Internal Revenue
bulletin

Bulletin No. 2002–28
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HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

Rev. Rul. 2002–41, page 75.
Health reimbursement arrangements (HRAs). This ruling describes an employer-provided medical care expense reimbursement plan called a health reimbursement arrangement (HRA), in which reimbursements for medical care expenses made from the plan are excludable from employee gross income. Among other things, the HRA described retains favorable tax treatment because it only reimburses employees or former employees for medical care expenses of the employee or former employee and their spouses and dependents; is solely employer-funded and not paid for directly or indirectly from salary reduction; and although it allows participants to carry forward unused amounts for use in later coverage periods, these amounts may never be used for anything but reimbursements for qualified medical care expenses.

Rev. Rul. 2002–44, page 84.
Short sale of stock. This ruling provides guidance on the timing of recognition of gain or loss on a short sale when stock is purchased to close the short sale using a regular-way sale.

T.D. 8999, page 78.
Final regulations under section 894 of the Code relate to the eligibility for treaty benefits of items of income paid by domestic entities that are not fiscally transparent under U.S. laws, but are fiscally transparent under the laws of the jurisdiction of the person claiming treaty benefits (domestic reverse hybrid entities).

T.D. 9000, page 87.
REG–103735–00; REG–110311–98, page 109.
Final, temporary, and proposed regulations under sections 6011, 6111, and 6112 of the Code modify the disclosure, registration, and list maintenance requirements relating to tax shelters.

REG–107524–00, page 110.
Proposed regulations define whether an organization has a significant trade or business of lending money under section 6050P of the Code for purposes of reporting discharges of indebtedness. A public hearing is scheduled for October 8, 2002.

Notice 2002–45, page 93.
This notice describes the tax treatment of an employer-provided medical care expense reimbursement plan called a health reimbursement arrangement (HRA). The notice explains that to maintain favorable tax treatment, HRAs may only reimburse employees or former employees for their medical care expenses and their spouses' and dependents'. This notice also explains that the requirements for flexible spending arrangements (FSAs) stated in section 125 of the Code are generally not applicable to HRAs. In particular, an HRA may allow a plan participant to carry forward unused reimbursement amounts to be used for medical care expense reimbursements in later coverage periods. Also, this notice explains that to retain exemption from the section 125 FSA requirements, the HRA must be solely employer-funded and cannot be directly or indirectly paid for pursuant to salary reduction election.

(Continued on the next page)

Announcements of Declaratory Judgment Proceedings Under Section 7428 begin on page 114.
Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

Notice 2002–50, page 98.
Partnership straddle tax shelter. This notice advises taxpayers and their representatives that the described transaction, which uses a straddle, a tiered partnership, a transitory partner and the absence of a section 754 election to obtain a permanent non-economic loss, is subject to challenge by the Service on several grounds. The notice holds that the described transaction is now a "listed transaction" and warns of the potential penalties that may be imposed if taxpayers claim losses from such a transaction.

EMPLOYEE PLANS

Rev. Rul. 2002–41, page 75.
Health reimbursement arrangements (HRAs). This ruling describes an employer-provided medical care expense reimbursement plan called a health reimbursement arrangement (HRA), in which reimbursements for medical care expenses made from the plan are excludable from employee gross income. Among other things, the HRA described retains favorable tax treatment because it only reimburses employees or former employees for medical care expenses of the employee or former employee and their spouses and dependents; is solely employer-funded and not paid for directly or indirectly from salary reduction; and although it allows participants to carry forward unused amounts for use in later coverage periods, these amounts may never be used for anything but reimbursements for qualified medical care expenses.

Rev. Rul. 2002–42, page 76.
Merger or conversion; partial termination; notice. This ruling describes a situation where a merger or conversion of a money purchase pension plan into a profit-sharing plan is not a partial termination of the money purchase pension plan and also describes the type of notice that must be given to affected plan participants. Rev. Rul. 94–76 amplified.

Notice 2002–45, page 93.
This notice describes the tax treatment of an employer-provided medical care expense reimbursement plan called a health reimbursement arrangement (HRA). The notice explains that to maintain favorable tax treatment, HRAs may only reimburse employees or former employees for their medical care expenses and their spouses' and dependents'. This notice also explains that the requirements for flexible spending arrangements (FSAs) stated in section 125 of the Code are generally not applicable to HRAs. In particular, an HRA may allow a plan participant to carry forward unused reimbursement amounts to be used for medical care expense reimbursements in later coverage periods. Also, this notice explains that to retain exemption from the section 125 FSA requirements, the HRA must be solely employer-funded and cannot be directly or indirectly paid for pursuant to salary reduction election.

Notice 2002–46, page 96.
Optional forms of benefit; section 645 of EGTRRA; request for comments. This notice requests comments from the public on proposed regulations that will be issued concerning elimination of optional forms of benefit from defined benefit plans.

Notice 2002–47, page 97.
Application of employment taxes to statutory stock options. This notice provides that until Treasury and the Service issue further guidance, in the case of a statutory stock option, the Service will not assess the Federal Insurance Contributions Act (FICA) tax or Federal Unemployment Tax Act (FUTA) tax, or apply federal income tax withholding obligations, upon either the exercise of the option or the disposition of the stock acquired by an employee pursuant to the exercise of the option.

EXCISE TAX

Rev. Rul. 2002–43, page 85.
Prohibited transactions; first tier excise tax calculations. This ruling illustrates the calculation of the first tier prohibited transactions excise taxes in the instance of the use of money where there are multiple excise tax rates.

ADMINISTRATIVE

T.D. 9000, page 87.
REG–103735–00; REG–110311–98, page 109.
Final, temporary, and proposed regulations under sections 6011, 6111, and 6112 of the Code modify the disclosure, registration, and list maintenance requirements relating to tax shelters.

Rev. Proc. 2002–43, page 99.
Agent for the group. This procedure provides instructions relating to the determination of a substitute agent to act on behalf of a consolidated group, pursuant to sections 1.1502–77(d) or 1.1502–77A(d) of the regulations. Procedures are provided for automatic approval of requests by a terminating common parent to designate its qualifying successor as substitute agent.

