is made based only on the taxpayer's regular taxable income.

(4) *Alternative minimum tax.* For purposes of computing alternative minimum taxable income, section 56(a)(3) generally requires long-term contracts within the meaning of section 460(f) (generally without regard to the exceptions in section 460(e)) to be accounted for using only the percentage of completion method as defined in section 460(b), including the look-back method of section 460(b), with respect to tax years beginning after December 31, 1986. However, section 56(a)(3) (and thus the look-back method) does not apply to any long-term contract entered into after June 20, 1988, and before the beginning of the first tax year that begins after September 30, 1990, that meets the conditions of both section 460(e)(1)(A) and clauses (i) and (ii) of section 460(e)(1)(B), and does not apply to any long-term contract entered into in a tax year that begins after

September 30, 1990, that meets the conditions of section 460(e)(1)(A). A taxpayer that applies the percentage of completion method (and thus the look-back method) to income from a long-term contract only for purposes of determining alternative minimum taxable income, and not regular taxable income, must apply the look-back method to the alternative minimum taxable income in the year of contract completion and other filing years whether or not the taxpayer was liable for the alternative minimum tax for the filing year or for any prior year. Interest is computed under the look-back method to the extent that the taxpayer's total tax liability (including the alternative minimum tax liability) would have differed if the percentage of completion method had been applied using actual, rather than estimated, contract price and contract costs.

(5) *Effective date.* The look-back method, including the de minimis exception, applies to long-term contracts entered into after February 28, 1986. With respect to activities that are subject to section 460 solely because they benefit a long-term contract of a related party, the look-back method generally applies only if the related party's long-term contract was entered into after June 20, 1988, unless a principal purpose of the related-party arrangement is to avoid the requirements of section 460.

(c) *Operation of the look-back method*—(1) *Overview*—(i) *In general.* The amount of interest charged or credited to a taxpayer under the look-back method is computed in three steps. This paragraph (c) describes the three steps for applying the look-back method. These steps are illustrated by the examples in paragraph (h). The first step is to hypothetically reapply the percentage of completion method to all long-term contracts that are completed or adjusted in the current year (the "filing year"), using the actual, rather than estimated, total contract price and contract costs. Based on this reapplication, the taxpayer determines the amount of taxable income (and alternative minimum taxable income) that would have been reported for each year prior to the filing year that is affected by contracts completed or adjusted in the filing year if the actual, rather than estimated, total contract price and costs had been used in applying the percentage of completion method to these contracts, and to any other contracts completed or adjusted in a year preceding the filing year. If the percentage of completion method only applies to alternative minimum taxable income for contracts completed or adjusted in the filing year, only alternative minimum taxable income is recomputed in the first step. The second step is to compare what the tax liability would have been under the percentage of completion method (as reapplied in the first step) for each tax year for which the tax liability is affected by income from contracts completed or adjusted in the filing year (a "redetermination year") with the most recent determination of tax liability for that year to produce a hypothetical underpayment or overpayment of tax. The third step is to apply the rate of interest on overpayments designated under section 6621 of the Code, compounded daily, to the hypothetical underpayment or overpayment of tax for each redetermination year to compute interest that runs, generally, from the due date (determined without regard to extensions) of the return for the redetermination year to the due date (determined without regard to extensions) of the return for the filing year. The net amount of interest computed under the third step is paid by or credited to the taxpayer for the filing year. Paragraph (d) provides a simplified marginal impact method that simplifies the second step—the computation of hypothetical underpayments or overpayments of tax liability for redetermination years—and, in some cases, the third step—the determination of the time period for computing interest.

(ii) *Post-completion revenue and expenses*—(A) *In general.* The look-back method is applied upon the completion of any long-term contract and (unless the taxpayer elects the delayed reapplication method of this section) is applied in any subsequent tax year for which there are taken into account any increases or decreases in either total contract price or total contract costs allocable to the contract under section 460(c) ("allocable contract costs") to the extent those increases or decreases were not previously taken into account under the percentage of completion method. Any year in which the look-back method must be reapplied is treated as a filing year. See Example (3) of paragraph (h)(4) for an illustration of how the look-back method is applied to post- completion adjustments.

(B) *Completion.* A contract is considered to be completed for purposes of the look-back method no later than the year in which final completion and acceptance within the meaning of §1.451-3(b)(2) have occurred. Accordingly, determination of the completion year for any long-term contract is based on an analysis of all the relevant facts and circumstances, including the manner in which the parties to the contract deal with each other and with the subject matter of the contract and the nature of any work or costs remaining to be performed or incurred on the contract. Therefore, the first application of the look-back method must occur no later than the tax year in which the subject matter of the contract has been delivered and is available for use by the customer, even if the taxpayer reasonably expects at that time to incur additional allocable contract costs.

(C) *Discounting of contract price and contract cost adjustments subsequent to completion; election not to discount—(1) General rule.* The amount of any post-completion adjustment to the total contract price or contract costs is discounted, solely for purposes of applying the look-back method, from its value at the time the amount is taken into account in computing taxable income to its value at the completion of the contract. The discount rate for this purpose is the Federal mid-term rate under section 1274(d) in effect at the time the amount is properly taken into account. For purposes of applying the look-back method for the completion year, no amounts are discounted, even if they are received after the completion year.

(2) Election not to discount. Notwithstanding the general requirement to discount post-completion adjustments, a taxpayer may elect not to discount contract price and contract cost adjustments with respect to any contract. The election not to discount

is to be made on a contract-by-contract basis and is binding with respect to all post-completion adjustments that arise with respect to a contract for which an election has been made. An election not to discount with respect to any contract is made by stating that an election is being made on the taxpayer's timely filed federal income tax return (determined with regard to extensions) for the first tax year after completion in which the taxpayer takes into account (i.e., includes in income or deducts) any adjustment to the contract price or contract costs. See §5h.6.

(*3*) *Year-end discounting convention.* In the absence of an election not to discount, any revisions to the contract price and contract costs must be discounted to their value as of the completion of the contract in reapplying the look-back method. For this purpose, the period of discounting is the period between the completion date of the contract and the date that any adjustment is taken into account in computing taxable income. Although taxpayers may use the period between the months in which these two events actually occur, in many cases, these dates may not be readily identifiable. Therefore, for administrative convenience, taxpayers are permitted to use the period between the end of the tax years in which these events occur as the period of discounting provided that the convention is used consistently with respect to all post-completion adjustments for all contracts of the taxpayer the adjustments to which are discounted. In that case, the taxpayer must use as the discount rate the Federal mid-term rate under section 1274(d) as of the end of the tax year in which any revision is taken into account in computing taxable income.

(D) *Revenue acceleration rule.* Section 460(b)(1) imposes a special rule that requires a taxpayer to include in gross income, for the tax year immediately following the year of completion, any previously unreported portion of the total contract price (including amounts that the taxpayer expects to receive in the future) determined as of that year, even if the percentage of completion ratio is less than 100 percent because the taxpayer expects to incur additional allocable contract costs in a later year. At the time any remaining portion of the contract price is includible in income under this rule, no offset against this income is permitted for estimated future contract costs. To achieve the requirement to report all remaining contract revenue without regard to additional estimated costs, a taxpayer must include only costs actually incurred through the end of the tax year in the denominator of the percentage of completion ratio in applying the percentage of completion method for any tax years after the year of completion. The look-back method also must be reapplied for the year immediately following the year of completion if any portion of the contract price is includible in income in that year by reason of section 460(b)(1). For purposes of reapplying the look-back method as a result of this inclusion in income, the taxpayer must only include in the denominator of the percentage of completion ratio the actual contract costs incurred as of the end of the year, even if the taxpayer reasonably expects to incur additional allocable contract costs. To the extent that costs are incurred in a subsequent tax year, the look-back method is reapplied in that year (or a later year if the delayed reapplication method is used), and the taxpayer is entitled to receive interest for the post-completion adjustment to contract costs. Because this reapplication occurs subsequent to the completion year, only the cumulative costs incurred as of the end of the reapplication year are includible in the denominator of the percentage of completion ratio.

(2) *Look-back Step One*—(i) *Hypothetical reallocation of income among prior tax years.* For each filing year, a taxpayer must allocate total contract income among prior tax years, by hypothetically applying the percentage of completion method to all contracts that are completed or adjusted in the filing year using the rules of this paragraph (c)(2). The taxpayer must reallocate income from those contracts among all years preceding the filing year that are affected by those contracts using the total contract price and contract costs, as determined as of the end of the filing year ("actual contract price and costs"), rather than the estimated contract price and contract costs. The taxpayer then must determine the amount of taxable income and the amount of alternative minimum taxable income that would have been reported for each affected tax year preceding the filing year if the percentage of completion method had been applied on the basis of actual contract price and contract costs in reporting income from all contracts completed or adjusted in the filing year and in any preceding year. If the percentage of completion method only applies to alternative minimum taxable income from the contract, only alternative minimum taxable income is recomputed in the first step. For purposes of reallocating income (and costs if the 10-percent year changes for a taxpayer using the 10-percent method) under the look-back method, the method of computing the percentage of completion ratio is the same method used to report income from the contract on the taxpayer's return. (Thus, an election to use the 10-percent method or the simplified cost-to-cost method is taken into account). See Example (1) of paragraph (h)(2) for an illustration of Step One.

(ii) *Treatment of estimated future costs in year of completion.* If a taxpayer reasonably expects to incur additional allocable contract costs in a tax year subsequent to the year in which the contract is completed, the taxpayer includes the actual costs incurred as of the end of the completion year plus the additional allocable contract costs that are reasonably expected to be incurred (to the extent includible under the taxpayer's percentage of completion method) in the denominator of the percentage of completion ratio. The completion year is the only filing year for which the taxpayer may include additional estimated costs in the denominator of the percentage of completion ratio in applying the look-back method. If the look-back method is reapplied in any year after the completion year, only the cumulative costs incurred as of the end of the year of reapplication are includible in the denominator of the percentage of completion ratio in reapplying the look-back method.

(iii) *Interim reestimates not considered.* The look-back method cannot be applied to a contract before it is completed. Accordingly, for purposes of applying Step One, the actual total contract price and contract costs are substituted for the previous estimates

of total contract price and contract costs only with respect to contracts that have been completed in the filing year and in a tax year preceding the filing year. No adjustments are made under Step One for contracts that have not been completed prior to the end of the current filing year, even if, as of the end of this year, the estimated total contract price or contract costs for these uncompleted contracts is different from the estimated amount that was used during any tax year for which taxable income is recomputed under the look-back method for the current filing year.

(iv) *Tax years in which income is affected.* In general, because income under the percentage of completion method is generally reported as costs are incurred, the taxable income and alternative minimum taxable income is recomputed only for each year in which allocable contract costs were incurred. However, there will be exceptions to this general rule. For example, a taxpayer may be required to cumulatively adjust the income from a contract in a year in which no allocable contract costs are incurred if the estimated total contract price or contract costs was revised in that year. However, in applying the look-back method, no contract income is allocated to that year. Thus, there may be a difference between the amount of contract income originally reported for that year and the amount of contract income as reallocated. Similarly, because of the revenue acceleration rule of section 460(b)(1), income may be reported in the year immediately following the completion year even though no costs were incurred during that year and, in applying the look-back method in that year or another year, if additional costs are incurred or the contract price is adjusted in a later year, no income is allocated to that year.

(v) *Costs incurred prior to contract execution; 10-percent method*—(A) *General rule.* There are two situations in which allocable contract costs may be incurred without causing contract income to be reported under the percentage of completion method. First, allocable contract costs that are incurred in tax years prior to the tax year the contract is entered into are deductible in the tax year the contract is entered into, and no contract income is required to be reported in any of these prior tax years. The look-back method does not require allocation of contract income to tax years before the contract was entered into. Costs incurred prior to the year a contract is entered into are similarly first taken into account in the numerator of the percentage of completion ratio in the year the contract is entered into. Second, under the elective 10-percent method of section 460(b)(5), a taxpayer takes no contract revenues or contract costs into account until the tax year as of the close of which at least 10 percent of the total estimated contract costs are incurred (the 10-percent year). Instead, contract costs incurred in a tax year preceding the 10-percent year are deferred until the 10-percent year, at which time they are included in the numerator of the percentage of completion ratio and deducted from gross income. A taxpayer using the 10-percent method must also use the 10-percent method in applying the look-back method, using actual total contract costs to determine the 10-percent year. Thus, contract income is never reallocated to a year before the 10-percent year as determined on the basis of actual contract costs. If the 10-percent year is earlier as a result of applying Step One of the look-back method, contract costs incurred up to and including the new 10-percent year (as determined based on actual contract costs), are reallocated from the original 10-percent year to the new 10-percent, and costs incurrred in later years but before the old 10-percent year are reallocated to those years. If the 10-percent year is later as a result of applying Step One of the look-back method, contract costs incurred up to and including the new 10-percent year are reallocated from all prior years to the new 10-percent year. This is the only case in which costs are reallocated under the look-back method.

(B) *Example.* The application of the look-back method by a taxpayer using the 10-percent method is illustrated by the following example:

Example. Z elected to use the 10-percent method of section 460(b)(5) for reporting income under the percentage of completion method. Z entered into a contract in 1990 for a fixed price of $1,000*x*. During 1990, Z incurred allocable contract costs of $80*x* and estimated that it would incur a total of $900*x* for the entire contract. Since $80*x* is less than 10 percent of total estimated contract costs, Z reported no revenue from the contract in 1990 and deferred the $80*x* of costs incurred. In 1991, Z incurred an additional $620*x* of contract costs, and completed the contract. Accordingly, in its 1991 return, Z reported the entire contract price of $1,000*x*, and deducted the $620*x* of costs incurred in 1991 and the $80*x* of costs incurred in 1990.

Under section 460(b)(5), the 10-percent method applies both for reporting contract income and the look-back method. Under the look-back method, since the costs incurred in 1990 ($80*x*) exceed 10 percent of the actual total contract costs ($700*x*), Z is required to allocate $114*x* of contract revenue ($80*x*/$700*x* × $1,000*x*) and the $80x of costs incurred to 1990. Thus, application of the look-back method results in a net increase in taxable income for 1990 of $34*x*, solely for purposes of the look-back method.

(vi) *Amount treated as contract price*—(A) *General rule.* The amount that is treated as total contract price for purposes of applying the percentage of completion method and reapplying the percentage of completion method under the look-back method under Step One includes all amounts that the taxpayer expects to receive from the customer. Thus, amounts are treated as part of the contract price as soon as it is reasonably estimated that they will be received, even if the all-events test has not yet been met.

(B) *Contingencies.* Any amounts related to contingent rights or obligations, such as incentive fees or amounts in dispute, are not separated from the contract and accounted for under a non-long-term contract method of accounting, notwithstanding any provision in §1.451-3(b)(2)(ii), (iii), (iv), and §1.451-3(d)(2), (3), and (4), to the contrary. Instead, those amounts are treated as part of the total contract price in applying the percentage of completion method and the look-back method. For example, if an incentive fee under a contract to manufacture a satellite is payable to the taxpayer after a specified period of successful performance, the incentive fee is includible in the total contract price at the time and to the extent that it can reasonably be predicted that the performance objectives will be met, for purposes of both the percentage of completion method and the look-back method. Similarly, a portion of the contract price that is in dispute is included in the total contract price at the time and to the extent that the taxpayer can reasonably expect the dispute will be resolved in the taxpayer's favor (without regard to when the taxpayer

receives payment for the amount in dispute or when the dispute is finally resolved).

(C) *Change orders.* In applying the look-back method, a change order with respect to a contract is not treated as a separate contract unless the change order would be treated as a separate contract under the rules for severing and aggregating contracts provided in §1.451-3(e). Thus, if a change order is not treated as a separate contract, the contract price and contract costs attributable to the change order must be taken into account in allocating contract income to all tax years affected by the underlying contract.

(3) *Look-back Step Two: Computation of hypothetical overpayment or underpayment of tax*—(i) *In general.* Step Two involves the computation of a hypothetical overpayment or underpayment of tax for each year in which the tax liability is affected by income from contracts that are completed or adjusted in the filing year (a "redetermination year"). The application of Step Two depends on whether the taxpayer uses the simplified marginal impact method contained in paragraph (d) or the actual method described in this paragraph. The remainder of this paragraph (c)(3) does not apply if a taxpayer uses the simplified marginal impact method.

(ii) *Redetermination of tax liability.* Under the method described in this paragraph (c)(3) (the "actual method"), a taxpayer, first, must determine what its regular and alternative minimum tax liability would have been for each redetermination year if the amounts of contract income allocated in Step One for all contracts completed or adjusted in the filing year and in any prior year were substituted for the amounts of contract income reported under the percentage of completion method on the taxpayer's original return (or as subsequently adjusted on examination, or by amended return). See Example (2) of paragraph (h)(3) for an illustration of Step Two.

(iii) *Hypothetical underpayment or overpayment.* After redetermining the income tax liability for each tax year affected by the reallocation of contract income, the taxpayer then determines the amount, if any, of the hypothetical underpayment or overpayment of tax for each of these redetermination years. The hypothetical underpayment or overpayment for each affected year is the difference between the tax liability as redetermined under the look-back method for that year and the amount of tax liability determined as of the latest of the following:

(A) the original return date;

(B) the date of a subsequently amended or adjusted return (if, however, the amended return is due to a carryback described in section 6611(f), see paragraph (c)(4)(iii); or,

(C) the last previous application of the look-back method (in which case, the previous hypothetical tax liability is used).

(iv) *Cumulative determination of tax liability.* The redetermination of tax liability resulting from previous applications of the look-back method is cumulative. Thus, for example, in computing the amount of a hypothetical overpayment or underpayment of tax for a redetermination year, the current hypothetical tax liability is compared to the hypothetical tax liability for that year determined as of the last previous application of the look-back method.

(v) *Years affected by look-back only.* A redetermination of income tax liability under Step Two is required for every tax year for which the tax liability would have been affected by a change in the amount of income or loss for any other year for which a redetermination is required. For example, if the allocation of contract income under Step One changed the amount of a net operating loss that was carried back to a year preceding the year the taxpayer entered into the contract, the tax liability for the earlier year must be redetermined.

(vi) *Definition of tax liability.* For purposes of Step Two, the income tax liability must be redetermined by taking into account all applicable additions to tax, credits, and net operating loss carrybacks and carryovers. Thus, the tax, if any, imposed under section 55 (relating to alternative minimum tax) must be taken into account. For example, if the taxpayer did not pay alternative minimum tax, but would have paid alternative minimum tax for that year if actual rather than estimated contract price and costs had been used in determining contract income for the year, the amount of any hypothetical overpayment or underpayment of tax must be determined by comparing the hypothetical total tax liability (including hypothetical alternative minimum tax liability) with the actual tax liability for that year. The effect of taking these items into account in applying the look-back method is illustrated in Examples (4) through (7) of paragraphs (h)(5) through (h)(8) below.

(4) *Look-back Step Three: Calculation of interest on underpayment or overpayment*—(i) *In general.* After determining a hypothetical underpayment or overpayment of tax for each redetermination year, the taxpayer must determine the interest charged or credited on each of these amounts. Interest on the amount determined under Step Two is determined by applying the overpayment rate designated under section 6621, compounded daily. In general, the time period over which interest is charged on hypothetical underpayments or credited on hypothetical overpayments begins at the due date (not including extensions) of the return for the redetermination year for which the hypothetical underpayment or overpayment determined in Step Two is computed. This time period generally ends on the earlier of

(A) the due date (not including extensions) of the return for the filing year, and

(B) the date both

(*1*) the income tax return for the filing year is filed, and

(*2*) the tax for that year has been paid in full. If a taxpayer uses the simplified marginal impact method contained in paragraph (d), the remainder of this paragraph (c)(4) does not apply.

(ii) *Changes in the amount of a loss or credit carryback or carryover.* The time period for determining interest may be different in cases involving loss or credit carrybacks or carryovers in order to properly reflect the time period during which the taxpayer (in the case of an underpayment) or the Government (in the case of an overpayment) had the use of the amount determined to be a hypothetical underpayment or overpayment. Thus, if a reallocation of contract income under Step One results in an increase or decrease to a net operating loss carryback (but not a carryforward), the

interest due or to be refunded must be computed on the increase or decrease in tax attributable to the change to the carryback only from the due date (not including extensions) of the return for the redetermination year that generated the carryback and not from the due date of the return for the redetermination year in which the carryback was absorbed. In the case of a change in the amount of a carryover as a result of applying the look-back method, interest is computed from the due date of the return for the year in which the carryover was absorbed. See Examples (8) and (9) of paragraph (h)(9) for an illustration of these rules.

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

Example. Upon the completion of a long-term contract in 1990, the taxpayer redetermines its tax liability for 1988 under the look-back method. This redetermination results in a hypothetical reduction of tax liability from $1,500*x* (actual liability originally reported) to $1,200*x* (hypothetical liability). In addition, the taxpayer had already received a refund of some or all of the actual 1988 tax by carrying back a net operating loss (NOL) that arose in 1989. The time period over which interest would be computed on the hypothetical overpayment of $300*x* for 1988 would depend on the amount of the refund generated by the carryback, as illustrated by the following three alternative situations:

(A) If the amount refunded because of the NOL is $1,500*x*: interest is credited to the taxpayer on the entire hypothetical overpayment of $300*x* from the due date of the 1988 return, when the hypothetical overpayment occurred, until the due date of the 1989 return, when the taxpayer received a refund for the entire amount of the 1988 tax, including the hypothetical overpayment.

(B) If the amount refunded because of the NOL is $1,000*x*: interest is credited to the taxpayer on the entire amount of the hypothetical overpayment of $300*x* from the due date of the 1988 return, when the hypothetical overpayment occurred, until the due date of the 1990 return. In this situation interest is credited until the due date of the return for the completion year of the contract, rather than the due date of the return for the year in which the carryback arose, because the amount refunded was less than the redetermined tax liability. Therefore, no portion of the hypothetical overpayment is treated as having been refunded to the taxpayer before the filing year.

(C) If the amount refunded because of the NOL is $1,300*x*: interest is credited to the taxpayer on $100*x* ($1,300*x* − $1,200*x*) from the due date of the 1988 return until the due date of the 1989 return because only this portion of the total hypothetical overpayment is treated as having been refunded to the taxpayer before the filing year. However, the taxpayer did not receive a refund for the remaining $200*x* of the overpayment at that time and, therefore, is credited with interest on $200*x* through the due date of the tax return for 1990, the filing year. See Examples (10) and (11) of paragraph (h)(9) for a further illustration of this rule.

(iv) *Additional interest due on interest only after tax liability due.* For each filing year, taxpayers are required to file a Form 8697 (Interest Computation Under the Look-back Method for Completed Long-term Contracts) at the time the return for that filing year is filed to report the interest due or to be refunded under the look-back method. Even if the taxpayer has received an extension to file its income tax return for the filing year, look-back interest is computed with respect to the hypothetical increase (or decrease) in the tax liability determined under the look-back method only until the initial due date of that return (without regard to the extension). Interest is charged (or credited) with respect to the amount of look-back interest due (or to be refunded) under the look-back method from the initial due date of the return through the date the return is filed. No interest is charged (or credited) after the due date of the return with respect to the amount of the hypothetical increases (or decreases) in tax liability determined under the look-back method.

(d) *Simplified marginal impact method*—(1) *Introduction.* This paragraph (d) provides a simplified method for calculating look-back interest based on an assumed marginal tax rate of the taxpayer. Any taxpayer may elect this simplified marginal impact method, except that pass-through entities described in paragraph (d)(4) are required to apply the simplified marginal impact method at the entity level with respect to domestic contracts and the owners of those entities do not apply the look-back method to those contracts. Under the simplified marginal impact method, a taxpayer calculates the hypothetical underpayments or overpayments of tax for a prior year based on certain simplifying assumptions.

(2) *Operation*—(i) *In general.* Under the simplified marginal impact method, income from those contracts that are completed or adjusted in the filing year is first reallocated in accordance with the procedures of Step One contained in paragraph (c)(2) of this section. Step Two is modified in the following manner. The hypothetical underpayment or overpayment of tax for each year of the contract (a "redetermination year") is determined by multiplying the applicable regular tax rate by the increase or decrease in regular taxable income (or, if it produces a greater amount, by multiplying the applicable alternative minimum tax rate by the increase or decrease in alternative minimum taxable income, whether or not the taxpayer would have been subject to the alternative minimum tax) as a result of reallocating income to the tax year under Step One. Generally, the product of the alternative minimum tax rate and the increase or decrease in alternative minimum taxable income will be the greater of the two amounts described in the preceding sentence only with respect to contracts for which a taxpayer uses the full percentage of completion method only for alternative minimum tax purposes and uses the completed contract method, or the percentage of completion-capitalized cost method, for regular tax purposes. Step Three is then applied. Interest is credited to the taxpayer on the net overpayment and is charged to the taxpayer on the net underpayment for each redetermination year from the due date (determined without regard to extensions) of the return for the redetermination year until the earlier of

(A) the due date (determined without regard to extensions) of the re-

turn for the filing year, and (B) the first date by which both

(*1*) the return is filed and

(*2*) the tax is fully paid.

(ii) *Applicable tax rate.* For purposes of determining hypothetical underpayments or overpayments of tax under the simplified marginal impact method, the applicable regular tax rate is the highest rate of tax in effect for the redetermination year under section 1 in the case of an individual and under section 11 in the case of a corporation. The applicable alternative minimum tax rate is the rate of tax in effect for the taxpayer under section 55(b)(1). The highest rate is determined without regard to the taxpayer's actual rate bracket and without regard to any additional surtax imposed for the purpose of phasing out multiple tax brackets or exemptions.

(iii) *Overpayment ceiling.* The net hypothetical overpayment of tax for any redetermination year is limited to the taxpayer's total federal income tax liability for the redetermination year reduced by the cumulative amount of net hypothetical overpayments of tax for that redetermination year resulting from earlier applications of look-back method. If the reallocation of contract income results in a net overpayment of tax and this amount exceeds the actual tax liability (as of the filing year) for the redetermination year, as adjusted for past applications of the look-back method and taking into account net operating loss, capital loss, or credit carryovers and carrybacks to that year, the actual tax so adjusted is treated as the overpayment for the redetermination year. This overpayment ceiling does not apply when the simplified marginal impact method is applied at the entity level by a widely held pass-through entity in accordance with paragraph (d)(4).

(iv) *Example.* The application of the simplified marginal impact method is illustrated by the following example:

Example. Corporation X, a calendar-year taxpayer, reports income from long-term contracts and elected the simplified marginal impact method when it filed its income tax return for 1989. X uses only the percentage of completion method for both regular taxable income and alternative minimum taxable income. X completed contracts A, B, and C in 1989 and, therefore, was required to apply the look-back method in 1989. Income was actually reported for these contracts in 1987, 1988, and 1989. X's applicable tax rate, as determined under section 11, for the redetermination years 1987 and 1988 was 40 percent and 34 percent, respectively. The amount of contract income originally reported and reallocated for contracts A, B, and C, and the net overpayments and underpayments for the redetermination years are as follows:

	1987	*1988*
Contract A:		
Originally reported	$5,000*x*	$4,000*x*
Reallocated	3,000*x*	5,000*x*
Increase/(Decrease)	(2,000*x*)	1,000*x*
Contract B:		
Originally reported	6,000*x*	2,000*x*
Reallocated	7,000*x*	1,500*x*
Increase/(Decrease)	1,000*x*	(500*x*)
Contract C:		
Originally reported	8,000*x*	5,000*x*
Reallocated	4,000*x*	7,000*x*
Increase/(Decrease)	(4,000*x*)	2,000*x*
Net Increase/ (Decrease)	(5,000*x*)	2,500*x*
Tentative (Underpayment)/Overpayment		
@ .40	2,000*x*	
@ .34		(850*x*)
Ceiling:		
Actual Tax Liability (After Carryovers and Carrybacks)	1,500*x*	500*x*
Final (Underpayment)/ Overpayment	1,500*x*	(850*x*)

Under the simplified marginal impact method, X determined a tentative hypothetical net overpayment for 1987 and a net underpayment for 1988. X determined these amounts by first aggregating the difference for contracts A, B, and C between the amount of contract price originally reported and the amount of contract price as reallocated and, then, applying the highest regular tax rate to the aggregate decrease in income for 1987 and the aggregate increase in income for 1988.

However, X's overpayment for 1987 is subject to a ceiling based on X's total tax liability. Because the tentative net overpayment of tax for 1987 exceeds the actual tax liability for that year after taking into account carryovers and carrybacks to that year, the final overpayment under the simplified marginal impact method is the amount of tax liability paid instead of the tentative net overpayment. Since application of the look-back method for 1988 results in a tentative underpayment of tax, it is not subject to a ceiling. If the look-back method is applied in 1991, the ceiling amount for 1987 will be zero and the ceiling amount for 1988 will be $1,350.

X is entitled to receive interest on the hypothetical overpayment from March 15, 1988, to March 15, 1990. X is required to pay interest on the underpayment from March 15, 1989, to March 15, 1990.

(3) *Anti-abuse rule.* A taxpayer electing to use the simplified marginal impact method must use the method for each long-term contract for which it reports income (except with respect to domestic contracts if the taxpayer is an owner in a widely held pass-through entity that is required to use the simplified marginal impact method at the entity level for those contracts). The district director, however, may recompute interest for any contract (including domestic contracts of widely held pass-through entities) under the look-back method using the actual method (and without regard to the simplified marginal impact method) if the amount of income originally reported with respect to the contract for any redetermination year exceeds the amount of income reallocated under the look-back method with respect to that contract for that year (using actual contract price and contract costs) by the lesser of $1,000,000 or 20 percent of the amount of income as reallocated (*i.e.*, based on actual contract price and contract costs) under the look-back method with respect to that contract for that year. In determining whether to exercise this authority upon examination of the Form 8697, the district director may take into account whether the taxpayer overreported income for a purpose of receiving interest under the look-back method on a hypothetical overpayment determined at the highest statutory tax rate. The district director also may take into account whether the taxpayer underreported income for the year in question with respect to other contracts. Notwithstanding the look-back method, the district director may require an adjustment to the tax liability for any open tax year if the taxpayer did not apply the percentage of completion method properly on its original return.

(4) *Application*—(i) *Required use by certain pass-through entities*—(A) *General rule.* The simplified marginal impact method is required to be used with respect to income reported from domestic contracts by a pass-through entity that is either a partnership, an S corporation, or a trust, and that is not closely held. With respect to contracts described in the preceding sentence, the simplified marginal impact method is applied by the pass-through entity at the entity level. For determining the amount of any hypothetical underpayment or overpayment, the applicable regular and alternative minimum tax rates, respectively, are generally the highest rates of tax in effect for corporations under section 11 and section 55(b)(1). However, the applicable regular and alternative

minimum tax rates are the highest rates of tax imposed on individuals under section 1 and section 55(b)(1) if, at all times during the redetermination year involved (i.e., the year in which the hypothetical increase or decrease in income arises), more than 50 percent of the interests in the entity were held by individuals directly or through 1 or more pass-through entities.

(B) *Closely held.* A pass-through entity is closely held if, at any time during any redetermination year, 50 percent or more (by value) of the beneficial interests in that entity are held (directly or indirectly) by or for 5 or fewer persons. For this purpose, the term "person" has the same meaning as in section 7701(a)(1), except that a pass-through entity is not treated as a person. In addition, the constructive ownership rules of section 156(3e) apply by substituting the term "beneficial interest" for the term "stock" and by substituting the term "pass-through entity" for the term "corporation" used in that section, as appropriate, for purposes of determining whether a beneficial interest in a pass-through entity is indirectly owned by any person.

(C) *Examples.* The following examples illustrate the application of the rules of paragraph (d)(4)(i):

Example (1). P, a partnership, began a long-term contract on March 1, 1986, and completed this contract in its tax year ending December 31, 1989. P used the percentage of completion method for all contract income. Substantially all of the income from the contract arose from U.S. sources. At all times during all of the years for which income was required to be reported under the contract, exactly 25 percent of the value of P's interests were owned by Corporation M. The remaining 75 percent of the value of P's interests was owned in equal shares by 15 unrelated individuals, who are also unrelated to Corporation M. M's ownership of P represents less than 50 percent of the value of the beneficial interests in P, and, therefore, viewed alone, is insufficient to make P a closely held partnership. In addition, because no 4 of the individual owners together own 25 percent or more of the remaining value of P's beneficial interests, there is no group of 5 owners that together own, directly or indirectly, 50 percent or more by value of the beneficial interests in P. Therefore, P is not a closely held pass-through entity.

Because P is not a closely held pass-through entity, and because P completed the contract after the effective date of section 460(b)(4), P is required to use the simplified marginal impact method. Any interest computed under the look-back method will be paid to, or collected from, P, rather than its partners, and will be includible or deductible in computing the partnership's ordinary income or loss on Form 1065. Further, assume that, for the redetermination years, Corporation M is subject to alternative minimum tax at the rate of 20 percent and 3 of the individuals who own interests in P are subject to the highest marginal tax rate of 33 percent in 1988. Regardless of the actual marginal tax rates of its partners, P is required to determine the underpayment or overpayment of tax for each redetermination year at the entity level by applying a single rate to the increase or decrease in income resulting from the reallocation of contract income under the look-back method. Because more than 50 percent of the interests in P are held by individuals, P must use the highest rate specified in section 1 for each redetermination year. Thus, the rate applied by P is 50 percent for 1986, 38.5 percent for 1987, and 28 percent for 1988.

Example (2). Assume the same facts as in Example (1), except that one of the individuals, Individual I, who directly owns 5 percent of the value of the interests of P, also owns 100 percent of the stock of Corporation M. Section 1563(e)(4) of the Code provides that stock owned directly or indirectly by or for a corporation is considered to be owned by any person who owns 5 percent or more in value of its stock in that proportion which the value of the stock which that person so owns bears to the value of all the stock in that corporation. Because section 460(b)(4)(C)(iii) and this paragraph (d)(4) provide that rules similar to the constructive ownership rules of section 1563(e) apply in determining whether a pass-through entity is closely held, all of M's interest in P is attributed to I because I owns 100 percent of the value of the stock in M. Accordingly, because I's direct 5 percent and constructive 25 percent ownership of P, plus the interests owned by any 4 other individual partners, equals 50 percent or more of the value of the beneficial interests of P, P is a closely held pass-through entity within the meaning of section 460(b)(4)(C)(iii). Therefore, P cannot use the simplified marginal impact method at the entity level. Accordingly, each of the partners of P must separately apply the look-back method to their respective interests in the income and expenses attributable to the contract, but each partner may elect to use the simplified marginal impact method with respect to the partner's share of income from the contract.

(D) *Domestic contracts*—(1) *General rule.* A domestic contract is any contract substantially all of the income of which is from sources in the United States. For this purpose, "substantially all" of the income from a long-term contract is considered to be from United States sources if 95 percent or more of the gross income from the contract is from sources within the United States as determined under the rules in sections 861 through 865.

(2) *Portion of contract income sourced.* In determining whether substantially all of the gross income from a long-term contract is from United States sources, taxpayers must apply the allocation and apportionment principles of sections 861 through 865 only to the portion of the contract accounted for under the percentage of completion method. Under the percentage of completion method, gross income from a long-term contract includes all payments to be received under the contract (*i.e.*, any amounts treated as contract price). Similarly, all costs taken into account in the computation of taxable income under the percentage of completion method are deducted from gross income rather than added to a cost of goods sold account that reduces gross income. Therefore, allocable contract costs are not considered in determining whether a long-term contract is a domestic contract or a foreign contract, even if, under the taxpayer's facts, the allocation of contract costs to any portion of a contract not accounted for under the percentage of completion method would affect the relative percentages of United States and foreign source gross income from the entire contract if this portion of the contract were taken into account in applying the 95-percent test.

(E) *Application to foreign contracts.* If a widely held pass-through entity has some foreign contracts and some domestic contracts, the owners of the pass-through entity each apply the look-back method (using, if they elect, the simplified marginal impact method) to their respective share of the income and expense from foreign contracts. Moreover, in applying the look-back method to foreign contracts at the owner level, the owners do not take into account their share of increases or decreases in contract income resulting from the application of the simplified marginal impact method with respect to domestic contracts at the entity level.

(F) *Effective date.* The simplified marginal impact method must be applied to pass-through entities described in paragraph (d)(4)(i) with respect to domestic contracts completed in tax years for which the due date of the return (determined with regard to extensions) of the pass-through entity is after November 9, 1988.

(ii) *Elective use*—(A) *General rule.* As provided in paragraph (d)(4)(i), the simplified marginal impact method must be used by certain pass-through entities with respect to domestic contracts. C corporations, individuals, and owners of closely held pass-through entities may elect

the simplified marginal impact method. Owners of other pass-through entities may also elect the simplified marginal impact method with respect to all contracts other than those for which the simplified marginal impact method is required to be applied at the entity level. This rule applies to foreign contracts of widely held pass-through entities. In the case of an electing owner in a pass-through entity, the simplified marginal impact method is applied at the owner level, instead of at the entity level, with respect to the owner's share of the long-term contract income and expense reported by the pass-through entity.

(B) *Election requirements.* A taxpayer elects the simplified marginal impact method by stating that the election is being made on a timely filed income tax return (determined with regard to extensions) for the first tax year the election is to apply. An election to use the simplified marginal impact method applies to all applications of the look-back method to all eligible long-term contracts for the tax year for which the election is made and for any subsequent tax year. The election may not be revoked without the consent of the Commissioner.

(C) *Consolidated group consistency rule.* In the case of a consolidated group of corporations within the meaning of section 1504(a), an election to use the simplified marginal impact method is made by the common parent of the group. The election is binding on all other affected members of the group (including members that join the group after the election is made with respect to all applications of the look-back method after joining). If a member subsequently leaves the group, the election remains binding as to that member unless the Commissioner consents to a revocation of the election. If a corporation using the simplified marginal impact method joins a group that does not use the method, the election is automatically revoked with respect to all applications of the look-back method after it joins the group.