Rev. Proc. 2002–46, page 105.
Changes in accounting method; non-life insurance companies; automatic consent. This procedure provides certain non-life insurance companies with a safe harbor method of accounting for premium acquisition expenses. This document also provides a procedure for these insurance companies to obtain automatic consent to change to this safe harbor method. Rev. Proc. 2002–9 modified and amplified.

The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Introduction

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

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

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

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

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.

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

Part II.—Treaties and Tax Legislation.

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

Part III.—Administrative, Procedural, and Miscellaneous.

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

Part IV.—Items of General Interest.

This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The first Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the first Bulletin of the succeeding semiannual period, respectively.

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

Section 105.—Amounts Received Under Accident and Health Plans

(Also §§ 106, 125.)

Health Reimbursement Arrangements (HRAs). This ruling describes an employer-provided medical care expense reimbursement plan called a health reimbursement arrangement (HRA), in which reimbursements for medical care expenses made from the plan are excludable from employee gross income. Among other things, the HRA described retains favorable tax treatment because it only reimburses employees or former employees for medical care expenses of the employee or former employee and their spouses and dependents; is solely employer-funded and not paid for directly or indirectly from salary reduction; and although it allows participants to carry forward unused amounts for use in later coverage periods, these amounts may never be used for anything but reimbursements for qualified medical expenses.

Rev. Rul. 2002–41

ISSUE

Whether employer-provided coverage and medical care expense reimbursements made under a reimbursement arrangement that allows unused amounts to be carried forward, as described in Situations 1 and 2 below, are excludable from gross income under §§ 106 and 105 of the Internal Revenue Code, respectively.

FACTS

Situation 1: An employer sponsors a major medical plan for all employees that provides coverage under a policy of accident and health insurance for certain medical care expenses described in § 213(d)(1)(A) and (B). The major medical plan has a $2,000 annual deductible for employee-only coverage and a $4,000 annual deductible for family coverage. However, certain preventive care benefits (*e.g.*, annual physicals and well-baby visits) are covered without regard to the plan's deductible. The major medical plan is paid for in part pursuant to salary reduction elections under the employer's cafeteria plan. The election form provides that salary reduction elections are used only to pay for the major medical plan. To participate in the major medical plan, an employee must make a $1,000 annual salary reduction election for employee-only coverage or a $3,500 annual salary reduction election for family coverage.

In addition to the major medical plan, the employer also sponsors a health reimbursement arrangement (HRA) that reimburses the medical care expenses of all participating employees and their spouses and dependents up to an annual maximum reimbursement amount that is fixed on January 1 of each year. The HRA is available only to employees who participate in the major medical plan. The HRA meets the nondiscrimination requirements of § 105(h).

The HRA is paid for by the employer and employees do not make any salary reduction election to pay for the HRA. The HRA operates on a calendar year basis. Employees have no right to receive cash or any benefit other than reimbursement for medical care expenses under the HRA.

The expenses reimbursable under the HRA are any medical care expenses that would be covered by the major medical plan but for the major medical plan's deductible, limitation to expenses that are "usual, customary and reasonable," or any other similar dollar limitation imposed by the major medical plan. Only expenses that are substantiated are reimbursed.

The maximum reimbursement amount for the first year in which an employee participates in the HRA is $1,000 for an employee who has employee-only coverage under the major medical plan and $2,000 for an employee who has family coverage under the major medical plan. Unused reimbursement amounts from one year are carried forward for use in later years. Therefore, in each year after the first year, the maximum reimbursement amount under the HRA equals $1,000 for an employee who has employee-only coverage under the major medical plan and $2,000 for an employee who has family coverage under the major medical plan, increased by the unused amount from the previous year. If an employee retires or otherwise terminates employment, any unused reimbursement amount remaining in the HRA is unavailable thereafter.

Under the terms of the plans, a qualified beneficiary who chooses to elect COBRA continuation coverage may only elect the HRA in conjunction with the major medical plan. However, a qualified beneficiary may choose to elect COBRA continuation coverage for only the major medical plan. The COBRA applicable premium for continuation of the major medical plan is $1,800 for employee-only coverage and $4,500 for family coverage.

Situation 2: The facts are the same as Situation 1, except that any portion of the maximum reimbursement amount under the HRA that is not applied to reimburse medical care expenses before an employee retires or otherwise terminates employment continues to be available after retirement or termination for any medical care expense under § 213(d)(1)(A), (B), and (D) incurred by the former employee or the former employee's spouse and dependents. However, after the employee retires or otherwise terminates employment, the maximum reimbursement amount is not increased unless COBRA continuation coverage is elected.

LAW AND ANALYSIS

Section 61(a)(1) and § 1.61–21(a)(3) of the Income Tax Regulations provide that, except as otherwise provided in subtitle A, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items.

Section 106 provides that "gross income of an employee does not include employer-provided coverage under an accident or health plan."

Section 1.106–1 provides that the gross income of an employee does not include contributions which the employee's employer makes to an accident or health plan for compensation (through insurance or otherwise) to the employee

for personal injuries or sickness incurred by the employee or the employee's spouse or dependents (as defined in § 152).

Section 105(a) provides that, except as otherwise provided in § 105, "amounts received by an employee through accident or health insurance for personal injuries or sickness shall be included in gross income to the extent such amounts (1) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (2) are paid by the employer."

Section 105(e) states that amounts received under an accident or health plan for employees are treated as amounts received through accident or health insurance for purposes of § 105 (and § 104 relating to compensation for injuries and sickness). Section 1.105–5(a) provides that an accident or health plan is an arrangement for the payment of amounts to employees in the event of personal injuries or sickness.

Section 105(b) states that except in the case of amounts attributable to (and not in excess of) deductions allowed under § 213 (relating to medical expenses) for any prior taxable year, gross income does not include amounts referred to in subsection (a) if such amounts are paid, directly or indirectly, to the taxpayer to reimburse the taxpayer for expenses incurred by the taxpayer for the medical care (as defined in § 213(d)) of the taxpayer or the taxpayer's spouse or dependents (as defined in § 152).

Section 1.105–2 provides that only amounts that are paid specifically to reimburse the taxpayer for expenses incurred by the taxpayer for the prescribed medical care are excludable from gross income. Thus, § 105(b) does not apply to amounts that the taxpayer would be entitled to receive irrespective of whether or not the taxpayer incurs expenses for medical care.

Section 105(h)(1) provides that, unless the plan satisfies the nondiscrimination requirements of § 105(h)(2), amounts paid under a self-insured medical expense reimbursement plan to a highly compensated individual will not be excludable from that individual's gross income under § 105(b) to the extent they constitute excess reimbursements.

Coverage provided under an accident and health plan to former employees and their spouses and dependents are excludable from gross income under § 106. See, Rev. Rul. 82–196, 1982–2 C.B. 53; Rev. Rul. 85–121, 1985–2 C.B. 57.

Under the facts described above, the HRA is an employer-provided accident and health plan used exclusively to reimburse expenses incurred for medical care as defined under § 213(d). Under the HRA, no benefits other than reimbursements for medical care expenses are available either in the form of cash or other non-taxable or taxable benefits at any time.

For purposes of determining whether any part of the salary reduction for the major medical plan is attributable to the HRA, under the facts and circumstances, the applicable premium for COBRA continuation coverage may be used as the actual cost of the major medical plan. Under the facts described above, the actual cost of the major medical plan for one year is $1,800 for employee-only coverage and $4,500 for family coverage. The amount of salary reduction election for employee-only coverage ($1,000) is less than $1,800 and the amount of salary reduction election for family coverage ($3,500) is less than $4,500. Also, the cafeteria plan election form states that salary reduction elections are used only to pay for the major medical plan. Under these facts and circumstances, the HRA reimbursement amounts are not attributable to the salary reduction contributions made to pay for the major medical plan.

In Situation 2, the employer provides accident and health coverage under the HRA for former employees. This coverage is provided based on the former employee's prior employment relationship with the employer. The HRA is used to reimburse the former employee only for medical care expenses of the former employee or the former employee's spouse or dependents. Neither the former employee nor the former employee's spouse or dependents receive any other benefits from the HRA at any time.

HOLDING

Employer-provided coverage and medical care expense reimbursements made under the reimbursement arrangement that allows unused amounts to be carried forward, as described in Situations 1 and 2, are excludable from gross income under §§ 106 and 105, respectively.

See Notice 2002–45 published elsewhere in this Internal Revenue Bulletin for further information and guidance concerning HRAs.

DRAFTING INFORMATION

The principal author of this revenue ruling is Lorianne D. Masano of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this revenue ruling, contact Lorianne D. Masano (202) 622–6080 (not a toll-free call).

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

(Also, §§ 411, 4980F; 26 CFR 1.411(d)–2.)

Rev. Rul. 2002–42

Merger or conversion; partial termination; notice. This ruling describes a situation where a merger or conversion of a money purchase pension plan into a profit-sharing plan is not a partial termination of the money purchase pension plan and also describes the type of notice that must be given to affected plan participants.

ISSUES

1. Whether, in the absence of other facts indicating a partial termination, the merger or conversion of a money purchase pension plan into a profit-sharing plan results in a partial termination of the money purchase pension plan under § 411(d)(3) of the Internal Revenue Code (the Code).

2. Whether the notice required by § 4980F of the Code and section 204(h) of the Employee Retirement Income Security Act of 1974, as amended (ERISA) must be provided to affected individuals in a money purchase pension plan that is merged or converted into a profit-sharing plan.

FACTS

Situation 1. Employer J maintains a money purchase pension plan qualifying under § 401(a) of the Code. The plan provides that upon a termination or partial termination of the plan, all affected participants will vest 100% in their account balances. Employer J converts the money purchase pension plan into a profit-sharing plan that covers the same employees as the money purchase pension plan and contains the same vesting schedule. It also provides that assets and liabilities in the profit-sharing plan that originated in the money purchase pension plan retain their money purchase pension plan attributes, in accordance with Rev. Rul. 94–76, 1994–2 C.B. 46.

Situation 2. Employer L maintains a money purchase pension plan qualifying under § 401(a). This plan provides that upon a termination or partial termination of the plan all affected participants will vest 100% in their account balances. Employer L also maintains a profit-sharing plan qualifying under § 401(a). L amends the money purchase pension plan to cease future employer contributions and to merge it into the profit-sharing plan in a transaction that satisfies the requirements of § 414(*l*). Following the merger, the profit-sharing plan covers the same employees and contains the same vesting schedule as the money purchase pension plan. Simultaneously, L amends the profit-sharing plan to provide that assets and liabilities transferred from the money purchase pension plan to the profit-sharing plan retain their money purchase pension plan attributes, in accordance with Rev. Rul. 94–76.

LAW AND ANALYSIS

Section 411(d)(3)

Section 411(d)(3) requires that a plan provide that upon its termination or partial termination the rights of all affected parties accrued to the date of such termination or partial termination, to the extent funded as of such date, or the amounts credited to the employees' accounts, are nonforfeitable.

Section 1.411(d)–2(b)(1) of the Income Tax Regulations provides that whether or not a partial termination of a defined contribution or defined benefit plan has occurred is dependent on the facts and circumstances in a particular case. Such facts and circumstances include: the exclusion, by reason of a plan amendment or severance by the employer, of a group of employees who have previously been covered by the plan; and plan amendments which adversely affect the rights of employees to vest in benefits under the plan. Section 1.411(d)–2(b)(2) contains a special rule providing that if a defined benefit plan ceases or decreases future benefit accruals under the plan, a partial termination shall be deemed to occur if, as a result of such cessation or decrease, a potential reversion to the employer maintaining the plan (determined as of the date such cessation or decrease is adopted) is created or increased.

Section 1.401(a)–2(b) provides that a plan may provide that upon the plan's termination assets held in a § 415 suspense account may revert to the employer.