(e) *Delayed reapplication method*—(1) *In general.* For purposes of reapplying the look-back method after the year of contract completion, a taxpayer may elect the delayed reapplication method to minimize the number of required reapplications of the look-back method. Under this method, the look-back method is reapplied after the year of completion of a contract (or after a subsequent application of the look-back method) only when one of the following conditions is met with respect to the contract:

(i) the net undiscounted value of increases or decreases in the contract price occurring since the time of the last application of the look-back method exceeds the lesser of $1,000,000 or 10 percent of the total contract price as of that time,

(ii) the net undiscounted value of increases or decreases in contract costs occurring since the time of the last application of the look-back method exceeds the lesser of $1,000,000 or 10 percent of the total actual contract costs as of that time,

(iii) the taxpayer goes out of existence, or

(iv) neither condition (i), (ii) nor (iii) above is met by the end of the fifth tax year that begins after completion of the contract or, after any subsequent reapplication of the look-back method, that begins after the last year of reapplication.

(2) *Time and manner of making election.* An election to use the delayed reapplication method may be made for any filing year for which the due date of the return (determined with regard to extensions) is after June 12, 1990. The election is made by a statement to that effect on the taxpayer's timely filed federal income tax return (determined with regard to extensions) for the first tax year the election is to be effective. An election to use the delayed reapplication method is binding with respect to all long-term contracts for which the look-back method would be reapplied without regard to the election in the year of election and any subsequent year unless the Commissioner consents to a revocation of the election. In the case of a consolidated group of corporations within the meaning of section 1504(a), an election to use the delayed reapplication method is made by the common parent of the group. The election is binding on all other affected members of the group (including members that join the group after the election is made with respect to contracts adjusted after joining). If a member subsequently leaves the group, the election remains binding as to that member unless the Commissioner consents to a revocation of the election. If a corporation that has made the election joins a consolidated group that has not made the election, the election is treated as revoked with respect to contracts adjusted after joining.

(3) *Examples.* The operation of this delayed reapplication method is illustrated by the following examples:

Example (1). X completes a contract in 1987, and applies the look-back method when its return for 1987 is filed. X properly uses $600,000 as the actual contract price in applying the look-back method. In 1990, as a result of the settlement of a dispute with its customer, X redetermines total contract price to be $640,000, and includes $40,000 in gross income. On its return for 1990, X states that it is electing the delayed reapplication method. X is not required to reapply the look-back method at that time, because $40,000 does not exceed the lesser of $1,000,000 or 10 percent of the unadjusted contact price of $600,000, and 5 years have not passed since the last application of the look-back method.

Example (2). Assume the same facts as in Example (1), except that at the end of 1992, the fifth year after completion of the contract, no other adjustments to contract price or contract costs have occurred. X is required to reapply the look-back method in 1992 and, accordingly, redetermine its tax liability for each redetermination year. After redetermining the underpayment of tax for those years, X must compute the amount of interest charged on the underpayments. Although 1992 is the filing year, interest is due on the amount of each underpayment resulting from the adjustment only from the due date of the return for each redetermination year to the due date of the return for 1990 because the tax liability for the adjustment was fully paid in 1990. However, from the due date of the 1990 return until the due date of the 1992 return, when the look-back method is reapplied for the adjustment, interest is due on the amount of interest attributable to the underpayments.

(f) *Look-back reporting*—(1) *Procedure.* The amount of any interest due or to be refunded as a result of applying the look-back method is computed and reported on Form 8697 for any filing year. In general, the look-back method is applied by and Form 8697 is filed by the taxpayer that reports income from a long-term contract. See paragraph (g) to determine who is responsible for applying the look-back method when, prior to the completion of a long-term contract, there is a transaction that changes the taxpayer that reports income from the contract.

(2) *Treatment of interest on return*—(i) *General rule.* The amount of interest required to be paid by a taxpayer is treated as an income tax

under subtitle A, but only for purposes of subtitle F of the Code (other than sections 6654 and 6655), which addresses tax procedures and administration. Thus, a taxpayer that fails to file Form 8697 with respect to interest required to be paid or fails to pay the amount of interest due is subject to any applicable penalties under subtitle F, including, for example, a penalty for failing to file Form 8697. However, interest required to be paid under the look-back method is treated as interest expense for purposes of computing taxable income under subtitle A, even though it is treated as income tax liability for penalty purposes. Interest received under the look-back method is treated as taxable interest income for all purposes, and is not treated as a reduction in tax liability. The determination of whether or not interest computed under the look-back method is treated as tax is determined on a "net" basis for each filing year. Thus, if a taxpayer computes for the current filing year both hypothetical overpayments and hypothetical underpayments for prior years, the taxpayer has an increase in tax only if the interest computed on the underpayments for all those prior years exceeds the interest computed on the overpayments for all those prior years, for all contracts completed or adjusted for the year.

(ii) *Accounting treatment of look-back interest.* For purposes of determining taxable income under subtitle A of the Code, any amount of interest refunded to the taxpayer under the look-back method is includible in gross income as interest income in the tax year it is properly taken into account under the taxpayer's method of accounting for interest income. Any amount of interest required to be paid by a taxpayer under the look-back method is treated as interest expense arising from an underpayment of income tax. Thus, look-back interest required to be paid by an individual, or by a pass-through entity on behalf of an individual owner (or beneficiary) under the simplified marginal impact method, is treated as personal interest and, therefore, is disallowed in accordance with §1.163-9T(b)(2). Interest required to be paid at the entity level under the simplified marginal impact method is allocated among the owners (or beneficiaries) for reporting purposes in the same manner that interest income and interest expense are allocated to owners (or beneficiaries) and subject to the requirements of section 704 and any other applicable rules. Look-back interest expense allocated to an individual owner (or beneficiary) in this situation accordingly is treated as personal interest.

(g) *Mid-contract change in taxpayer*—(1) *General rules*—(i) *Application of look-back method.* If, prior to the completion of a contract, there is a transaction that changes the taxpayer that is responsible for reporting income from the contract, the look-back method is not applied at the time of that transaction, but is instead applied for the first time when the contract is completed by the successor taxpayer. For purposes of this paragraph, a contract will be treated as the same contract if the terms of the contract are not substantially changed in connection with the transaction, whether or not the customer agrees to release the predecessor from any or all of its obligations under the contract by novation. Upon completion of the entire contract, the look-back method is applied with respect to both the pre-transaction period and the post-transaction period, taking into account all amounts paid by the customer and all contract costs incurred during both periods. The successor is liable for interest computed on hypothetical underpayments for both the pre- and post-transaction years, but, in general, is entitled to receive interest only with respect to hypothetical overpayments determined for post-transaction years. The predecessor, in general, is entitled to receive interest computed on hypothetical overpayments determined for pre-transaction years. For purposes of this paragraph (g), pre- transaction years are all tax years of the predecessor in which the predecessor reported income from the contract. Post-transaction years are all tax years of the successor in which the successor reported income from the contract.

(ii) *Operation of percentage of completion method.* The predecessor and successor report income under the percentage of completion method, and apply the look-back method, using as total contract price only and all amounts expected to be received from the customer by both the predecessor and the successor. Thus, the successor reports income from the contract during the post-transaction period by "stepping into the shoes" of the predecessor with respect to the percentage of completion formula. The successor must therefore continue to use the same percentage of completion method (*i.e*, the simplified cost-to-cost method or the 10-percent method) used by the predecessor with respect to the contract for purposes of both reporting income under the percentage of completion method and recomputing income under the look-back method.

(2) *Application of look-back method to pre-transaction period*—(i) *Responsible party.* The successor is liable for interest computed on hypothetical underpayments for both the pre- and post-transaction years, but, in general, is entitled to receive interest only with respect to hypothetical overpayments determined for post-transaction years. The existence of a hypothetical underpayment (and thus whether the successor computes interest under the look-back method) is determined separately for each year and for each contract during the pre-transaction period and without regard to any other year or any other contract. Thus, the successor does not get credit with respect to any hypothetical underpayments for any hypothetical overpayments in pre-transaction years. In the case, however, of a taxable sale of a contract or of a business or an interest in a pass-through entity the assets of which include a contract, the following rules apply. Unless the sale is to a related party within the meaning of section 707(b) or 267(b) (determined without regard to section 267(f)(1)(A) and determined by substituting "80 percent" for "50 percent" with regard to the ownership of the stock of a C corporation in subsections (b)(2), (b)(8), (b)(10)(A) and (b)(12) of section 267), the successor is entitled to receive interest on hypothetical overpayments arising in pre-transaction years. In all other cases, only the predecessor is permitted to apply the look-back method to pre-transaction years to receive interest on hypothetical overpayments determined with respect to any pre-transaction year. The predecessor will be secondarily liable for any interest required to be paid with respect to the pre-transaction period (reduced by any interest on pre-trans-

action overpayments to which the predecessor is entitled).

(ii) *Look-back method for pre-transaction period.* For purposes of the look-back method, the total contract price (and contract costs if the 10-percent method was used by the predecessor) is reallocated to all affected pre-transaction and post-transaction years. The amount treated as total contract price includes only and all amounts received from the customer by both the predecessor and the successor. Thus, any payments between the predecessor and successor with respect to the contract are not treated as contract price or contract costs. See paragraph (c)(2)(vi) of this section. The successor must apply the look-back method to each pre-transaction year that is a redetermination year using the simplified marginal impact method described in paragraph (d) (regardless of whether or not the predecessor would have actually used that method). Any hypothetical underpayment for a redetermination year is treated as described in paragraph (g)(2)(iii).

(iii) *Interest on underpayments.* With respect to any hypothetical underpayment for a pre-transaction year, interest is charged on the underpayment from the due date of the predecessor's tax return for the year of the underpayment until the due date of the successor's return for the completion year, and the successor is primarily liable for the payment of interest on these amounts and the filing of Form 8697.

(iv) *Interest on overpayments.* With respect to any hypothetical overpayment for a pre-transaction year, the successor is not entitled to receive any interest on that overpayment, except in the case of a taxable sale to an unrelated party. In the case of a taxable sale to an unrelated party, the successor is entitled to interest on a hypothetical overpayment determined using the simplified marginal impact method (regardless of whether the predecessor used the method and without regard to the tax liability ceiling). In all other cases, only the predecessor is entitled to receive interest with respect to any hypothetical overpayment of tax for any pre-transaction year if the predecessor applies the look-back method to that contract for that year and computes an overpayment (using the simplified marginal impact method with regard to the tax liability ceiling, or the actual method, whichever applies to the predecessor). For purposes of determining the time period for computing interest on a resulting hypothetical overpayment, interest runs from that pre-transaction redetermination year to the year the contract is completed by the successor.

(v) *Information predecessor must provide.* In order to help the successor to apply the look-back method with respect to pre-transaction tax years, any predecessor that reported income from a long-term contract as defined in section 460(f) (whether or not under the percentage of completion method) or otherwise reported income under section 460, is required to provide the information described in this paragraph to the successor by the due date (without regard to extensions) of the predecessor's return for the tax year ending with, or the first tax year ending after, a transaction that causes a change in the taxpayer. If the predecessor fails to provide this information, the district director may require the predecessor to apply the look-back method to pre-transaction tax years and pay interest on underpayments for those years. The required information is:

(A) The portion of the contract reported by the predecessor under the percentage of completion method of section 460(b) for regular and alternative minimum tax purposes (*i.e.*, whether the predecessor used the percentage of completion method, the 40/60 method, the 70/30 method, or the 90/10 method). If the predecessor did not report any income from the contract under the percentage of completion method for either regular or alternative minimum tax purposes (as modified by section 460(b)), no other information is required to be reported.;

(B) the method used to apply the percentage of completion method (*i.e.*, the simplified cost-to-cost method or the 10-percent method, or neither);

(C) the amount of contract price reported by year;

(D) the numerator and the denominator of the percentage of completion ratio by year;

(E) the due date (without regard to extensions) of the predecessor's returns for each year in which income was required to be reported;

(F) whether the transferor is a corporate or a noncorporate taxpayer; and

(G) any other information required by the Commissioner by administrative pronouncement.

(vi) *Information successor must provide.* If the predecessor requests, the successor taxpayer must provide the information described in this paragraph to the predecessor by the due date of the return for the completion year or each year thereafter in which the successor is required to reapply the look-back method. This information is not required to be reported in the case of a taxable sale of a contract or of an interest in a pass-through entity to an unrelated party:

(A) the due date (without regard to extensions) of the return for any year in which the successor is required to apply the look-back method with respect to the contract;

(B) the total contract price reported by the successor;

(C) the total allocable contract costs incurred by the successor as of the filing year and required to be taken into account in computing the percentage of completion ratio under the percentage of completion method in use; and

(D) any other information required by the Commissioner by administrative pronouncement.

(3) *Application of look-back method to post-transaction period.* With respect to post-transaction tax years, only the successor applies the look-back method. For these years, the successor uses the same look-back method it uses for other contracts (*i.e.*, the simplified marginal impact method or the actual method) to determine the amount of any hypothetical overpayment or underpayment of tax and the time period for computing interest on these amounts.

(4) *Examples of transactions to which this paragraph applies; meaning of "predecessor and successor"—*
(i) *General rule.* For purposes of this paragraph, the term "predecessor" generally means any taxpayer that reported income from a contract before and not after any transaction that causes a change in the taxpayer that is responsible for reporting income from the contract. The term "successor" generally means any tax-

payer that reported income from a contract after but not before any transaction described in the preceding sentence.

(ii) *Examples.* The following are examples of transactions to which this paragraph applies, showing the successor and predecessor in each:

Transaction	*Predecessor*	*Successor*
Section 336 corporate liquidation	Liquidating corporation	Distributee/assignee of contract
Section 338 (qualified stock purchase	Target corporation	Acquiring
Taxable sale of contract (including sale of business)	Seller-assignor	Purchaser-assignee
S conversion to C closely held or foreign contracts)	S corporation shareholders	C corporation
C conversion to S (closely held or foreign contracts)	C corporation	S corporation shareholders
S conversion to C (widely held for domestic contracts)	S corporation	C corporation
C conversion to S (widely held for domestic contracts)	C corporation	S corporation
Separate return to consolidated return	Corporation performing contract	Parent
Consolidated return to separate return	Parent	Corporation performing contract
Consolidated return to different consolidated return	Old parent	New parent
Section 351 (tax-free incorporation)	Transferor(s)	Controlled corporation
Section 708 (termination of partnership) (widely held for domestic contracts)	Partnership	Transferees
Section 708 (termination of partnership) (closely held or foreign contracts)	Partners	Transferees
Section 721 (contribution to partnership) (widely held for domestic contracts)	Contributing Partner	Partnership
Section 721 (contribution to partnership) (closely held or foreign contracts)	Contributing Partner	Partners
Sale of partnership interest (nonterminating) (widely held for domestic contracts)	Partnership	Partnership
Sale of partnership interest (nonterminating) (closely held or foreign contracts)	Selling Partner	Purchasing Partner
Sale of S corporation stock (widely held for domestic contracts)	S corporation	S corporation
Sale of S corporation stock (closely held or foreign contracts)	Selling shareholder	Purchasing shareholder

(5) *Special rules.* In the case of a mid-contract conversion from C corporation to S corporation status, the corporation (rather than its shareholders) must apply the look-back method with respect to any C corporation tax years. In doing so, the corporation must use the same look-back method (*i.e.*, the simplified marginal impact method, or the actual method) that the corporation used for other contracts prior to electing S corporation status. The corporation is entitled to receive interest on hypothetical overpayments determined for C corporation tax years. The S corporation has the right to receive look-back interest and the liability to pay look-back interest for the C corporation years, but these amounts flow through to the shareholders for pur-

poses of subtitle A. These amounts are not treated as built-in gains or built-in losses under section 1374. A mid-contract S corporation election does not eliminate the requirement that certain S corporations use the simplified marginal impact method with respect to post-election tax years. If an S corporation that is required to use the simplified marginal impact method terminates its S election, the successor C corporation must use the simplified marginal impact method with respect to pre-transaction tax years. In that case, the C corporation as a successor in interest is also entitled to receive interest with respect to hypothetical overpayments determined for pre-transaction years. In the case of a termination of a widely-held partnership within the meaning of section 708, the successors in interest are entitled to receive interest using the simplified marginal impact method for domestic contracts. In the case of a transaction subject to section 338, the simplified method is not applied to pre-transaction years unless that was the method used by the acquired corporation.

(6) *Effective date.* In general, the rules of this paragraph apply to mid-contract changes in the taxpayer after June 12, 1990. With respect to any other mid-contract changes, taxpayers may use any reasonable method to take into account a mid-contract change in applying the look-back method, including the rules in this paragraph (g).

(h) *Examples*—(1) *Overview.* This paragraph provides computational examples of the rules of this section. Except as otherwise noted, the examples involve calendar-year taxpayers and involve long-term contracts subject to section 460 that are accounted for using the percentage of completion method, rather than the percentage of completion-capitalized cost method. If the percentage of completion-capitalized cost method were used by a taxpayer described in the examples, the amounts of contract income and expenses shown in the examples would be reduced, for purposes of determining regular taxable income, to the appropriate fraction (40, 70, or 90 percent) of contract items accounted for under the percentage of completion method. Tens of thousands of dollars ($ 00,000's) are omitted from the figures in the examples. The contracts described in the examples are assumed to be the taxpayers' only contracts that are subject to the look-back method of section 460. Except as otherwise stated, the examples assume that the taxpayer has no adjustments and preferences for purposes of section 55, so that alternative minimum taxable income is the same as taxable income, and no alternative minimum tax is imposed for the years involved. The examples assume that the taxpayer does not elect the 10-percent method, the simplified marginal impact method, or the delayed reapplication method.

(2) *Step One.* The following example illustrates the application of paragraph (c)(2):

Example (1). In 1989, W completes three long-term contracts, A, B, and C, entered into on January 1 of 1986, 1987, and 1988, respectively. For Contract A, W used the completed contract method of accounting. For Contract B, W used the percentage of completion-capitalized cost method of accounting, taking into account 60 percent of contract income under W's normal method of accounting, which was the completed contract method. For Contract C, W used the percentage of completion method of accounting. The total price for each contract was $1,000. In computing alternative minimum taxable income, W is required to use the percentage of completion method for Contracts B and C. W used regular tax costs for purposes of determining the degree of contract completion under the alternative minimum tax.

Contract A is not taken into account for purposes of applying the look-back method, because it is subject to neither section 460 nor section 56(a)(3). Thus, even if W had used the percentage of completion method as permitted under §1.451-3, instead of the completed contract method, the look-back method would not be applicable because the Contract A was entered into before the effective date of section 460.

The actual costs allocated to Contracts B and C under section 460(c) and incurred in each year of the contract were as follows:

Contract	*1987*	*1988*	*1989*	*Total*
B	$200	$400	$200	$800
C	100	300	400	800

In applying the look-back method, the first step is to allocate the contract price among tax years preceding and including the completion year. That allocation would produce the following amounts of gross income for purposes of the regular tax. Note that no income from Contract C is allocated to 1987, the year before the contract was entered into, even though contract costs were incurred in 1987:

Contract	*1987*	*1988*	*1989*
B	$100 (40% x $200/$800 x $1000)	$200 ((40% x $600/$800 x $1000) − $100)	$700
C	0	500 ($400/$800 x $1000)	500

Because the percentage of completion-capitalized cost method may not be used for alternative minimum tax purposes, the allocation of contract income would produce the following amounts of gross income for purposes of computing alternative minimum taxable income:

Contract	*1987*	*1988*	*1989*
B	$250 ($200/$800 x $1000)	$500 (($600/$800 x $1000) − $250)	$250
C	0	500	500

(3) *Step Two.* The following example illustrates the application of paragraph (c)(3):

Example (2). (i) X enters into two long-term contracts (D and E) in 1988. X determines its tax liability for 1988 as follows:

e = estimate
a = amount originally reported (actual)
h = hypothetical

	1988		
	D	*E*	*Total*
1988 contract costs	$ 3,000a	$ 2,000a	
Total contract costs	8,000e	8,000e	
Total contract price	10,000e	10,000e	
1988 completion %	37.5%e	25%e	
1988 gross income	3,750a	2,500a	
less, 1988 costs	(3,000a)	(2,000a)	
1988 net contract income	750a	500a	$1,250a
Other 1988 net income (loss)			(2,000a)
Taxable income (NOL)			(750a)
Tax			-0-a
Refund from NOL carryback fully absorbed in 1985, at 46%			345a

(ii) X completes Contract D during 1989. X determines its taxable income for 1989 as follows:

1989	*D*	*E*	*Total*
1989 contract costs	$ 3,000a	$ -0-a	
Total contract costs	6,000a	9,000e	
Total contract price	10,000a	10,000e	
1989 completion %	100%a	22.2%e	
1989 gross income/(loss)	6,250a	(278a)	
less, 1989 costs	(3,000a)	-0-a	
1989 net contract income	3,250a	(278a)	$2,972a
Other 1989 net income (loss)			-0-a
Taxable income (NOL)			2,972a
Tax at 34%			1,011a

(iii) For purposes of the look-back method, X must reallocate the actual total contract D price between 1988 and 1989 based on the actual total contract D costs. This results in the following hypothetical underpayment of tax for 1988 for purposes of the look-back method. Note that X does not reallocate the contract E price in applying the look-back method in 1989 because contract E has not been completed, even though X's estimate of contract E costs has changed. The following computation is only for purposes of applying the look-back method, and does not result in the assessment of a tax deficiency.

1988	*D*	*E*	*Total*
1988 contract costs	$ 3,000a	$ 2,000a	
Total contract costs	6,000a	8,000e	
Total contract price	10,000a	10,000e	
1988 completion %	50%a	25%e	
1988 gross income	5,000h	2,500a	
less, 1988 costs	(3,000a)	(2,000a)	
1988 net contract income	2,000h	500a	$ 2,500h
Other 1988 net income (loss)			(2,000a)
Taxable income (NOL)			500h
Tax at 34%			170h
less, previously computed tax			-0-a
Underpayment of 1988 tax			170h
Underpayment of 1985 tax from NOL carryback refund in 1988			345h
Total underpayment of tax			515h

For purposes of any subsequent application of the look-back method for which 1989 is a redetermination year, because the reallocation of contract income and redetermination of tax liability are cumulative, X will use for 1989 the amount of contract D income and the amount of tax liability that would have been reported in 1989 if X had used actual contract costs instead of the amounts that were originally reported using the estimate of $8,000. Assuming no subsequent revisions (due to, for example, adjustments to contract D price and costs determined after the end of 1989), this amount would be determined as follows:

1989	*D*	*E*	*Total*
1989 contract costs	$ 3,000a	$ -0-a	
Total contract costs	6,000e	9,000e	
Total contract price	10,000a	10,000e	
1989 completion %	100%a	22.2%e	
1989 gross income	5,000h	(278a)	
less, 1989 costs	(3,000a)	-0-a	
1989 net contract income	2,000h	(278a)	$1,722h
Other 1989 net income (loss)			-0-a
Taxable income (NOL)			1,722h
Tax at 34%			585h

(iv) X completes contract E during 1990. X determines its taxable income for 1990 as follows:

1990	*D*	*E*	*Total*
1990 contract costs		$ 7,000a	
Total contract costs		9,000a	
Total contract price		10,000a	
1990 completion %		100%a	
1990 gross income		7,778a	
less, 1990 costs		(7,000a)	
1990 net contract income		778a	$778a
Other 1990 net income (loss)			-0-a
Taxable income (NOL)			778a
Tax at 34%			265a

(v) For purposes of the look-back method, X must reallocate the actual total contract E price between 1988, 1989, and 1990, based on the actual total contract E costs. This results in the following hypothetical overpayment of tax for 1988. Note that X uses the amount of income for contract D determined in the last previous application of the look-back method, and not the amount of income actually reported:

1988

	D	*E*	*Total*
1988 contract costs	$ 3,000a	$ 2,000a	
Total contract costs	6,000a	9,000a	
Total contract price	10,000a	10,000a	
1988 completion %	50%a	22.2%a	
1988 gross income	5,000h	2,222h	
less, 1988 costs	(3,000a)	(2,000a)	
1988 net contract income	2,000h	222h	$ 2,222h
Other 1988 net income (loss)			(2,000a)
Taxable income (NOL)			222h
Tax at 34%			75h
less, previously computed tax (based on most recent application of the look-back method)			170h
Overpayment of 1988 tax			(95h)

In applying the look-back method to 1989, X again uses the amounts substituted as of the last previous application of the look-back method with respect to contract D. Thus, X computes its hypothetical underpayment for 1989 as follows:

1989

	D	*E*	*Total*
1989 contract costs	$ 3,000a	$ -0-a	
Total contract costs	6,000a	9,000a	
Total contract price	10,000a	10,000a	
1989 completion %	100%a	22.2%a	
1989 gross income	5,000h	-0-h	
less, 1989 costs	(3,000a)	(-0-a)	
1989 net contract income	2,000h	-0-a	$2,000h
Other 1989 net income (loss)			(-0-a)
Taxable income (NOL)			2,000h
Tax at 34%			680h
less, previously computed tax			585h
Underpayment of 1989 tax			95h

For purposes of any subsequent application of the look-back method for which 1990 is a redetermination year, X will use for 1990 the amount of Contract E income, and the amount of tax liability, that was originally reported in 1990 because X's estimate of the total contract costs from $8,000 to $9,000 did not change after 1989. Without regard to any subsequent revisions, these amounts are the same as in the table in paragraph (h)(3)(iv) above:

(4) *Post-completion adjustments.* The following example illustrates the application of paragraph (c)(1)(ii):

Example (3). The facts are the same as in Example (2). In 1991, X settles a lawsuit against its customer in Contract E. The customer pays X an additional $3,000, without interest, in 1991. Applying the Federal mid-term rate then in effect, this $3,000 has a discounted value at the time of contract completion in 1990 of $2,700. X is required to apply the look-back method for 1991 even though no contract was completed in 1991. X must include the full $3,000 adjustment (which was not previously includible in total contract price) in gross income for 1991. X does not elect not to discount adjustments to the contract price or costs. Thus, X adjusts the contract price by the discounted amount of the adjustment and, therefore, uses $12,700 (not $13,000) for total Contract E price, rather than $10,000, which was used when the look- back method was first applied with respect to Contract E.

For purposes of the look-back method, X must allocate the revised total Contract E price of $12,700 between 1988, 1989 and 1990 based on the actual total Contract E costs, and compare the resulting revised tax liability with the tax liability determined for the last previous application of the look-back method involving those years. This results in the following hypothetical underpayments of tax for purposes of the look-back method:

r = revised

1988

	D	*E*	*Total*
1988 contract costs	$ 3,000a	$ 2,000a	
Total contract costs	6,000a	9,000a	
Total contract price	10,000a	12,700r	
1988 completion %	50%a	22.2%a	
1988 gross income	5,000h	2,822rh	
less, 1988 costs	(3,000a)	(2,000a)	
1988 net contract income	2,000h	822rh	$ 2,822rh
Other 1988 net income/ (loss)			(2,000a)
Taxable income			822rh
Tax at 34%			279rh
less, previously computed tax			75h
Underpayment of 1988 tax			204rh

No Contract E costs were incurred in 1989, and there is no hypothetical underpayment for 1989.

1990

	D	*E*	*Total*
1990 contract costs		$ 7,000a	
Total contract costs		9,000a	
Total contract price		12,700r	
1990 completion %		100%a	
1990 gross income		9,878rh	
less, 1990 costs		(7,000a)	
1990 net contract income		2,878rh	$2,878rh
Other 1990 net income (loss)			-0-a
Taxable income (NOL)			2,878rh
Tax at 34%			978rh
less, previously computed tax			265h
Underpayment of 1990 tax			713rh

In 1992, X incurs an additional cost of $1,000 allocable to the contract, which was not previously includible in total contract costs. Applying the Federal mid-term rate then in effect, the $1,000 has a discounted value at the time of contract completion of $800. X deducts this additional $1,000 in expenses in 1992. Based on this increase to contract costs, X reapplies the look-back method, and determines the following hypothetical overpayments for 1988, 1989 and 1990 for purposes of the look-back method:

1988

	D	*E*	*Total*
1988 contract costs	$ 3,000a	$ 2,000a	
Total contract costs	6,000a	9,800r	
Total contract price	10,000a	12,700r	
1988 completion %	50%a	20.4%r	
1988 gross income	5,000h	2,592rh	
less, 1988 costs	(3,000a)	(2,000a)	
1988 net contract income	2,000h	592rh	$ 2,592rh
Other 1988 net income (loss)			(2,000a)
Taxable income (NOL)			592rh
Tax at 34%			201rh
less, previously computed tax			279rh
Overpayment of 1988 tax			(78rh)

No Contract E costs were incurred in 1989, and there is no hypothetical underpayment for 1989.

1990

	D	*E*	*Total*
1990 contract costs		$ 7,000a	
Total contract costs		9,800r	
Total contract price		12,700r	
1990 completion %		92%a	
1990 gross income		9,071rh	
less, 1990 costs		(7,000a)	
1990 net contract income		2,071rh	$2,071rh
Other 1990 net income (loss)			-0-a
Taxable income (NOL)			2,071rh
Tax at 34%			704rh
less, previously computed tax			978rh
Overpayment of 1990 tax			(274rh)

(5) *Alternative minimum tax.* The operation of the look-back method in the case of a taxpayer liable for the alternative minimum tax as provided in paragraph (c)(3)(vi) is illustrated by the following example:

Example (4). Y enters into a long-term contract in 1988 that is completed in 1989. Y used regular tax costs for purposes of determining the degree of contract completion under the alternative minimum tax.

(i) Y determines its tax liability for 1988 as follows:

1988 contract costs	$ 4,000a
Total contract costs	8,000e
Total contract price	20,000e
1988 completion %	50%e
1988 gross income	10,000a
less, 1988 contract costs	(4,000a)
1988 net contract income	6,000a
Other 1988 net income/(loss)	(3,400a)
Taxable income	2,600a
Regular tax at 34%	884a
Adjustments and preferences to produce alternative minimum taxable income	600a
Alternative minimum taxable income	3,200a
Tentative minimum tax at 20%	640a
Tax liability	884a

In 1989, Y determines the following amounts:

1989 contract costs	$ 6,000a
Total contract costs	10,000a
Total contract price	20,000a

(ii) For purposes of applying the look-back method, Y redetermines its tax liability for 1988, which results in a hypothetical overpayment of tax. This hypothetical overpayment is determined by comparing Y's original regular tax liability for 1988 with the hypothetical total tax liability (including alternative minimum tax liability) for that year because Y would have paid the alternative minimum tax if Y had used its actual contract costs to report income:

1988 contract costs	$ 4,000a
Total contract costs	10,000a
Total contract price	20,000a
1988 completion %	40%a
1988 gross income	8,000h
less, 1988 contract costs	(4,000a)
1988 net contract income	4,000h
Other 1988 net income/(loss)	(3,400a)
Taxable income	600h
Regular tax at 34%	204h
Adjustments and preferences to produce alternative minimum taxable income	600a
Alternative minimum taxable income	1,200h
Tentative minimum tax at 20%	240h
Alternative minimum tax	36h
Total tax liability	240h
less, previously computed tax	884a
Underpayment/(overpayment)	(644h)

(6) *Credit carryovers.* The operation of the look-back method in the case of credit carryovers as provided in paragraph (c)(3)(v) is illustrated by the following example:

Example (5). Z enters into a contract in 1986 that is completed in 1987. Z determines its tax liability for 1986 as follows:

1986 contract costs	$ 400a
Total contract costs	1,000e
Total contract price	2,000e
1986 completion %	40%e
1986 gross income	800a
less, 1986 costs	(400a)
1986 net contract income	400a
Other 1986 net income	-0-a
Taxable income	400a
Tax at 46%	184a
Unused tax credits carried forward from 1985 allowable in 1986	350a
Net tax due	-0-a

Z determines the following amounts for 1987:

1987 contract costs	$ 400a
Total contract price	2,000a
Total contract costs	800a

If Z had used actual rather than estimated contract costs in determining gross income for 1986, Z would have reported tax liability of $276 (46% x $600) rather than $184. However, Z would have paid no additional tax for 1986 because its unused tax credits carried forward from 1985 would have been sufficient to offset this increased tax liability. Therefore, there is no hypothetical underpayment for 1986 for purposes of the look-back method. However, this hypothetical earlier use of the credit may increase the hypothetical tax liability for 1987 (or another subsequent year) for purposes of subsequent applications of the look-back method.

(7) *Net operating losses.* The operation of the look-back method in the case of net operating loss ("NOL") carryovers as provided in paragraph (c)(3)(v) is illustrated by the following example:

Example (6). A entered into a long-term contract in 1986, which was completed in 1987. A determined its tax liability for 1986 as follows:

1986 contract costs	$ 400a
Total contract costs	1,000e
Total contract price	2,000e
1986 completion %	40%e
1986 gross income	800a
less, 1986 costs	(400a)
1986 net contract income	400a
Other 1986 net income/(loss)	(1,000a)
Taxable income/(NOL)	(600a)
Tax	-0-a

A elected to carry this loss forward to 1987 pursuant to section 172(b)(3)(C).

For 1987, A determined the following amounts:

1987 contract costs	$ 400a
Total contract costs	800a
Total contract price	2,000a

If actual rather than estimated contract costs had been used in determining gross income for 1986, A would have reported $1,000 of gross income from the contract rather than $800, and thus would have reported a loss of $400 rather than $600. However, since A would have paid no tax for 1986 regardless of whether actual or estimated contract costs had been used, A does not have an underpayment for 1986 for purposes of the look-back method. If A had, instead, carried back the 1986 NOL, and this NOL had been absorbed in the tax years 1983 through 1985, it would have resulted in refunds of tax for those years in 1986. When A applies the look-back method, a hypothetical underpayment of tax would have resulted for those years due to a hypothetical reduction in the amount that would have been refunded if income had been reported on the basis of actual contract costs. See Example (2)(iii).

(8) *Alternative minimum tax credit.* The following example illustrates the application of the look-back method if affected by the alternative minimum tax credit as provided in paragraph (c)(3)(vi):

Example (4), above, illustrates that the reallocation of contract income under the look-back method can result in a hypothetical underpayment or overpayment determined using the alternative minimum tax rate, even though the taxpayer actually paid only the regular tax for that year. However, application of the look-back method had no effect on the difference between the amount of alternative minimum taxable income and the amount of regular taxable income taken into account in that year because the taxpayer was required to use the percentage of completion method for both regular and alternative minimum tax purposes and used the same version of the percentage of completion method for both regular and alternative minimum tax purposes (*i.e.*, the taxpayer had made an election to use regular tax costs in determining the percentage of completion for purposes of computing alternative minimum taxable income).

The following example illustrates the application of the look-back method in the case of a taxpayer that does not use the percentage of completion method of accounting for long-term contracts in computing taxable income for regular tax purposes and thus must make an adjustment to taxable income to determine alternative minimum taxable income. The example also shows how interest is computed under the look-back method when the taxpayer is entitled to a credit under section 53 for minimum tax paid because of this adjustment.

Example (7). X is a taxpayer engaged in the construction of real property under contracts that are completed within a 24-month period and whose average annual gross receipts do not exceed $10,000,000. As permitted by section 460(e)(1)(B), X uses the completed contract method ("CCM") for regular tax purposes. However, X is engaged in the construction of commercial real property and, therefore, is required to use the percentage of completion method ("PCM") for alternative minimum tax ("AMT") purposes.

Assume that for 1988, 1989, and 1990, X has only one long-term contract, which is entered into in 1988 and completed in 1990. Assume further that X estimates gross income from the contract to be $2,000, total contract costs to be $1,000, and that the contract is 25 percent complete in 1988 and 75 percent complete in 1989. In 1990, the year of completion, the percentage of completion does not change but, upon completion, gross income from the contract is actually $3,000, instead of $2,000, and costs are actually $1,000.

For 1988, 1989, and 1990, X's income and tax liability using estimated contract price and costs are as follows:

Estimates	*1988*	*1989*	*1990*
Regular tax			
Long-term			
Contract-CCM	$-0-	$ -0-	$2,000
Other Income	-0-	5,000	-0-
Total Income	-0-	5,000	2,000
Tax @ 34%	-0-	1,700	680
AMT			
Gross Income	500	1,000	1,500
Deductions	(250)	(500)	(250)
Total long-term			
Contract-PCM	250	500	1,250
Other Income	-0-	5,000	-0-
Total Income	250	5,500	1,250
Tax @ 20%	50	1,100	250
Tentative Minimum Tax	50	1,100	250
Regular Tax	-0-	1,700	680
Minimum Tax Credit	-0-	(50)	-0-
Net Tax Liability	50	1,650	680

When X files its tax return for 1990, X applies the look-back method to the contract. For 1988, 1989, and 1990, X's income and tax liability using actual contract price and costs are as follows:

Actual	*1988*	*1989*	*1990*
Regular tax			
Long-term			
Contract-CCM	$-0-	$ -0-	$2,000
Other Income	-0-	5,000	-0
Total Income	-0-	5,000	2,000
Tax @ 34%	-0-	1,700	680
AMT			
Gross Income	750	1,500	750
Deductions	(250)	(500)	(250)
Total long-term			
Contract-PCM	500	1,000	500
Other Income	-0-	5,000	-0-
Total Income	500	6,000	500
Tax @ 20%	100	1,200	100
Tentative Minimum Tax	100	1,200	100
Regular Tax	-0-	1,700	680
Minimum Tax Credit	-0-	(100)	-0-
Net Tax Liability	100	1,600	680
Underpayment	50		
Overpayment		50	

As shown above, application of the look-back method results in a hypothetical underpayment of $50 for 1988 because X was subject to the alternative minimum tax for that year. Interest is charged to X on this $50 underpayment from the due date of X's 1988 return until the due date of X's 1990 return.