Section 1.415–6(b)(6) describes how amounts in a § 415 suspense account must be allocated to participants before any amount in the § 415 suspense account may revert to the employer on plan termination.

Rev. Rul. 85–6, 1985–1 C.B. 133, provides that a defined benefit plan that has surplus resulting from actuarial error may allow that surplus to revert to the employer upon termination of the plan.

Rev. Rul. 80–155, 1980–1 C.B. 84, provides that a profit-sharing, stock bonus, or money purchase pension plan (*i.e.*, a defined contribution plan) will not satisfy plan qualification requirements unless all funds are allocated to participants' accounts under the plan in accordance with a definite formula (although certain exceptions are allowed, such as the use of a suspense account in accordance with the requirements of § 415 of the Code).

Rev. Rul. 94–76 provides that, under § 414(*l*), the transfer of assets and liabilities from a money purchase pension plan to a profit-sharing plan is considered a spinoff of those assets and liabilities from the money purchase pension plan and a merger of those assets and liabilities with the assets and liabilities of the profit-sharing plan. The merger does not divest the assets and liabilities of the money purchase pension plan of their attributes as money purchase pension plan assets and liabilities. The holding in Rev. Rul. 94–76 is applicable when an employer converts a money purchase pension plan into a profit-sharing plan.

The special rule provided in § 1.411(d)–2(b)(2) for determining whether a partial termination has occurred is limited to defined benefit plans. The listed facts and circumstances in § 1.411(d)–2(b)(1) do not include the creation of a potential reversion as a factor to be considered in determining whether there has been a partial termination of a defined contribution plan. Unlike a defined benefit plan, in a defined contribution plan all assets must be allocated to participants' accounts with the exception of amounts held in a § 415 suspense account. Therefore, on the termination of a defined contribution plan, the only amounts that may revert to the employer are amounts in a § 415 suspense account and then only to the extent amounts in the § 415 suspense account are not required to be allocated as provided under § 1.415–6(b)(6). In a defined contribution plan, the cessation or reduction of benefit accruals does not create or increase the potential for reversion. Accordingly, the creation or increase of a potential reversion is not a relevant fact or circumstance in determining whether there has been a partial termination in a defined contribution plan as a result of the cessation or reduction of benefit accruals.

In Situations 1 and 2, all of the employees who are covered by the converted or merged money purchase plan remain covered under the continuing profit-sharing plan, the money purchase plan assets and liabilities retain their characterization under the profit-sharing plan, and the employees vest in the continuing profit-sharing plan under the same vesting schedule that existed under the money purchase plan. Under these facts and circumstances, no partial termination has occurred.

Section 4980F of the Code and § 204(h) of ERISA

ERISA § 204(h), as amended by § 659(b) of the Economic Growth and Tax Relief Reconciliation Act of 2001, Public Law 107–16 (EGTRRA), provides that a defined benefit pension plan or an individual account plan subject to the funding standards of § 412 of the Code not be amended to provide a significant reduction in the rate of future benefit accrual unless the plan administrator provides a notice describing the reduction to each affected individual whose benefit is adversely affected by the reduction and to each employee organization representing these individuals.

Section 4980F, as added by § 659(a) of EGTRRA, provides for an excise tax if a defined benefit pension plan or an individual account plan subject to the funding standards of § 412 is amended to provide a significant reduction in the rate of future benefit accrual and the plan administrator does not provide a notice describing the reduction to each affected individual whose benefit is adversely affected by the reduction and to each employee organization representing these individuals.

If a money purchase plan is converted or merged into a profit-sharing plan, there is necessarily a significant reduction in the rate of future benefit accrual under the money purchase plan requiring notice under § 4980F of the Code and § 204(h) of ERISA. Allocations under the profit-sharing plan are not benefit accruals under the money purchase plan for purposes of determining if there is a reduction in the rate of future benefit accrual for purposes of § 4980F of the Code and § 204(h) of ERISA. A profit-sharing plan is neither subject to § 4980F of the Code or § 204(h) of ERISA. Consequently, a notice is required to be given to affected individuals under § 4980F of the Code and § 204(h) of ERISA.

HOLDINGS

Issue 1. In the absence of other facts, the merger or conversion of a money purchase pension plan into a profit-sharing plan does not result in a partial termination of the money purchase pension plan under § 411(d)(3) of the Code. Under either the facts in Situation 1 or 2 there is no partial termination.

Issue 2. The notice required by § 4980F of the Code and § 204(h) of ERISA must be provided to affected individuals in a money purchase pension plan that is merged or converted into a profit-sharing plan. Under the facts in either Situation 1 or 2, the notice must be given to affected individuals.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 94–76 is amplified.

DRAFTING INFORMATION

The principal author of this revenue ruling is Andrew Zuckerman of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this revenue ruling, please contact the Employee Plans' taxpayer assistance telephone service at 1–877–829–5500 (a toll-free number), between the hours of 8:00 a.m. and 6:30 p.m. Eastern time, Monday through Friday. Mr. Zuckerman may be reached at 1–202–283–9655 (not a toll-free number).

Section 411.—Minimum Vesting Standards

26 CFR 1.411(d)–2: Termination or partial termination; discontinuance of contributions.

Whether, in the absence of other facts, the merger or conversion of a money purchase pension plan into a profit-sharing plan creates or increases a potential for reversion that results in a partial termination of the money purchase pension plan. See Rev. Rul. 2002–42, page 76.

Section 894.—Income Affected by Treaty

26 CFR 1.894–1: Income affected by treaty.

T.D. 8999

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Treaty Guidance Regarding Payments With Respect to Domestic Reverse Hybrid Entities

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations under section 894 relating to the eligibility for treaty benefits of items of income paid by domestic entities that are not fiscally transparent under U.S. law but are fiscally transparent under the laws of the jurisdiction of the person claiming treaty benefits (domestic reverse hybrid entities). The regulations affect the determination of tax treaty benefits with respect to U.S. source income of foreign persons.

DATES: *Effective Date*: These regulations are effective June 12, 2002.

Applicability Date: These regulations are applicable to items of income paid by a domestic reverse hybrid entity on or after June 12, 2002, with respect to amounts received by the domestic reverse hybrid entity on or after June 12, 2002.

FOR FURTHER INFORMATION CONTACT: Elizabeth U. Karzon at (202) 622–3880 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On February 27, 2001, the IRS and Treasury published a notice of proposed rulemaking (REG–107101–00, 2001–1 C.B 1083) in the **Federal Register** (66 FR 12445) under section 894 relating to whether payments made by domestic reverse hybrid entities to their interest holders are eligible for benefits under income tax treaties. A limited number of comments responding to the notice of proposed rulemaking were received. After consideration of these comments, the proposed regulations are adopted as final regulations as revised by this Treasury decision.

Explanation of Provisions

I. *General*

These final section 894 regulations clarify the availability of treaty benefits on payments made by a domestic reverse hybrid entity (DRH) to its interest holders. A DRH is a U.S. entity that the United States treats as non-fiscally transparent (*e.g.*, as a corporation), but the interest holder's country treats as fiscally transparent (*e.g.*, as a partnership or branch). These regulations are the final piece of guidance associated with section 894 regulations finalized on July 3, 2000 (T.D. 8889, 2000–2 C.B. 124 [65 FR 40993]) (the "2000 regulations"), that generally address the availability of treaty benefits on items of U.S. source income paid to hybrid entities (*i.e.*, entities treated as fiscally transparent by one jurisdiction but non-fiscally transparent by another).

The preamble to the 2000 regulations noted that the IRS and Treasury had learned that non-U.S. multinationals were establishing DRH structures in the United States to manipulate the U.S. tax treaty network to obtain tax-advantaged financing. The IRS and Treasury notified the public in that preamble that they intended to issue regulations to address this situation.

Proposed regulations were issued on February 27, 2001. The proposed regulations provided guidance with respect to two distinct issues involving domestic reverse hybrid entities. First, to resolve a technical question raised by commentators regarding the application of the 2000 regulations, the proposed regulations clarified that a payment by a domestic reverse hybrid entity to a foreign interest holder may be eligible for treaty benefits. No comments were received on this portion of the proposed regulations, and the rule in the proposed regulations is accordingly adopted without change in these final regulations.

The proposed regulations also addressed certain structures involving domestic reverse hybrid entities that Treasury and the IRS believed represented the use of such entities to obtain inappropriate treaty benefits. The comments received in response to this portion of the proposed regulations generally confirmed the need for regulations to address the use of DRH structures by non-U.S. companies. One commentator wrote in its comment that "regulations addressing the DRH structure are appropriate." The commentator noted that DRH structures are "relatively uncommon" with the exception of their use by highly sophisticated non-U.S. multinational groups to procure acquisition financing at a tax-advantaged rate vis-a-vis their U.S. competitors.

Several commentators expressed concern that the approach taken in the proposed DRH regulations might erode the simplicity achieved by the section 7701 entity classification rules, known as the Check-the-Box (CTB) regulations. The IRS and Treasury have carefully considered this comment, but continue to believe that the approach in these final regulations is appropriate. The regulations only apply to a DRH structure established by a group of taxpayers related to each other by 80% common ownership. This high ownership requirement minimizes the possibility that a taxpayer might inadvertently establish such a structure. In addition, the comments confirm that DRH structures remain "relatively uncommon." Thus, any loss of the simplification benefits of the CTB regulations also will be relatively uncommon.

One commentator suggested that, rather than adopt the approach in the regulations, the IRS and Treasury should pursue an approach under section 1503(d) to directly address structures similar to, and potentially including, the DRH that rely on hybrid entity structures to deduct the same interest expense in two jurisdictions (commonly called a "double dip" of interest deductions) to achieve tax-advantaged financing. The commentator expressed the view that the real concern of the IRS and Treasury should be this double dip on deductions, rather than the tax treaty manipulation present in DRH structures.

Treasury and the IRS agree that a re-examination of the rules of section 1503(d) and the policies underlying those rules may be appropriate. Such a re-examination will require substantial and careful analysis with respect to the interaction of U.S. and foreign law in a variety of contexts and is therefore beyond the scope of these regulations, which, as noted above, focus on the use of DRH structures to obtain inappropriate treaty benefits.

In this regard, the commentator misconstrues the concern of the IRS and Treasury with respect to the issues associated with the use of DRH structures. Treasury and the IRS are concerned that DRH structures are being established by related parties to manipulate differences in U.S. and foreign entity classification rules to reduce, through inappropriate use of an income tax treaty, the amount of tax imposed on items of income paid by domestic corporations to related foreign companies. The overall effect of these transactions, if respected, would be (1) a deduction under U.S. law for the "outbound" payment of an item of income, (2) the reduction or elimination of U.S. withholding tax on that item of income under an applicable treaty, and (3) the imposition of little or no tax by the treaty partner on the item of income. This result is inconsistent with the expectation of the United States and its treaty partners that treaties should be used to reduce or eliminate double taxation of income. The legislative history of section 894(c) supports this analysis. Congress specifically expressed its concern about the use of income tax treaties to manipulate the inconsistencies between U.S. and foreign tax laws to obtain similar benefits. See H.R. Conf. Rep. No 220, 105th Cong., 1st Sess. 573 (1997); Joint Committee on Taxation, 105th Cong., 1st Sess., General Explanation of Tax Legislation Enacted in 1997 (JCS–23–97), at 249 (December 17, 1997). The approach adopted by these regulations also is consistent with the U.S. view that contracting states to an income tax treaty may adopt provisions in their domestic laws to prevent inappropriate use of the treaty. See, *e.g.*, the Treasury Department Technical Explanation to Article 22 (Limitation on Benefits) of the 1996 United States Model Income Tax Convention. See also Commentaries to Article 1 of the 2000 OECD Model Tax Convention on Income and Capital; S. Rep. No. 445, 100th Cong. 2d Sess. 322–23 (1988).