In 1989, although X was required to compute alternative minimum taxable income using the percentage of completion method, X was not required to pay alternative minimum tax. Nevertheless, the look-back method must be applied to 1989 because use of actual rather than estimated contract price in computing alternative minimum taxable income for 1988 would have changed the amount of the alternative minimum tax credit carried to 1989. Interest is paid to X on the resulting $50 overpayment from the due date of X's 1989 return until the due date of X's 1990 return.

(9) *Period for interest.* The following Examples (8) through (11) illustrate how to determine the period for computing interest as provided in paragraph (c)(4):

Example (8). The facts are the same as in Example (6), except that the contract is completed in 1988, and A determined the following amounts for 1987 and 1988:

for 1987:

1987 contract costs	$ -0-
Total contract costs	1,000e
Total contract price	2,000e
1987 completion %	40%e
1987 gross income	-0-a
less, 1987 costs	-0-a
Other 1987 net income	600a
Net operating loss carryforward from 1986	(600a)
taxable income	-0-a
tax	-0-a

for 1988:

1988 contract costs	400a
Total contract costs	800a
Total contract price	2,000a

If actual rather than estimated contract costs had been used in determining gross income for 1986, A would have reported $1,000 of gross income from the contract for 1986 rather than $800, and would have reported a net operating loss carryforward to 1987 of $400 rather than $600. Therefore, A would have reported taxable income of $200, and would have paid tax of $80 (*i.e.*, $200 x 40%) for 1987. The due date for filing A's Federal income tax return for its 1988 taxable year is March 15. A obtains an extension and files its 1988 return on September 15, 1989. Under the look-back method, A is required to pay interest on the amount of this hypothetical underpayment ($80) computed from the due date (determined without regard to extensions) for A's return for 1987 (not 1986, even though 1986 was the year in which the net operating loss arose) until March 15 (not September 15), the due date (without regard to extensions) of A's return for 1988. A is required to pay additional interest from March 15 until September 15 on the amount of interest outstanding as of March 15 with respect to the hypothetical underpayment of $80.

Example (9). The facts are the same as in Example (6), except that A carries the net operating loss of $600 back to 1983 rather than forward to 1987, and receives a refund of $276 ($600 reduction in 1983 taxable income x 46% rate in effect in 1983). As in Example (6), if actual contract costs had been used, A would have reported a loss for 1986 of $400 rather than $600. Thus, A would have received a refund of 1983 tax of $184 ($400 x 46%) rather than $276. Under the look-back method A is required to pay interest on the difference in these two amounts ($92) computed from the due date (determined without regard to extensions) of A's return for 1986 (the year in which the carryback arose rather than 1983, the year in which it was used) until the due date of A's return for 1988.

Example (10). B enters into a long-term contract in 1986 that is completed in 1988. B determines its 1986 tax liability as follows:

1986 contract costs	$ 400a
Total contract costs	1,000e
Total contract price	2,000e
1986 completion %	40%e
1986 gross income	800a
less, 1986 costs	(400a)
1986 net contract income	400a
Other 1986 net income	2,000a
Taxable income	2,400a
Tax at 46%	1,104a

B determines its tax liability for 1987 as follows:

1987 contract costs	$ 400a
Total contract costs	1,600e
Total contract price	2,000e
1987 completion %	50%e
1987 gross income	200a
(=(50% x $2,000)	$800 previously reported)
less, 1987 costs	(400a)
1987 net contract income	(200a)
Other 1987 net income/(loss)	(2,200a)
Taxable income (NOL)	(2,400a)
Tax	-0-a

Assume that B had no taxable income in either 1984 or 1985, so that the entire amount of the $2,400 net operating loss is carried back to 1986, and B receives a refund, with interest from the due date of B's 1987 return, of the entire $1,104 in tax that it paid for 1986.

In 1988, B determines the following amounts:

1988 contract costs	$ 800a
Total contract costs	1,600a
Total contract price	2,000a

If B had used actual contract costs rather than estimated costs in determining its gross income for 1986, B would have had gross income from the contract of $500 rather than $800, and thus would have had taxable income of $2,100 rather than $2,400, and would have paid tax of $966 rather than $1,104. B is entitled to receive interest on the difference between these two amounts, the hypothetical overpayment of tax of $138. Interest is computed from the due date (without regard to extensions) of B's return for 1986 until the due date for B's return for 1987. Interest stops running at this date, because B's hypothetical overpayment of tax ended when B filed its original 1987 return and received a refund for the carryback to 1986, and interest on this refund began to run only from the due date of B's 1987 return. See section 6611(f).

Example (11). C enters into a long-term contract in 1986, its first year in business, which is completed in 1988. C determines its tax liability for 1986 as follows:

1986 contract costs	$ 400a
Total contract costs	1,000e
Total contract price	2,000e
1986 completion %	40%e
1986 gross income	800a
less, 1986 costs	(400a)
1986 net contract income	400a
Other 1986 net income	2,000a
Taxable income (NOL)	2,400a
Tax at 46%	1,104a

C determines its tax liability for 1987 as follows:

1987 contract costs	$ 400a
Total contract costs	1,066e
Total contract price	2,000e
1987 completion %	75%e
1987 gross income	700a
less, 1987 costs	(400a)
1987 net contract income	300a
Other 1987 net income	(2,450a)
Taxable income (NOL)	(2,150a)
Tax	-0-a

C carries back the net operating loss to 1986, and files an amended return for 1986, showing taxable income of $250, and receives a refund of $989 (46% x $2,150). Interest on this refund begins to run only as of the due date of C's 1987 return. See section 6611(f).

In 1988, when the contract is completed, C determines the following amounts:

1988 contract costs	$ 800a
Total contract costs	1,600a
Total contract price	2,000a

If C had used actual contract price and contract costs in determining gross income for 1986, it would have reported gross income from the contract of $500 rather than $800, taxable income of $2,100 rather than $2,400, and tax liability of $966 rather than $1,104.

If C had used actual contract price and contract costs in determining gross income for 1987, it would have reported gross income from the contract of $500 rather than $700, and would have reported a net operating loss of $2,350, rather than $2,150, which would have been carried back to 1986.

Under the look-back method, C receives interest with respect to a total 1986 hypothetical overpayment of $138 ($1,104 minus $966). C is credited with interest on $23 of this amount only from the due date of C's 1986 return until the due date of C's 1987 tax return, because this portion of C's total hypothetical overpayment for 1986 was refunded to C with interest computed from the due date of C's 1987 return and, therefore, was no longer held by the government. However, because the remainder of the total hypothetical overpayment of $115 was not refunded to C, C is credited with interest on this amount from the due date of C's 1986 return until the due date of C's 1988 tax return. Under the look-back method, C receives no interest with respect to 1987, because C had no tax liability for 1987 using either estimated or actual contract price and costs.

§1.460-7. Exempt long-term contracts. [Reserved.]

§1.460-8. Changes in method of accounting. [Reserved.]

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

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

Authority: 26 U.S.C. 7805

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

"§1.460-6 . . . 1545-1031."

Fred T. Goldberg, Jr.,
Commissioner of Internal Revenue .

(Fiiled by the Office of the Federal Register on June 11, 1990, 8:45 a.m., and published in the issue of the Federal Register for June 12, 1990, 55 F.R. 23755)

Notice of Proposed Rulemaking

Returns Relating to Cash in Excess of $10,000 Received in a Trade or Business

IA-41-89

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In the rules and regulations portion of *** [T.D. 8304, page 250, this Bulletin], the Internal Revenue Service is issuing temporary regulations to provide rules relating to the reporting of cash in excess of $10,000 received in a trade or business. These regulations enable law enforcement authorities to ascertain the magnitude of large transfers of cash with respect to the same transaction. The regulations affect trades or businesses that are currently required to report large receipts of cash. The text of the temporary regulations also serves as the comment document for this notice of proposed rulemaking.

DATES: These amendments are proposed to be effective for amounts received after December 31, 1989. Comments and requests for a public hearing must be received by September 7, 1990.

ADDRESS: Send comments and requests for a public hearing to: Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Attn: CC: CORP:TR (IA-41-89), Room 4429, 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 1980 (44 U.S.C. 3504(h)). Comments concerning the accuracy of the burden estimate and suggestions for reducing the burden should be directed to the Office of Management and Budget, Attention: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, D.C. 20503.

The collection of information in this regulation is in §1.6050I-1. This information is required by the Internal Revenue Service to ascertain the magnitude of transfers of large amounts of cash. This information will be used by law enforcement authorities with respect to the enforcement of federal and state laws. The likely respondents are businesses or other for-profit institutions and nonprofit institutions.

These estimates are an approximation of the average time expected to be necessary for a collection of information. They are based on such information as is available to the Internal Revenue Service. Individual respondents may require greater or less time, depending on their particular circumstances. Estimated total annual reporting burden: 7,489 hours. The estimated average annual burden per respondent is 18 minutes. Estimated number of respondents: 8,300. Estimated annual frequency of responses: 3.

Background

The temporary regulations published in the Rules and Regulations portion of this issue of the Federal Register add a new temporary regulation §1.6050I-1T to Part 1 of Title 26 of the Code of Federal Regulations. The temporary regulations require a person who currently must report the receipt of cash in excess of $10,000 with respect to a transaction to also make a report each time subsequent cash payments received within a one-year period with respect to the same transaction or a related transaction aggregate an amount in excess of $10,000. For the text of the new temporary regulations, see T.D. 8304 published in *** [page 250, this Bulletin]. The preamble to the temporary regulations explains the regulations.

Special Analyses

It has been determined that these proposed rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. 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, an initial Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations will be submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

Comments and Requests for a Public Hearing

Before the adoption of these proposed regulations, consideration will be given to any written comments that are submitted (preferably an original and eight copies) to the Internal Revenue Service. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Internal Revenue Service by any person who also submits written comments. If a public hearing is held, notice of the time and place will be published in the Federal Register.

Fred T. Goldberg, Jr.,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on July 6, 1990, 8:45 a.m., and published in the issue of the Federal Register for July 9, 1990, 55 F.R. 28061)

Notice of Proposed Rulemaking

Information With Respect to Certain Foreign-Owned Corporations

IL-868-89

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed Income Tax Regulations relating to information which must be reported and records which must be maintained by certain foreign-owned corporations under sections 6038A and 6038C of the Internal Revenue Code. These regulations will provide appropriate guidance for affected reporting corporations and related parties. The regulations will affect any reporting corporation, that is, certain domestic corporations or foreign corporations, as well as certain related parties of the reporting corporation.

DATES: Written comments, requests to appear, and outlines of oral comments to be presented at a public hearing scheduled for Friday, February 22, 1991, at 10:00 a.m., must be received by Friday, February 8, 1991. See notice of hearing published elsewhere in *** [Announcement 90-145, 1990-53 I.R.B. 64].

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 in accordance with the Paperwork Reduction Act of 1980 (44 U.S.C. 3504(h)). Comments on the collection of information should be sent to the Office of Management and Budget, Attention: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, D. C. 20503, with copies to the Internal Revenue Service, Attention: IRS Reports Clearance Officer T:FP, Washington, D. C. 20224. The collection of information in this regulation is in §§1.6038A-2 and 1.6038A-3. This information is required by the Internal Revenue Service to determine the correct tax treatment of transactions between 25-percent foreign-owned corporations engaged in a U.S. trade or business and related parties. The likely respondents for Form 5472 are corporations.

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

Estimated total annual reporting and recordkeeping burden: 1,539,000 hours.

The estimated average annual reporting burden per respondent is 14 hours and 26 minutes.

The estimated average annual recordkeeping burden per recordkeeper is 10 hours.

Estimated number of respondents/recordkeepers: 63,000.

Estimated annual frequency of responses: 1.

Background

This document contains proposed Income Tax Regulations (26 CFR Part 1) under sections 6038A and 6038C of the Internal Revenue Code of 1986. These regulations are generally proposed to be effective for taxable years beginning after July 10, 1989. However, special effective date rules are proposed to provide that certain provisions sections will be effective as of December 10, 1990, except as follows:

§1.6038A-1(c)	July 10, 1989
§1.6038A-2.....	July 10, 1989
§1.6038A-3.....	March 20, 1990
§1.6038A-4.....	July 10, 1989
§1.6038A-6.....	November 5, 1990

Explanation of Provisions

Prior Law

Prior to the enactment of the Revenue Reconciliation Act of 1989, section 6038A required an annual filing of an information return, Form 5472, by a domestic corporation (or a foreign corporation engaged in trade or business within the United States) that is controlled by a foreign person. A person controlled a corporation if that person owned stock possessing more than 50 percent of the total voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock. If a corporation failed to furnish the information required under the statute, a penalty of $1000 was imposed for each taxable year with respect to which such failure occurred. An additional penalty of $1000 was imposed for each 30-day period during which such failure continued after the expiration of a 90-day period following the mailing of a notice of failure. The increase in the additional penalty was limited to $24,000.

Statutory Provision

The Revenue Reconciliation Act of 1989 amended section 6038A in several significant ways. First, the threshold of foreign ownership subjecting a corporation to the application of section 6038A was lowered from 50 percent to 25 percent. Second, amended section 6038A requires the maintenance of records as prescribed by regulations.

The penalty for the failure either to file timely the annual information return or to maintain (or to cause another to maintain) the prescribed records is $10,000 for each taxable year with respect to which such failure occurs. The former maximum additional penalty of $24,000 has been deleted. If the failure continues for more than 90 days after the day on which notice is given by the Service of such failure, an additional penalty of $10,000 is assessed for each 30-day period or part thereof that the failure continues.

In addition to the above changes, the 1989 Act added a new section, section 6038A(e)(1), requiring a foreign related party that engages in transactions with a reporting corporation to authorize the reporting corporation to act as its agent solely for purposes of sections 7602, 7603, and 7604.

If the related party does not authorize the reporting corporation to act as its agent, the Secretary shall apply the noncompliance penalty with respect to transactions between the related party and the reporting corporation.

If the noncompliance penalty applies, the amount allowed as a deduction for amounts paid or incurred to the related party and for the cost of

goods purchased from the related party or sold by the reporting corporation to the related party is determined by the Secretary in his sole discretion based upon such probative information as the Secretary may choose to obtain. See H.R. Conf. Rep. 386, 101st Cong., 1st Sess. 593-595 (1989).

The noncompliance penalty may also be applied to a transaction between the related party and the reporting corporation if the reporting corporation does not substantially comply with a summons for records or testimony relating to such transaction.

The Omnibus Budget Reconciliation Act of 1990 (the 1990 Act) added section 6038C to the Internal Revenue Code. Foreign corporations engaged in U.S. trade or business are subject to the provisions of section 6038C, which are similar to the provisions of section 6038A. Additional regulations under section 6038C will be issued at a later time which will reflect the 1990 Act changes with respect to such corporations.

Comments

Comments are solicited with respect to ways to permit related foreign corporations to file a single agency designation, in a manner similar to the rules contained in paragraph (g) of §1.6038A-1 regarding the ability of the common parent of an affiliated group to file a consolidated Form 5472 for all related party transactions of the U.S. consolidated return group and to be designated as agent for related parties.

The *de minimis* rule of §1.6038A-1(h) was developed after consideration of case studies submitted by international examiners. Comments from taxpayers are solicited.

Comments and case studies are also solicited on whether the various tests for determining material profit and loss statements under §1.6038A-3(c)(3) are appropriate. In particular, comments regarding the existing accounting and business practices for maintaining profit and loss statements are requested. Objections to the profit and loss statement standards set forth in these regulations should be accompanied by proposed alternatives. Comments also are solicited on when a profit margin analysis, rather than a return on assets analysis, might be appropriate for the high profit test under paragraph (c)(6) of section 1.6038A-3.

Explanation of Proposed Regulations

General requirement and definitions

Section 1.6038A-1 provides the general rule that certain foreign-owned U.S. corporations and foreign corporations engaged in trade or business within the United States (reporting corporations) must furnish certain information annually on an information return, Form 5472, and maintain records relating to transactions between the reporting corporation and a foreign related party as described in §1.6038A-3. Definitions are provided for the terms reporting corporation, 25-percent foreign-owned, 25-percent foreign shareholder, related party, foreign person, and foreign related party. Special rules are provided for U.S. consolidated return groups.

Requirement of return

Section 1.6038A-2 describes the information that must be furnished annually on Form 5472. Reporting corporations whose sole trade or business in the United States is a banking, financing, or similar business as defined in §1.864-4(c)(5)(i) (formerly excepted from filing Form 5472) will be subject to the information filing requirement of §1.6038A-2.

Record maintenance

Section 1.6038A-3 provides the general rule that records to be maintained by a reporting corporation are those records sufficient to establish the correctness of the federal income tax return (including the correct treatment of transactions with related parties) of the reporting corporation. Records prepared, maintained, or possessed by a foreign related party relating to transactions between the reporting corporation and any related parties must be maintained in the United States, except where an election is in effect under paragraph (f) of §1.6038A-3. A record may be maintained in the United States by a party other than the reporting corporation; however, the reporting corporation remains liable for the proper compilation and maintenance of such records.

The regulations generally are based upon the view that the requirement to "maintain" records does not require their creation. However, basic accounting records and material profit and loss statements must be created if they are not otherwise maintained. In connection with record maintenance and production, labels placed upon documents by the taxpayer shall not control.

Some reporting corporations may be unfamiliar with record maintenance practices generally adopted in the United States under the guidance of section 6001, its regulations, and longstanding administrative practice developed thereunder. In addition, such corporations may not be aware of the specific information that would be relevant to an examination of their related party transactions. In the absence of detailed guidance, such reporting corporations might not retain the information that is required for U.S. tax purposes. Therefore, six general categories of records with respect to related party transactions are provided as a safe harbor. Reporting corporations that maintain records in the categories that apply to the particular industry or business of the reporting corporation, to the extent such records may be relevant to the correct U.S. tax treatment of the transactions between related parties, are deemed to meet the record maintenance requirements of section 6038A.

Reporting corporations may enter into agreements with the District Director or the Assistant Commissioner (International) specifying what records must be maintained to satisfy the maintenance requirements for such reporting corporations under this section. Agreements with respect to retention of machine-sensible records under Rev. Proc. 86-19 [1986-1 C.B. 558] may also be executed. An annual election to maintain records outside the United States is provided if the reporting corporation agrees to produce the records as prescribed by the regulations. The District Director or the Assistant Commissioner (International) may invalidate the election to maintain records outside the United States under certain circumstances.

Monetary penalty

Section 1.6038A-4 provides for the imposition of a monetary penalty of $10,000 for each taxable year in which a reporting corporation fails to timely file Form 5472, fails to maintain or cause another to maintain the records described in §1.6038A-3, or fails to produce the records within the time prescribed in §1.6038A-3. A rule permitting a reporting corporation to show reasonable cause as to why the failure occurred is provided. The reasonable cause exception is to be interpreted in accordance with the legislative history. *See* S. Prt. 101- [ ], 101st Cong., 1st Sess. 117 (1989) and H. Conf. Rep. No. 386, 101st Cong., 1st Sess. 593 (1989). Failure to maintain records is determined upon the basis of the overall compliance with the records maintenance requirement by a reporting corporation. Finally, rules relating to the increase in the penalty where the failure continues after notification are provided.

Authorization of agent

Section 1.6038A-5 provides that the noncompliance penalty in §1.6038A-7 shall apply to any transaction between a related party and a reporting corporation, unless the related party authorizes the reporting corporation to act as its limited agent solely for purposes of sections 7602, 7603, and 7604. When the proposed regulations become final, a related party annually shall authorize the reporting corporation to act as its limited agent on Form 5472 or within 30 days of a request from the Service. Until official Internal Revenue Service forms are available, the authorization as set forth in the regulations should be utilized. A procedure is provided for the retroactive authorization of an agent with respect to inadvertent transactions with related parties when the relationship is attenuated and certain other requirements are met. Additionally, a provision allows for the authorization by a foreign related party to be deemed under certain circumstances. A deemed authorization is effective only for transactions entered into prior to the time when the reporting corporation knew or had reason to know that the related party was in fact related.

Failure to furnish information

Section 1.6038A-6 provides that the noncompliance penalty contained in §1.6038A-7 may be applied under certain circumstances when information requested by the Service is not produced. A special rule permits the District Director or the Assistant Commissioner (International) to choose not to apply the noncompliance penalty when, in the discretion of the District Director or the Assistant Commissioner (International), the failure to furnish information is *de minimis.*

Noncompliance penalty

Section 1.6038A-7 provides that if a foreign related party does not authorize the reporting corporation to act as its agent as required by §1.6038A-5 or, if following a failure to furnish information as required by §1.6038A-6, the District Director or the Assistant Commissioner (International) determines that §1.6038A-7 should apply, the District Director or the Assistant Commissioner (International) shall determine the amount of deductions allowed for any amount paid or incurred by the reporting corporation to the related party in connection with such transaction and the cost to the reporting corporation of any property acquired in such transaction from the related party or transferred to the related party. The amount of the deduction or cost to the reporting corporation shall be determined in the sole discretion of the District Director or the Assistant Commissioner (International). *See* H. Conf. Rep. 386, 101st Cong., 1st Sess. 593-95 (1989).

Section 6038C

Corporations subject to section 6038C generally will be subject to the rules contained in §§1.6038A-1 through 1.6038A-7.

Special Analyses

It has been determined that these proposed rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. 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 final Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations will be submitted to the Administrator of the Small Business Administration for comments on their impact on small business.

Comments and Request for a Public Hearing

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably a signed original and eight copies) to the Internal Revenue Service. All comments will be available for public inspection and copying. A public hearing will be held on Friday, February 22, 1991.

List of Subjects in 26 CFR §§1.6000-1 through 1.6109-2

Income taxes, Administration and procedure, Payment of tax.

Adoption of amendment to the regulations

Accordingly, 26 CFR Part 1 is amended as follows:

PART 1—INCOME TAX REGULATIONS

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

Authority: 26 U.S.C. 7805. * * * Sections 1.6038A-1, 1.6038A-2, 1.6038A-3, 1.6038A-4, 1.6038A-5, 1.6038A-6, and 1.6038A-7 also issued under 26 U.S.C. 6038A. * * *

Par. 2. Section 1.6038A-1 is removed.

Par. 3. New §§1.6038A-0 through 1.6038A-7 are added to read as follows:

§1.6038A-0 *Table of contents.*

This section lists the captions that appear in the regulations under section 6038A.

§1.6038A-1 *General requirements and definitions.*

(a) Purpose and scope.
(b) In general.
(c) Reporting corporation.
(1) In general.
(2) 25-percent foreign-owned.
(3) 25-percent foreign shareholder.
(i) In general.
(ii) Total voting power and value.

(d) Related party.
(e) Attribution rules.
(1) Attribution under section 318.
(2) Attribution of transactions with related parties engaged in by a partnership.
(f) Foreign person.
(g) Foreign related party.
(h) Safe harbor for reporting corporations with *de minimis* value of related party transactions.
(1) In general.
(2) Aggregate value of gross payments made or received.
(i) Consolidated return groups.
(1) Required information.
(2) Authorization of agent and retention of records.
(3) Monetary penalties.
(j) Examples.
(k) Effective dates.
(1) Section 1.6038A-1.
(2) Section 1.6038A-2.
(3) Section 1.6038A-3.
(4) Section 1.6038A-4.
(5) Section 1.6038A-5.
(6) Section 1.6038A-6.
(7) Section 1.6038A-7.
§1.6038A-2 *Requirement of return.*
(a) Form 5472 required.
(1) In general.
(2) Reportable transaction.
(b) Contents of return.
(1) Reporting corporation.
(2) Related party.
(3) Foreign related party transactions for which only monetary consideration is paid or received by the reporting corporation.
(4) Foreign related party transactions involving nonmonetary consideration or no consideration.
(5) Additional information.
(6) Reasonable estimate.
(i) Estimate within 25 percent of actual amount.
(ii) Other estimates.
(7) Small amounts.
(8) Accrued payments and receipts.
(c) Method of reporting.
(d) Time and place for filing returns.
(e) Duplicate filing required.
(f) Exceptions.
(1) No reportable transactions.
(2) Transactions solely with a domestic reporting corporation.
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(g) Filing Form 5472 when transactions with related parties engaged in by a partnership are attributed to a reporting corporation.
(h) Effective dates for certain reporting corporations.
§1.6038A-3 *Record maintenance.*
(a) General maintenance requirements.
(1) Section 6001 and section 6038A.
(2) Safe harbor.
(b) Other maintenance requirements.
(1) Records that must be maintained in the United States.
(2) Indirectly related records.
(3) Foreign related party or third-party maintenance.
(4) Translation of records.
(5) Exception for foreign governments.
(c) Specific records to be maintained for safe harbor.
(1) In general.
(2) Descriptions of categories of documents to be maintained.
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(ii) Profit and loss statements.
(iii) Pricing documents.
(iv) Foreign country and third party filings.
(v) Ownership and capital structure records.
(vi) Records of loans, services, and other non-sales transactions.
(3) Material profit and loss statements.
(4) Existing records test.
(5) Significant industry segment test.
(i) In general.
(ii) Gross revenue test.
(iii) Percentage tests.
(iv) Definitions.
(A) Gross revenue.
(B) Identifiable assets.
(C) Operating profit or loss.
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(E) Related products or services.
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(G) Product line.
(v) Level of specificity required.
(vi) Examples.
(6) High profit test.
(i) In general.
(ii) Return on assets test.
(d) Liability for certain partnership record maintenance.
(e) Agreements with the District Director or the Assistant Commissioner (International).
(f) Exception to U.S. maintenance.
(1) Annual election.
(2) Retroactive elections.
(3) Scheduled production for high volume or other reasons.
(4) Invalidation of non-U.S. maintenance election.
(g) Period of retention.
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§1.6038A-4 *Monetary penalty.*
(a) Imposition of monetary penalty.
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(2) Liability for certain partnership transactions.
(3) Calculation of monetary penalty.
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(1) In general.
(2) Affirmative showing required.
(i) In general.
(ii) Small corporations.
(c) Failure to maintain records or to cause another to maintain records.
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(a) Failure to authorize.
(b) Annual authorization by related party.
(1) In general.
(2) Authorization for prior years.
(c) Legal effect of authorization of agent.
(1) Agent for purposes of commencing judicial proceedings.
(2) Foreign related party found where reporting corporation found.
(d) Successors in interest.
(e) Retroactive authorization for inadvertent transaction.
(1) In general.
(2) Procedure for requesting retroactive authorization.
(3) Effect of retroactive authorization.
(i) Noncompliance penalty adjustments.
(ii) Monetary penalty.
(4) Deemed compliance.
(5) Reason to know.
(6) Effect of deemed compliance.

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§1.6038A-6 *Failure to furnish information.*

(a) In general.

(b) Enforcement proceeding not required.

(c) De minimis failure.

(d) Effective dates.

§1.6038A-7 Noncompliance.

(a) In general.

(b) Determination of the amount.

(c) Separate application.

(d) Effective dates.

§1.6038A-1 *General requirements and definitions.*

(a) *Purpose and scope.* This section and §§1.6038A-2 through 1.6038A-7 provide rules for certain foreign-owned U.S. corporations and foreign corporations engaged in trade or business within the United States (reporting corporations) relating to information that must be furnished, records that must be maintained, and the authorization of the reporting corporation to act as agent for related foreign persons for purposes of sections 7602, 7603, and 7604 that must be executed. Section 6038A(a) and this §1.6038A-1 require that a reporting corporation furnish certain information annually and maintain certain records relating to transactions between the reporting corporation and certain related parties. This §1.6038A-1 also provides definitions of terms used in section 6038A. Section 1.6038A-2 provides guidance concerning the information to be submitted and the filing of the required return. Section 1.6038A-3 provides guidance concerning the maintenance of records. Section 1.6038A-4 provides guidance concerning the application of the monetary penalty for the failure either to furnish information or to maintain records. Section 1.6038A-5 provides guidance concerning the authorization of an agent for purposes of sections 7602, 7603, and 7604. Section 1.6038A-6 provides guidance concerning the failure to furnish information requested by a summons. Finally, §1.6038A-7 provides guidance concerning the application of the noncompliance penalty for failure by the related party to authorize an agent or for the reporting corporation to substantially comply with a summons.

(b) *In general.* A reporting corporation must furnish the information described in §1.6038A-2 by filing an annual information return (Form 5472), and must maintain records as described in §1.6038A-3.

(c) *Reporting corporation*—(1) *In general.* For purposes of section 6038A, a reporting corporation is either a domestic corporation that is 25-percent foreign-owned as defined in paragraph (c)(2), or a foreign corporation that is 25-percent foreign-owned and engaged in trade or business within the United States. After November 4, 1990, a foreign corporation engaged in a trade or business within the United States at any time during a taxable year is a reporting corporation. See section 6038C.

(2) *25-percent foreign-owned.* A corporation is 25-percent foreign-owned if it has at least one 25-percent foreign shareholder at any time during the taxable year.

(3) *25-percent foreign shareholder*—(i) *In general.* A foreign person is a 25-percent foreign shareholder of a corporation if such person owns at least 25 percent of—

(A) the total voting power of all classes of stock of such corporation entitled to vote, or

(B) the total value of all classes of stock of such corporation.

(ii) *Total voting power and value.* In determining whether one foreign person owns 25 percent of the total voting power of all classes of stock of a corporation entitled to vote or 25 percent total value of all classes of stock of a corporation, consideration will be given to all the facts and circumstances of each case, under principles similar to §1.957-1(b)(2) (consideration of arrangements to shift formal voting power away from the foreign person).

(d) *Related party.* The term "related party" means—

(1) Any 25-percent foreign shareholder of the reporting corporation,

(2) Any person who is related within the meaning of section 267(b) or 707(b)(1) to the reporting corporation or to a 25-percent foreign shareholder of the reporting corporation, or

(3) Any other person who is related to the reporting corporation within the meaning of section 482 and the regulations thereunder.

However, the term "related party" does not include any corporation filing a consolidated federal income tax return with the reporting corporation.

(e) *Attribution rules*—(1) *Attribution under section 318.* For purposes of determining whether a corporation is 25-percent foreign-owned and whether a person is a related party under section 6038A, the constructive ownership rules of section 318 shall apply. However, "10 percent" shall be substituted for "50 percent" in section 318(a)(2)(C), and subparagraphs (A), (B), and (C) of section 318(a)(3) shall not be applied so as to consider a U.S. person as owning stock that is owned by a person who is not a U.S. person.

(2) *Attribution of transactions with related parties engaged in by a partnership.* The transactions in which a domestic or foreign partnership engages shall be attributed to any reporting corporation whose interest in the capital or profits of the partnership, either directly or indirectly, combined with the interests of all related parties to the reporting corporation partner, equals 25 percent or more of the total partnership interests. Attribution of such transactions shall be made only to the extent of the partnership interest held by that reporting corporation partner. *See* sections 875 and 702(a) and the regulations thereunder. (Attribution shall not be made, however, of transactions directly between the partnership and a reporting corporation.) Accordingly, a reporting corporation partner that is deemed to engage in transactions with related parties under this rule is subject to the information reporting requirements of §1.6038A-2, to the record maintenance requirements of §1.6038A-3, to the monetary penalty under §1.6038A-4, to the requirement of authorization of agent under §1.6038A-5, and to the rules of §1.6038A-6 relating to the requirement to produce records.

(f) *Foreign person.* For purposes of section 6038A, a foreign person is—

(1) Any individual who is not a citizen or resident of the United States, but not including any individual for whom an election under section 6013(g) or (h) (relating to an election to file a joint return) is in effect;

(2) Any individual who is a citizen of any possession of the United States and who is not otherwise a

citizen or resident of the United States;

(3) Any partnership, association, company, or corporation that is not created or organized in the United States or under the law of the United States or any State thereof;

(4) Any foreign trust or foreign estate, as defined in section 7701(a)(31); or

(5) Any foreign government or foreign controlled commercial entity as defined by section 892(a)(2)(B) and the regulations thereunder to the extent that it is engaged directly or indirectly in a U.S. trade or business and receives income that is not exempt under section 892(a) and the regulations thereunder. A foreign government or foreign controlled commercial entity, however, will be treated as a foreign person under section 6038A and this section only for purposes of the return requirement described in §1.6038A-2. For purposes of section 6038A(a), a possession of the United States shall be considered to be a foreign country.

(g) *Foreign related party.* A foreign related party is a foreign person as defined under paragraph (f) of this §1.6038A-1 that is also a related party as defined under paragraph (d) of this §1.6038A-1.

(h) *Safe harbor for reporting corporations with de minimis value of related party transactions*—(1) *In general.* A reporting corporation

(i) that has an aggregate value of not more than $2,000,000 of gross payments made to (or received from) foreign related parties with respect to related party transactions, including monetary consideration, nonmonetary consideration, and the value of transactions involving no consideration, and

(ii) for which the aggregate value of the gross payments made to (or received from) foreign related parties with respect to related party transactions is less than 10 percent of its U.S. gross income, is not subject to the requirements of §§1.6038A-3 and 1.6038A-5. Such a corporation remains subject to the information reporting requirements of §1.6038A-2 and the general record maintenance requirements of section 6001. The threshold amounts described in this paragraph are to be applied separately to such amounts paid to or received from foreign related parties, rather than netting such amounts.

(2) *Aggregate value of gross payments made or received.* The aggregate value of gross payments made to (or received from) a foreign related party with respect to foreign related party transactions is determined by totaling the dollar amounts of related party transactions as described in §1.6038A-2(b)(3) and (4) on all Forms 5472 filed by the reporting corporation. The aggregate value of gross payments made to (or received from) all foreign related parties with respect to transactions engaged in with reporting corporations that are related (under the principles described in paragraphs (d) and (e) of this §1.6038A-1) is determined by totaling all dollar amounts of payments made to (or received from) all foreign related parties as described in §1.6038A-2(b)(3) and (4) on all Forms 5472 filed by all such related reporting corporations.

(i) *Consolidated return groups*—(1) *Required information.* If a U.S. consolidated income tax return is filed, the return requirement described in §1.6038A-2 may be satisfied for the U.S. consolidated group by the filing of a consolidated Form 5472. In such a case, the common parent, as indicated on Form 851, must attach a schedule to the consolidated Form 5472 stating which members of the U.S. consolidated return group would otherwise be separate reporting corporations under section 6038A. The schedule must provide the name, address, and taxpayer identification number of each member. A member is not required to join in filing a consolidated Form 5472 merely because other members of the group choose to file one or more Forms 5472 on a consolidated basis.

(2) *Authorization of agent and retention of records.* The common parent of a group of reporting corporations filing a consolidated income tax return may be authorized to act as the agent for foreign related persons engaged in transactions with members of the consolidated return group solely for purposes of section 7602, 7603, and 7604 under section 6038A(e)(1) and §1.6038A-5. The common parent may be authorized to act as an agent by the completion of the authorization of agent on the Form 5472, or by filing an authorization of agent statement as described in §1.6038A-5 until amended Form 5472 is available. Each member of the group, however, must maintain the records required under section 6038A(a) and §1.6038A-3 relating to its related party transactions.

(3) *Monetary penalties.* The common parent and each reporting corporation that join in the filing of a consolidated Form 5472 are liable jointly and severally for penalties for failure to file Form 5472 and for failure to maintain records under section 6038A(d) and §1.6038A-4(e). *See* §1.1502-77(a) regarding the scope of agency of the common parent corporation.

(j) *Examples.* The following examples illustrate the rules of this section.

Example (1). A U.S. partnership that is engaged in a U.S. trade or business is 75 percent owned by FC1, a foreign corporation that, in turn, is wholly owned by another foreign corporation, FC2. The remaining 25 percent of the U.S. partnership is owned by Corp, a domestic corporation, that is wholly owned by FC3. The U.S. partnership engages in transactions solely with FC2 and FC3. These transactions are attributed to FC1 and Corp. For purposes of section 6038A and this §1.6038A-1, FC1 and Corp are reporting corporations and must report their respective pro rata shares of the value of the transactions with FC2 and FC3, 25 percent to Corp and 75 percent to FC1.

Example (2). FC2 and FC3 are both foreign corporations that are wholly owned by FC1, also a foreign corporation. FC2 engages in a trade or business in the United States through a branch. The branch engages in related party transactions with FC1. FC2 is a reporting corporation. FC3 is a foreign related party. FC1 is a 25-percent foreign shareholder of both FC2 and FC3. Neither FC1 nor FC3 is a reporting corporation.

Example (3). FC1 owns 25 percent of total voting power in each of FC2 and FC3. FC2 and FC3 each own 20 percent of the total voting power of Corp, a domestic corporation. The remaining stock of Corp is owned by an unrelated domestic corporation. Neither FC2 nor FC3 is engaged in a U.S. trade or business. Under section 318(a)(2)(C) and paragraph (e) of this §1.6038A-1, FC1 constructively owns its proportionate share of the stock of Corp owned directly by FC2 and FC3. Thus, FC1 is treated as constructively owning five percent of Corp through each of FC2 and FC3 or a total of 10 percent of the Corp stock. Consequently, Corp is not a reporting corporation because no 25 percent shareholder exists.

(k) *Effective dates*—(1) *Section 1.6038A-1.* Section 1.6038A-1(c) (relating to the definition of a reporting corporation) is effective for taxable years beginning after July 10, 1989. The remaining paragraphs of section 1.6038A-1 are effective as of Decem-

ber 10, 1990, without regard to when the taxable year began.

(2) *Section 1.6038A-2.* Section 1.6038A-2 (relating to the requirement to file Form 5472) is generally effective for taxable years beginning after July 10, 1989. However, §1.6038A-2 as it applies to reporting corporations whose sole trade or business in the United States is a banking, financing, or similar business as defined in §1.864-4(c)(5)(i) is effective as of December 10, 1990.

(3) *Section 1.6038A-3.* Section 1.6038A-3 (relating to the record maintenance requirement) is generally effective as of December 10, 1990. However, records in existence on or after March 20, 1990, must be maintained, without regard to when the taxable year (to which the records relate) began.

(4) *Section 1.6038A-4.* Section 1.6038A-4 (relating to the monetary penalty) is generally effective for taxable years beginning after July 10, 1989, for the failure to file Form 5472. For the failure to maintain records or the failure to produce documents as agreed under the election to maintain records outside the United States, the effective date is December 10, 1990, without regard to when the taxable year (to which the records relate) began.

(5) *Section 1.6038A-5.* Section 1.6038A-5 (relating to the authorization of agent requirement) is effective as of without regard to when the taxable year (to which the records relate) began.

(6) *Section 1.6038A-6.* Section 1.6038A-6 (relating to the failure to furnish information under a summons) is effective after November 5, 1990, without regard to when the taxable year (to which the summons relates) began.

(7) *Section 1.6038A-7.* Section 1.6038A-7 (relating to the noncompliance penalty adjustment) is effective as of without regard to when the taxable year began.

§1.6038A-2 *Requirement of return.*

(a) *Form 5472 required*—(1) *In general.* Each reporting corporation as defined in §1.6038A-1(c) shall make a separate annual information return on Form 5472 with respect to each related party as defined in §1.6038A-1(d) with which such reporting corporation has had any reportable transaction during the taxable year. The information required by section 6038A and this section must be furnished even though it may not affect the amount of any tax due under the Code.

(2) *Reportable transaction.* A reportable transaction is any transaction of the types listed in paragraph (b)(3) and (4) of this section. However, if neither party to the transaction is a United States person as defined in section 7701(a)(30) and the transaction—

(i) Does not give rise to any deferred payment or recognized income or gain that is from sources within the United States or that is effectively connected, or treated as effectively connected, with the conduct of a trade or business within the United States, and

(ii) Does not give rise to any expense, loss or other deduction that is allocable or apportionable to such income,

the transaction is not a reportable transaction.

(b) *Contents of return*—(1) *Reporting corporation.* Form 5472 must provide the following information in the manner the form prescribes with respect to each reporting corporation.

(i) Name, address (including mailing code) and U.S. taxpayer identification number; each country in which the reporting corporation files an income tax return as a resident under the tax laws of the country or countries; country or countries of organization and incorporation; total assets; where its business is conducted; and principal business activity;

(ii) Name, address, U.S. tax identification number, if applicable, of each 25-percent foreign shareholder; country or countries in which the 25-percent foreign shareholder files an income tax return as a resident under the tax laws of the country or countries; the place where the 25-percent shareholder conducts its business; and country or countries of organization, citizenship, or incorporation of each 25-percent foreign shareholder of the reporting corporation;

(iii) Number of Forms 5472 filed for the taxable year and aggregate value in U.S. dollars of gross payments as defined by paragraph (h)(2) of §1.6038A-1 made with respect to all foreign related party transactions as reported on all Forms 5472.

(2) *Related party.* The taxpayer must provide information on Form 5472, set forth in the manner the form prescribes, about each related party, whether foreign or domestic, with which the reporting corporation had a transaction of the types described in paragraph (b)(3) and (4) of this section during its taxable year, including the following information.

(i) The name, U.S. tax identification number, if applicable, and address of the related party;

(ii) The nature of the related party's business and the principal place or places where such business is conducted;

(iii) Each country in which the related party files an income tax return as a resident under the tax laws of the country; and

(iv) The relationship of the reporting corporation to the related party.

(3) *Foreign related party transactions for which only monetary consideration is paid or received by the reporting corporation.* If the related party is a foreign person, the reporting corporation must set forth on Form 5472 the dollar amounts of all reportable transactions for which monetary consideration (including U.S. and foreign currency) was the sole consideration paid or received during the taxable year of the reporting corporation. The total amount of such transactions, as well as the separate amounts for each type of transaction described below, must be reported on Form 5472, in the manner the form prescribes. Where actual amounts are not determinable, a reasonable estimate (as described in paragraph (b)(6) of §1.6038A-2) is permitted. The types of transactions described in this paragraph are:

(i) Sales and purchases of stock in trade (inventory);

(ii) Sales and purchases of tangible property other than stock in trade;

(iii) Rents and royalties paid and received (other than amounts reported under paragraph (b)(3)(iv) of this paragraph);

(iv) Sales, purchases, and amounts paid and received as consideration for the use of all intangible property, including (but not limited to) copyrights, designs, for-

mulas, inventions, models, patents, processes, trademarks, and other similar intangible property rights;

(v) Consideration paid and received for technical, managerial, engineering, construction, scientific, or similar services;

(vi) Commissions paid and received;

(vii) Amounts loaned and borrowed (except open accounts resulting from sales and purchases reported under other items listed in this paragraph (b)(3) that arise and are collected in full in the ordinary course of business);

(viii) Interest paid and received;

(ix) Premiums paid and received for insurance and reinsurance; and

(x) Other amounts paid or received not specifically identified in this paragraph (b)(3).

Amounts required to be reported under paragraph (b)(3)(vii) of this section shall be reported as monthly averages or outstanding balances at the beginning and end of the taxable year, as the form shall prescribe.

(4) *Foreign related party transactions involving nonmonetary consideration or no consideration.* If the related party is a foreign person, the reporting corporation must provide on Form 5472 a description of any reportable transaction, or group of reportable transactions, listed in paragraph (b)(3) of this section, for which any part of the consideration paid or received was not monetary consideration, or for which no consideration was paid or received. A description required under this paragraph (b)(4) of this section shall include sufficient information from which to determine the nature and approximate monetary value of the transaction or group of transactions, and shall include—

(i) A description of all property (including monetary consideration), rights, or obligations transferred from the reporting corporation to the foreign related party and from the foreign related party to the reporting corporation;

(ii) A description of all services performed by the reporting corporation for the foreign related party and by the foreign related party for the reporting corporation; and

(iii) A reasonable estimate of the fair market value or a description of such property (other than money), rights, obligations, or services. If, for any transaction, the entire consideration received includes both tangible and intangible property and the consideration paid is solely monetary consideration, the transaction should be reported under paragraph (b)(3) if the intangible property was related and incidental to the transfer of the tangible property (*e.g.*, a right to warranty services.)

(5) *Additional information.* In addition to the information required under paragraph (b)(3) and (4) of this section, a reporting corporation must provide on Form 5472, in the manner the form prescribes, the following information.

(i) If the reporting corporation imports goods from a foreign related party, whether the costs taken into account in computing the basis or inventory cost of such goods are different from the costs taken into account in computing the valuation of the goods for customs purposes, adjusted pursuant to section 1059A and the regulations thereunder, and if so, the reason or reasons for such difference.

(ii) Whether the documents supporting the reporting corporation's treatment of the items set forth in paragraph (b)(5)(i) of this section are in existence and available in the United States at the time of the filing of Form 5472.

(6) *Reasonable estimate*—(i) *Estimate within 25 percent of actual amount.* Any amount reported under this section is considered to be a reasonable estimate if it is at least 75 percent and not more than 125 percent of the actual amount.

(ii) *Other estimates.* If any amount reported under this paragraph (b) of this section fails to meet the reasonable estimate test of paragraph (b)(6)(i) of this section, the reporting corporation may, nevertheless, show that such amount is a reasonable estimate by making an affirmative showing of relevant facts and circumstances in a written statement containing a declaration that it is made under the penalties of perjury. The District Director or the Assistant Commissioner (International) shall determine whether the amount reported was a reasonable estimate.

(7) *Small amounts.* If any actual amount required under this section does not exceed $50,000, the amount may be reported as "$50,000 or less."

(8) *Accrued payments and receipts.* For purposes of this section, in the case of an accrual basis taxpayer, the terms "paid" and "received" shall include accrued payments and receipts, respectively.

(c) *Method of reporting.* All statements required on or with the Form 5472 under this section and §1.6038A-5 shall be in the English language. All amounts required to be reported under paragraph (b) of this section shall be expressed in United States currency, with a statement of exchange rates used to translate into U.S. currency.

(d) *Time and place for filing returns.* A Form 5472 required under this section shall be filed with the reporting corporation's income tax return for the sametaxable year, and shall be filed by the due date (including extensions) for filing that income tax return. However, if a reporting corporation's income tax return is not timely filed (including extensions), the Form 5472 shall be filed with the Internal Revenue Service Center with which the reporting corporation's income tax return is required to be filed and the Philadelphia Service Center, and shall be filed on or before the due date required by law (including extensions) for filing of that income tax return. In such a case, a copy of the Form 5472 also must be filed with the income tax return when such return is filed.

(e) *Duplicate filing required.* The reporting corporation shall file a duplicate copy of each Form 5472 (including any attachments and/or schedules) (at the same time as the original copy is filed) with the Internal Revenue Service Center, Philadelphia, PA 19255.

(f) *Exceptions*—(1) *No reportable transactions.* A reporting corporation is not required to file Form 5472 if it has no transactions of the types listed in paragraph (b)(3) and (4) of this section during the taxable year with any related party. Such a reporting corporation, however, remains subject to the record maintenance requirements of §1.6038A-3 and the authorization of agent requirement of §1.6038A-5.

(2) *Transactions solely with a domestic reporting corporation.* If all of

a foreign reporting corporation's reportable transactions are with one or more related domestic reporting corporations, the foreign reporting corporation shall furnish on Form 5472 only the information required under paragraph (b)(1) and (2) of this section, if the domestic reporting corporations provide the information required under paragraph (b)(3) through (5) of this section. Such a foreign reporting corporation is, nonetheless, subject to the record maintenance requirements of §1.6038A-3 and the requirements of §§1.6038A-5 and 1.6038A-6. The name or names, address(es), and taxpayer identification number(s) of the domestic reporting corporation that provided such information must be indicated on Form 5472 in the space provided for the information under paragraph (b)(1) and (2) of this section.

(3) *Transactions with a corporation subject to reporting under section 6038.* A reporting corporation is not required to make a return of information on Form 5472 with respect to a related corporation for a taxable year for which a U.S. person that controls the reporting corporation makes a return of information on Form 5471 that is required under section 6038 and §1.6038-2, if that return contains information required under §1.6038-2(f)(11) with respect to the reportable transactions between the reporting corporation and the related corporation for that taxable year.

(g) *Filing Form 5472 when transactions with related parties engaged in by a partnership are attributed to a reporting corporation.* A reporting corporation, to which transactions engaged in by a partnership are attributed under paragraph (e)(2) of §1.6038A-1, must report on Form 5472 only the value of the transaction or transactions that is represented by its partnership interest. Thus, for example, if a partnership buys $1000 of widgets from the foreign parent of a reporting corporation whose partnership interest in the partnership equals 50 percent of the partnership interests (and the remaining 50 percent is held by unrelated parties), the reporting corporation must report $500 of purchases from a foreign related party on Form 5472.

(h) *Effective dates for certain reporting corporations.* For effective dates for this section, see §1.6038A-1(k).

§1.6038A-3 *Record maintenance.*

(a) *General maintenance requirements—(1) Section 6001 and section 6038A.* A reporting corporation must keep the permanent books of account or records as required by section 6001 that are sufficient to establish the correctness of the federal income tax return of the corporation, including information, documents, or records ("records") to the extent they may be relevant to determine the correct treatment of transactions with related parties. *See* section 6001 and the regulations thereunder. This requirement applies to records of the reporting corporation itself, as well as to records of any foreign related party that may be relevant to determine the correct treatment of transactions between the reporting corporation and foreign related parties. While records required to establish the correct tax treatment of transactions between the reporting corporation and foreign related parties are within the scope of section 6001, section 6038A and this section provide detailed guidance regarding the required maintenance of records with respect to such transactions and specifies penalties for noncompliance.

(2) *Safe harbor.* A safe harbor for record maintenance is provided under paragraph (c) of this section, which sets forth detailed guidance concerning the types of records to be maintained with respect to related party transactions. A corporation that maintains or causes another person to maintain the records listed in paragraph (c)(2) will be deemed to have met the record maintenance requirements of section 6038A.

(b) *Other maintenance requirements—(1) Records that must be maintained in the United States.* Records prepared, maintained, or possessed by a foreign related party relating to transactions between the reporting corporation and any related parties must be maintained in the United States, except where an election is in effect under paragraph (f) of this section.

(2) *Indirectly related records.* This section applies to records that are directly or indirectly related to transactions between the reporting corporation and any foreign related parties. An example of records that are indirectly related to such transactions is records possessed by a foreign subsidiary of a foreign related party that document the raw material or component costs of a product that is manufactured or assembled by the subsidiary and sold as a finished product by the foreign related party to the reporting corporation.

(3) *Foreign related party or third-party maintenance.* If records that are required to be maintained under this section are in the control of a foreign related party, the records may be obtained or compiled (if not already in the possession of the foreign related party or already compiled) under the direction of the reporting corporation and then maintained by the reporting corporation, the foreign related party, or a third party. A foreign related party or third party may make arrangements with the District Director or the Assistant Commissioner (International) to directly furnish requested records, rather than through a reporting corporation. If a foreign related party or a third party maintains records in the ordinary course of business that are not in the possession of the reporting corporation, the reporting corporation, nonetheless, is liable for the maintenance of such records. A reporting corporation shall be subject to the monetary penalty for the failure of a foreign related party or third party to maintain required records.

(4) *Translation of records.* When records are provided to the Service under a request for production, any portion of such records must be translated into the English language within 30 days of a request for translation of that portion by the District Director or the Assistant Commissioner (International). An extension of this time period may be requested under the rules of paragraph (f)(3) of this section.

(5) *Exception for foreign governments.* A foreign government or a controlled commercial entity as defined by section 892(2)(B) is not subject to the obligation to maintain records under this section.

(c) *Specific records to be maintained for safe harbor—(1) In general.* A reporting corporation that

maintains or causes another person to maintain the records specified in this paragraph (c) will be deemed to have met the record maintenance requirements of this section. This paragraph provides general descriptions of the categories of records to be maintained; the particular title or label applied by a reporting corporation or related party does not control. Functional equivalents of the specified documents are acceptable. Record maintenance in accordance with this safe harbor, however, requires only the maintenance of types of documents described in paragraph (c)(2) of this section that are directly or indirectly related to transactions between the reporting corporation and any foreign related party. Additionally, to the extent the reporting corporation establishes that records in a particular category are not applicable to the industry or business of the reporting corporation and any foreign related party, maintenance of such records is not required under this paragraph. Record maintenance in accordance with this paragraph (c) generally does not require the original creation of records that are ordinarily not created by the reporting corporation or its related parties. (If, however, a document that is actually created is described in this paragraph (c), it is to be maintained even if the document is not of the type ordinarily created by the reporting corporation or its related parties.) There are two exceptions to the rule. First, basic accounting records, if they do not otherwise exist, must be created and retained that are sufficient to document the U.S. tax effects of transactions between related parties. Second, records sufficient to produce material profit and loss statements as described in paragraphs (c)(2)(ii) and (c)(3) of this section must be created if such records are not ordinarily maintained. All internal records storage and retrieval systems used for each taxable year must be retained.

(2) *Descriptions of categories of documents to be maintained.* The following records must be maintained in order to satisfy this paragraph (c) to the extent they may be relevant to determine the correct treatment of transactions between the reporting corporation and any foreign related party.

(i) *Original entry books and transaction records.* This category includes books and records of original entry or their functional equivalents, however designated or labelled, that are relevant to transactions between any foreign related party and the reporting corporation. Examples include, but are not limited to, general ledgers, sales journals, purchase order books, cash receipts books, cash disbursement books, canceled checks and bank statements, workpapers, sales contracts, and purchase invoices.

(ii) *Profit and loss statements.* This category includes records from which the reporting corporation can compile and supply, within a reasonable time, material profit and loss statements of the reporting corporation and all related parties as defined under §1.6038A-1(d) (the "related party group") which reflect profit or loss of the related party group attributable to U.S.-connected products or services. The determination of whether a profit and loss statement is material is made under the rules provided in paragraph (c)(3) of this section. For purposes of this paragraph (c), the term "U.S.-connected products or services" means products or services that are imported to or exported from the United States by transfers between the reporting corporation and any of its foreign related parties. The material profit and loss statements described in this paragraph (c)(2)(ii) must reflect revenue and expenses of all members of the related party group. Thus, records in this category include the documentation of the cost of raw materials used by a related party to manufacture finished goods that are then sold by another related party to the reporting corporation. The records should be kept under U.S. generally accepted accounting principles if they are ordinarily maintained in such manner. If such records are not ordinarily maintained under such accounting principles, an explanation of the material differences between the accounting principles used and U.S. generally accepted accounting principles must be made available. An explanation of methods used to allocate specific items to a particular profit and loss statement also must be made available.

(iii) *Pricing documents.* This category includes all documents relevant to establishing the appropriate price or rate for transactions between the reporting corporation and any foreign related party. Examples include, but are not limited to, documents related to transactions involving the same or similar products or services entered into by the reporting corporation or a foreign related party with related and unrelated parties; shipping and export documents; commission agreements; documents relating to production or assembly facilities; third-party and intercompany purchase invoices; manuals, specifications, and similar documents relating to or describing the performance of functions conducted at a location; intercompany correspondence discussing any instructions or assistance relating to such transactions provided to the reporting corporations by the related foreign person (or vice versa); intercompany and intracompany correspondence concerning the price or the negotiation of the price used in such transactions; documents regarding the value of intangibles used or developed by the reporting corporation or the foreign related party; documents regarding the direct and indirect costs of materials, labor, cost of goods sold, and other expenses; and documents relating to direct and indirect selling, general and administrative expenses (e.g., relating to advertising, sales promotions, or warranties).

(iv) *Foreign country and third party filings.* This category includes financial and other documents filed with or prepared for any foreign government entity, any independent commission, or any financial institution relating to transactions between the reporting corporation and any foreign related party.

(v) *Ownership and capital structure records.* This category includes records or charts showing the relationship between the reporting corporation and the related foreign party; the location, ownership, and status (for example, joint venture, partnership, branch, or division) of all entities and offices directly or indirectly involved in the transactions between the reporting corporation and any foreign related party; a worldwide organization chart; records showing the management structure of all foreign affiliates; and loan documents, agreements, and other documents relating to any transfer of the stock of

the reporting corporation that results in the change of the status of a foreign person as a foreign related party.

(vi) *Records of loans, services, and other non-sales transactions.* This category includes documents relating to loans (including all third-party loans that are related to a transaction between a reporting corporation and a foreign related party); guarantees of a related foreign party of debts of the reporting corporation and vice versa; hedging arrangements involving the reporting corporation and any foreign related party; security agreements between the reporting corporation and any foreign related party; research and development expense allocations between any foreign related party and the reporting corporation; service transactions between any foreign related party and the reporting corporation, including, for example, a description of the allocation of charges for management services, time or travel records, or allocation studies; import and export transactions; the registration of patents and copyrights with respect to transactions between the reporting corporation and any foreign related party; and documents regarding lawsuits in foreign countries that relate to such transactions (for example, product liability suits for U.S. products).

(3) *Material profit and loss statements.* For purposes of paragraph (c)(2)(ii), the determination of whether a profit and loss statement is material will be made according to the following rules. An agreement between the reporting corporation and the District Director or the Assistant Commissioner (International) as described in paragraph (d) of this section may identify all material profit and loss statements of the related party group and describe the items to be included in any profit and loss statements for which records are to be maintained to satisfy the requirements of paragraph (c)(2)(ii) of this section. In the absence of such an agreement, a profit and loss statement will be material if it meets any of the following tests: the existing records test described in paragraph (c)(4) of this section, the significant industry segment test described in paragraph (c)(5) of this section, or the high profit test described in paragraph (c)(6) of this section.

(4) *Existing records test.* A profit and loss statement is material under the existing records test described in this paragraph (c)(4) if any member of the related party group creates or compiles such statement in the course of its business operations. For example, a profit and loss statement is described in this paragraph if it was produced for internal accounting or management purposes, or for disclosure to shareholders, financial institutions, government agencies, or any other persons. Accordingly, such existing statements and the records from which they were compiled are subject to the record maintenance requirements described in paragraph (c)(2)(ii) of this section to the extent they reflect the profit or loss of the related party group attributable to U.S.-connected products or services.

(5) *Significant industry segment test*—(i) *In general.* A profit and loss statement is material under the significant industry segment test described in this paragraph (c)(5) if—

(A) The statement reflects the profit or loss of the related party group attributable to a single industry segment;

(B) The gross revenue from U.S.-connected products or services attributable to such industry segment meets the gross revenue test described in paragraph (c)(5)(ii) of this section; and

(C) One of the percentage tests described in paragraph (c)(5)(iii) of this section is satisfied with respect to the products and services attributable to such industry segment.

An industry segment is a segment of the related party group's combined operations which is engaged in providing a product or service or a group of related products or services (as defined in paragraph (c)(5)(iv)(E)) primarily to customers that are not members of the related party group. Paragraph (c)(5)(v) provides rules for determining the level of specificity required in grouping related products and services. Profit and loss statements compiled for each significant industry segment must reflect revenues and expenses attributable to the operations in such segment by all members of the related party group.

(ii) *Gross revenue test.* An industry segment meets the gross revenue test described in this paragraph (c)(5)(ii) if the amount of gross revenue earned within such segment by the provision of U.S.-connected products or services by the related party group to customers outside of such group is $25 million or more in the taxable year. Where the U.S.-connected products or services consist of components which are incorporated into other products or services before sale to customers, the portion of the total gross revenue derived from sales of such finished products or services attributable to the components may be determined on the basis of relative costs of production. Thus, where relevant for determining whether the $25 million threshold has been met, the amount of gross revenue derived by the related party group from the provision of such finished products or services may be reduced by multiplying such gross revenue by a fraction, the numerator of which is the costs of production of the related party group attributable to the component products or services that constitute U.S.-connected products or services and the denominator of which is the costs of production of the related party group attributable to the finished products in which such components are incorporated.

(iii) *Percentage tests.* An industry segment meets one of the percentage tests described in this paragraph (c)(5)(iii) if

(A) Its gross revenue is 10 percent or more of the combined gross revenue of all of the group's industry segments;

(B) Its identifiable assets are 10 percent or more of the combined identifiable assets of all industry segments; or

(C) The absolute amount of its operating profit or operating loss is 10 percent or more of the greater, in absolute amount, of the combined operating profit of allindustry segments that did not incur an operating loss or the combined operating loss of all industry segments that did incur an operating loss.

(iv) *Definitions.* The following definitions apply for purposes of this paragraph (c)(5).

(A) *Gross revenue.* Gross revenue includes receipts (prior to reduction for cost of goods sold) both from sales to customers outside of the related party group and from inter-

segment sales or transfers within the related party group. Interest from sources outside the related party group and interest earned on intersegment trade receivables is included in gross revenue if the asset on which the interest is earned is included among the industry segment's identifiable assets, but interest earned on advances or loans to other industry segments is not included. Accounting for intersegment sales or transfers must be made on a reasonable basis and a description of such basis must be provided.

(B) *Identifiable assets.* The identifiable assets of an industry segment are those tangible and intangible assets of the related party group that are used by the industry segment, including assets that are used exclusively by that industry segment and an allocated portion of assets used jointly by two or more industry segments. Any allocation of assets among industry segments must be made on a reasonable basis and a description of such basis must be provided. Assets of an industry segment that transfers products or services to another industry segment shall not be allocated to the receiving segment. Assets that represent part of the related party group's investment in an industry segment, such as goodwill, shall be included in the industry segment's identifiable assets. Assets maintained for general corporate purposes (*i.e.*, those not used in the operations of any industry segment) shall not be allocated to industry segments.

(C) *Operating profit or loss.* The operating profit or loss of an industry segment is its gross revenue (as defined in paragraph (c)(5)(iv)(A) of this section) minus all operating expenses. None of the following shall be added or deducted in computing the operating profit or loss of an industry segment: revenue earned at the corporate level and not derived from the operations of any industry segment; general corporate expenses; interest expense (except where the industry segment's operations are principally of a financial nature, such as banking, insurance, leasing or financing); domestic and foreign income taxes; and extraordinary items not reflecting the ongoing business operations of the industry segment.

(D) *Product.* The term "product" generally means an item of property (or combination of component parts) which is the result of a production process, is primarily sold to unrelated parties (or incorporated by the relatedparty group into other products sold to unrelated parties), and performs a specific function.

(E) *Related products or services.* The term "related products or services" refers to groupings of products and types of services that reflect reasonable accounting, marketing, or other business practices within the industries in which the related party group operates. For this purpose, products are segregated into narrow classifications of models and also aggregated into broad classifications of product lines. Similar principles shall be applied in grouping types of services into reasonable levels of narrow and broad classifications.

(F) *Model.* The term "model" generally means a classification of products that incorporate particular components, options, styles, and any other unique features resulting in product differentiation. Examples of models would include electronic products that are sold or accounted for under a single model number and automobiles sold under a single model name.

(G) *Product line.* The term "product line" generally means a group of products that are aggregated into a single classification for accounting, marketing, or other business purposes. Examples of product lines would include groups of products that perform similar functions; products that are marketed under the same trade names, brand names or trademarks; and products that are related economically (*i.e.*, having similar rates of profitability, similar degrees of risk, and similar opportunities for growth).

(v) *Level of specificity required.* In applying the significant industry segment test of this paragraph (c)(5), groups of related products and services must be chosen to provide a reasonable level of specificity that results in the greatest number of separate significant industry segments in comparison to other possible classifications. This determination must be made on the basis of the particular facts presented by the operations of the related party group. The following rules, however, provide general guidelines for making such classifications. First, the related party group's operations that involve the provision of U.S.-connected products should be grouped into product lines. The rules of this paragraph (c)(5) should then be applied to determine if any such product line would, standing alone, constitute a significant industry segment when compared to the operations of the related party group as a whole. Any significant industry segments determined at the level of product lines should be further segregated, and tested for significant industry segments, at the level of separate products. Finally, any significant industry segments determined at the level of separate products should be segregated, and tested for significant industry segments, at the level of separate models. Similar principles should be applied in classifying and testing types of services. A profit and loss statement reflecting the related party group's provision of any product or service (or group of products or services as classified under these rules) that constitutes a significant industry segment will be considered material for purposes of this paragraph (c)(5).

(vi) *Examples.* The rules for determining reasonable levels of specificity for significant industry segments may be illustrated by the following examples.

Example (1). A related party group is engaged in the manufacture and worldwide sales of automobiles and aftermarket parts. The group's operations within the categories of "automobiles" and "aftermarket parts" are each sufficient to constitute significant industry segments for the group under the rules of paragraph (c)(5) of this section. No narrower classification of aftermarket parts results in any significant industry segments. Automobiles produced by the group are generally classified for marketing purposes by trade names; aggregating groups of automobiles by these trade names results in three significant industry segments, those for trade names A, B, and C. Finally, two car models sold under the trade name A ("A1" and "A2") and one car model sold under the trade name B ("B3"), produce sufficient revenue to constitute significant industry segments. Such classifications into trade names and car models are generally used in the related party group's industry; moreover, different types of classifications would produce fewer significant industry segments. Accordingly, a reasonable level of specificity for this related party group's industry segments would be eight categories of products consisting of "automobiles", "aftermarket parts", "A", "B", "C", "A1", "A2", and "B3".

Example (2). A related party group is engaged in manufacturing electronic goods that are distributed at retail in the United States by the reporting corporation. The group sells three types of products in the United States: televisions, radios, and video cassette recorders (VCRs). Each of these three broad product areas constitutes a significant industry segment for the group as a whole. VCRs can be further segregated by price into high-end and low-end models, and the provision of each constitutes a significant industry segment for the group. Revenues from only one VCR model, model number VCRX-10, are sufficiently large to make the provision of that model a significant industry segment. With respect to televisions, the group normally accounts for these products by size. Using this classification, portable televisions, medium-sized televisions, and consoles each constitute significant industry segments. Narrower classifications by television model numbers result in no additional significant industry segments. Finally, sales of a single radio product line, those sold under the trade name R, results in a significant industry segment, but no other radio models or product groups are large enough to constitute a significant industry segment. In each case, these classifications conform to normal business practices in the industry and result in the greatest possible number of significant industry segments for this related party group. Accordingly, a reasonable level of specificity for this related party group's industry segments would include the ten categories consisting of "VCRs", "high-end VCRs", "low-end VCRs", "model number VCRX-10", "televisions", "portable televisions", "medium-sized televisions", "console televisions", "radios", and "radio trade name R".

(6) *High profit test*—(i) *In general.* A profit and loss statement is material under the high profit test described in this paragraph (c)(6) if—

(A) The statement reflects the profit or loss of the related party group attributable to a single industry segment;

(B) The gross revenues from U.S.-connected products or services attributable to such segment meet the gross revenue test described in paragraph (c)(5)(ii) of this section (except that the $25 million threshold for this purpose is raised to $75 million); and

(C) The return on assets test described in paragraph (c)(6)(ii) of this section is satisfied with respect to the products and services attributable to such segment.

Accordingly, a significant industry segment (as determined under paragraph (c)(5) of this section) must be divided into any narrower industry segments that meet the high profit test of this paragraph (c)(6), even if such narrower segments would not, standing alone, meet the significant industry segment test of paragraph (c)(5) of this section.

(ii) *Return on assets test.* An industry segment meets the return on assets test if the rate of return on assets earned by the related party group within this industry segment exceeds 10 percent, and is at least 200 percent or more of the rate of return on assets earned by any significant industry segment (determined under the rules of paragraph (c)(5) of this section) which incorporates the business operations of the first industry segment. One industry segment will be considered to incorporate the business operations of a narrower industry segment only if all of the gross revenue attributable to the narrower segment is also attributable to the broader segment. For purposes of this paragraph, the rate of return on assets earned by an industry segment is determined by dividing that segment's operating profit (as defined in paragraph (c)(5)(iv)(C) of this section) by its identifiable assets (as defined in paragraph (c)(5)(iv)(B) of this section).

(d) *Liability for certain partnership record maintenance.* A reporting corporation, to which transactions engaged in by a partnership are attributed under paragraph (e)(2) of §1.6038A-1, is subject to the record maintenance requirements of this §1.6038A-3 to the extent of the transactions so attributed.

(e) *Agreements with the District Director or the Assistant Commissioner (International).* The District Director or the Assistant Commissioner (International), in the discretion of either, may negotiate and enter into an agreement with a reporting corporation that establishes what records the reporting corporation must maintain or cause another to maintain, how such records must be maintained, and by whom such records must be maintained in order to satisfy the reporting corporation's obligations under this section.

(f) *Exception to U.S. maintenance*—(1) *Annual election.* A reporting corporation may elect to maintain outside the United States records not ordinarily maintained in the United States but required to be maintained in the United States under this section. To make the election, the reporting corporation must agree to the production of records by either:

(i) Delivering to the Service duplicates of the original documents requested within 60 days of the request by the Service for such records and providing translations of such documents within 30 days of a request for translations of specific documents; or

(ii) Moving duplicates of the original documents requested to the United States within 60 days of the request of the Service for such records; providing the Service with an index to the requested records, the name and address of a custodian located within the United States having control over the records, and the address where the records are located within 60 days of the Service's request for such records; and continuing to maintain such records within the United States throughout the period of retention described in paragraph (g) of this section. For summons procedures with respect to such records that have been moved to the United States, see sections 6038A(e), 7602, 7603, and 7604.

For material profit and loss statements described in paragraphs (c)(5) and (c)(6) of this section, "120 days" shall be substituted for "60 days" in paragraphs (f)(1)(i) and (f)(1)(ii) of this section, and labels and text with respect to such statements must be in the English language. The agreement described in this paragraph must be signed by an officer of the reporting corporation. An annual agreement may be made on Form 5472. Until revised Forms 5472 are available, the agreement shall be made on an attachment to the Form 5472 which contains the following heading and statement.

ELECTION TO MAINTAIN RECORDS OUTSIDE THE U.S.

"[Name of reporting corporation] hereby elects to maintain outside the United States the records described in paragraph (b) of §1.6038A-3, relating to transactions between [name of reporting corporation] and [name of foreign related party] for its taxable year ending on [date]. [Name of reporting corporation] agrees to produce upon request of the Internal Revenue Service any [name of reporting corporation] or [name of foreign related party] records covered by this election (and translations of specified records) within the time and in the manner prescribed by the regulations.

Signature for [name of reporting corporation]

(To be signed by a corporate officer, on behalf of the reporting corporation: I certify that I have the authority to execute this agreement on behalf of [name of reporting corporation].)

(Signature) (Title) (Date)

Please print or type your name below.

(2) *Retroactive elections.* An election pertaining to documents that were in existence on or after March 20, 1990, with respect to taxable years for which the Form 5472 was required to be filed prior to the date on which the final regulations under section 6038A are published may be made on the first timely filing of Form 5472 after that date. Such election should bear the caption "Retroactive election for taxable years prior to final section 6038A regulations."

(3) *Scheduled production for high volume or other reasons.* Upon a written request, for good cause shown, the District Director or the Assistant Commissioner (International), in the discretion of either, may grant an extension of the time for the production or translation of the requested documents. Such requests should be made within 30 days of the request for records by the Internal Revenue Service. If an extension is needed because of the volume of records requested, the District Director or the Assistant Commissioner (International) may allow production to be scheduled over a period of time so that not all records must be produced at the same time.

(4) *Invalidation of non-U.S. maintenance election.* The District Director (with the concurrence of the Assistant Commissioner (Examination)), or the Assistant Commissioner (International), may invalidate, for cause, an election to maintain outside the United States the records specified in paragraph (b) of this section. An election may be invalidated only if there exists a clear pattern of failure to maintain or timely produce the required records. The assessment of a monetary penalty under section 6038A(d) and §1.6038A-4 for failure to maintain records is not necessarily sufficient in and of itself to cause invalidation of the election to maintain records outside the United States.

(g) *Period of retention.* Records required to be maintained by section 6038A(a) and this section shall be kept as long as they may be relevant to determining the correct tax treatment of any transaction between the reporting corporation and a related party, but in no case less than the applicable statute of limitations on assessment and collection with respect to the taxable year in which the transaction or item to which the records relate affects the U.S. tax liability of the reporting corporation. See section 6001 and the regulations thereunder.

(h) *Effective dates.* For effective dates for this section, see §1.6038A-1(k).

§1.6038A-4 *Monetary penalty.*

(a) *Imposition of monetary penalty—(1) In general.* If a reporting corporation fails to furnish the information described in §1.6038A-2 within the time and manner prescribed in paragraphs (d) and (e) of §1.6038A-2 (relating to the filing of Form 5472), fails to maintain or cause another to maintain records as required by §1.6038A-3, or fails to produce records maintained outside the United States within the time prescribed in paragraph (f) of §1.6038A-3 (relating to the production of maintained records), a penalty of $10,000 shall be assessed for each taxable year with respect to which such failure occurs. Such a penalty may be imposed by the District Director, the Assistant Commissioner (International), or the Director of the Internal Revenue Service Center where the income tax return is filed. The filing of a substantially incomplete Form 5472 constitutes a failure to file Form 5472. Where, however, the information described in paragraph (b)(3) through (5) of §1.6038A-2 is not required to be reported, a Form 5472 filed without such information is not a substantially incomplete Form 5472.

(2) *Liability for certain partnership transactions.* A reporting corporation, to which transactions engaged in by a partnership are attributed under paragraph (e)(2) of §1.6038A-1, is subject to the rules of this section to the extent failures occur with respect to the partnership transactions so attributed to the reporting corporation.

(3) *Calculation of monetary penalty.* If a reporting corporation fails to maintain records as required by §1.6038A-3 of transactions with multiple related parties, the monetary penalty may be assessed for each failure to maintain records with respect to each related party. The monetary penalty, however, shall be im-

posed on a reporting corporation only once for a taxable year with respect to each related party for a failure to furnish the information required on Form 5472, for a failure to maintain or cause another to maintain records, or for a failure to timely produce records under an election to maintain records outside the United States. An additional penalty for a another failure may be imposed, however, under the rules of paragraph (d)(2) of this section. Thus, unless such failures continue after notification as described in paragraph (d) of this section, the maximum penalty under this paragraph with respect to each related party for all such failures in a taxable year is $10,000. The members of a group of corporations filing a consolidated return are jointly and severally liable for any monetary penalty under this section that may be imposed.

(b) *Reasonable cause*—(1) *In general.* If an affirmative showing is made that there is reasonable cause for a failure that results in the assessment of the monetary penalty, the period during which reasonable cause exists shall be treated as beginning on the day reasonable cause is established and ending not earlier than the last day on which reasonable cause existed for any such failure. Failures which may be excused for reasonable cause include not timely filing Form 5472, not maintaining or causing another to maintain records as required by §1.6038A-3, and not producing records maintained outside the United States within the time prescribed in paragraph (f) of §1.6038A-3. Additionally, the beginning of the 90-day period after mailing of a notice by the District Director, the Assistant Commissioner (International), or the Director of an Internal Revenue Service Center of a failure described in paragraph (d) of this §1.6038A-4, shall be treated as not earlier than the last day on which reasonable cause existed.