Another commentator questioned Treasury's authority for issuing the regulations, arguing that the recharacterization of an interest payment as a dividend payment may contravene the definition of interest contained in various U.S. treaties.

The IRS and Treasury have concluded that the regulations are consistent with U.S. law, including U.S. treaties. These final regulations are issued under the authority of sections 894(a), 894(c), 7805 and 7701(l). Further, as noted above, contracting states to an income tax treaty may adopt provisions in their domestic laws to counter inappropriate uses of the treaty. *Id*.

II. *Comments and Changes to § 1.894–1(d)(2)(ii)(B)(1): Payment Made to Related Foreign Interest Holder*

Section 1.894–1(d)(2)(ii)(B)(*1*) of the proposed regulations provided a special rule that was generally targeted at payments made by a domestic reverse hybrid entity to a foreign parent of the domestic reverse hybrid entity. This rule would apply if: (1) a domestic subsidiary made a payment to a domestic reverse hybrid entity, the payment was considered to be a dividend either under the laws of the United States or under the laws of the jurisdiction of the foreign parent of the domestic reverse hybrid entity, and the domestic reverse hybrid entity was treated as a fiscally transparent, or "pass-through," entity under the foreign parent's laws; and (2) the domestic reverse hybrid entity made a deductible payment to the foreign parent that otherwise would qualify for a treaty-based reduction in U.S. withholding tax. Under these circumstances, the proposed regulations provided that the payment by the domestic reverse hybrid entity would be treated as a dividend for all purposes of the Internal Revenue Code and the applicable income tax treaty, but only to the extent of the foreign parent's proportionate share of the prior dividend payments made to the domestic reverse hybrid entity by the domestic subsidiary.

Commentators recommended the inclusion of a tax avoidance purpose test in the final regulations. As part of this approach, commentators suggested consideration of several factors, including the ability of the domestic reverse hybrid entity to satisfy the debt independent of dividends or payments from the domestic entity, and the amount of time between the time the related foreign interest holder, the domestic reverse hybrid entity, and the domestic entity became related persons and the incurrence of the intercompany debt. This recommendation was not adopted. These regulations are intended to provide objective rules regarding eligibility for treaty benefits on certain items of U.S. source income paid by domestic reverse hybrid entities.

Commentators requested clarification that paragraph (d)(2)(ii)(B) does not apply to payments made by a domestic reverse hybrid entity that would not be subject to withholding tax without regard to a treaty. Commentators are correct in reading the regulations to provide that paragraph (d)(2)(ii)(B) will not apply if the payment made by the domestic reverse hybrid entity is exempt from withholding tax under the Internal Revenue Code. Commentators also requested clarification that the regulations apply only to payments received by the domestic reverse hybrid entity while it is related to both the domestic entity and the related foreign interest holder, and to payments made by the domestic reverse hybrid entity while it is related to the related foreign interest holder. The text of these regulations also confirms this result. Accordingly, no changes to the regulations were considered necessary on either of these points.

As a general matter, commentators questioned whether paragraph (d)(2)(ii)(B)(*1*) of the regulations applies to a situation in which the dividend withholding rate under the applicable income tax treaty is lower than the withholding rate for interest under the treaty. The regulations do not make the recharacterization of the deductible payment dependent on the withholding rates in the applicable income tax treaty. Therefore, if the requirements of the regulations are met, the regulations will apply regardless of whether the dividend withholding rate is higher than the withholding rate for interest or other deductible payments in the applicable income tax treaty. An example to this effect has been added to the final regulations.

III. *Comments and Changes to § 1.894–1(d)(2)(ii)(B)(3): Definition of Related*

Paragraph (d)(2)(ii)(B)(*3*) of the proposed regulations defined the term *related* for purposes of determining whether a domestic entity made a dividend payment to a related domestic reverse hybrid entity, and for purposes of determining whether a domestic reverse hybrid entity made a payment to a related foreign interest holder. The ownership requirements set forth in section 267(b) or 707(b)(1), the constructive ownership rules of sections 318, and attribution rules of section 267(c) were used solely to determine whether an entity was "related" for purposes of paragraph (d)(2)(ii)(B); and not to determine if the entity was an interest holder.

Commentators consequently have questioned whether corporations that do not own any stock directly in the domestic reverse hybrid entity, but are related to the domestic reverse hybrid entity within the meaning of paragraph (d)(2)(ii)(B)(*3*), can be interest holders, and, therefore, related foreign interest holders for purposes of paragraph (d)(2)(ii)(B). For example, commentators questioned whether the regulations apply if a domestic reverse hybrid entity, which has received a dividend payment from a related domestic entity, makes an interest payment to a foreign sister corporation of the domestic reverse hybrid entity which is not itself a shareholder in the domestic reverse hybrid entity. Commentators believe that the application of the regulations to a foreign sister corporation should depend on whether that corporation is part of a "consolidated group" under the laws of the jurisdiction of the foreign parent.

The IRS and Treasury generally agree with this position. Paragraph (d)(2)(ii)(B)(*ii*) of the final regulations provides that a payment to a person, wherever organized, the income and losses of which are available, under the laws of the jurisdiction of the related foreign interest holder, to offset the income and losses of a related foreign interest holder, will be treated as a payment to a related foreign interest holder, and the regulations will apply. Examples have been added to the final regulations illustrating these principles.

Paragraph (d)(2)(ii)(B)(*3*) of the proposed regulations also contained a special rule that would treat certain accommodation parties as related foreign interest holders. Pursuant to the rule in the proposed regulations, if a person entered into a transaction with a domestic reverse hybrid entity, its related interest holder, or

other related entity, and the effect of the transaction was to avoid the principles of these regulations, then that person would be treated as related to the domestic reverse hybrid entity for purposes of this section. Commentators expressed concern that this language could encompass legitimate dealings with unrelated third parties. For example, an unrelated foreign bank that makes a loan to a domestic reverse hybrid entity and receives interest payments under the loan could be treated as related to the domestic reverse hybrid entity under paragraph (d)(2)(ii)(B)(*3*). In recognition of the fact that the special rule in paragraph (d)(2)(ii)(B)(*3*) was potentially overbroad and created uncertainty as to its application, the rule was deleted.