(2) *Affirmative showing required*—(i) *In general.* To show that reasonable cause exists for purposes of paragraph (b)(1), the reporting corporation must make an affirmative showing of all the facts alleged as reasonable cause for such failure in a written statement containing a declaration that it is made under penalties of perjury. The statement must be filed with the District Director or the Assistant Commissioner (International) (in the case of failure to maintain or furnish requested information permitted to be maintained outside the United States under the election or a failure to file), or the Director of the Internal Revenue Service Center where the Form 5472 is required to be filed (in the case of failure to file Form 5472). The District Director, the Assistant Commissioner (International), or the Director of the Internal Revenue Service Center where the income tax return is filed, as appropriate, shall determine whether the applicable failure was due to reasonable cause, and if so, the period of time for which such reasonable cause existed. If a return has been filed as required by §1.6038A-2 or records have been maintained and produced as required by §1.6038A-3, except for an omission of, or error with respect to, some of the information required or a record to be maintained, the omission or error shall not constitute a failure for purposes of section 6038A(d) if the reporting corporation who filed the return establishes to the satisfaction of the District Director, the Assistant Commissioner (International), or the Director of the Internal Revenue Service Center that the person has substantially complied with the filing of Form 5472 or the requirement to maintain or produce records.

(ii) *Small corporations.* The District Director or the Assistant Commissioner (International) shall apply the reasonable cause exception liberally in the case of a small corporation that

(A) had no knowledge of the requirements imposed by section 6038A;

(B) has limited presence in and contact with the United States; and

(C) promptly and fully complies with all requests by the District Director or the Assistant Commissioner (International) to file Form 5472, and to furnish books, records, or other materials relevant to the reportable transaction.

(c) *Failure to maintain records or to cause another to maintain records.* A failure to maintain records or to cause another to maintain records is determined by the District Director or the Assistant Commissioner (International) upon the basis of the overall compliance (including compliance with an agreement to produce records under the election to maintain records outside the United States) with the maintenance of records requirement by a reporting corporation. It is not an item-by-item determination. Thus, for example, a failure to maintain a single or small number of items may not constitute a failure for purposes of section 6038A(d), unless such item or items are essential to the correct determination of the tax liability of the reporting corporation. Upon such a determination, the District Director or the Assistant Commissioner (International) shall notify the reporting corporation of the failure in writing.

(d) *Increase in penalty where failure continues after notification*—(1) *In general.* If any failure described in this section continues for more than 90 days after the day on which the District Director, the Assistant Commissioner (International), or the Director of the Internal Revenue Service Center where the return is required to be filed (regarding a failure to file Form 5472), mails notice of the failure to the reporting corporation, the reporting corporation shall pay a penalty (in addition to the penalty described in paragraph (a) of this section) of $10,000 with respect to each related party for which a failure occurs for each 30-day period during which the failure continues after the expiration of the 90-day period. Any uncompleted fraction of a 30-day period shall count as a 30-day period for purposes of this paragraph (d) of this section.

(2) *Additional penalty for another failure.* An additional penalty for a taxable year may be imposed, however, if at a subsequent time from the time of the imposition of the monetary penalty described in paragraph (a) of this section, a second failure is determined and such second failure continues after notification under paragraph (d)(1) of this section. Thus, if a taxpayer fails to file Form 5472 and is assessed a monetary penalty and later, upon audit, is determined to have failed to maintain records, an additional penalty for the failure to maintain records may be assessed under the rules of this paragraph if the failure to maintain records continues after notification under this paragraph.

(3) *Cessation of accrual.* The monetary penalty will cease to accrue if

the reporting corporation either files Form 5472 (in the case of a failure to file Form 5472), furnishes information to substantially complete Form 5472, or demonstrates compliance with respect to the maintenance of records (in the case of a failure to maintain) records for the taxable year in which the examination occurs and subsequent years to the satisfaction of the District Director or the Assistant Commissioner (International). The monetary penalty also will cease to accrue if requested information, documents, or records, kept outside the United States under an the election contained in §1.6038A-3(f) and not produced within the time specified, are produced.

(4) *Continued failures.* If a failure under this section relating to a taxable year beginning before July 11, 1989, occurs, and if the failure continues following 90 days after the notice of failure under this paragraph is sent, the amount of the additional penalty to be assessed under this paragraph is $10,000 for each 30-day period (or fraction thereof) beginning after November 5, 1990, during which the failure continues.

There is no limitation on the amount of the monetary penalty that may be assessed after November 5, 1990.

(e) *Other penalties.* For criminal penalties for failure to file a return and filing a false or fraudulent return, see sections 7203 and 7206 of the Code.

(f) *Examples.* The following examples illustrate the rules of this section.

Example (1)—Failure to file Form 5472. Corp X, a U.S. reporting corporation, engages in related party transactions with FC. Corp X does not file timely a Form 5472 or maintain records relating to the transactions with FC for Year 1 or subsequent years. The Service Center with which Corp X files its income tax return imposes a $10,000 penalty for each of Years 1, 2, and 3 under section 6038A(d) and this §1.6038A-4 for failure to provide information as required on Form 5472 and mails a notice of failure to provide information. Corp X does not file Form 5472. Ninety days following the mailing of the notice of failure to Corp X an additional penalty of $10,000 is imposed. On the 135th day following the mailing of the notice of failure, Corp X files Form 5472 for Years 1, 2, and 3. The total penalty owed by Corp X for Year 1 is $30,000. ($10,000 for not timely filing Form 5472, $10,000 for the first 30-day period following the expiration of the 90-day period, and $10,000 for the fraction of the second 30-day period). The penalty for Years 2 and 3 for the failure to file Form 5472 is also $30,000 for each year, calculated in the same manner as for Year 1. The total penalty for failure to file Form 5472 for Years 1, 2, and 3 is $90,000.

Example (2)—Failure to maintain records. Assume the same facts as in *Example (1).* In Year 5, Corp X is audited for Years 1 through 3. Corp X has not been maintaining records relating to the transactions with FC. The District Director issues a notice of failure to maintain records. Corp X has already been subject to the monetary penalty of $10,000 for each of Years 1, 2, and 3 for failure to file Form 5472 and, therefore, a monetary penalty under paragraph (a) of this section for failure to maintain records is not assessed. However, an additional penalty is assessed after the 90th day following the mailing of the notice of failure to maintain records. Corp X develops a record maintenance system as required by section 6038A and §1.6038A-3. On the 180th day following the mailing of the notice of failure to maintain records, Corp X demonstrates to the satisfaction of the District Director that the newly developed record maintenance system will comply with the requirements of §1.6038A-3 and the increase in the monetary penalty after notification ceases to accrue. The additional penalty for failure to maintain records is $30,000. An additional penalty of $30,000 per year is assessed for each of years 2 and 3 for the failure to maintain records for a total of $90,000.

(g) *Effective dates.* For effective dates for this section, see §1.6038A-1(k).

§1.6038A-5 *Authorization of agent.*

(a) *Failure to authorize.* The rules of §1.6038A-7 shall apply to any transaction between a foreign related party and a reporting corporation (including any transaction engaged in by a partnership that is attributed to the reporting corporation under paragraph (e)(2) of §1.6038A-1), unless the foreign related party authorizes the reporting corporation to act as its limited agent solely for purposes of sections 7602, 7603, and 7604 with respect to any request by the Secretary to examine records or produce testimony related to such a transaction or with respect to any summons by the Secretary for such records or testimony. The fact that a reporting corporation is authorized to act as an agent for a foreign related party is not sufficient without other activities to establish for the foreign related party either a trade or business in the United States for purposes of the Code or a permanent establishment or fixed base for purposes of an income tax treaty.

(b) *Annual authorization by related party*—(1) *In general.* A foreign related party annually shall authorize as its agent (solely for purposes of sections 7602, 7603, and 7604) the reporting corporation with which it engages in transactions by providing a statement on Form 5472, signed by the foreign related party or an officer of the foreign related party possessing the authority to authorize an agent for purposes of Rule 4 (d)(3) of the Federal Rules of Civil Procedure. The reporting corporation will accept this appointment by providing such a statement, signed by an officer of the reporting corporation possessing the authority to accept such an appointment. The agency shall be effective at all times. Until official Internal Revenue Service forms are available, the authorization and acceptance must be attached to the Form 5472 and must contain a heading and statement as set forth below. A foreign government or a controlled commercial entity as defined by section 892(2)(B) is not subject to the authorization of agent requirement.

AUTHORIZATION OF AGENT

"[Name of foreign related party] hereby expressly authorizes [name of reporting corporation] to act as its agent solely for purposes of sections 7602, 7603, and 7604 of the Internal Revenue Code with respect to any request to examine records or produce testimony related to any transaction between [name of the above-named foreign related party] and [name of reporting corporation] or with respect to any summons for such records or testimony.

Signature of or for
[name of foreign related party] _____ (Title) _____ (Date) _____

(If signed by a corporate officer, partner, or fiduciary on behalf of foreign related party]: I certify that I have the authority to execute this authorization of agent to act on behalf of [name of foreign related party]).

Type or print your name below if signing for a foreign related party that is not an individual.

[Name of reporting corporation] accepts this appointment to act as agent for [name of foreign related party] for the above purpose."

Signature for [Name of Reporting Corporation]	(Title)	(Date)

I certify that I have the authority to accept this appointment to act as agent on behalf of [name of foreign related party] and agree to accept service of process for the above purposes.

Type or print your name below.

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(2) *Authorization for prior years.* A foreign related party may authorize a reporting corporation to act as its agent with respect to taxable years for which a Form 5472 is required to be filed prior to the date on which the final regulations under section 6038A are published by providing the above executed authorization of agent within 30 days of a request by the Service for such an authorization.

(c) *Legal effect of authorization of agent.* The legal consequences of a foreign related party authorizing a reporting corporation to act as its agent for purposes of sections 7602, 7603, and 7604 of the Code are as follows.

(1) *Agent for purposes of commencing judicial proceedings.* A reporting corporation that is authorized by a foreign related party to act as its agent for purposes of sections 7602, 7603, and 7604 (including service of process) is also the agent of the foreign related party for purposes of—

(i) The filing of a petition to quash under section 6038A(e)(4)(A) or a petition to review an Internal Revenue Service determination of noncompliance under section 6038A(e)(4)(B), and (ii) The commencement of a judicial proceeding to enforce a summons under section 7604, whether commenced in conjunction with a petition to quash under section 6038A(e)(4)(A) or commenced as a separate proceeding in the federal district court for the district in which the person to whom the summons is issued resides or is found.

(2) *Foreign related party found where reporting corporation found.* For any purposes relating to sections 7602, 7603, or 7604 (including service of process), a foreign related party that authorizes a reporting corporation to act on its behalf under section 6038A(e)(1) and this section may be found anywhere where the reporting corporation has residence or is found.

(d) *Successors in interest.* A successor in interest to a related party should execute and file a new Authorization of Agent on Form 5472 following the succession event. If the Form 5472 containing the new Authorization of Agent is not filed as part of an income tax return, only the information regarding the reporting corporation and the related party as described in paragraph (b)(1) and (2) of §1.6038A-2, plus the Authorization of Agent sections of Form 5472 (or attachment thereto) need be completed. The Form 5472 should be sent to the Internal Revenue Service Center with which the reporting corporation's income tax return is required to be filed. A duplicate copy of the Form 5472 must be filed with the Internal Revenue Service Center, Philadelphia, PA 19255. A new Authorization of Agent should be filed no later than the next filing date (including extensions) of the corporate income tax return of the reporting corporation.

(e) *Retroactive authorization for inadvertent transaction*—(1) *In general.* If a foreign person and a reporting corporation that engage in a transaction discover only after the completion of the transaction and after the time to timely file Form 5472 that the foreign person is a related party within the meaning of section 6038A(c)(2) and §1.6038A-1(c)(4) and the foreign person has not authorized the reporting corporation to act as its agent under section 6038A(e)(1) and paragraph (b) of this section, the related party, upon discovery of the relationship, retroactively may authorize the reporting corporation to act as its agent for purposes of section 6038A(e)(1) and this section if the District Director or the Assistant Commissioner (International) permits. The District Director or the Assistant Commissioner (International) may permit a retroactive authorization if—

(i) The transaction is a small or isolated transaction on arm's-length terms; and

(ii) The related party engaging in the transaction does not directly own stock in the reporting corporation.

(2) *Procedure for requesting retroactive authorization.* In cases described in paragraph (e)(1) of this section, a foreign related party may submit a request in writing to the District Director or the Assistant Commissioner (International) that it be permitted retroactively to authorize as its agent a reporting corporation with which it engaged in a transaction. The request should include statements demonstrating that the foreign related party and the reporting corporation meet the requirements

of paragraph (e)(1) of this section. If the District Director or the Assistant Commissioner (International) so permits, such permission should be in writing. The foreign related party may authorize the reporting corporation to act as its agent by filing a Form 5472 within 30 days after receipt of such written permission (or if the Form 5472 has not been revised to include an authorization section, the Form 5472 and the authorization of agent statement contained in paragraph (b) of this section for the year in which the transaction occurred). One Form 5472 should be filed as an amended return with the Internal Revenue Service Center with which the reporting corporation's income tax return is required to be filed. A duplicate Form 5472 should be filed at the same time as the amended return is filed with the Internal Revenue Service Center, Philadelphia, PA 19255.

(3) *Effect of retroactive authorization*—(i) *Noncompliance penalty adjustment.* If a foreign related party retroactively authorizes as its agent a reporting corporation with which it engaged in a transaction, the foreign related party shall be treated as having complied with the authorization of agent requirement of this section. If a related party does not retroactively authorize a reporting corporation as its agent for purposes of sections 7602, 7603, and 7604, the reporting corporation will be subject to the noncompliance penalty contained in §1.6038A-7 with respect to transactions that occurred prior to the time the reporting corporation first became aware that the requirements of section 6038A would apply.

(ii) *Monetary penalty.* A Form 5472 that is filed under paragraph (e)(2) of this section within 30 days of the receipt of the written permission to retroactively authorize an agent will be treated as timely filed. Accordingly, the monetary penalty under §1.6038A-4 will not be applicable.

(4) *Deemed compliance.* In exceptional circumstances, the District Director or the Assistant Commissioner (International) may treat a reporting corporation as retroactively authorized to act as agent for a related party for purposes of sections 7602, 7603, and 7604 in the absence of an actual agency appointment by the foreign related party. Factors to be considered include—

(i) If neither the reporting corporation nor the other party to the transaction knew or had reason to know that the two parties were related at the time of the transaction, and

(ii) The extent to which the taxpayer establishes to the satisfaction of the District Director or the Assistant Commissioner (International) that all transactions between the reporting corporation and the related party were on arm's-length terms and did not involve the participation of any known related party.

(5) *Reason to know.* Whether the reporting corporation or other party had reason to know that the two parties were related at the time of the transaction will be determined by all the facts and circumstances.

(6) *Effect of deemed compliance.* If a reporting corporation is deemed under paragraph (e)(4) of this section to have been retroactively authorized to act as an agent for a foreign related party for purposes of section 7602, 7603, and 7604, such deemed compliance is applicable only for that particular transaction and other reportable transactions entered into prior to the time when the reporting corporation knew or had reason to know that the related party, in fact, was related. The noncompliance rule of §1.6038A-7 shall apply to any transaction subsequent to that time with the same related party, unless the related party actually authorizes the reporting corporation to act as its agent under paragraph (a) of this section. A new authorization must be executed for all subsequent transactions. In addition, the record maintenance requirements of §1.6038A-3 will apply to all subsequent transactions and, with respect to prior transactions, will apply to relevant records in existence at the time the relationship was discovered.

(f) *Effective dates.* For effective dates for this section, see §1.6038A-1(k).

§1.6038A-6 *Failure to furnish information.*

(a) *In general.* The rules of §1.6038A-7 may be applied with respect to a transaction between a foreign related party and the reporting corporation (including any transaction engaged in by a partnership that is attributed to the reporting corporation under paragraph (e)(2) of §1.6038A-1) if a summons is issued to the reporting corporation to produce any records or testimony, either directly or as agent for such related party, to determine the correct treatment under Title 1 of the Code of such a transaction between the reporting corporation and the related party; and if—

(1)(i) The summons is not quashed in a proceeding, if any, begun under section 6038A(e)(4) and is not determined to be invalid in a proceeding, if any, begun under section 7604 to enforce such summons; and

(ii) The reporting corporation does not substantially and timely comply with the summons, and the District Director or the Assistant Commissioner (International) has sent by certified or registered mail a notice under section 6038A(e)(2)(C) to the reporting corporation that it has not so complied; or

(2) The reporting corporation fails to maintain or to cause another to maintain records as required by §1.6038A-3, and by reason of that failure, the summons is quashed in a proceeding under section 6038A(e)(4) or in a proceeding begun under section 7604 to enforce the summons, or the reporting corporation is not able to provide the records requested in the summons.

(b) *Enforcement proceeding not required.* The District Director or the Assistant Commissioner (International) is not required to begin an enforcement proceeding to enforce the summons in order to apply the rules of §1.6038A-7.

(c) *De minimis failure.* Where a reporting corporation's failure to comply with the requirement to furnish information under this section is *de minimis*, the District Director or the Assistant Commissioner (International), in the discretion of the District Director or the Assistant Commissioner (International), may choose not to apply the noncompliance penalty. Thus, for example, in cases where a particular document or group of documents is not furnished upon request or summons, the District Director or the Assistant Commissioner (International), in their sole discre-

tion, may choose not to apply the noncompliance penalty if the District Director or the Assistant Commissioner (International) deems the document or documents not to have significant or sufficient value in the determination of the correctness of the tax treatment of the related party transaction.

(d) *Effective dates.* For effective dates for this section, see §1.6038A-1(k).

§1.6038A-7 *Noncompliance.*

(a) *In general.* In the case of any failure described in §1.6038A-5 or §1.6038A-6, the rules of this §1.6038A-7 apply to the reporting corporation. In such a case

(1) The amount of the deduction allowed under subtitle A for any amount paid or incurred by the reporting corporation to the related party in connection with such transaction, and

(2) The cost to the reporting corporation of any property acquired in such transaction from the related party or transferred by such corporation in such transaction to the related party, may be determined by the District Director or the Assistant Commissioner (International).

(b) *Determination of the amount.* The amount of the deduction or the cost to the reporting corporation shall be the amount determined by the District Director or the Assistant Commissioner (International) in the sole discretion of the District Director or the Assistant Commissioner (International) from the District Director's or Assistant Commissioner (International)'s own knowledge or from such information as the District Director or Assistant Commissioner (International) may choose to obtain through testimony or otherwise. The District Director or Assistant Commissioner (International) may disregard any information, documents, or records submitted by the reporting corporation or the related party if, in the sole discretion of the District Director or the Assistant Commissioner (International), the District Director or the Assistant Commissioner (International) deems that they do not have significant or sufficient value in the determination of the correctness of the tax treatment of the related party transaction.

(c) *Separate application.* If the noncompliance penalty of this section applies with respect to transactions with a related party of the reporting corporation, it will not be applied with respect to any other related parties of the reporting corporation solely upon the basis of that failure. Thus, for example, if a reporting corporation engages in transactions with related party A and related party B, and the reporting corporation does not respond to a summons for records related to the transactions between the reporting corporation and related party A, the noncompliance penalty imposed as a result of such failure will not apply to the transactions between the reporting corporation and related party B. If a separate summons is issued for records relating to the transactions between the reporting corporation and related party B and the reporting corporation does not produce such records, the noncompliance penalty may be applied to those transactions.

(d) *Effective dates.* For effective dates for this section, see § 1.6038A-1(k).

Par. 4. The authority for Part 1 is amended by adding the following citation:

Authority: 26 U.S.C. 7805. * * * Section 1.6038C-1 also issued under 26 U.S.C. 6038C.

Par. 5. New §1.6038C-1 is added to read as follows: §1.6038C-1 *General rule.*

The rules of §§1.6038A-1 through 1.6038A-7 generally will apply for purposes of section 6038C.

Fred T. Goldberg, Jr.,
Commissioner of Internal Revenue.

Approved November 29, 1990.

Kenneth W. Gideon,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 4, 1990, 2:30 p.m., and published in the issue of the Federal Register for December 10, 1990, 55 F.R. 50706)

Notice of Proposed Rulemaking

One Class of Stock Requirement

PS-4-73

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to the requirement that a small business corporation have only one class of stock. Changes to the applicable law were made by the Subchapter S Revision Act of 1982. These regulations affect corporations and their shareholders, and are necessary to provide them with guidance needed to comply with the applicable tax law.

DATE: Written comments and requests for a public hearing must be received by January 3, 1991.

ADDRESS: Send comments and requests for a public hearing to: Internal Revenue Service, P.O. Box 7604 Ben Franklin Station, Attn: CC:CORP:T:R (PS-4-73), Room 4429, Washington, D.C. 20044.

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Income Tax Regulations (26 CFR Part 1) under section 1361 of the Internal Revenue Code. These amendments are proposed to implement section 1361(b)(1)(D) and (c)(4) and (5) as added by the Subchapter S Revision Act of 1982.

Only a small business corporation is eligible to elect subchapter S status. Section 1361(b) defines a small business corporation as a domestic corporation that is not an ineligible corporation and that does not have—(i) more than 35 shareholders, (ii) as a shareholder a person (other than an estate and certain types of trusts) who is not an individual, (iii) a nonresident alien as a shareholder, and (iv) more than one class of stock.

Proposed regulations relating to the definition of an S corporation under section 1361 were published in the Federal Register (51 FR 35659) [LR-262-82, 1986-2 C.B. 789] on October 7, 1986. The paragraph relat-

ing to the one class of stock requirement was reserved in that document. This document contains proposed regulations relating to the one class of stock requirement. Provisions relating to the other requirements under section 1361 are generally reserved in this document. See the notice of proposed rulemaking published on October 7, 1986, with respect to those provisions.

Explanation of Provisions

The proposed regulations relate to the one class of stock requirement for S corporations provided in section 1361(b)(1)(D) of the Code. The proposed regulations provide that a corporation has more than one class of stock if the outstanding shares of stock do not confer identical rights to distributions and liquidation proceeds, regardless of whether the difference in rights occurs pursuant to the corporate charter, articles of incorporation, the corporate bylaws, by operation of state law, by administrative action, or by agreement. Distributions that are made by a corporation with respect to its outstanding shares of stock and that vary with respect to timing or amount are considered non-conforming distributions and generally result in a second class of stock. However, differences in voting rights, rights that arise out of buy-sell agreements among shareholders, and restrictions on the transferability of stock are disregarded in determining whether a corporation has more than one class of stock. Transfers made by a corporation to a shareholder that are characterized as distributions under the Code (*e.g.*, under section 7872) or under general principles of Federal tax law are considered distributions with respect to stock for purposes of these regulations.

All outstanding shares of stock are taken into account in determining whether a corporation has a second class of stock. The proposed regulations provide that, solely for purposes of subchapter S, stock that is substantially nonvested within the meaning of §1.83-3(b) is not treated as outstanding stock unless the holder makes an election under section 83(b). The proposed regulations also provide that most types of deferred compensation arrangements that do not involve property subject to section 83 are not treated as outstanding stock for purposes of subchapter S.

Any instrument, obligation, or arrangement, regardless of whether designated as debt, which constitutes equity or otherwise results in the holder being treated as the owner of stock under general principles of Federal tax law is treated as a second class of stock of the corporation. See Rev. Rul. 80-238, 1980-2 C.B. 96, Rev. Rul. 82-150, 1982-2 C.B. 110, and Rev. Rul. 85-87, 1985-1 C.B. 268, for examples of the application of general principles to treat an option to acquire stock of a corporation as a present stock interest. In addition, the proposed regulations provide that options that are substantially certain to be exercised are treated as a second class of stock for purposes of subchapter S regardless of whether they would be treated as stock under general principles of Federal tax law.

Prior to the amendment of subchapter S by the Subchapter S Revision Act of 1982, some courts had held that the general principles of Federal tax law under which purported debt would ordinarily be recharacterized as equity did not necessarily require purported debt to be treated as a second class of stock for purposes of subchapter S. *See, e.g., Portage Plastics Co. v. United States*, 486 F.2d 632 (7th Cir. 1973) (en banc). The legislative history of the Subchapter S Revision Act of 1982, however, indicates that Congress intended to supplant this case law with the straight debt safe harbor of section 1361(c)(5) of the Code. Thus, consistent with Congressional intent, this pre-1982 case law is not reflected in these proposed regulations, and a purported debt instrument that is outside the safe harbor rules will be treated as a second class of stock for subchapter S purposes if it constitutes equity under general principles of Federal tax law. *See* H.R. Rep. No. 826, 97th Cong., 2d Sess. 8 (1982); S. Rep. No. 640, 97th Cong., 2d Sess. 8 (1982).

Section 1361(c)(5) and the proposed regulations provide that straight debt is not treated as a second class of stock even if it would otherwise be treated as equity under general principles of Federal tax law. Section 1361(c)(5)(B) defines straight debt as a written unconditional promise to pay on demand or on a specified date a sum certain in money if (i) the interest rate and interest payment dates are not contingent on profits, the corporation's discretion, or similar factors, (ii) there is no convertibility (directly or indirectly) into stock, and (iii) the creditor is an individual (other than a nonresident alien), an estate or a trust described in section 1361(c)(2).

The proposed regulations provide that, to qualify as straight debt, the obligation must bear a reasonable rate of interest. The determination of whether an obligation bears a reasonable rate of interest is made based on all the facts and circumstances, including the amount borrowed and the timing and amount of the payments due under the obligation. An obligation may provide for a variable interest rate that is based on a current objective interest index, if the interest rate meets the reasonable interest rate requirement. An "objective interest index" is an interest rate that is made known publicly and offered contemporaneously to unrelated borrowers in private lending transactions by a financial institution or that is based on a similar objective interest rate index which is regularly published. Examples of an objective interest index include the prime rate of a designated financial institution, LIBOR (London Interbank Offered Rate), or the applicable Federal rate under section 1274(d). The proposed regulations set forth two safe harbors for satisfying the reasonable interest rate requirement. An obligation is treated as bearing a reasonable interest rate if the obligation has a yield to maturity that is at least equal to the applicable Federal rate, but not more than five points above the applicable Federal rate (determined as of the date that the obligation is issued). Similarly, an obligation bearing a variable interest rate is treated as bearing a reasonable interest rate if (A) the issue price of the obligation equals the obligation's stated redemption price at maturity, (B) the obligation's interest rate is expressed as a fixed multiple of a current objective interest index or as a constant number of percentage points or basis points more or less than a current objective interest index, and (C) the rate resulting from the formula at the time of issuance of

the obligation is at least equal to the applicable Federal rate at that time and is no greater than five percentage points above the applicable Federal rate at that time.

The Service invites public comment on alternative rules or safe harbors relating to whether an instrument, obligation, or arrangement should be treated as a second class of stock. In particular, the Service invites public comment on whether a safe harbor should be created for obligations held by financial institutions.

The regulations are proposed to be effective for taxable years beginning after December 31, 1982. However, in the case of an instrument or obligation designated as debt that was in existence on or before October 5, 1990, and was held solely by the owners of, and in substantially the same proportion as, the nominal stock of the corporation, §1.1361-1-(1)(3)(ii) will apply to taxable years beginning on or after (*Insert the date that is 90 days after publication of the final regulations in the Federal Register*) with respect to the purported debt. In addition, in the case of an instrument or obligation that met the straight debt safe harbor described in section 1361(c)(5) of the Code and that was in existence on or before October 5, 1990, the reasonable interest rate requirement of §1.1361-1(1)-(4)(i)(B) will apply to taxable years beginning on or after (*Insert date that is 90 days after the publication of the final regulations in the Federal Register*), with respect to that instrument or obligation. Finally, in the case of an option, warrant, or similar instrument that was in existence on or before October 5, 1990, §1.1361-1(1)-(3)(iii) will apply to taxable years beginning on or after (*Insert the date that is 90 days after publication of the final regulations in the Federal Register*) with respect to the option, warrant, or similar instrument.

Special Analyses

It has been determined that these proposed rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. 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 the proposed rulemaking for the regulations was submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

Comments and requests for a public hearing

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably a signed original and eight copies) to the Internal Revenue Service. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Internal Revenue Service by any person who also submits timely written comments. If a public hearing is held, notice of the time and place will be published in the Federal Register.

List of Subjects

26 CFR 1.1361-OA through 1.1388-1

Cooperatives, Income taxes, Small business, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

The proposed amendments to 26 CFR Part 1 are as follows:

PART 1—[AMENDED]

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

Authority: 26 U.S.C. 7805. *** §1.1361-1(1) also issued under 26 U.S.C. 1361(c)(5)(C).

Par. 2. The following new section is added to read as follows:

§1.1361-1 S corporation defined.

(a) [RESERVED]

(b) *Small business corporation defined*—(1) *In general.* For purposes of subchapter S, chapter 1 of the Code and the regulations thereunder, the term "small business corporation" means a domestic corporation that is not an ineligible corporation (as defined in paragraph (d) of this section) and that does not have—

(i) More than 35 shareholders,

(ii) As a shareholder, a person (other than an estate and other than certain trusts described in paragraph (h)(1) of this section) who is not an individual,

(iii) A nonresident alien as a shareholder, or

(iv) More than one class of stock.

(2) *Estate in bankruptcy.* The term "estate" for purposes of this paragraph, includes the estate of an individual in a case under title 11 of the United States Code.

(3) *Treatment of restricted stock.* Solely for purposes of subchapter S, stock that is substantially nonvested (within the meaning of §1.83-3(b)) is not treated as outstanding stock of the corporation, and the holder of such stock is not treated as a shareholder solely by reason of holding such stock, unless the holder makes an election under section 83(b). In the event of such an election, the stock is treated as outstanding stock of the corporation and the holder of the stock is treated as a shareholder for purposes of subchapter S. See paragraph (1)(2) of this section for rules for determining whether substantially nonvested stock with respect to which an election under section 83(b) has been made is treated as a second class of stock.

(4) *Treatment of deferred compensation plans.* For purposes of subchapter S, an instrument, obligation, or arrangement that does not convey the right to vote, that is not property under §1.83-3 of the regulations, and that is issued to an employee by a corporation in connection with the performance of services under a plan with respect to which an employee is not taxed currently on income, is not treated as outstanding stock.

(5) *Straight debt.* For purposes of subchapter S, an instrument or obligation that satisfies the definition of straight debt in paragraph (1)(4) of this section is not treated as outstanding stock.

(c)—(k) [RESERVED]

(1) *Classes of stock*—(1) *General rule.* A corporation that has more than one class of stock does not qualify as a small business corporation.

(2) *Outstanding shares of stock treated as a second class of stock*—(i) *In general.* A corporation has more than one class of stock for purposes of this paragraph if all of the outstanding shares of stock of the

corporation do not confer identical rights to distribution and liquidation proceeds, regardless of whether any differences in rights occur pursuant to the corporate charter, articles or bylaws, by operation of state law, by administrative action, or by agreement. Thus, for example, substantially nonvested stock with respect to which an election under section 83(b) has been made is treated as a second class of stock, unless such stock confers rights to distribution and liquidation proceeds that are identical to those rights conferred by the other outstanding shares of stock. Differences in voting rights among shares of stock of a corporation are disregarded in determining whether a corporation has more than one class of stock. Thus, for example, if all shares have identical rights to distribution and liquidation proceeds, an S corporation may have voting and nonvoting common stock, a "class" of stock that may vote only on certain issues, irrevocable proxy agreements, or groups of shares that differ with respect to rights to elect members of the board of directors. Buy-sell agreements among shareholders and restrictions on the transferability of stock are disregarded in determining whether a corporation has more than one class of stock. Agreements to redeem shares of stock of a corporation are disregarded in determining whether a corporation has more than one class of stock unless the agreement—

(A) Restricts the rights of the holders of the subject stock to share in liquidation proceeds, or

(B) Provides for distributions that would be treated as non-conforming distributions under paragraph (1)(2)(ii)(C) of this section.

(ii) *Non-conforming distributions*—(A) *In general.* Notwithstanding that all outstanding shares of stock confer identical rights to distribution and liquidation proceeds, a corporation has more than one class of stock if the corporation makes nonconforming distributions (*i.e.*, distributions that differ with respect to timing or amount with respect to each outstanding share of stock), unless the distribution is described in paragraph (1)(2)(ii)(B) or (C) of this section.

(B) *Pro rata distributions.* Distributions that differ with respect to timing but are pro rata with respect to all outstanding shares of stock, taking into account the entire taxable year of the S corporation (or the deemed taxable year if an election under section 1377(a)(2) is made), are not treated as non-conforming distributions if the differences in timing of the distributions were unintentional or if the distributions that differ with respect to timing are made within a three-month period (provided the aggregate distributions during the three-month period are pro rata with respect to all outstanding shares of stock).

(C) *Redemptions.* A distribution that is treated as a distribution in part or full payment in exchange for stock under sections 302(a) or 303(a) is not treated as a non-conforming distribution. A distribution that is treated as a distribution under section 301 pursuant to section 302(d) is not treated as a non-conforming distribution unless the distribution is made pursuant to a plan that provides for a series of distributions to the shareholders of the S corporation that would result in the shareholders owning substantially the same proportionate interest in the corporation that they had before the series of distributions.

(iii) *Stock taken into account.* Except as provided in paragraphs (b)(3) and (b)(4) of this section (relating to restricted stock and to deferred compensation plans), and paragraph (1)(4) of this section (relating to the safe harbor for straight debt), all outstanding shares of stock of a corporation are taken into account in determining whether the corporation has a second class of stock.

(3) *Other instruments, obligations, or arrangements treated as a second class of stock*—(i) *In general.* Except as provided in paragraph (b)(4) of this section (relating to deferred compensation plans) and paragraph (1)(4) of this section (relating to the safe harbor for straight debt), any instrument, obligation, or arrangement described in paragraph (1)(3)(ii) or (iii) is treated as a second class of stock for purposes of this paragraph (1).

(ii) *Instruments, obligations, or arrangements treated as equity under general principles.* Any instrument, obligation, or arrangement issued by a corporation (other than outstanding shares of stock described in paragraph (1)(2)(iii) of this section), regardless of whether designated as debt, as treated as a second class of stock of the corporation if the instrument, obligation, or arrangement constitutes equity or otherwise results in the holder being treated as the owner of stock under general principles of Federal tax law.

(iii) *Certain call options, warrants or similar instruments*—(A) *In general.* Except as otherwise provided in this paragraph (1)(3)(iii), a call option, warrant, or similar instrument (collectively "call option") issued by a corporation is treated as a second class of stock of the corporation if the call option is substantially certain to be exercised by the holder. This rule applies regardless of whether the owner of the call option is treated as the owner of the underlying stock under general principles of Federal tax law. The determination of whether a call option is substantially certain to be exercised is made at the time of issuance and, in the event of a material modification by the corporation or subsequent transfer to another holder (other than by gift or subsequent transfer to another holder (other than by gift or transfer at death subject to chapter 11 or 12, a transfer between spouses or former spouses subject to section 1041), at the time of such material modification or transfer. Thus, for example, a corporation that issues or has outstanding a call option with a strike price substantially below the market price of the underlying stock on the date that the call option is issued, transferred, or materially modified is treated as having more than one class of stock.

(B) *Certain exceptions.* (*1*) A call option that is issued by a corporation to a qualified person in connection with a loan to the corporation is not treated as a second class of stock for purposes of this paragraph (1) if the call option is exercisable only if the corporation defaults on the repayment of the loan. For this purpose, a "qualified person" means any person that—

(*i*) Is actively and regularly engaged in the business of lending, and

(*ii*) Is not a related person with respect to the corporation within the meaning of section 465(b)(3)(C), or if such person is a related person with respect to the corporation, the financing from the related person is com-

mercially reasonable and on substantially the same terms as loans involving unrelated persons.

(*2*) A call option that is issued to an employee in connection with the performance of services is not treated as a second class of stock if—

(*i*) The call option is nontransferable within the meaning of §1.83-3(d) and

(*ii*) The call option does not have a readily ascertainable fair market value as defined in §1.83-7(b) at the time the option is granted.

If the call option becomes transferable, this paragraph (1)(3)(iii)(B)(*2*) will cease to apply.

(C) *Safe harbor for certain options.* A call option that conveys the right to acquire stock of the corporation at a specified strike price is not treated as substantially certain to be exercised at the time of issuance or material modification by the corporation (including a material modification of the strike price pursuant to the terms of the instrument) or subsequent transfer to another holder, if the strike price of the call option at such time is at least 90 percent of the fair market value of the stock with respect to which the call option may be exercised.

(4) *Straight debt safe harbor*—(i) *In general.* Notwithstanding paragraph (1)(3) of this section, straight debt is not treated as a second class of stock. For purposes of section 1361(c)(5) and this section, the term "straight debt" means a written unconditional obligation, regardless of whether embodied in a formal note, to pay a sum certain on demand, or on a specified due date, which—

(A) Does not provide for an interest rate or payment dates that are contingent on profits, the borrower's discretion, the payment of dividends with respect to common stock, or similar factors;

(B) Bears a reasonable interest rate;

(C) Is not convertible (directly or indirectly) into stock or any other equity interest of the S corporation; and

(D) Is held by an individual (other than a nonresident alien), an estate, or a trust described in section 1361(c)(2).

For purposes of paragraph (1)(4)(i)(B) of this section, an obligation may have less than a reasonable interest rate or may bear no interest if the term of the obligation is one year or less and the obligation is not part of a series of obligations designed to avoid the requirement that an obligation bear a reasonable interest rate.

(ii) *Interest Rate*—(A) *Reasonable interest rate in general.* For purposes of paragraph (1)(4)(i)(B) of this section, the determination of whether an obligation bears a reasonable interest rate is made taking into account all of the facts and circumstances, including the amount borrowed and the timing and amount of payments due under the obligation (whether characterized as interest or principal).