IV. *Comments and Changes to §1.894–1(d)(2)(ii)(C): Commissioner's discretion.*

Paragraph (d)(2)(ii)(C) of the proposed regulations provided the Commissioner with the authority to recharacterize, for all purposes of the Internal Revenue Code, all or part of any transaction (or series of transactions) between related parties if the effect of the transaction was to avoid the principles of paragraph (d)(2)(ii)(B). Commentators also questioned the scope of this provision and requested the inclusion of examples of situations in which the Commissioner would not exercise his discretion and situations in which the Commissioner may exercise his discretion. Commentators were concerned that this provision would allow the Commissioner to apply the regulations to legitimate, non-abusive transactions involving domestic reverse hybrid entities.

In response to these comments, and in recognition of the potentially overbroad reach of the proposed provision, paragraph (d)(2)(ii)(C) has been modified in the final regulations to narrow its scope and clarify the circumstances under which the provision will apply. Thus, under paragraph (d)(2)(ii)(C)(*1*) of the final regulations (which applies to transactions involving related parties), the Commissioner has authority to recharacterize a transaction only if the following conditions are met: (1) A deductible payment is made to a person who is related, as that term is defined in paragraph (d)(2)(ii)(B)(*3*), to the domestic reverse hybrid entity (but is not otherwise described in paragraph (d)(2)(ii)(B)(*1*)(*ii*)); and (2) that payment is made in connection with one or more transactions the effect of which is to avoid the application of paragraph (d)(2)(ii)(B). If paragraph (d)(2)(ii)(C)(*1*) applies, the Commissioner is authorized to treat the deductible payment as if it were received directly by the related foreign interest holder in the domestic reverse hybrid entity.

In addition, paragraph (d)(2)(ii)(C)(*2*) of the final regulations (which applies to transactions involving an unrelated "middleman") provides that the Commissioner may treat a deductible payment made by a domestic reverse hybrid entity to an unrelated person as being made directly to a related foreign interest holder if: (1) the unrelated person (or other person (whether related or not) which receives a payment in a series of transactions that includes a transaction involving such unrelated person) makes a payment to the related foreign interest holder (or other person described in paragraph (d)(2)(ii)(B)(*1*)(*ii*)); (2) the payment to the unrelated person and the payment to the related foreign interest holder are made in connection with a series of transactions which constitute a financing arrangement, as defined in § 1.881–3(a)(2)(i); and (3) the transactions have the effect of avoiding the application of paragraph (d)(2)(ii)(B) of this section. An example has been added to illustrate the principles contained in this revised paragraph (d)(2)(ii)(C)(*2*).

To the extent the Commissioner recharacterizes a deductible payment as a distribution within the meaning of section 301(a) under this paragraph (d)(2)(ii)(C), the payment will be treated as such for all purposes of the Internal Revenue Code and the applicable income tax treaty.

Special Analysis

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

Drafting Information

The principal author of these regulations is Karen A. Rennie-Quarrie of the Office of the Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. In § 1.894–1, paragraphs (d)(2)(ii) and (d)(2)(iii) are added and paragraph (d)(6) is revised to read as follows:

§ 1.894–1 Income affected by treaty.

* * * * *

(d) * * *

(2) * * *

(ii) *Payments by domestic reverse hybrid entities*—(A) *General rule*. Except as otherwise provided in paragraph (d)(2)(ii)(B) of this section, an item of income paid by a domestic reverse hybrid entity to an interest holder in such entity shall have the character of such item of income under U.S. law and shall be considered to be derived by the interest holder, provided the interest holder is not fiscally transparent in its jurisdiction, as defined in paragraph (d)(3)(iii) of this section, with respect to the item of income. In determining whether the interest holder is fiscally transparent with

respect to the item of income under this paragraph (d)(2)(ii)(A), the determination under paragraph (d)(3)(ii) of this section shall be made based on the treatment that would have resulted had the item of income been paid by an entity that is not fiscally transparent under the laws of the interest holder's jurisdiction with respect to any item of income.

(B) *Payment made to related foreign interest holder*—(1) *General rule*. If—

(*i*) A domestic entity makes a payment to a related domestic reverse hybrid entity that is treated as a dividend under either the laws of the United States or the laws of the jurisdiction of a related foreign interest holder in the domestic reverse hybrid entity, and under the laws of the jurisdiction of the related foreign interest holder in the domestic reverse hybrid entity, the related foreign interest holder is treated as deriving its proportionate share of the payment under the principles of paragraph (d)(1) of this section; and

(*ii*) The domestic reverse hybrid entity makes a payment of a type that is deductible for U.S. tax purposes to the related foreign interest holder or to a person, wherever organized, the income and losses of which are available, under the laws of the jurisdiction of the related foreign interest holder, to offset the income and losses of the related foreign interest holder, and for which a reduction in U.S. withholding tax would be allowed under an applicable income tax treaty; then

(*iii*) To the extent the amount of the payment described in paragraph (d)(2)(ii)(B)(*1*)(*ii*) of this section does not exceed the sum of the portion of the payment described in paragraph (d)(2)(ii)(B)(*1*)(*i*) of this section treated as derived by the related foreign interest holder and the portion of any other prior payments described in paragraph (d)(2)(ii)(B)(*1*)(*i*) of this section treated as derived by the related foreign interest holder, the amount of the payment described in (d)(2)(ii)(B)(*1*)(*ii*) of this section will be treated for all purposes of the Internal Revenue Code and any applicable income tax treaty as a distribution within the meaning of section 301(a) of the Internal Revenue Code, and the tax to be withheld from the payment described in paragraph (d)(2)(ii)(B)(*1*)(*ii*) of this section (assuming the payment is a dividend under section 301(c)(1) of the Internal Revenue Code) shall be determined based on the appropriate rate of withholding that would be applicable to dividends paid from the domestic reverse hybrid entity to the related foreign interest holder in accordance with the principles of paragraph (d)(2)(ii)(A) of this section.