(B) *Variable interest rate.* An obligation may provide for a variable interest rate that is based on a current objective interest index, if the interest rate meets the reasonable interest rate requirement of paragraph (1)(4)(i)(B) of this section. An "objective interest index" is a rate that is made known publicly and offered contemporaneously to unrelated borrowers in private lending transactions by a financial institution or that is based on a similar objective interest rate index which is regularly published. Examples of an objective interest index include the prime rate of a designated financial institution, LIBOR (London Interbank Offered Rate), or the applicable Federal rate under section 1274(d).

(C) *Reasonable interest rate safe harbors.* For purposes of paragraph (1)(4)(i)(B) of this section, an obligation is treated as bearing a reasonable interest rate if the obligation has a yield to maturity that is at least equal to the applicable Federal rate, but not more than five percentage points above the applicable Federal rate (determined as of the date that the obligation is issued). Similarly, for purposes of paragraph (1)(4)(i)(B) of this section, an obligation bearing a variable interest rate is treated as bearing a reasonable interest rate if—

(*1*) The issue price of the obligation equals the obligation's stated redemption price at maturity;

(*2*) The obligation's interest rate expressed as a fixed multiple of a current objective interest index or as a constant number of percentage or basis points more or less than a current objective interest index; and

(*3*) The rate resulting from the formula described in paragraph (1)(4)(ii)(C)(*2*) of this section at the time of issuance of the obligation is at least equal to the applicable Federal rate at that time and is no greater than five percentage points above the applicable Federal rate at that time.

See paragraph (1)(4)(ii)(B) of this section for the meaning of the term "objective interest index." Notwithstanding that an obligation has a yield to maturity or a variable interest rate that is not within the range described in the preceding sentences, the obligation may be considered to bear a reasonable rate of interest taking into account the facts and circumstances of the transaction.

(iii) *Subordination.* The fact that an obligation is subordinated to other debt of the corporation will not prevent the obligation from qualifying as straight debt.

(iv) *Modification or transfer.* An obligation that originally qualifies as straight debt ceases to so qualify if the obligation—

(A) Is materially modified so that the definition of straight debt is no longer satisfied, or

(B) Is transferred to a third party who would not be eligible to be a shareholder in an S corporation (without regard to the 35 shareholder requirement of section 1361(b)(1)(A)).

(v) *Treatment of straight debt for other purposes.* An obligation of an S corporation that satisfies the definition of straight debt in paragraph (1)(4)(i) of this section is not treated as a second class of stock. Such an obligation is treated as debt and is subject to the applicable rules governing indebtedness for other purposes of the Code unless the Commissioner determines that a principal purpose for issuing the obligation is tax avoidance. Accordingly, interest paid or accrued with respect to a straight debt obligation is generally treated as interest by the corporation and the recipient and does not constitute a distribution to which section 1368 applies.

(vi) *Treatment of C corporation "debt" upon conversion to S status.* If a C corporation has outstanding an obligation that satisfies the definition of straight debt in paragraph (1)(4)(i) of this section, but that may be considered equity under general principles of Federal tax law, the obligation is not treated as a second class of

stock for purposes of this section if the C corporation converts to S status. In addition, the conversion from C corporation status to S corporation status will not be treated as an exchange of debt for stock with respect to such an instrument.

(5) *Examples.* The application of this paragraph may be illustrated by the following examples:

Example 1. The law of State A requires that permission be obtained from the State Commissioner of Corporations before stock may be issued by a corporation. The Commissioner grants permission to M, a corporation, to issue its stock subject to the restriction that any person who is issued stock in exchange for property, and not cash, must waive all rights to receive distributions until the shareholders who contributed cash for stock have received a stated amount of distributions per share. The shareholders who are issued stock for property execute an agreement with M based on the aforementioned condition. The condition placed by the Commissioner pursuant to State law upon the prospective holders of stock to be issued for property results in a difference as to the rights to distributions among shares. Accordingly, M is considered to have more than one class of stock and does not qualify as a small business corporation.

Example 2. Corporation N issues a debt instrument to another corporation that is convertible into stock of N corporation. The debt instrument does not satisfy the straight debt safe harbor both because it is convertible into stock of the issuing corporation and because it is held by a corporation. However, the instrument is considered a second class of stock only if it is treated as equity under the general principles of Federal tax law governing the distinction between debt and equity, or if it is a call option that is substantially certain to be exercised.

Example 3. Corporation Q has 500 shares of issued and outstanding common stock. A and B each own 250 shares of the stock. In addition, A and B each hold equal amounts of debt issued by Q that does not constitute straight debt and that is treated as equity under the general principles of Federal tax law governing the distinction between debt and equity. The debt, although held proportionately by the shareholders, is treated as a second class of stock.

Example 4. Corporation R, an S corporation, executes an agreement with its shareholders to modify its normal distribution policy by making upward adjustments of its distributions to those shareholders who bear heavier state tax burdens based on a formula to give the shareholders the same after tax results. The agreement causes the stock of Corporation R to have different rights to distributions. Therefore, Corporation R is considered to have a second class of stock.

Example 5. Corporation T, an S corporation with a calendar taxable year, has two shareholders, A and B, each owning 50 percent of the stock of the corporation. The corporate bylaws require that A and B receive equal distributions with respect to their stock. A $100 distribution is made to A on March 1 but because the corporation's bookkeeper inadvertently filed B's check instead of mailing it, a $100 distribution is not made to B until June 1 of the same taxable year. Because the distributions were not intentionally nonconforming and the distributions would be pro rata if the entire taxable year were taken into account, the distributions will not result in a second class of stock.

(6) *Inadvertent terminations.* See section 1362(f) and the regulations thereunder for rules relating to inadvertent terminations in cases where the one class of stock requirement has been inadvertently breached.

(7) *Effective date.* Section 1.1361-1(l) generally applies to taxable years beginning on or after January 1, 1983. However, in the case of an instrument or obligation designated as debt that was in existence on or before October 5, 1990, and was held solely by the owners of, and in substantially the same proportion as, the nominal stock of the corporation, §1.1361-1(l)(3)(ii) will apply to taxable years beginning on or after (*Insert the date that is 90 days after the publication of the final regulations in the Federal Register*) with respect to the purported debt. In addition, in the case of an instrument or obligation that met the straight debt safe harbor described in section 1361(c)(5) of the Code and that was in existence on or before October 5, 1990, the reasonable interest rate requirement of §1.1361-1(l)(4)(i)(B) will apply to taxable years beginning on or after (*Insert date that is 90 days after the publication of the final regulations in the Federal Register*), with respect to that instrument or obligation. Finally, in the case of an option, warrant, or similar instrument that was in existence on or before October 5, 1990, §1.1361-1(l)(3)(iii) will apply to taxable years beginning on or after (*Insert the that is 90 days after publication of the final regulations in the Federal Register*) with respect to the option, warrant, or similar instrument.

Fred T. Goldberg, Jr.,
Commissioner of
Internal Revenue.

(Filed by the Office of the Federal Register on October 4, 1990, 8:45 a.m., and published in the issue of the Federal Register for October 5, 1990, 55 F.R. 40870)

Notice of Proposed Rulemaking

Normalization: Inconsistent Procedures and Adjustments

PS-107-88

AGENCY: Internal Revenue Service, Treasury.

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

SUMMARY: In response to numerous questions, the regulations proposed in this notice provide guidance on the application of the normalization requirements of sections 167(l) and 168(i)(9) of the Internal Revenue Code to utility companies that file consolidated federal income tax returns. The proposed regulations establish the extent to which certain ratemaking procedures and adjustments that are based on tax savings attributable to the filing of a consolidated return will be treated as inconsistent with the normalization requirements. These regulations provide that, in order to comply with the normalization requirements, a utility's ratemaking tax expense must be determined as though it filed a separate return. At the same time, however, the proposed regulations provide that in certain circumstances it will not violate the normalization requirements to exclude from rate base a utility's share of the tax savings attributable to the filing of a consolidated return.

DATES: Written comments must be received by January 28, 1991. A public hearing on these proposed regulations has been scheduled for 10:00 a.m. on February 8, 1991. Persons wishing to speak at this hearing must deliver outlines of their comments by January 25, 1991. These regulations are proposed to be effective for rate orders that become final on or after December 20, 1990.

ADDRESSES: Send comments and requests to speak at the public hearing to the Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Attn: CC:CORP:T:R (PS-107-88), Room 4429, Washington, D.C. 20044. If desired, comments and requests to speak may be hand-delivered to the Internal Revenue Service, Attn: CC:CORP:T:R (PS-107-88), Room 4429, 1111 Constitution Ave., NW, Washington, D.C.

SUPPLEMENTARY INFORMATION:

Background

This notice proposes to add new sections 1.167(l)-1(h)(7) and 1.168(i)-1 to Part 1 of Title 26 of the Code of Federal Regulations (CFR). The final regulations will be added to Part 1 of Title 26 of the CFR in accordance with the Internal Revenue Service's specific regulatory authority under 26 U.S.C. 167(l) and 26 U.S.C. 168(i)(9)(B)(iii), as well as its general regulatory authority under 26 U.S.C. 7805.

Any public utility taking advantage of accelerated depreciation in determining its federal income tax liability must use "normalization" accounting in calculating the rates to be charged to its customers and in maintaining its regulated books of account. These proposed regulations provide guidance on the proper application of the normalization requirements to a public utility filing a consolidated income tax return.

Accelerated depreciation was introduced by Congress as a means of encouraging capital formation by taxpayers by permitting earlier deductions for the cost of capital items. The reduction in current tax liability due to accelerated depreciation creates a deferral of taxes owed, and the difference between a company's federal income tax liability calculated using accelerated depreciation and the tax liability it would have were it to use the straight-line method of depreciation is, in effect, an interest-free loan from the Treasury. As with other loans, this difference is not permanent and must be "repaid" in the later years of the asset's life when a slower depreciation method would have provided larger deductions because the accelerated method has used up all available basis. Flow-through accounting, in effect, takes the principal amount of this congressionally-mandated loan away from the utility and flows it through to the utility's current customers.

In 1969, Congress enacted section 167(l) of the Code to prohibit the use of flow-through accounting. (Section 167(l) corresponds to sections 168(f)(2) and 168(i)(9)(A) under the Accelerated Cost Recovery System (ACRS), as modified by the Tax Reform Act of 1986.) In general, any utility taking advantage of accelerated depreciation must use normalization accounting for ratemaking purposes. Under normalization, a utility must calculate its ratemaking tax expense using depreciation that is no more accelerated than its ratemaking depreciation. Normalization also requires a utility to treat as a reserve the difference between its tax liability as computed using accelerated depreciation and the tax liability the utility would have were the tax to be computed using its ratemaking depreciation method (typically straight-line).

The purpose of these normalization requirements is to prevent the flow through to utility ratepayers of the reduction in current taxes stemming from the use of accelerated depreciation. The normalization rules require a utility to treat the reduction as a deferred tax expense that is collected from current customers through utility rates, and thus is available to utilities as cost-free investment capital until it must be paid to the Treasury. See H.R. Rep. No. 643, 97th Cong., 2d Sess. 6 (1982).

Under normalization accounting, ratepayers may receive a benefit from a utility's use of accelerated depreciation in calculating its federal income tax liability. The normalization rules do not prevent a regulatory agency from passing through to ratepayers the benefit of cost-free capital over the period for which the taxes are deferred. In other words, a utility commission may establish rates that reflect the capital cost savings resulting from accelerated depreciation by excluding the reserve for deferred taxes from the base to which the utility's rate of return is applied (or by treating the deferred taxes as cost-free capital in determining the rate of return allowed).

In response to various ratemaking procedures, Congress enacted the predecessor of section 168(i)(9)(B) (section 168(e)(3)(C) under ACRS, before its modification by the Tax Reform Act of 1986 [Pub. L. 99-514, 1986-3 C.B. (Vol. 1) 1]). See S. Rep. No. 1038, 96th Cong., 2d Sess. 11 (1980). Section 168(i)(9)(B)(i) provides that the normalization requirements of section 168(i)(9)(A) are not met if the taxpayer, for ratemaking purposes, uses a procedure or adjustment that is inconsistent with these requirements. Section 168(i)(9)(B)(ii) specifies certain procedures and adjustments that are to be treated as inconsistent for purposes of section 168(i)(9)(B)(i). (Congress amended section 167(l) to include the rules of section 168(i)-(9)(B).)

Recognizing that it could not foresee all possible ratemaking procedures that might undermine the purpose of the normalization rules, Congress granted the Secretary broad regulatory authority in Section 168(i)(9)(B)(iii) to identify such procedures. (The Secretary has similarly broad authority under section 167(l)(5), which directs the Service to issue regulations if, for any reason, the application of any of the provisions of section 167(l) to any public utility property does not carry out the purposes of that section.)

Over the last several years, the Service has faced the question of whether the calculation of ratemaking tax expense on a consolidated group basis is inconsistent under section 168(i)(9)(B)(i) with the normalization requirements, or, if not, whether it should be treated as inconsistent by exercise of the Service's broad regulatory authority under sections 167(l)(5) and 168(i)(9)(B)(iii). When computed on a consolidated group basis, ratemaking tax expense is reduced to reflect the savings from filing a consolidated return with affiliated companies having net operating losses.

Under one variation—the "consolidated tax savings adjustment"—the ratemaker first determines the utility's total tax expense on a separate return basis and then reduces it by the utility's share of the consolidated tax savings. Under another variation, the ratemaker computes an "effective tax rate" by dividing the tax liability of the group by the sum of the taxable incomes of all members with positive taxable income. The ratemaker then applies this "effective tax rate" to the utility's taxable income to compute its current tax expense. One state court has held that consolidated tax savings adjustments are not inconsistent with the normalization rules, so long as the adjustment does not exceed the utility's current tax expense. See *Continental Telephone Co. of Pennsylvania v. Pennsylvania Public Utility Commission*, 120 Pa. Commw. 25, 548 A.2d 344 (1988), *appeal denied*,

521 Pa. 613, 557 A.2d 345 (1989).

A related issue that has also arisen is whether a utility may, consistent with the requirement to normalize, reduce rate base (rather than ratemaking tax expense) by its share of the consolidated tax savings.

In May 1989, Notice 89-63 [1989-1 C.B. 720] announced that the Service had opened a regulations project to give guidance on the application of the normalization requirements to public utilities filing consolidated federal income tax returns. Notice 89-63 stated that the regulations would address the extent to which the use of "effective tax rates" or "consolidated tax savings adjustments" will be treated as inconsistent with the normalization rules. These proposed regulations are the result of that project.

Explanation of Provisions

Overview

The proposed regulations provide that it is a violation of the normalization requirements to determine a utility's ratemaking tax expense, either current or deferred, by taking into account the income, losses, deductions, or credits of other taxpayers with which it files a consolidated return. To comply with the normalization rules, a utility must compute its ratemaking tax expense as if it filed a separate return. The proposed regulations provide, however, that it is not a violation of the normalization rules for a utility that files a consolidated return to reduce its rate base by its share of the cumulative net tax savings attributable to the filing of a consolidated return for certain tax years. The proposed regulations provide the method, based on provisions of the consolidated return regulations, for determining a utility's share of the consolidated group's cumulative net tax savings. As with the requirements under section 1.167(l)-1(h), these requirements do not apply to the determination of state tax expense for ratemaking purposes.

Detailed Explanation

Under the authority of sections 167(l) and 168(i)(9)(B)(iii), sections 1.167(l)-1(h)(7) and 1.168(i)-1 of the proposed regulations provide that a utility must compute its ratemaking tax expense as if it filed a separate return. Thus, for example, the proposed regulations provide that it is inconsistent with normalization for ratemaking tax expense to be reduced on account of the losses of another corporation with which the utility files a consolidated return. Similarly, it is inconsistent with normalization to calculate ratemaking tax expense, either current or deferred, using an effective tax rate determined by taking into account the losses of any other corporation. Any rate order that becomes a "final determination" (within the meaning of section 1.46-6(f)(8)(iii) of the regulations) on or after December 20, 1990, violates the normalization requirements if it provides for a ratemaking tax expense calculated by taking into account the income, losses, deductions, or credits of any other corporation with which the utility files a consolidated return. Such a violation will result in the denial of accelerated depreciation deductions on public utility property.

Section 1.168(i)-1 of the proposed regulations does not address the treatment under the normalization rules of reductions in a utility's tax liability resulting from expenses of the utility itself, even if these expenses are not taken into account in determining cost of service. Thus, for example, if a utility is not permitted to include in its cost of service the cost of an abandoned power plant, a particular advertising expense, or any other cost a ratemaking authority considers to be imprudent, the proposed regulations do not prohibit a reduction in ratemaking tax expense to reflect the concomitant reduction in its tax liability on account of these expenses. The Service invites comments on the proper treatment of these items under the normalization rules.

Consolidated Tax Savings May Be Treated As No-cost Capital

The effect of the proposed regulations is to require utility customers to pay, through cost of service, the same tax expense they would pay if the utility filed a separate return. In some cases, this requirement will permit the utility to collect from customers an amount of tax expense that, because the utility joins in filing a consolidated return with an affiliate generating net operating losses, exceeds the amount the group must remit to the Treasury. This reduction in the group's tax liability, though, might not be permanent. When the loss affiliate becomes profitable (and therefore would be in a position to use its earlier net operating losses had it not joined with the utility in filing a consolidated return), the group as a whole will be liable for more tax for the year than if the members had not filed a consolidated return.

Consolidated tax savings are similar to the deferred taxes arising from the allowance of accelerated depreciation on public utility property in that the temporary tax savings available to the utility is cost-free capital from the time it is collected from ratepayers until the time the affiliate becomes profitable. The Service has concluded that it is not inconsistent with the normalization requirements for a regulatory commission to share the benefits of this cost-free capital with ratepayers through a reduction in the utility's capital costs reflected in its rates.

Consistent with the analogous provisions of section 1.167(l)-1(h)(6) of the current regulations, which permit reduction of rate base by the amount of the deferred tax reserve, section 1.168(i)-1(c) of the proposed regulations permits the exclusion from a utility's rate base (or, alternatively, the treatment as no-cost capital) of an amount not in excess of the utility's share of the consolidated tax savings as determined under the proposed regulations. This exclusion of amounts from the utility's rate base is permitted notwithstanding any implication to the contrary in section 1.167(l)-1(h)(6)(i) of the current regulations.

Section 1.168(i)-1(c) of the proposed regulations does not require the exclusion of any amount from a utility's rate base, or the treatment of any amount as no-cost capital; it simply provides an upper limit. As with the deferred tax reserve resulting from accelerated depreciation, ratemakers may decide how much of the benefit of the consolidated tax savings to pass through.

The Service understands that, although practice varies, most state utility commissions have set rates in a way that does not take consolidated

tax savings into account, either in determining ratemaking tax expense or in determining rate base or cost of capital. The Service intends that issuance of these proposed regulations will not disturb this existing practice during the period prior to the issuance of final regulations. Specifically, under the proposed regulations, any rate order that becomes final on or after December 20, 1990, that takes consolidated tax savings into account in computing ratemaking tax expense will violate the normalization rules. In addition, the Service intends that commissions should not conclude that they may, consistent with the normalization rules, change their practice to reduce rate base by consolidated tax savings during the period in which the Service is considering public comments on the provisions of the proposed regulations permitting rate base reduction. Accordingly, the provisions of the proposed regulations permitting rate base reduction generally will not be effective until issuance of final regulations.

Therefore, in determining the maximum amount by which rate base is to be reduced (or the maximum amount that may be treated as no-cost capital) the proposed regulations do not allow consideration of consolidated tax savings arising in tax years ending prior to the date that is 30 days after final regulations incorporating the provisions of these proposed regulations are published, or, if sooner, January 1, 1992. Furthermore, notwithstanding the general effective date of these proposed regulations, the provisions permitting reduction of rate base by consolidated tax savings (or treatment of consolidated tax savings as no-cost capital) apply only to rate orders that become final on or after the date that is 30 days after the date that final regulations are published, or, if sooner, January 1, 1992. Thus, any rate order that becomes final prior to this date, but on or after December 20, 1990, will violate normalization if it reduces rate base by consolidated tax savings or treats consolidated tax savings as no-cost capital.

In addition, the proposed regulations do not permit consolidated tax savings to be excluded from rate base (or treated as no cost capital) for any year for which rates were determined under a method that flowed through the consolidated tax savings as a reduction to ratemaking tax expense. Thus, for example, if consolidated tax savings are considered in computing ratemaking tax expense for any tax year by reason of a rate order that became final prior to December 20, 1990, these consolidated tax savings may not be excluded from rate base.

The Service invites comments regarding the appropriateness of these effective date rules.

In general, a utility's share of the tax savings attributable to the filing of a consolidated return ("cumulative net tax savings") is the difference between its cumulative share of the consolidated group's tax liability and the cumulative tax liability the utility would have were it to file a separate return for the current year and all previous years. The proposed regulations provide the method for determining a utility's share of a group's consolidated tax savings. This amount is determined on a cumulative basis; it must be reduced when the group's tax liability increases because a former loss affiliate becomes profitable.

The method in the proposed regulations for determining a utility's share of consolidated tax savings is based on a method for allocating tax liability among members of a consolidated group for purposes of calculating earnings and profits that is provided in sections 1.1502-33(d)(2)(i) and 1.1552-1(a)(2) of the consolidated return regulations. This approach ensures appropriate treatment of deferred intercompany transactions, as well as losses, of the consolidated group, and it is most likely familiar to taxpayers affected by the proposed regulations.

To determine its cumulative net tax savings, a utility must first determine its share of the consolidated group's tax savings for each tax year beginning with the "election year." (Flexibility is provided by allowing the selection of the election year, but in no instance may the election year be earlier than the first tax year ending on or after the date that is 30 days after the date final regulations are published, or, if sooner, January 1, 1992. The utility's share (which may be negative) of the consolidated tax savings for any tax year is determined by subtracting its share of the consolidated group's tax liability for the year, determined in accordance with sections 1.1552-1(a)(2) and 1.1502-33(d)(2)(i), from its tax liability for the year calculated as if it had filed a separate return for that year and all previous years. Under these rules, no adjustment is made for payments by the utility under a tax sharing agreement. Comments are invited on any adjustments that might be necessary where there are minority interests in a nonutility affiliate.

Operation of Section 1.1502-33(d)(2)(i)

Under section 1.1502-33(d)(2)(i), the tax liability of a consolidated group is first allocated among the members of the group in proportion to their relative separate return tax liabilities, as provided in section 1.1552-1(a)(2). (For this purpose, separate return tax liability is determined as if a separate return were filed for the current year only, and thus does not take into account NOL's from other years.) However, in situations in which one member of the group generates losses in one year that are used to reduce the group's tax liability, but becomes profitable in a subsequent year, tax liability as allocated under section 1.1552-1(a)(2) must be adjusted so that the cumulative amount of tax liability allocated to the loss member does not exceed the amount that would have been its cumulative tax liability if it had not joined in the consolidated return. The loss member's excess liability is allocated to the other members of the group that benefitted from the losses. Section 1.1502-33(d)(2)(i) provides the mechanism for making these adjustments.

Under section 1.1502-33(d)(2)(i)(*a*), the amount of group tax liability allocated to any member for a tax year is equal to the member's proportionate share of the group's liability based on the member's separate return tax liability under section 1.1552-1(a)(2). It may not, however, exceed the excess of (1) the total of the tax liabilities of the member on a separate return basis for all tax years to which the election under section 1.1502-33(d)(3) applies, and for which the member joined in the filing of a consolidated return of the group (including the current tax year) computed as if it had actually filed sepa-

rate returns for all of these years, over (2) the total of the portions of the group tax liability allocated to the member for all previous tax years to which the election applies. The proposed regulations provide that any tax year ending on or after the date that is 30 days after final regulations are published, or, if sooner, January 1, 1992, may be treated as the first year to which an election applies for purposes of this rule.

Any tax liability of a group that cannot be allocated to a member that previously generated losses because of this limitation must be allocated to the other members that benefitted from these losses, thus increasing their share of the group's tax liability above the amount that would be allocated under section 1.1552-1(a)(2). Under section 1.1502-33(d)(2)(i)(*b*), any excess tax liability that would be allocated to a member of a group but for section 1.1502-33(d)(2)(i)(*a*) must be allocated among the other members in direct proportion to (and limited to) the reduction in tax liability resulting to the other members. The reduction for any member is the excess, if any, of (1) the total of its tax liabilities on a separate return basis for all tax years to which the election under section 1.1502-33(d)(3) applies and for which it joined in the filing of a consolidated return of the group (including the current tax year) computed as if it had actually filed separate returns for all these years, over (2) the total of the portions of the tax liability of the group allocated to the member for all tax years to which the election applies (including, for the current year, only the amount allocated under section 1.1552-1(a)(2)).

This allocation of excess tax liability may have the effect of increasing a utility's share of the group's tax liability above the amount that would have been its tax liability for the current year if it had not filed a consolidated return. This difference can be viewed as a recapture of the utility's share of previous consolidated tax savings. Accordingly, if the utility's share of the group's tax savings is excluded from its rate base (or, alternatively, is treated as no-cost capital), the maximum amount permitted to be excluded from rate base must be reduced to reflect this repayment of tax savings from prior years.

The proposed regulations provide an example to illustrate the exclusion of consolidated tax savings from rate base as permitted under the regulations.

Special Analyses

The Commissioner of Internal Revenue has determined that these proposed rules are not major rules as defined in Executive Order 12291, and that a Regulatory Impact Analysis therefore is not required. Furthermore, it has been certified that these rules, if issued, will not have a significant economic impact on a substantial number of small entities. Therefore, an initial Regulatory Flexibility Analysis is not required under the Regulatory Flexibility Act (5 U.S.C. chapter 6).

Comments and Public Hearing

Before these proposed regulations are adopted, consideration will be given to any written comments that are submitted (preferably a signed original and eight copies) to the Internal Revenue Service. All comments will be available for public inspection and copying. A public hearing will be held at 10:00 a.m. on February 8, 1991, in the I.R.S. Auditorium, Seventh Floor, 7400 Corridor of the Internal Revenue Building, 1111 Constitution Ave., NW, Washington, D.C.

List of Subjects in 26 CFR 1.61-1 through 1.281-4

Deductions, Exemptions, Income tax, Taxable income.

Proposed Amendments to the Regulations

Accordingly, Title 26, Part 1, of the Code of Federal Regulations is proposed to be amended as follows:

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

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

Authority: 26 U.S.C. 7805 *** §1.167(l)-1(h)(7) also issued under 26 U.S.C. 167(l), and §1.168(i)-1 also issued under 26 U.S.C. 168(i)(9)-(B)(iii).

Par. 2. Section 1.167(l)-1 is amended by adding a new paragraph (h)(7) to read as follows:

§1.167(l)-1 Limitations on reasonable allowance in case of property of certain public utilities.

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(h) ***

(7) *Application of normalization requirements to utilities filing consolidated returns.* Notwithstanding §1.167(l)-1(a)(1) of the regulations, in order to use a normalization method of accounting, any corporation that owns public utility property and that is a member of a consolidated group must comply with the requirements of §1.168(i)-1.

Par. 3. New §1.168(i)-1 is added to read as follows:

§1.168(i)-1 Normalization rules.

(a) *In general.* Under section 168(f)(2), section 168 does not apply to any public utility property (within the meaning of section 167(l)(3)(A)) if the taxpayer does not use a normalization method of accounting. Sections 167(l)(3)(G) and 168(i)(9) describe the requirements of a normalization method of accounting. Section 167(l)(5) directs the Secretary to issue regulations if, for any reason, the application of any of the provisions of section 167(l) to any public utility property does not carry out the purposes of that section. Section 168(i)(9)(B)(iii) provides that the Secretary may by regulation prescribe the procedures and adjustments that are to be treated as inconsistent with the requirements of a normalization method of accounting. Under this authority, any corporation that owns public utility property and that is a member of a consolidated group (a "utility") will be considered to use a normalization method of accounting only if its federal income tax expense for determining cost of service for ratemaking purposes ("ratemaking tax expense") is computed as if it filed a separate federal income tax return. Any procedure or adjustment that results in the flow-through of tax savings arising from the filing of a consolidated return will be treated as inconsistent with a normalization method of accounting. See paragraph (b) of this section. The procedures and adjustments described in paragraph (c) of this section, however, which exclude the cumulative amount of these savings from the base to

which the utility's rate of return is applied ("rate base"), will not be treated as inconsistent with a normalization method of accounting. This section is effective for rate orders that become final determinations within the meaning of §1.46-6(f)(8)(iii) of the regulations on or after December 20, 1990.

(b) *Flow-through of consolidated tax savings treated as inconsistent with normalization.* Except as provided in paragraph (c) of this section, it is inconsistent with a normalization method of accounting to compute a utility's ratemaking tax expense or the amount treated as no-cost capital or the amount of the rate base by taking into account the income, losses, deductions, or credits, of any other member of the consolidated group of which it is a member. Thus, for example, it is inconsistent with a normalization method of accounting to reduce ratemaking tax expense on account of the losses or loss carryovers of another member of the utility's consolidated group. Similarly, it is inconsistent with a normalization method of accounting to determine either the current or deferred portion of ratemaking tax expense using an effective tax rate determined by taking into account the losses or credits of other members of the utility's consolidated group, or otherwise to reduce cost of service for ratemaking purposes to take into account the current tax savings resulting from the losses or credits of other members of the utility's consolidated group.

(c) *Exclusion from rate base permitted*—(1) *In general.* It is not inconsistent with the requirements of a normalization method of accounting to treat as no-cost capital (or, alternatively, to exclude from rate base) under this section an amount not in excess of the cumulative amount of the utility's allocable shares of the federal income tax savings attributable to the filing of a consolidated return for the tax year and all prior tax years, beginning with the election year selected under paragraph (c)(3) of this section ("cumulative net tax savings"). (This amount is in addition to the deferred tax reserve, which also may be applied to reduce rate base or be treated as cost-free capital.) If the cumulative net tax savings is less than zero, no adjustment is made to rate base. However, exclusion from rate base or treatment as no-cost capital is not permitted for the utility's share of the consolidated tax savings for any year for which rates were determined under a method that takes consolidated tax savings into account in computing ratemaking tax expense. Thus, if consolidated tax savings are taken into account in computing ratemaking tax expense for any tax year by reason of a rate order that became final prior to December 20, 1990, the utility's share of the consolidated tax savings for that year may not be excluded from the rate base or treated as no-cost capital. This paragraph (c) applies only to treatment of consolidated tax savings pursuant to a rate order that becomes final on or after the date that is 30 days after the date that final regulations are published, or, if sooner, January 1, 1992.

(2) *Allocable share of tax savings.* For any tax year, a utility's allocable share (which may be negative) of tax savings attributable to the filing of a consolidated return is equal to—

(i) Its federal income tax liability for the year, determined as if it actually filed a separate return for that tax year and all previous and subsequent tax years, minus

(ii) Its allocable share of the consolidated group's tax liability for the year, determined in accordance with §§1.1552-1(a)(2) and 1.1502-33(d)-(2)(i).

(3) *Selection of election year.* For purposes of applying the allocation rules of §§1.1552-1(a)(2) and 1.1502-33(d)(2)(i), any tax year ending on or after the date that is 30 days after the date that final regulations are published, or, if sooner, January 1, 1992, may be treated as the year of the election referred to in §1.1502-33(d)(2)(i).

(4) *Use of test periods.* In determining cost of service for future periods based on an historical test period, the amount of consolidated tax savings for future periods may be projected, and thus changes from the test period in the amount excluded from rate base (or treated as no-cost capital) under this section may also be projected. Any projections, however, must be reasonable. For example, a projection may not take into account an extraordinary event, such as the termination or acquisition of a business, unless it is evident that such an event will occur.

(d) *Example*—(1) This example illustrates the following series of calculations necessary to determine the maximum amount that may be treated as no-cost capital or by which rate base may be reduced. First, the group's consolidated tax liability for the year is allocated among the members in proportion to their separate return liabilities (determined as though separate returns were filed for the current year only). Second, the amount allocated to each member is limited to ensure that this amount does not cause the cumulative total amount of group tax liability allocated to the member for all years to exceed the amount that would have been the member's cumulative total tax liability if it had actually filed a separate return for all years. Any part of the group's consolidated tax liability for the year that cannot be allocated to a member because of this limit is apportioned among the other members, to produce each member's final allocation of the group's consolidated tax liability for the year. The utility's final allocation is then subtracted from the amount that would have been the utility's separate return tax liability for the current year if the utility had actually filed separate returns for all years. This difference is the utility's share of the consolidated tax savings for the year. The utility's cumulative share of the consolidated tax savings may be used to reduce rate base or be treated as cost-free capital. (This amount is in addition to the deferred tax reserve, which also may be applied to reduce rate base or be treated as cost-free capital.)

(2) In this example, regulated public utility *U* files a consolidated return with its nonregulated affiliates *X* and *Y*. The year 1991 has been selected as the year of election, and a 34 percent tax rate has been assumed. Line references are to the tables below.

Allocation under §1.1552-1(a)(2). Under §1.1552-1(a)(2), the group's consolidated tax liability for the year is allocated among the members in proportion to their separate return tax liabilities. For purposes of this allocation, a member's separate return tax liability is computed as though it filed a separate return for the current year, without regard to other years. The following information and calculations are required to make this allocation. *U*'s separate taxable income for the year, as defined in §1.1502-12 and determined using accelerated depreciation, is 60. *X* has a loss of 50, and *Y* has separate taxable income of 45. (Line A.1). The group's consolidated taxable income (as defined in §1.1502-11) and tax liability are 55 and 18.7 (34 percent of 55), respectively. (Lines A.2 and A.3). The separate taxable incomes of *U*, *X* and *Y*, for purposes of §1.1552-1(a)-(2)(ii), are 60, a loss of 50, and 45, respectively. (Line A.4). Thus, the separate return tax liabilities of *U*, *X*, and *Y* are 20.4, 0, and 15.3, respectively. (Line A.5). The group's tax liability of 18.7 is then allocated among the members in proportion to their separate return tax liabilities, resulting in an allocation under §1.1552-1(a)(2) of 10.69 to *U*, O to *X*, and 8.01 to *Y*. (Line A.6).

(A) *Allocation under §1.1552-1(a)(2).*

	U	X	Y	Group
(*1*) Separate taxable income (as defined in §1.1502-12) (using accelerated depreciation)	60	50	45	-
(*2*) Consolidated taxable income (as defined in §1.1502-11)	-	-	-	55
(*3*) Consolidated tax liability	-	-	-	18.7
(4) Separate taxable income for purposes of §1.1552-1(a)(2) calculation	60	(50)	45	-
(*5*) Separate return tax liability as calculated in §1.1552-1(a)(2)	20.4	-0-	15.3	-
(*6*) Allocation of consolidated tax liability under §1.1552-1(a)(2)	10.69	-0-	8.01	-

Allocation under §1.1502-33(d)(2)(i). Under §1.1502-33(d)(2)(i), the first step is to ensure that the amount allocated to each member under §1.1552-1(a)(2) for the current year does not cause the cumulative total amount of group tax liability allocated to the member for all years (beginning with the year treated as the year of election) to exceed the amount that would have been the member's cumulative total tax liability if it had actually filed a separate return for all years. Thus, the maximum amount that may be allocated to any member for the year is the excess of the cumulative total of the member's tax liabilities on a separate return basis (determined as though the member had actually filed separate returns for all years, beginning with the year treated as the year of election), as determined in §1.1502-33(d)(2)(i)(*a*)(*1*) (line B.2), over the total portions of group tax liability allocated to the member for all previous years, as determined in §1.1502-33(d)(2)(i)(*a*)(*2*) (line B.3). Because the current year, 1991, is treated as the year of election, the amounts shown on line B.3 are all 0. The excess for each member (line B.2 minus line B.3), which for 1991 is the same as the member's separate return liability for 1991, is shown on line B.4. It is the maximum amount that may be allocated to the member. This amount is compared with the amount allocated under §1.1552-1(a)(2) (line B.1), and the lesser of the two amounts is the amount allocated under §1.1502-33(d)(2)(i)(*a*) to the member. (Line B.5). For 1991, these two amounts are the same. Thus for 1991, the amount allocated to each member under §1.1552-1(a)(2) is not limited under the first step.

(B) *Allocation under §1.1502-33(d)(2)(i).*

	U	X	Y	Group
(*1*) Allocation under §1.1552-1(a)(2) (from line A.6)	10.69	-0-	8.01	-
(*2*) Cumulative total of tax liabilities on separate return basis as though separate returns filed for all years (as determined in §1.1502-33(d)(2)(i)(*a*)(*1*))	20.4	-0-	15.3	-
(*3*) Total portions of group tax liability allocated to member for all previous years (as determined in §1.1502-33(d)(2)(i)(*a*)(*2*))	-0-	-0-	-0-	-
(*4*) Excess of cumulative total of separate return liabilities over amounts allocated for all previous years (line B.2 minus line B.3) (as determined in §1.1502-33(d)(2)(i)(*a*)) (limit on amount that may be allocated to a member)	20.4	-0-	15.3	-
(*5*) Initial allocation (lesser of line B.1 and line B.4)	10.69	-0-	8.01	-

Apportionment of excess. The second step under §1.1502-33(d)(2)(i) is to apportion among the other members any amount of the group's consolidated tax liability that may not be allocated to a member because of the limit determined under the first step. This excess is determined by subtracting the total of the amounts allocated under §1.1502-33(d)(2)(i)(*a*) (line C.2) from the consolidated tax liability (line C.1). Because the amount allocated under §1.1552-1(a)(2)(ii) is not limited under the first step for 1991, the two amounts are the same (18.7), and the difference (line C.3) is 0. Thus, there is no excess tax liability to be apportioned under the second step.

(C) *Apportionment of excess.*

	U	X	Y	Group
(*1*) Consolidated tax liability (from line A.3)	-	-	-	18.7
(*2*) Total of amounts allocated in line B.5	-	-	-	18.7
(*3*) Amount of consolidated tax liability that cannot be allocated because of limit in line B.4 (line C.1 minus line C.2)	-	-	-	-0-

Cumulative consolidated tax savings. Each member's current year consolidated tax savings is equal to the excess of its separate return tax liability for the year, determined as if separate returns had actually been filed for all years (line D.1), over the amount of the consolidated group's tax liability finally allocated to the member for the year (line D.2). Thus, the amount finally allocated to each member (line D.2) is subtracted from the member's separate return tax liability shown on line D.1 (20.4, 0, and 15.3, of *U*, *X*, and *Y*, respectively) to produce its consolidated tax savings for the year (9.71, 0, and 7.29). (Line D.3). Each member's cumulative consolidated tax savings is equal to the consolidated tax savings for the year added to the cumulative consolidated tax savings for preceding year. (Line D.4). Because 1991 is treated as the year of election, the cumulative consolidated tax savings is the same as the consolidated tax savings for 1991. The maximum amount that may be treated as cost-free capital to *U* (or by which *U*'s rate base may be reduced) under the rules of this section is 9.71 for 1991.

(D) *Cumulative consolidated tax savings.*

	U	X	Y	Group
(*1*) Separate return tax liability for current year determined as though separate returns filed for all years (see §1.1502-33(d)(2)(i)(*a*)(*1*))	20.4	-0-	15.3	-
(*2*) Final allocation (line B.5 plus any excess group tax liability apportioned under C)	10.69	-0-	8.01	-
(*3*) Consolidated tax savings (line D.1 minus line D.2)	9.71	-0-	7.29	-
(*4*) Cumulative consolidated tax savings (line D.3 plus line D.4 from preceding year)	9.71	-0-	7.29	-

1992

Allocation under §1.1552-1(a)(2). Under §1.1552-1(a)(2), the group's consolidated tax liability for the year is allocated among the members in proportion to their separate return tax liabilities. The following information and calculations are required to make this allocation. *U*'s separate taxable income for the year, as defined in §1.1502-12, and determined using accelerated depreciation, is 75. *X* and *Y* have separate taxable incomes of 30 and 50, respectively. (Line A.1). The group's consolidated taxable income and tax liability are 155 and 52.7 (34 percent of 155), respectively. (Lines A.2 and A.3). The separate taxable incomes of *U*, *X*, *Y*, for purposes of §1.1552-1(a)(2)(ii), are 75, 30, and 50, respectively. (Line A.4). Thus the separate return tax liabilities of *U*, X, and Y, are 25.5, 10.2, and 17, respectively. (Line A.5). Note that *X*'s separate return tax liability does not take into account *X*'s net operating loss from the preceding year, because, for this purpose, separate return tax liability is determined as if a separate return were filed only for the current year, and not for preceding years also. The group's tax liability of 52.7 is then allocated among the members in proportion to their separate return tax liabilities, resulting in an allocation under §1.1552-1(a)(2) of 25.5, 10.2, and 17, to *U*, *X*, and *Y*, respectively. (Line A.6).

(A) *Allocation under §1.1552-1(a)(2).*

	U	X	Y	Group
(*1*) Separate taxable income (as defined in §1.1502-12) (using accelerated depreciation)	75	30	50	-
(*2*) Consolidated taxable income (as defined in §1.1502-11)	-	-	-	155
(*3*) Consolidated tax liability	-	-	-	52.7
(*4*) Separate taxable income for purposes of §1.1552-1(a)(2) calculation	75	30	50	-
(*5*) Separate return tax liability as calculated in §1.1552-1(a)(2)	25.5	10.2	17	-
(*6*) Allocation of consolidated tax liability under §1.1552-1(a)(2)	25.5	10.2	17	-

Allocation under §1.1502-33(d)(2)(i). Under the first step of §1.1502-33(d)(2)(i), the maximum amount that may be allocated to any member for the year is the excess of the cumulative total of the member's tax liabilities on a separate return basis (determined as though the member had actually filed separate returns for all years, beginning with the year treated as the year of election), as determined in §1.1502-33(d)(2)(i)(*a*)(*1*) (line B.2), over the total portions of group tax liability allocated to the member for all previous years, as determined in §1.1502-33(d)(2)(i)(*a*)(*2*) (line B.3). The cumulative totals of the members' tax liabilities (1991 and 1992) are 45.9, 0, and 32.3, for *U*, *X*, and *Y*, respectively. Note that the total for *X* takes into account the fact that, if *X* had filed a separate return for both years, a deduction for a net operating loss carryover from 1991 would have been allowed for 1992, so that *X* would have had no liability for either year. The portion of group tax liability that was allocated to each member for 1991 is shown on line B.3. The excess (line B.2 minus line B.3) is shown on line B.4. It is the maximum amount that may be allocated to each member. This amount is compared with the amount allocated under §1.1552-1(a)(2) (line B.1), and the lesser of the two amounts is the amount allocated under §1.1502-33(d)(2)(i)(*a*) to the member. (Line B.5). Note that the amount allocated to *X* under §1.1502-33(d)(2)(i)(*a*) is thus 0), rather than 10.2, the amount allocated under §1.1552-1(a)(2).

(B) *Allocation under §1.1502-33(d)(2)(i).*

	U	X	Y	Group
(*1*) Allocation under §1.1552-1(a)(2) (from line A.6)	25.5	10.2	17	-
(*2*) Cumulative total of tax liabilities on separate return basis as though separate returns filed for all years (as determined in §1.1502-33(d)(2)(i)(*a*)(*1*))	45.9	-0-	32.3	-
(*3*) Total portions of group tax liability allocated to member for all previous years (as determined in §1.1502-33(d)(2)(i)(*a*)(*2*))	10.69	-0-	8.01	-
(*4*) Excess of cumulative total of separate return liabilities over amounts allocated for all previous years (line B.2 minus line B.3) (as determined in §1.1502-33(d)(2)(i)(*a*)) (limit on amount that may be allocated to a member)	35.21	-0-	24.29	-
(*5*) Initial allocation (lesser of line B.1 and line B.4)	25.5	-0-	17	-

Apportionment of excess. The second step under §1.1502-33(d)(2)(i) is to apportion among the other members any amount of the group's consolidated tax liability that may not be allocated to a member because of the limit determined under the first step. This excess is determined by subtracting the total of the amounts allocated under §1.1502-33(d)(2)(i) (line C.2), which is 42.5, from the consolidated tax liability, which is 52.7 (line C.1). The difference (line C.3) is 10.2, the amount that could not be allocated to *X* because of the limit in step 1. This excess must be apportioned between *U* and *Y* in proportion to their relative reductions in tax liability for 1991 and 1992 as a result of filing a consolidated return, as determined in §1.1502-33(d)(2)(i)(*b*). These reductions are equal to the excess of the cumulative total of separate return liabilities, determined as if separate returns had been filed for both 1991 and 1992, (line C.4), over the total of the portions of tax liability of the group allocated for both years (line C.5). These reductions, which are shown on line C.6, are 9.71 and 7.29 for *U* and *Y*, respectively. The total of these reductions is 17. (Line C.7). *U*'s and *Y*'s percent, respectively. (Line C.8). Thus, the amounts of excess tax liability apportioned to *U* and *Y* are 5.83 and 4.37, respectively. (Line C.9).

(C) *Apportionment of excess.*

	U	X	Y	Group
(*1*) Consolidated tax liability (from line A.3)	-	-	-	52.7
(*2*) Total of amounts allocated in line B.5	-	-	-	42.5
(*3*) Amount of consolidated tax liability that cannot be allocated because of limit in line B.4 (line C.1 minus line C.2)	-	-	-	10.2
(*4*) Cumulative total of separate return liabilities, computed as though separate returns filed for all years (as determined in §1.1502-33(d)(2)(i)(*b*)(*1*)) (same as line B.2)	45.9	-	32.3	-
(*5*) Total of the portions of tax liability of group allocated to member for all years (as determined in §1.1502-33(d)(2)(i)(*b*)(*2*))	36.19	-	25.01	-
(*6*) Reduction in tax liability to other members (as determined in §1.1502-33(d)(2)(i)(*b*)) (line C.5 minus line C.4)	9.71	-	7.29	-
(*7*) Total reduction in tax liability (sum of numbers on line C.6)	-	-	-	17
(*8*) Each member's share of total reduction (line C.6 divided by line C.7)	0.57	-	0.43	-
(*9*) Apportionment of excess tax liability (line C.3 multiplied by line C.8)	5.83	-	4.37	-

Cumulative consolidated tax savings. Each member's current year consolidated tax savings is equal to the excess of its separate return tax liability for the year, determined as if separate returns had actually been filed for all years (line D.1), over the amount of the consolidated group's tax liability finally allocated to the member for the year (line D.2). Thus, the amount finally allocated to each member (line D.2) is subtracted from the member's separate return tax liability shown on line D.1 (25.5, 0, and 17, for *U*, *X*, and *Y*, respectively) to produce its consolidated tax savings for the year. Thus, *U*'s and *Y*'s consolidated tax savings for the year are negative 5.83 and negative 4.37, respectively, representing a partial recapture of the benefit that *U* and *Y* received from filing a consolidated return in 1991. (Line D.3). Each member's cumulative consolidated tax savings is equal to the consolidated tax savings for the year added to the cumulative consolidated tax savings for the preceding year. Thus, *U*'s cumulative consolidated tax savings is 9.71 minus 5.83, or 3.88, while *Y*'s is 7.29 minus 4.37, or 2.92. (Line D.4). The maximum amount that may be treated as cost-free capital to *U* (or by which *U*'s rate base may be reduced) under the rules of this section is 3.88 for 1991.

(D) *Cumulative Consolidated Tax Savings.*

	U	X	Y	Group
(*1*) Separate return tax liability for current year determined as though separate returns filed for all years (see §1.1502-33(d)(2)(i)(*a*)(*1*))	25.5	-0-	17	-
(*2*) Final allocation (line B.5 plus line C.9)	31.33	-0-	21.37	-
(*3*) Consolidated tax savings (line D.2 minus line D.1)	(5.83)	-0-	(4.37)	-
(*4*) Cumulative consolidated tax savings (line D.3 plus line D.4 from preceding year)	3.88	-0-	2.92	-

Fred T. Goldberg, Jr.,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on November 20, 1990, 2:45 p.m., and published in the issue of the Federal Register for November 27, 1990, 55 F.R. 49294)

Notice of Proposed Rulemaking

Limitations on Passive Activity Losses and Credits—Developer Rule Amendments

PS-71-89

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In *** [T.D. 8318, page 103, this Bulletin], the Internal Revenue Service is issuing temporary regulations that amend previously issued temporary regulations concerning the limitations on passive activity losses and passive activity credits. The text of those temporary regulations also serves as the comment document for this notice of proposed rulemaking.

DATES: Comments and requests for a public hearing must be delivered by February 19, 1991. These regulations are proposed to apply for taxable years beginning after December 31, 1987.

ADDRESS: Send comments and requests for a public hearing to: Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Room 4429, Washington, D.C. 20044 (Attn: CC: CORP:T:R (PS-071-89)).

FOR FURTHER INFORMATION CONTACT: Dexter A. Johnson at (202) 566-4751 (not a toll-free num-

SUPPLEMENTARY INFORMATION

Background

The temporary regulations in *** [T.D. 8318, page 103, this Bulletin] amend §1.469-2T(f)(5) in Title 26 of the Code of Federal Regulations. Section 1.469-2T(f)(5) excludes certain net income and gain from passive activity gross income. This document proposes to adopt the temporary regulations as final regulations. Accordingly, the text of the temporary regulations serves as the comment document for this notice of proposed rulemaking. In addition, the preamble to the temporary regulations explains the proposed and temporary rules.

For the text of the temporary regulations, see T.D. 8318, published in *** [page 103, this Bulletin].

Special Analyses

It has been determined that these proposed rules are not major rules as defined in Executive Order 12291.

Therefore, a Regulatory Impact Analysis is not required. 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, an initial Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations will be submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted, consideration will be given to any written comments that are submitted (preferably a signed original and seven copies) to the Internal Revenue Service. All comments will be available for public inspection and copying. A public hearing will be scheduled and held upon written request by any person who submits written comments on the proposed rules. Notice of the time and place for the hearing will be published in the Federal Register.

Fred T. Goldberg, Jr.,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on November 16, 1990, 8:45 a.m., and published in the issue of the Federal Register for November 19, 1990, 55 F.R. 48135)

Notice of Proposed Rulemaking

Excise Tax on Chemicals That Deplete the Ozone Layer and on Products Containing Such Chemicals

PS-73-89

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In *** [T.D. 8311, page 223, this Bulletin], the Internal Revenue Service is issuing temporary regulations relating to the tax on chemicals that deplete the ozone layer and on products containing such chemicals. The text of those temporary regulations also serves as the comment document for this notice of proposed rulemaking.

DATES: Written comments and requests for a public hearing must be received before November 6, 1990.

ADDRESSES: Send comments and requests for a public hearing to: Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Room 4429, Attention: CC:CORP:T:R (PS-73-89), Washington, D.C. 20044. In the alternative, comments and requests may be hand delivered to: CC:CORP:T:R (PS-73-89), Internal Revenue Service, Room 4429, 1111 Constitution Ave., N.W., Washington, D.C. 20224

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The requirements for collection of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1980 (44 U.S.C. 3504(h)). Comments concerning the accuracy of the burden estimates and suggestions for reducing this burden should be directed to the Office of Management and Budget, Attention: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, D.C. 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, T:FP, Washington, D.C. 20224.

The requirements for collection of information in this proposed regulation are in §§52.4682-1T(b)(2)(iii), 52.4682-2T(b), 52.4682-2T(d), 52.4682-3T(c)(2), 52.4682-3T(g), and 52.4682-4T(f). This information is required by the Internal Revenue Service to verify compliance with sections 4681 and 4682 of the Internal Revenue Code. This information will be used as evidence that qualifying sales have taken place, to determine whether modifications to the list of imported taxable products are necessary, and to determine the amount of floor stocks tax for which a person is liable. The likely respondents and/or recordkeepers are businesses and other organizations.

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

Estimated total annual recordkeeping burden: 75,022 hours.

Estimated average annual burden per recordkeeper: 0.5 hour.

Estimated number of recordkeepers: 150,216.

Estimated total annual reporting burden: 120 hours.

Estimated average burden per respondent: 0.4 hour.

Estimated number of respondents: 300.

Estimated frequency of responses: On occasion.

Background

Temporary regulations in *** [T.D. 8311, page 223, this Bulletin] amend the Environmental Tax Regulations (26 CFR Part 52) by adding rules under sections 4681 and 4682 of the Internal Revenue Code. The temporary regulations contain rules concerning the tax on chemicals that deplete the ozone layer and on products containing such chemicals.

This document proposes to adopt the temporary regulations as final regulations. Accordingly, the text of the temporary regulations serves as the comment document for this notice of proposed rulemaking. For the text of the temporary regulations, see T.D. 8311 published in *** [page 223, this Bulletin]. The preamble to the temporary regulations explains the proposed and temporary rules.

Special Analyses

It has been determined that these proposed rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. 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, an initial Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations will be submitted to the Administrator of

the Small Business Administration for comment on their impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted, consideration will be given to any written comments that are submitted (preferably a signed original and seven copies) to the Internal Revenue Service. All comments will be available for public inspection and copying. A public hearing will be scheduled and held upon written request to the Internal Revenue Service by any person who also submits written comments. If a public hearing is scheduled, notice of the time and place will be published in the Federal Register.

Fred T. Goldberg, Jr.,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on August 31, 1990, 3:16 p.m., and published in the issue of the Federal Register for September 6, 1990, 55 F.R. 36659)

Notice of Proposed Rulemaking

Tax on Transportation by Water

PS-3-90

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In *** [T.D. 8314, page 220, this Bulletin], the Internal Revenue Service is issuing final and temporary regulations that implement the tax on the transportation of passengers on covered voyages by certain vessels under sections 4471 and 4472 of the Internal Revenue Code as enacted by section 7504 of the Revenue Reconciliation Act of 1989 (Pub. L. 101-239, 103 Stat. 2106, 2362) [1990-1 C.B. 210, 246]. The text of the final and temporary regulations also serves as the comment document for this notice of proposed rulemaking.

DATES: Written comments and requests for a public hearing must be received by December 11, 1990.

ADDRESSES: Send written comments and requests for a public hearing to: Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Room 4429, Attn: CC:CORP:T:R (PS-003-90), Washington, D.C. 20044. In the alternative, comments and requests may be hand delivered to: CC:CORP:T:R (PS-003-90), Internal Revenue Service, Room 4429, 1111 Constitution Ave., N.W., Washington, D.C. 20224.

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed regulations on the Excise Tax on Transportation by Water (26 CFR Part 43) under sections 4471 and 4472 of the Internal Revenue Code. Final and temporary regulations containing the text of the proposed regulations are published in *** see T.D. 8314 page 220, this Bulletin]. The temporary regulations contain rules concerning the excise tax on the initial embarkation or disembarkation of passengers on certain commercial passenger vessels and on certain other commercial vessels transporting passengers engaged in gambling. The preamble to the final and temporary regulations explains the regulations.

Special Analyses

It has been determined that these proposed rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. 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, an initial Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking for the regulations was submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

Comments and Requests for a Public Hearing

Before the adoption of these proposed regulations, consideration will be given to any written comments that are submitted (preferably a signed original and eight copies) to the Internal Revenue Service. All comments will be available for public inspection and copying in their entirety. A public hearing will be scheduled and held upon written request by any person who submits written comments on the proposed rules. Notice of the time and place for the hearings will be published in the Federal Register.

Charles H. Brennan,
Acting Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on October 5, 1990, 4:34 p.m., and published in the issue of the Federal Register for October 12, 1990, 55 F.R. 41546)

Notice of Proposed Rulemaking

Nuclear Decommissioning Fund Qualification Requirements

PS-7-90

AGENCY: Internal Revenue Service, Treasury

ACTION: Notice of Proposed Rulemaking

SUMMARY: This document contains proposed regulations relating to the qualification requirements of nuclear decommissioning reserve funds that combine their assets for investment purposes. Final regulations published March 3, 1988, (T.D. 8184) [1988-1 C.B. 49] contain the requirement that nuclear decommissioning reserve funds invest directly in permissible assets as well as a provision that permits one or more of such funds to combine assets for investment purposes. The proposed regulations describe two types of pooling arrangements that satisfy the direct investment requirement.

DATES: Written comments and requests for a public hearing must be received by August 13, 1990. These regulations are proposed to be effective as of July 18, 1984.

ADDRESS: Send comments and requests for a public hearing to Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Attention: CC:CORP:T:R (PS-7-90), Room 4429, Washington, D.C. 20044.

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR Part 1) to provide rules under section 468A of the Internal Revenue Code of 1986. Section 468A, relating to nuclear decommissioning costs, was added to the Code by section 91(c) of the Tax Reform Act of 1984 (Public Law 98-369, 98 Stat. 609) [1984-3 C.B. (Vol. 1) 1, 112].

Section 468A provides special rules pursuant to which a taxpayer is allowed a deduction for the tax year in which the taxpayer makes a contribution to a Nuclear Decommissioning Reserve Fund ("Fund"), notwithstanding the fact that economic performance with respect to the nuclear decommissioning costs will occur in a later tax year. Section 468A outlines rules governing the treatment of a Fund and contributions to a Fund. Section 468A(e)(4) provides that a Fund may be used exclusively for (A) satisfying, in whole or in part, any liability of any person that contributes to the Fund for the decommissioning of a nuclear power plant; (B) payment of administrative costs of the Fund; and (C) to the extent not currently used for the purposes set forth in paragraphs (A) and (B), making investments described in section 501(c)(21)(B)(ii).

Section 1.468A-5(a)(3)(i)(C) of the regulations describes the investments listed in section 501(c)(21)(B)(ii) of the Code as direct investments in public debt securities of the United States, obligations of a State or local government that are not in default as to principal or interest, or time or demand deposits in a bank or insured credit union. The preamble to T.D. 8184 makes it clear that the direct investment requirement was intended to prevent Funds from investing in mutual funds or annuity contracts. Section 1.468A-5(a)(1)(i) requires that each Fund must be established as a trust under State law. Section 1.468A-5(a)(1)(iii) provides that the assets of one or more qualified Funds may be pooled for investment purposes. Section 1.468A-5(a)(1)(iv) provides similar rules for the pooling of the assets for investment purposes of one or more qualified or non-qualified Funds.

The regulations under section 468A are silent as to whether the pooling of assets creates a separate taxable entity and thus violates the direct investment requirement. These proposed regulations are issued to provide guidance concerning the type of pooling arrangements that will satisfy the investment restrictions.

Explanation of Provisions

The proposed regulations apply to any pooling of the assets of one or more qualified nuclear decommissioning funds, as well as the pooling of one or more qualified nuclear decommissioning funds with one or more non-qualified nuclear decommissioning funds.

The proposed regulations provide that the pooling of assets for investment purposes in a regulated investment company as defined in section 851 or common trust fund described in section 584 will satisfy the investment requirement if certain requirements are satisfied. These requirements include the general investment and self-dealing restrictions applicable to all qualified nuclear decommissioning reserve funds.

Comments and Requests for a Public Hearing

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably an original and eight copies) to the Internal Revenue Service. All comments will be available for public inspection and copying. A public hearing will be held upon written request by any person who has submitted written comments. If a public hearing is held, notice of the time and place will be published in the Federal Register.

Special Analysis

It has been determined that these proposed rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. It has also been determined that section 553(b) of the Administrative Procedures 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, an initial Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations will be submitted to the Administrator of the Small Business Administration for comment on their impact on small businesses.

List of Subjects 26 CFR 1.441-1 through 1.483-2

Income taxes, Accounting, Deferred compensation plans.

Amendments to the regulations

For reasons set out in the preamble, Title 26, Part 1 of the Code of Federal Regulations is proposed to be amended in part:

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

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

Par. 2. Section 1.468A-5 is amended as follows:

1. Paragraph (a)(1)(iii) is revised.
2. Paragraph (a)(1)(iv) is revised.
3. Paragraph (a)(3)(i)(C) is revised.
4. The revised provisions read as follows:

§1.468A-5 Nuclear decommissioning fund qualification requirements; prohibitions against self-dealing; disqualification of nuclear decommissioning fund; termination of fund upon substantial completion of decommissioning.

(a) Qualification requirements

(1) In general ***

(iii) The assets of two or more nuclear decommissioning funds (whether or not established pursuant to a single trust agreement) can be pooled in the manner described in paragraph (a)(3)(i)(C)(*2*) of this section for the purpose of investing the assets in the property described in paragraph (a)(3)(i)(C)(*1*) of this section if and only if—

(A) The trustee of each nuclear decommissioning fund separately accounts for the contributions, earnings, expenses and distributions of such fund;

(B) The earnings and expenses are reasonably apportioned among such nuclear decommissioning funds; and

(C) The books and records of such funds enable the Internal Revenue Service to verify that the requirements of section 468A and §§1.468A-1 through 1.468A-8 are satisfied with respect to each nuclear decommissioning fund.

(iv) The assets of nonqualified decommissioning funds can be pooled with the assets of one or more nuclear decommissioning funds in the manner described in paragraph (a)(3)(i)(C)(*2*) of this section for the purpose of investing the assets in the property described in paragraph (a)(3)(i)(C)(*1*) of this section if and only if the requirements of paragraph (a)(1)(iii)(A) and (C) of this section are satisfied and earnings and expenses are reasonably apportioned among the pooled funds.

***

(3) *Limitation on use of fund*—(i) ***

(C) To the extent that the assets of the nuclear decommissioning fund are not currently required for the purposes described in paragraph (a)(3)(i)(A) or (B) of this section, to:

(*1*) invest directly in—

(*i*) Public debt securities of the United States;

(*ii*) Obligations of a State of local government that are not in default as to principal or interest; or

(*iii*) Time or demand deposits in a bank (as defined in section 581) or an insured credit union (within the meaning of section 101(6) of the Federal Credit Union Act, 12 U.S.C. 1752(7)(1982)), located in the United States; or

(*2*) invest in a regulated investment company as defined in section 851 or in a common trust fund as described in section 584 that meets the following requirements—

(*i*) The regulated investment company or common trust fund invests only in property described in paragraph (a)(3)(i)(C)(*1*) of this section;

(*ii*) The investors in the regulated investment company or common trust fund are limited to qualified or nonqualified decommissioning funds;

(*iii*) The requirements of paragraph (a)(1)(iii) or (iv) of this section are satisfied; and

(*iv*) The regulated investment company or common trust fund do not engage in any acts of self-dealing as defined in paragraph (b)(2) of this section.

* * * * *

Fred T. Goldberg, Jr.,
Commissioner of
Internal Revenue.

(Filed by the Office of the Federal Register on June 27, 1990, 8:45 a.m., and published in the issue of the Federal Register for June 28, 1990, 55 F.R. 26460)

Notice of Proposed Rulemaking

Tax on Transportation by Water

PS-69-90

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains a notice of proposed rulemaking relating to definitions under section 4472 of the Internal Revenue Code for purposes of the tax on the transportation of passengers on covered voyages by certain vessels under sections 4471 and 4472 as enacted by section 7504 of the Revenue Reconciliation Act of 1989 (Pub. L. 101-239, 103 Stat. 2106, 2362) [1990-1 C.B. 210, 246].

DATES: Written comments and requests for a public hearing must be received by December 11, 1990.

ADDRESSES: Send written comments and requests for a public hearing to: Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Room 4429, Attn: CC:CORP:T:R (PS-069-90), Washington, D.C. 20044. In the alternative, comments and requests may be hand delivered to: CC:CORP:T:R (PS-069-90), Internal Revenue Service, Room 4429, 1111 Constitution Ave., N.W., Washington, D.C. 20224.

SUPPLEMENTARY INFORMATION:

Background

This document contains a proposed regulation on the Excise Tax on Transportation by Water (26 CFR Part 43) under section 4472 of the Internal Revenue Code.

Explanation of Provisions

The proposed regulation would provide taxpayers with definitions of terms under section 4472 for purposes of the tax imposed by section 4471 of the Code. Section 4471 of the Code imposes a tax of $3 per passenger on a covered voyage, as that term is defined in section 4472, to be paid by the person providing the covered voyage. The tax is to be imposed only once for each passenger on a covered voyage, either at the time of first embarkation or disembarkation in the United States. Under section 4472(1) of the Code, the term "covered voyage" means a voyage of (a) a commercial passenger vessel that extends over one or more nights, or (b) a commercial vessel transporting passengers engaged in gambling aboard the vessel beyond the territorial waters of the United States. Proposed §43.4472-1(b) defines the term "voyage" as an outward and a homeward passage of the vessel, but states that a voyage may be a covered voyage with respect to a passenger even if the passenger does not make both an outward and a homeward passage. Under proposed §43.4472-1(c) a voyage extends over 1 or more nights if it extends for 18 or more hours including midnight. Under proposed §43.4472-1(d) of the regulations a passenger on a commercial vessel will be considered to be engaged in gambling aboard the vessel if that person is participating as a player in a game of chance, for money or other thing of value, that is conducted, sponsored, or operated by the owner or operator of the vessel. There is an exception for persons who participate with other passengers in casual, "friendly" games of chance to which the owner or operator of the vessel is not connected. Under proposed §43.4472-1(e), a vessel is considered to be beyond the territorial waters of the United States if it is beyond the international boundary line between the United States and any contiguous foreign country or it is over 3 nautical miles (3.45 statute miles) from the low tide on the coastline. The regulations provide for a 3 nautical mile territorial limit to coincide with existing federal and state jurisdiction over gambling activities.

Special Analyses

It has been determined that this proposed rule is not a major rule as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis 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 this regulation, and, therefore, an initial Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal

Revenue Code, the notice of proposed rulemaking for the regulations was submitted to the Administrator of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before the adoption of these proposed regulations, consideration will be given to any written comments that are submitted (preferably a signed original and eight copies) to the Internal Revenue Service. All comments will be available for public inspection and copying in their entirety. A public hearing will be scheduled and held upon written request by any person who submits written comments on the proposed rules. Notice of the time and place for the hearings will be published in the Federal Register.

List of Subjects in 26 CFR Part 43

Excise taxes, Gambling, Transportation by water, Vessels.

Proposed Regulations

Accordingly, Title 26, Part 43, of the Code of Federal Regulations is amended as follows:

PART 43—[Amended]

Paragraph 1. The authority for Part 43 continues to read in part:

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

Par. 2. A new §43.4472-1 is added to read as follows:

§43.4472-1 Definitions.

(a) *In general.* For definitions of the terms "covered voyage" and "passenger vessel," see sections 4472(1) and (2).

(b) *Voyage.* For purposes of this section the term "voyage" means a journey of a vessel that includes the outward and homeward trips or passages. The voyage commences when the vessel begins to load passengers and continues during the entire ensuring period until the vessel has made one outward and one homeward passage (including intermediate passages, if made). A voyage may be a covered voyage with respect to a passenger even if the passenger does not make both an outward and homeward passage or if the point of first embarkation or disembarkation by the passenger in the United States is at an intermediate stop of the vessel.

(c) *Over 1 or more nights.* A voyage is considered to extend over 1 or more nights if it extends for 18 or more hours including midnight.

(d) *Engaged in gambling.* A passenger is engaged in gambling aboard a vessel if that person is participating as a player in any policy game or other lottery, or any other game of chance, for money or other thing of value, provided that the policy game, other lottery, or game of chance is conducted, sponsored, or operated by the owner or operator of the vessel, as either principal or agent, or by an employee, agent, or franchisee of the owner or operator of the vessel. A passenger is not engaged in gambling aboard a vessel if the passenger participates with other passengers in a casual, "friendly" game of chance that is not conducted, sponsored, or operated by the owner or operator of the vessel or by an employee, agent, or franchisee of the owner or operator.

(e) *Territorial waters.* For purposes of sections 4471 and 4472, the territorial waters of the United States are those waters within the international boundary line between the United States and any contiguous foreign country or within 3 nautical miles (3.45 statute miles) from low tide on the coastline. No inference is intended as to the extent of the territorial limits for other tax purposes.

Charles H. Brennan,
Acting Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on October 5, 1990, 4:35 p.m., and published in the issue of the Federal Register for October 12, 1990, 55 F.R. 41545)

Notice of Proposed Rulemaking

Fuel Floor Stocks Tax of 1990

PS-98-90

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of Proposed Rulemaking.

SUMMARY: This document contains a notice of proposed rulemaking relating to the floor stocks taxes on gasoline, diesel fuel, and aviation fuel that are held on December 1, 1990. These rules reflect changes to the law made by the Revenue Reconciliation Act of 1990. The proposed regulations provide guidance relating to the person liable for the tax, exemptions from the tax, and reporting and recordkeeping responsibilities for the tax.

DATES: Written comments and requests for a public hearing must be received by January 2, 1991.

ADDRESSES: Send written comments and requests for a public hearing to: Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Room 4429, Attn: CC:CORP:T:R (PS-98-90), Washington, DC 20044. In the alternative, comments and requests may be hand delivered to: CC:CORP:T:R (PS-98-90), Internal Revenue Service, Room 4429, 1111 Constitution Ave., N.W., Washington, DC 20224.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The requirements for the collection of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1980 (44 U.S.C. 3504(h)). Comments on the collection of information requirements should be sent 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, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224.

The requirements for collection of information in this proposed regulation are in section 42.5(b). This information is required by the Internal Revenue Service to verify compliance with sections 11211 and 11213 of the Revenue Reconciliation Act of 1990. This information will be used to determine the amount of floor stocks tax for which a person is liable. The likely respondents/recordkeepers are businesses and other organizations.

These estimates are an approximation of the average time expected to be necessary for a collection of information. They are based on informa-

tion that is available to the Internal Revenue Service. Individual respondents and recordkeepers may require more or less time, depending on their particular circumstances.

Estimated total annual recordkeeping burden: 75,000 hours.

Estimated average annual burden per recordkeeper: 0.5 hour.

Estimated number of recordkeepers: 150,000.

Explanation of provisions

Background and purpose of the floor stocks tax

The Revenue Reconciliation Act of 1990, Public Law 101-508 (the "Act"), increases the rates of excise taxes on gasoline, diesel fuel, and aviation fuel, effective December 1, 1990. The gasoline tax, under section 4081 of the Internal Revenue Code (the "Code"), increases from 9 cents per gallon to 14.1 cents per gallon; the diesel fuel tax, under section 4091, increases from 15 cents per gallon to 20.1 cents per gallon; and the aviation fuel tax, under section 4091, increases from 14 cents per gallon to 17.6 cents per gallon. These new rates include the 0.1-cent-per-gallon tax that funds the Leaking Underground Storage Tank Trust Fund ("LUST Fund").

The Act also imposes a floor stocks tax, which does not appear in the Code, on these fuels. The floor stocks tax is a one-time tax on fuels that are held at the first moment of December 1, 1990, at a point in the distribution chain where these fuels would not otherwise be subject to the increased tax rates. The rate of floor stocks tax generally is equal to the difference between the old and new tax rates, without regard to the LUST Fund financing rate. Thus, for example, the tax on sales or removals of gasoline after November 30, 1990, is increased by 5.1 cents per gallon but the floor stocks tax on gasoline is only 5 cents per gallon.

General operation of the tax

A floor stocks tax of 5 cents per gallon generally is imposed on previously-taxed gasoline and diesel fuel that is held at the first moment of December 1, 1990. Also, a floor stocks tax of 3.5 cents per gallon generally is imposed on previously-taxed aviation fuel that is held at the first moment of December 1, 1990. A 2.5-cents-per-gallon tax is imposed on diesel fuel that is held at that time for use in trains and was not previously taxed at the Highway Trust Fund financing rate under section 4091. Special rates apply to gasoline or diesel fuel used to produce gasohol or a diesel/fuel alcohol mixture. Exemptions from the tax are allowed for fuel held exclusively for an exempt use, for gasoline and diesel fuel held in the tank of a motor vehicle or motorboat, and gasoline or diesel fuel held by a person if the aggregate amount of such fuel held by that person (or the controlled group of which that person is a member) is not in excess of a specified amount. The person liable for the tax is the person that has title to the fuel at the first moment of December 1, 1990. This person must pay the tax to the Internal Revenue Service on or before May 31, 1991.

Definitions

Section 42.2 of the regulations provides definitions relating to the floor stocks taxes. The definitions of "aviation fuel" and "diesel fuel" are in substance the same as the existing definitions under Notice 89-17, 1989-1 C.B. 647. Similarly, the definition of "gasoline" is in substance the same as the existing definition under section 48.4081-1(e)(4) of the proposed gasoline tax regulations (52 FR 44141, 44144 (November 18, 1987)) but also includes gasoline blend stocks and additives specified in Rev. Rul. 88-70, 1988-2 C.B. 338. The definition of "train" is similar to the existing definition in section IV(D)(1) of Notice 88-30, 1988-1 C.B. 497, 506, but is clarified to include both freight and passenger trains.

Imposition of floor stocks tax

Section 42.3 identifies the fuels subject to the floor stocks tax, lists the applicable rates of tax, and identifies the person liable for the tax.

Section 42.3(d) and section 11218 of the Act provide that fuel held in a foreign trade zone at the first moment of December 1, 1990, is subject to the floor stocks tax. However, this fuel is not taxed if it is otherwise exempt from tax under the rules of §42.4.

Exemptions from the floor stocks tax

Section 42.4 provides rules relating to exemptions from the floor stocks tax.

First, under §42.4(b), the floor stocks tax generally does not apply to fuel held at the first moment of December 1, 1990, exclusively for an exempt use. An "exempt use" is any use of a fuel (other than use in producing gasohol or a diesel fuel/alcohol mixture, or use as fuel in a train) discussed in sections 6420, 6421, or 6427 of the Code which entitles the user to a credit or refund of the tax imposed under sections 4081 or 4091, as the case may be. The regulations provide that fuel is held exclusively for an exempt use only if (i) the person holding the fuel at the first moment of December 1, 1990, actually uses the fuel in an exempt use, or (ii) in the case of gasoline, the person holding the fuel at that time is a gasoline wholesale distributor described in section 6416(a)(4) to the extent it actually sells the fuel at a tax-excluded price for a use described in section 6416(b)(2). Accordingly, except in the case of gasoline actually sold at a tax-excluded price by such a gasoline wholesale distributor, fuel is not held exclusively for an exempt use if it is held for resale (including resale to a person who will use the fuel for an exempt use). However, the user of fuel in an exempt use may be entitled to a credit or refund of floor stocks tax pursuant to sections 34, 6416, 6420, 6421 and 6427.

Diesel fuel held for use in a train is not treated as held for an exempt use and, therefore, a floor stocks tax of 2.5 cents per gallon applies to such fuel, even if the operator or owner of the train is a State or local government. Although State and local governments generally may obtain a credit or refund of tax paid on diesel fuel used by them for their exclusive use, section 6427(l)(4), as added by the Act, provides that the 2.5-cents-per-gallon tax on diesel fuel used in trains is not refundable.

Second, under §42.4(c), the floor stocks tax does not apply to gasoline or diesel fuel held at the first moment of December 1, 1990, in the fuel supply tank of a motor vehicle or motorboat. No exemption is provided for fuel held in "dead storage" (i.e., the amount of fuel that will not be pumped out of a storage tank because

the fuel is below the mouth of the draw pipe).

Third, under §42.4(d), a person is not liable for the floor stocks tax on gasoline if the amount of gasoline held by the person at the first moment of December 1, 1990, does not exceed 4,000 gallons. In determining whether this threshold is crossed, the amount of gasoline a person holds exclusively for an exempt use and the amount of gasoline held by a person in the fuel supply tank of a motor vehicle or motorboat is not taken into account. If a person holds more than 4,000 gallons of gasoline, then the floor stocks tax is imposed on all gasoline that is held by the person and that is not otherwise exempt.

Members of a controlled group of companies and other organizations must aggregate the gasoline held by all members of the group in determining whether they hold not more than 4,000 gallons of gasoline. If holdings of all members in aggregate exceed 4,000 gallons, then the *de minimis* exemption does not apply to any member of the group. The aggregation rule for controlled groups does not affect the requirement that each separate person liable for floor stocks tax file a return. See §§42.3(c) and 42.5(d).

The rules in §42.4(d) also apply to diesel fuel except that the threshold amount is 2,000 gallons.

Inventory, payment, and return

Section 42.5 requires that every person liable for tax and certain other specified persons must prepare and retain an inventory of fuel held at the first moment of December 1, 1990 (other than fuel that was not previously subject to tax or that is in the fuel supply tank of a motor vehicle or motorboat). Fuel held for use in a train must also be inventoried.

The tax must be paid by May 31, 1991, using Form 8109, Federal Tax Deposit Coupon. A return on Form 720, Quarterly Federal Tax Return, (Revised January 1991), must also be filed by that date. Persons who are also required to report other excise taxes for the first quarter of 1991 must report the floor stocks tax and the other excise taxes on one Form 720. The due date for the return is May 31, 1991, even if returns for the other excise taxes are ordinarily due at an earlier date. This rule does not extend the time for making deposits or payments of the other excise taxes.

Reliance on These Proposed Regulations

These regulations are being issued in proposed form to provide timely guidance to taxpayers and to allow interested parties appropriate opportunity to provide comments prior to issuance of final regulations. Although final regulations may include changes made, for example, in response to comments, it is intended that taxpayers may rely on the proposed regulations until final regulations are issued.

Special Analyses

It has been determined that these proposed rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. 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, an initial 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 Administrator of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before the adoption of these proposed regulations, consideration will be given to any written comments that are submitted (preferably a signed original and eight copies) to the Internal Revenue Service. All comments will be available for public inspection and copying in their entirety. A public hearing will be scheduled and held upon written request by any person who submits written comments on the proposed rules. If a public hearing is scheduled, notice of the time and place for the hearings will be published in the Federal Register.

List of Subjects in 26 CFR Part 42

Excise taxes, Revenue Reconciliation Act of 1990.

Proposed Amendments to the Regulations

Accordingly, 26 CFR, Ch. I, is proposed to be amended as follows:

Paragraph 1. A new Part 42 of the Code of Federal Regulations is added as follows:

PART 42— FUEL FLOOR STOCKS TAX FOR 1990

§42.1 Scope of part.

§42.2 Definitions relating to the floor stocks tax.

§42.3 Imposition of floor stocks tax.

§42.4 Exemptions from floor stocks tax.

§42.5 Requirements with respect to inventory, payment and return.

§42.6 Applicability of other laws.

Authority: 26 U.S.C. 7805.

§42.1 Scope of part.

The regulations in this part 42 relate to the fuel floor stocks taxes imposed by sections 11211(j) and 11213(b)(5) of the Revenue Reconciliation Act of 1990, Public Law 101-508. The taxes are imposed on previously-taxed gasoline, diesel fuel, and aviation fuel held at the first moment of December 1, 1990, and on diesel fuel held for use in trains on that date. These regulations describe the specific articles subject to tax, the rates of tax, and the persons liable for tax. These regulations also describe exemptions from the tax and requirements for inventory of fuel, payment of tax, and filing a return reporting the tax. These regulations are effective on December 1, 1990.

§42.2 Definitions relating to the floor stocks tax.

(a) *Overview.* This section provides definitions for purposes of the regulations in this part.

(b) *Act.* The term "Act" means the Revenue Reconciliation Act of 1990, Public Law 101-508.

(c) *Aviation fuel.* The term "aviation fuel" means any liquid (other than gasoline) that is commonly or commercially known or sold as a fuel that is suitable for use in an aircraft.

(d) *Controlled group*—(1) *In general.* The term "controlled group" means—

(i) Any controlled group of corporations (within the meaning of paragraph (d)(2) of this section); and

(ii) Any other group of organizations under common control (within the meaning of paragraph (d)(3) of this section).

(2) *Controlled group of corporations*—(i) *In general.* The term "controlled group of corporations" has the meaning given that term by section 1563(a), except that the phrase "more than 50 percent" shall be substituted for the phrase "at least 80 percent" each place it appears therein.

(ii) *Excluded members.* For purposes of this part, a controlled group of corporations includes members that are described in section 1563(b) (relating to excluded members).

(iii) *Examples of controlled groups.* Under section 1563(a), controlled groups of corporations include, but are not limited to—

(A) Parent-subsidiary controlled groups as defined in §1.1563-1(a)(2);

(B) Brother-sister controlled groups as defined in §1.1563-1(a)(3); and

(C) Combined groups as defined in §1.1563-1(a)(4).

(3) *Group of organizations under common control.* The term "group of organizations under common control" means any group of organizations (as defined in §1.52-1(b)) that would be treated as a group of trades or businesses under common control for purposes of §1.52-1 if—

(i) The rules of §1.52-1 were applied without regard to whether an organization conducts a trade or business; and

(ii) The phrase "more than 50 percent" were substituted for "at least 80 percent" each place it appears in §1.52-1(d)(2).

(e) *Diesel fuel.* The term "diesel fuel" means any liquid (including a diesel fuel/alcohol mixture but not including gasoline) that is commonly or commercially known or sold as a fuel that is suitable for use in a diesel-powered highway vehicle or diesel-powered train.

(f) *Diesel fuel/alcohol mixture.* The term "diesel fuel/alcohol mixture" means any mixture described in section 4091(c)(1)(A).

(g) *Floor stocks tax.* The term "floor stocks tax" means the tax imposed by sections 11211(j) and 11213(b)(5) of the Act on fuel held at the first moment of December 1, 1990.

(h) *Fuel.* The term "fuel" means gasoline, diesel fuel, and aviation fuel.

(i) *Gasohol.* The term "gasohol" means any mixture treated as gasohol for purposes of section 4081(c).

(j) *Gasoline.* The term "gasoline" means—

(1) All products (including gasohol) that are commonly or commercially known or sold as gasoline and are suitable for use as a motor fuel (other than products that are not sold as gasoline and have an American Society for Testing Materials octane number of less than 75 as determined by the "motor method"); and

(2) All products that are listed in Revenue Ruling 88-70, 1988-2 Cumulative Bulletin 338, as "gasoline blend stocks" or "products commonly used as additives in gasoline."

(k) *Train.* The term "train" means any equipment or machinery that rides on rails regardless of whether the equipment or machinery transports passengers, freight, or a combination of both passengers and freight. Thus, the term includes a locomotive, work train, switching engine, or track maintenance machine. The term "train" does not include any equipment or machinery that does not ride on rails.

§42.3 Imposition of floor stocks tax.

(a) *Overview.* This section identifies the fuels subject to the floor stocks tax, the applicable rates of tax, and the persons liable for the tax.

(b) *Fuels subject to tax and rates of tax*—(1) *Gasoline*— (i) *Imposition of tax.* Section 11211(j)(1)(A) of the Act imposes a floor stocks tax on gasoline (including gasohol)—

(A) On which tax was imposed under section 4081 before December 1, 1990; and

(B) Which is held at the first moment of December 1, 1990, by any person.

(ii) *Generally applicable rate of tax.* Except as otherwise provided in paragraph (b)(1)(iii) of this section, the rate of floor stocks tax on gasoline is 5 cents per gallon.

(iii) *Rates relating to gasohol.* The rate of floor stocks tax under this paragraph (b)(1) is—

(A) 5 cents per gallon in the case of gasohol;

(B) 6.22 cents per gallon in the case of gasoline that was taxed at a reduced rate under section 4081(c) and is used in producing gasohol that contains ethanol;

(C) 5.56 cents per gallon in the case of gasoline that was taxed at a reduced rate under section 4081(c) and is used in producing gasohol that does not contain ethanol;

(D) .55 cent per gallon in the case of gasoline that was not taxed at a reduced rate under section 4081(c) and is used in producing gasohol that contains ethanol (and no amount is recoverable pursuant to section 6427(f) with respect to such gasoline); and

(E) Zero in the case of gasoline that was not taxed at a reduced rate under section 4081(c) and is used in producing gasohol that does not contain ethanol (and .11 cent per gallon is recoverable pursuant to section 6427(f) with respect to such gasoline).

(2) *Diesel fuel*—(i) *Imposition of tax.* Section 11211(j)(1)(A) of the Act imposes a floor stocks tax on diesel fuel (including diesel fuel/alcohol mixtures)—

(A) On which tax was imposed at a Highway Trust Fund financing rate under section 4091 before December 1, 1990; and

(B) Which is held at the first moment of December 1, 1990, by any person.

(ii) *Generally applicable rate of tax.* Except as otherwise provided in paragraph (b)(2)(iii) of this section, the rate of floor stocks tax on diesel fuel described in paragraph (b)(2)(i) of this section is 5 cents per gallon.

(iii) *Rates relating to diesel fuel/alcohol mixtures.* The rate of floor stocks tax under this paragraph (b)(2) is—

(A) 5 cents per gallon in the case of a diesel fuel/alcohol mixture;

(B) 6.22 cents per gallon in the case of diesel fuel that was taxed at a reduced rate under section 4091(c)-(1)(B) and is used in producing a diesel fuel/alcohol mixture that contains ethanol;

(C) 5.56 cents per gallon in the case of diesel fuel that was taxed at a reduced rate under section 4091(c)-(1)(B) and is used in producing a diesel fuel/alcohol mixture that does not contain ethanol;

(D) 1.22 cents per gallon in the case of diesel fuel that was not taxed at a reduced rate under section 4091(c)-(1)(B)and is used in producing a die-

sel fuel/alcohol mixture that contains ethanol (and no amount is recoverable pursuant to section 6427(f) with respect to such diesel fuel); and

(E) .56 cent per gallon in the case of diesel fuel that was not taxed at a reduced rate under section 4091(c)-(1)(B) and is used in producing a diesel fuel/alcohol mixture that does not contain ethanol (and no amount is recoverable pursuant to section 6427(f) with respect to such diesel fuel).

(3) *Diesel fuel held for use in trains*—(i) *Imposition of tax.* Section 11211(j)(1)(B) of the Act imposes a floor stocks tax on diesel fuel—

(A) On which no tax was imposed at a Highway Trust Fund financing rate under section 4091 before December 1, 1990; and

(B) Which is held at the first moment of December 1, 1990, by any person and is used by that person to propel a train on rails.

(ii) *Rate of tax.* The rate of floor stocks tax under this paragraph (b)(3) is 2.5 cents per gallon.

(4) *Aviation fuel*—(i) *Imposition of tax.* Section 11213(b)(5) of the Act imposes a floor stocks tax on aviation fuel—

(A) On which tax was imposed under section 4041(c)(1) or 4091 before December 1, 1990; and

(B) Which is held at the first moment of December 1, 1990, by any person.

(ii) *Rate of tax.* The rate of floor stocks tax under this paragraph (b)(4) is 3.5 cents per gallon.

(c) *Person liable for tax*—(1) *In general.* The person liable for the floor stocks tax on any fuel subject to tax is the person that holds the fuel at the first moment of December 1, 1990. For purposes of the floor stocks tax, fuel is held at the first moment of December 1, 1990, by the person that has title to the fuel (whether or not delivery to that person has been made) at such time, as determined under applicable local law.

(2) *Special rule.* Each business unit that has, or is required to have, its own employer identification number is treated as a separate person for purposes of the floor stocks tax. For example, a chain of retail service stations that has one employer identification number is one person for purposes of the floor stocks tax and a parent corporation and a subsidiary that each have a different employer identification number are two persons for purposes of the floor stocks tax.

(d) *Treatment of fuel in foreign trade zones.* Notwithstanding the Act of June 18, 1934 (48 Stat. 998, 19 U.S.C. 81a) or any other provision of law, any fuel that is located in a foreign trade zone at the first moment of December 1, 1990, shall be subject to floor stocks tax, if—

(1) Internal revenue taxes have been determined, or customs duties liquidated, with respect to such fuel before December 1, 1990, pursuant to a request made under the first proviso of section 3(a) of the Act of June 18, 1934; or

(2) Such fuel is held at the first moment of December 1, 1990, under the supervision of a customs officer pursuant to the second proviso of such section 3(a).

§42.4 Exemptions from floor stocks tax.

(a) *Overview.* This section provides rules for determining exemptions from the floor stocks tax. Generally, tax is not imposed—

(1) On fuel held exclusively for an exempt use;

(2) On gasoline or diesel fuel held in the tank of a motor vehicle or motorboat; or

(3) On gasoline or diesel fuel held by a person if the person does not hold more than a specified amount of that fuel.

(b) *Fuel held for exempt uses*—(1) *Gasoline.* The floor stocks tax does not apply to gasoline held exclusively for an exempt use. In determining whether gasoline is held exclusively for an exempt use, the following rules apply:

(i) The term "exempt use" means, with respect to gasoline, any use of gasoline (other than use in producing gasohol) which is described in sections 6420, 6421 or 6427 and which entitles the user to a credit or refund of the tax imposed by section 4081. Thus, for example, exempt use of gasoline includes use on a farm for farming purposes, use in an offhighway business use, use in certain intercity, local and school buses, exclusive use by a State or local government or nonprofit educational organization, and use in commercial aircraft.

(ii) Gasoline is held exclusively for an exempt use only if—

(A) The person that holds gasoline at the first moment of December 1, 1990, actually uses the gasoline in an exempt use; or

(B) A gasoline wholesale distributor described in section 6416(a)(4) holds gasoline at the first moment of December 1, 1990, and sells the gasoline at a tax-excluded price for a use described in section 6416(b)(2).

Accordingly, except as provided in this paragraph (b)(1)(ii), gasoline is not held exclusively for an exempt use if, at the first moment of December 1, 1990, the gasoline is held for resale (including resale to a person that will use the gasoline in an exempt use). Thus, for example, gasoline held by a gasoline service station is not exempt from the floor stocks tax under this paragraph (b)(1) if it will be sold to a farmer for use on a farm for farming purposes. However, the farmer would be eligible to claim an income tax credit for the tax under sections 34 and 6420.

(2) *Diesel fuel.* The floor stocks tax does not apply to diesel fuel held exclusively for an exempt use. In determining whether diesel fuel is held exclusively for an exempt use, the following rules apply:

(i) The term "exempt use" means, with respect to diesel fuel, any use of diesel fuel (other than in producing a diesel fuel/alcohol mixture or as fuel in a diesel-powered train) which is described in section 6427 and which entitles the user to a credit or refund of the tax imposed by section 4091. Thus, for example, exempt uses of diesel fuel that is not used as fuel in a diesel-powered train include use other than as a fuel in a diesel-powered highway vehicle (as defined in §48.4041-8(b)(4)), use on a farm for farming purposes, exclusive use by a State or local government or nonprofit educational organization, and use in an off-highway business use.

(ii) Diesel fuel held for use in a diesel-powered train is not exempt from the floor stocks tax under this paragraph (b)(2) even if the fuel is held by a State or local government. Similarly, the exemptions for use oth-

er than as fuel in a diesel-powered highway vehicle and off-highway business use do not apply to fuel used in a diesel-powered train. See section 6427(l)(4), as added by the Act.

(iii) The floor stocks tax does not apply to diesel fuel held for use in a bus if a credit for, or a refund of, the tax, in whole or in part, is allowable for diesel fuel used in the bus under section 6427(b). Thus, for example, the floor stocks tax does not apply to diesel fuel held for use in an intercity bus if the diesel fuel was previously subject to tax at a reduced rate of 3 cents per gallon or 3.1 cents per gallon.

(iv) Diesel fuel is held exclusively for an exempt use only if the person that holds the fuel at the first moment of December 1, 1990, actually uses the diesel fuel in an exempt use.

(v) Accordingly, diesel fuel is not held exclusively for an exempt use if, at the first moment of December 1, 1990, the diesel fuel is held for resale (including resale to a person that will use the diesel fuel in an exempt use). Thus, for example, diesel fuel held by a retailer is not exempt from the floor stocks tax under this paragraph (b)(2) if it will be sold to a construction company for use in the construction company's off-road machinery. However, the construction company would be eligible to claim a credit or refund of the tax under section 6427.

(3) *Aviation fuel.* The floor stocks tax does not apply to aviation fuel held exclusively for an exempt use. In determining whether aviation fuel is held exclusively for an exempt use, the following rules apply:

(i) The term "exempt use" means, with respect to aviation fuel, any use of aviation fuel which is described in section 6427 and which entitles the user to a credit or refund of the tax imposed by section 4091. Thus, for example, exempt use of aviation fuel includes any use other than use as a fuel in an aircraft in noncommercial aviation (as defined in section 4041(c)), use on a farm for farming purposes, and exclusive use by a State or local government or nonprofit educational organization.

(ii) Aviation fuel is held exclusively for an exempt use only if the person that holds the aviation fuel at the first moment of December 1, 1990, actually uses the aviation fuel in an exempt use. Accordingly, aviation fuel is not held exclusively for an exempt use if, at the first moment of December 1, 1990, the aviation fuel is held for resale (including resale to a person that will use the aviation fuel in an exempt use). Thus, for example, aviation fuel held by a fixed base operator is not exempt from the floor stocks tax under this paragraph (b)(3) if it will be sold to an airline for use in commercial aviation. However, the airline would be eligible to claim a credit or refund of the tax under section 6427.

(c) *Exemption for gasoline or diesel fuel held in vehicle tank.* The floor stocks tax does not apply to gasoline or diesel fuel held, at the first moment of December 1, 1990, in the fuel supply tank of a motor vehicle (as defined in §48.4041-8(c)) or motorboat. Fuel held in the fuel supply tank of a train or an aircraft is not exempt from the floor stocks tax under this paragraph (c).

(d) *Exemption for certain amounts of fuel*—(1) *In general.* The floor stocks tax does not apply to—

(i) Gasoline that a person holds at the first moment of December 1, 1990, if the aggregate amount of gasoline held by that person at that time does not exceed 4,000 gallons; and

(ii) Diesel fuel that a person holds at the first moment of December 1, 1990, if the aggregate amount of diesel fuel held by that person at that time does not exceed 2,000 gallons.

(2) *Additional rules.* The following additional rules apply for purposes of this paragraph (d):

(i) *Aviation fuel.* Aviation fuel is not exempt from the floor stocks tax merely because it is held in de minimis amounts at the first moment of December 1, 1990.

(ii) *Coordination with other exemptions.* In determining the aggregate amount of gasoline or diesel fuel held by a person at the first moment of December 1, 1990, there shall be excluded the amount of gasoline or diesel fuel exempt from the floor stocks tax by reason of paragraph (b) of this section (relating to fuel held for exempt uses), or paragraph (c) of this section (relating to gasoline and diesel fuel held in the tank of a vehicle).

(iii) *All amounts held subject to tax if threshold exceeded.* The floor stocks tax applies to all amounts of gasoline (or diesel fuel, as the case may be) held by a person (and not exempt from tax under paragraph (b) or (c) of this section) if the aggregate amount of fuel held by the person at the first moment of December 1, 1990, exceeds 4,000 gallons (2,000 gallons in the case of diesel fuel).

(iv) *Controlled groups.* A member of a controlled group (as defined in §42.2(d)) holds more than 4,000 gallons of gasoline (2,000 gallons in the case of diesel fuel) if the aggregate amount of all gasoline (or diesel fuel, as the case may be) held by all members of the controlled group exceeds 4,000 gallons of gasoline (2,000 gallons in the case of diesel fuel).

(3) *Examples.* The following examples illustrate the rules of this paragraph (d):

Example 1. *A* holds 10,000 gallons of gasoline on December 1, 1990, 6,000 of which are held exclusively for use on a farm for farming purposes. The remaining 4,000 gallons are held for use in *A*'s highway vehicles. *A* is not a member of a controlled group. A is not subject to the floor stocks tax on any of the 10,000 gallons because the aggregate amount of fuel held by *A* for uses other than exempt uses does not exceed 4,000 gallons.

Example 2. On December 1, 1990, *B* holds 1,900 gallons of diesel fuel and 3,900 gallons of gasoline. *B* is not a member of a controlled group. *B* is not liable for the floor stocks tax on diesel fuel because *B*'s holdings of diesel fuel do not exceed 2,000 gallons. *B* is not liable for the floor stocks tax on gasoline because *B*'s holdings of gasoline do not exceed 4,000 gallons.

Example 3. On December 1, 1990, *C* holds 4,100 gallons of gasoline for resale at a service station. *C* is liable for a floor stocks tax of $205 (4,100 X $.05) on that gasoline.

Example 4. *D, E,* and *F* are members of the same controlled group. On December 1, 1990, D holds 2,000 gallons of gasoline, *E* holds 2,500 gallons of gasoline, and *F* holds 500 gallons of gasoline. None of the gasoline is held for an exempt use or in the fuel supply tank of a motor vehicle. Because the aggregate amount held by all members of the group exceeds 4,000 gallons, all gasoline held by each member is subject to the floor stocks tax. Thus, *D* is liable for tax of $100 (2,000 X $.05), *E* is liable for tax of $125 (2,500 X $.05) and *F* is liable for tax of $25 (500 X $.05).

§42.5 Requirements with respect to inventory, payment and return.

(a) *Overview.* This section sets forth requirements for inventory of fuel, payment of tax and filing a

return reporting the tax.

(b) *Inventory.* Every person liable for the floor stocks tax, every person holding gasoline or diesel fuel for resale, and every person holding gasoline or diesel fuel for use as a fuel in a trade or business of providing transportation services by motor vehicle (other than a bus to which section 6421(b) or 6427(b) applies) shall prepare an inventory of all gasoline, diesel fuel and aviation fuel held by that person at the first moment of December 1, 1990 (other than fuel on which no tax under section 4081 or 4091 was imposed before December 1, 1990, and gasoline or diesel fuel held in the fuel supply tank of a motor vehicle or motorboat). In addition every person who, at the first moment of December 1, 1990, holds diesel fuel for use in a train shall prepare an inventory of all such fuel. The inventory shall be determined as of the first moment of December 1, 1990, but work-back and work-forward inventories will be acceptable if supported by adequate commercial records of receipt, use and disposition of the fuel. Persons subject to the inventory requirement of this paragraph (b) must maintain records of the inventory and make the records available for inspection and copying by internal revenue agents and officers. Records of the inventory are not to be filed with the Internal Revenue Service.

(c) *Payment of tax.* The floor stocks tax shall be paid without assessment or notice on or before May 31, 1991. The payment shall be accompanied by Form 8109, *Federal Tax Deposit Coupon*, in accordance with the instructions applicable to that form. The boxes on Form 8109 for "720" and "1st Quarter" shall be marked.

(d) *Filing of returns*—(1) *Form 720.* Every person liable for the floor stocks tax shall make a return of the tax on Form 720, *Quarterly Federal Excise Tax Return*, (Revised January 1991). The return shall be prepared and filed in accordance with the instructions relating to the return. The applicable Form 720 and its separate instructions may be obtained at many local Internal Revenue Service offices or by calling the following toll-free number: 1-800-829-3676.

(2) *Time for filing Form 720.* The Form 720 reporting liability for the floor stocks tax shall be filed on or before May 31, 1991. This Form 720 is for the first calendar quarter of 1991. In the case of a person not otherwise required to file Form 720 for that calendar quarter, the return shall be marked "FINAL-FLOOR STOCKS" at the top. Only one Form 720 shall be filed for any calendar quarter. If a person is also required to report liability for other excise taxes for the first calendar quarter of 1991 on Form 720 and that Form 720 would otherwise be due on or before a date earlier than May 31, 1991, that person shall report the floor stocks tax and the other taxes on one Form 720 filed on or before May 31, 1991. This rule does not extend the time for making deposits or paying any excise tax.

§42.6 Applicability of other laws.

(a) *In general.* All provisions of law, including penalties, applicable with respect to the taxes imposed by section 4081 in the case of gasoline and section 4091 in the case of diesel fuel or aviation fuel shall, insofar as applicable and not inconsistent with the provisions of this part, apply with respect to floor stocks tax to the same extent as if that tax was imposed by section 4081 or section 4091, as the case may be.

(b) *Credits and refunds.* For rules relating to credits and refunds with respect to floor stocks tax paid on gasoline, diesel fuel, or aviation fuel used in an exempt use, see sections 34, 6416, 6420, 6421 and 6427.

(c) *Penalties and interest.* For the application of provisions relating to interest and penalties, see chapters 67 and 68 of subtitle F.

Fred T. Goldberg, Jr.,
Commissioner of
Internal Revenue.

(Filed by the Office of the Federal Register on November 28, 1990, 1:54 p.m., and published in the issue of the Federal Register for December 3, 1990, 55 F.R. 49908)

Announcement of the Disbarment, Suspension, or Consent to Voluntary Suspension of Attorneys, Certified Public Accountants, Enrolled Agents and Enrolled Actuaries from Practice Before the Internal Revenue Service

Under Section 330, Title 31 of the United States Code (1970 ed.), the Secretary of the Treasury, after due notice and opportunity for hearing, is authorized to suspend or disbar from practice before the Internal Revenue Service any person who has violated the rules and regulations governing the recognition of attorneys, certified public accountants, enrolled agents or enrolled actuaries to practice before the Internal Revenue Service.

Attorneys, certified public accountants, enrolled agents, and enrolled actuaries are prohibited in any Internal Revenue Service matter from directly or indirectly employing, accepting assistance from, being employed by or sharing fees with, any practitioner disbarred or under suspension from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants, enrolled agents and enrolled actuaries to identify such disbarred or suspended practitioners, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been disbarred or suspended from such practice, their designation as attorney, certified public accountant, enrolled agent or enrolled actuary, and the date of disbarment or period of suspension. This announcement will appear in the weekly Bulletin for five successive weeks or 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	Date of Disbarment
Bandas, William I.	Richmond, VA	Attorney	December 31, 1989
Bent, C. Frederick, III	Boston, MA	Attorney	July 11, 1990
Cullum, William E.	Mobile, AL	CPA	July 16, 1990
Esposito, James A.	Fairmount, WV	Attorney	April 16, 1990
Harris, Thomas W., Jr.	Irvine, CA	Attorney	June 18, 1990
Kennedy, John B.	Wilmington, DE	Attorney	April 16, 1990
Larson, Bruce N.	West Des Moines, IA	CPA	April 16, 1990
Malone, Thomas F.	Gorham, ME	Attorney	April 27, 1990
Mann, Walter R.	Tallahassee, FL	Attorney	April 16, 1990
Paris, Chester C.	Pocasset, MA	Attorney	July 16, 1990
Shook, Douglas L.	Salem, IL	Attorney	May 25, 1990
Spaulding, James T.	Syracuse, NY	Attorney	April 16, 1990
Sussman, Harold G.	Brooklyn, NY	CPA	April 27, 1990
Wilson, Jim L.	Birmingham, AL	Attorney	April 16, 1990
Wilson, William H., Jr.	Andover, MA	CPA	April 5, 1990

After due notice and opportunity for hearing before an administrative law judge, the following individuals have been suspended from further practice before the Internal Revenue Service:

Name	Address	Designation	Date of Suspension
Corrette, Bruce A.	St. Johnsbury, VT	CPA	Definite from April 16, 1990 to April 16, 1993
Hunt, Christopher J.	Mercer Island, WA	CPA	Indefinite from July 13, 1990
Weiner, Irwin	Calumet City, IL	CPA	Definite from June 17, 1990 to December 17, 1990

Under 31 Code of Federal Regulations, Part 10, an attorney, certified public accountant, enrolled agent or enrolled actuary, in order to avoid the institution or conclusion of a proceeding for his disbarment or suspension from practice before the Internal Revenue Service, may offer his consent to suspension from such practice. The Director of Practice, in his discretion, may suspend an attorney, certified public accountant, enrolled agent or enrolled actuary in accordance with the consent offered.

Attorneys, certified public accountants, enrolled agents, and enrolled actuaries are prohibited in any Internal Revenue Service matter from directly or indirectly employing, accepting assistance from, being employed by or sharing fees with, any practitioner disbarred or under suspension from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants, enrolled agents and enrolled actuaries to identify practitioners under consent suspension from practice before the Internal Rev-

enue 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:

Name	Address	Designation	Date of Suspension
Aronson, Mitchell D.	Ft. Myers, FL	Attorney	Indefinite from June 7, 1990
Bowers, Theodore R.	Panama City, FL	Attorney	Indefinite from March 6, 1990
Coats, Jack	Cleveland, TX	CPA	Indefinite from April 12, 1990
Craft, James D.	Bay City, TX	Enrolled Agent	Indefinite from May 25, 1990
Crow, Kenneth H.	Waco, TX	Attorney	Indefinite from May 4, 1990
Gillis, Stephen S.	Chula Vista, CA	Attorney	Indefinite from May 25, 1990
Harper, Emmett D.	Ft. Walton Beach, FL	Enrolled Agent	Indefinite from March 16, 1990
Kadish, Charles	Portland, ME	Attorney	Indefinite from April 23, 1990
Marcus, Richard M.	Encino, CA	Attorney	Indefinite from April 2, 1990
McGinnis, Lyle B., Jr.	Huntington, WV	CPA	Indefinite from September 18, 1990
Perry, James N.	Cincinnati, OH	Attorney	Indefinite from May 22, 1990
Schafer, James H.	Hutchinson, MN	Attorney	Indefinite from April 12, 1990
Stern, Wallace E.	Southport, CT	CPA	Indefinite from June 8, 1990
Thier, Richard H.	Miami Beach, FL	Attorney	Indefinite from August 10, 1990
Wallace, Gerald O.	Montgomery, AL	Attorney	Indefinite from April 16, 1990

Summaries of Disciplinary Actions Taken by the Director of Practice

The following summaries have been selected from closed cases in the Office of Director of Practice to provide information to tax practitioners regarding the types of activity that may result in disciplinary action. These summaries do not constitute precedent in any matter before the Director of Practice. This is the first publication of disciplinary action summaries. It is anticipated that summaries will be published on a quarterly basis. Before the next publication, your comments on the style and substance of the summaries are invited. Please send comments to: Office of Director of Practice, HR:DP, Internal Revenue Service, 1111 Constitution Ave., N.W., Washington, D.C. 20224.

After due notice and opportunity for hearing, the following resulted in suspensions or disbarments from practice before the Internal Revenue Service:

1. A tax practitioner owned and operated an accounting firm which had a number of employees. Although the proper amount of taxes were withheld from their paychecks, the practitioner failed to pay over this money to the U.S. Government and to file the quarterly tax returns (Form 941) reflecting such taxes. The failure to file the Forms 941 as required by the revenue laws, as well as the failure to pay over the withheld taxes, indicated a violation of section 10.51(d) of Circular 230. When contacted by the Director of Practice relative to the matter, the practitioner explained that he had insufficient funds with which to pay the taxes on behalf of his employees. The Director of Practice found this explanation inadequate justification for failure to pay such taxes in a timely manner, believing that when the taxes were withheld from employees' wages, the practitioner had an affirmative duty to transmit them to the Government. Further, his failure to file Forms 941 was a willful disregard of the requirements of the law. Consequently, his failure to do so was found to place him in violation of section 10.51(d) of Circular 230. The practitioner was suspended from practice before the Internal Revenue Service for a period of not less than five years.

2. The practitioner, an attorney, in preparing several of his clients' tax returns, failed to report all items of income and claimed deductions to which the taxpayers were not entitled. In addition, he promoted a tax shelter in which sham sales were used to artificially increase the basis of the value of the shelter's assets. He also was a partner in that shelter. He later represented clients before the Internal Revenue Service regarding the tax positions taken in connection with the shelter. The clients' interests were found to be in conflict with his interests as a partner in the tax shelter. Further, his preparation of his clients' tax returns was in willful disregard of the revenue laws. The conduct violated sections 10.22, 10.29, and 10.51 of Circular 230 and resulted in the practitioner's disbarment from practice before the Internal Revenue Service.

The following individuals were placed under consent suspension from practice before the Internal Revenue Service:

1. The practitioner prepared tax returns on which bogus deductions were claimed for charitable contributions to a mail order ministry. After being contacted by the Director of Practice, the practitioner indicated he had no specific knowledge of the organization of the mail order ministry. However, the facts showed he was present at meetings in which the ministry organization was explained to audiences. (After these meetings, the attendees were solicited to become "ordained ministers" of the organization upon payment of a fee.) The facts also showed that the ministry's promoter referred the "ordained ministers" to the practitioner for preparation of their individual Federal income tax returns. After possible violations of sections 10.21, 10.22, 10.51(b), and 10.51(d) of Circular 230 were raised, the practitioner offered his consent to suspension from practice before the Internal Revenue Service for a period of two years. Such offer was accepted.

2. The practitioner did not file Federal income tax returns for four taxable years until being contacted by representatives of the Internal Revenue Service Criminal Investigation Division regarding the matter. The Director of Practice raised possible violation of Circular 230, section 10.51(d). After providing mitigating circumstances as an explanation of the matter, the practitioner offered his consent to suspension from practice before the Internal Revenue Service for a period of two years. Such offer was accepted.

3. The practitioner was the executor of an estate. Before becoming the executor, he served as legal counsel to the decedent. During the course of his service as counsel and (later) executor, he commingled assets of the decedent, as well as the estate, with his own funds. In addition, the practitioner made charitable donations of works of art belonging to the estate. He claimed deductions of the contributions on his own Federal income tax return. The Director of Practice alleged possible violations of sections 10.51(b) and (d) of Circular 230. The Director of Practice accepted the practitioner's offer of consent to suspension from practice before the IRS for an indefinite period of time.

The following individuals received letters of reprimand pursuant to section 10.54 of Circular 230:

1. While representing a taxpayer before the Internal Revenue Service under a power of attorney, an enrolled agent advised the taxpayer that he would file a petition on his behalf with the U. S. Tax Court. Because the enrolled agent was not admitted to practice before that court, an order of dismissal for lack of jurisdiction was issued. It was concluded that the practitioner knew or should have known admission to practice before the U. S. Tax Court was required before he could file petitions on behalf of taxpayers. His erroneous advice to taxpayers and resultant activity, together with the delays that resulted therefrom, were found to constitute violations of sections 10.22(a) and 10.23 of Circular 230. A letter of reprimand was issued.

2. At an IRS examination of a client's tax returns for three years, a practitioner brought with him numerous supporting documents. Three Internal Revenue Service employees attended the examination for review of the documents. The practitioner refused to release more than one document at a time. When asked why he would not allow each employee to review separate documents, he stated the taxpayer had directed him to maintain control of each and every document during the examination and

not to relinquish possession of the documents. In order to abide by the wishes of the taxpayer, the practitioner felt he could exercise effective control over only one document at a time. Due to the large number of documents to be reviewed and the fact the Internal Revenue Service review would take place in the presence of the practitioner, the refusal to relinquish possession of more than one document at a time was found to be unreasonable under the circumstances. The fact that a client places demands of the sort under consideration on a practitioner was found not to be a basis for altering his responsibilities as a tax professional (to conduct his affairs in accordance with the requirements of Circular 230). Consequently, his conduct resulted in an unreasonable delay in the prompt disposition of the examination, in violation of section 10.23 of Circular 230. The practitioner was issued a reprimand and was also counselled that repetition of dilatory tactics on his part would result in a proceeding for his suspension or disbarment from practice before the Internal Revenue Service.

3. The practitioner signed his client's name on a power of attorney in his favor (rather than have the taxpayer execute the document herself) and submitted the power of attorney to the Internal Revenue Service. When asked by Service personnel concerning the improper signature, the practitioner stated the taxpayer gave him verbal authorization to represent her. While there was no clear finding of unauthorized representation, his signing the taxpayer's purported signature was improper. Based on the practitioner's assurances that he would be more diligent in abiding by correct procedures in the future, as well as his previous unblemished record, the sanction for his violation of Circular 230 was limited to a reprimand.

Cases were opened in the following instances but were closed without any disciplinary action taken.

1. A referral to the Director of Practice concerned a certified public accountant's preparation of a corporate tax return for a professional corporation controlled by a physician. The return reflected substantial overstatements of country club dues and subscriptions. An issue of possible violation of section 10.22(a) of Circular 230 (failure to exercise due diligence in the preparation of tax returns) was raised. The practitioner explained that the client was a long-standing one. During his preparation of the returns, he informed the taxpayer he would need substantiation for the deductions claimed and was assured that such records existed. In the practitioner's view, nothing during the engagement indicated a variance generally from the corporation's modus operandi. Consequently, he concluded there was no reason to assume the taxpayer had misrepresented the facts. It was found the practitioner was justified in relying in good faith upon the information provided by the taxpayer. Accordingly, it was determined the certified public accountant had not violated section 10.22(a) of Circular 230, and the matter was closed.

2. A matter referred to the Director of Practice disclosed that the practitioner, an employee of a tax service firm, had submitted a power of attorney to the Internal Revenue Service containing false representations. The practitioner and two co-workers had signed the power of attorney as enrolled agents. Although the practitioner was in fact an enrolled agent, his co-workers were not and thus had misrepresented their status to the Internal Revenue Service. It was alleged that the practitioner knew or should have known of this misrepresentation and had affirmative duties relating to the situation. The practitioner was contacted by the Director of Practice concerning the matter. A possible violation of Subpart C, sections 10.51(b) and 10.51(h) of Circular 230 was raised. In response, the practitioner provided proof that his employment with the firm had terminated before submission of the power of attorney at issue. Further, he represented that the power of attorney was executed by the non-enrolled agents and submitted without his knowledge or approval. Accordingly, it was determined the practitioner had not violated the provisions of Circular 230 and the matter was closed.

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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

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