(2) *Determining amount to be recharacterized under paragraph (d)(2)(ii)(B)(1)(iii)*. For purposes of determining the amount to be recharacterized under paragraph (d)(2)(ii)(B)(*1*)(*iii*) of this section, the portion of the payment described in paragraph (d)(2)(ii)(B)(*1*)(*i*) of this section treated as derived by the related foreign interest holder shall be increased by the portion of the payment derived by any other person described in paragraph (d)(2)(ii)(B)(*1*)(*ii*), and shall be reduced by the amount of any prior section 301(c) distributions made by the domestic reverse hybrid entity to the related foreign interest holder or any other person described in paragraph (d)(2)(ii)(B)(*1*)(*ii*) and by the amount of any payments from the domestic reverse hybrid entity previously recharacterized under paragraph (d)(2)(ii)(B)(*1*)(*iii*) of this section.

(3) *Tiered entities*. The principles of this paragraph (d)(2)(ii)(B) also shall apply to payments referred to in this paragraph (d)(2)(ii)(B) made among related entities when there is more than one domestic reverse hybrid entity or other fiscally transparent entity involved.

(4) *Definition of related*. For purposes of this section, a person shall be treated as related to a domestic reverse hybrid entity if it is related by reason of the ownership requirements of section 267(b) or 707(b)(1), except that the language "at least 80 percent" applies instead of "more than 50 percent," where applicable. For purposes of determining whether a person is related by reason of the ownership requirements of section 267(b) or 707(b)(1), the constructive ownership rules of section 318 shall apply, and the attribution rules of section 267(c) also shall apply to the extent they attribute ownership to persons to whom section 318 does not attribute ownership.

(C) *Payments to persons not described in paragraph (d)(2)(ii)(B)(1)(ii)*—(*1*) Related persons. The Commissioner may treat a payment by a domestic reverse hybrid entity to a related person (who is neither the related foreign interest holder nor otherwise described in paragraph (d)(2)(ii)(B)(*1*)(*ii*) of this section), in whole or in part, as being made to a related foreign interest holder for purposes of applying paragraph (d)(2)(ii)(B) of this section, if —

(*i*) The payment to the related person is of a type that is deductible by the domestic reverse hybrid entity; and

(*ii*) The payment is made in connection with one or more transactions the effect of which is to avoid the application of paragraph (d)(2)(ii)(B) of this section.

(*2*) *Unrelated persons*. The Commissioner may treat a payment by a domestic reverse hybrid entity to an unrelated person, in whole or in part, as being made to a related foreign interest holder for purposes of applying paragraph (d)(2)(ii)(B) of this section, if —

(*i*) The payment to the unrelated person is of a type that is deductible by the domestic reverse hybrid entity;

(*ii*) The unrelated person (or other person (whether related or not) which receives a payment in a series of transactions that includes a transaction involving such unrelated person) makes a payment to the related foreign interest holder (or other person described in paragraph (d)(2)(ii)(B)(*1*)(*ii*));

(*iii*) The foregoing payments are made in connection with a series of transactions which constitute a financing arrangement, as defined in § 1.881–3(a)(2)(i); and

(*iv*) The transactions have the effect of avoiding the application of paragraph (d)(2)(ii)(B) of this section.

(iii) *Examples*. The rules of this paragraph (d)(2) are illustrated by the following examples:

Example 1. Dividend paid by unrelated entity to domestic reverse hybrid entity. (i) *Facts*. Entity A is a domestic reverse hybrid entity, as defined in paragraph (d)(2)(i) of this section, with respect to the U.S. source dividends it receives from B, a domestic corporation to which A is not related within the meaning of paragraph (d)(2)(ii)(B)(*4*) of this section. A's 85-percent shareholder, FC, is a corporation organized under the laws of Country X, which has an income tax treaty in effect with the United States. A's remaining 15-percent shareholder is an unrelated domestic corporation. Under Country X law, FC is not fiscally transparent with respect to the dividend, as defined in paragraph (d)(3)(ii) of this section. In year 1, A receives $100 of dividend income from B. Under Country X law, FC is treated as deriving $85 of the $100 dividend payment received by A. The applicable rate of tax on dividends under the U.S.-Country X income tax treaty is 5 percent with respect to a 10-percent or more corporate shareholder.

(ii) *Analysis*. Under paragraph (d)(2)(i) of this section, the U.S.-Country X income tax treaty does not apply to the dividend income received by A because the payment is made by B, a domestic corporation, to A, another domestic corporation. A remains fully taxable under the U.S. tax laws as a domestic corporation with regard to that item of income. Further, pursuant to paragraph (d)(2)(i) of this section, notwithstanding the fact that A is treated as fiscally transparent with respect to the dividend income under the laws of Country X, FC may not claim a reduced rate of taxation on its share of the U.S. source dividend income received by A.

Example 2. Interest paid by domestic reverse hybrid entity to related foreign interest holder where dividend is paid by unrelated entity. (i) *Facts*. The facts are the same as in *Example 1*. Both the United States and Country X characterize the payment by B in year 1 as a dividend. In addition, in year 2, A makes a payment of $25 to FC that is characterized under the Internal Revenue Code as interest on a loan from FC to A. Under the U.S.-Country X income tax treaty, the rate of tax on interest is zero. Under Country X laws, had the interest been paid by an entity that is not fiscally transparent under Country X's laws with respect to any item of income, FC would not be fiscally transparent as defined in paragraph (d)(2)(ii) of this section with respect to the interest.

(ii) *Analysis*. The analysis is the same as in *Example 1* with respect to the $100 payment from B to A. With respect to the $25 payment from A to FC, paragraph (d)(2)(ii)(B) of this section will not apply because, although FC is a related foreign interest holder in A, A is not related to B, the payor of the dividend income it received. Under paragraph (d)(2)(ii)(A) of this section, the $25 of interest paid by A to FC in year 2 is characterized under U.S. law as interest. Accordingly, in year 2, A is entitled to an interest deduction with respect to the $25 interest payment from A to FC, and FC is entitled to the reduced rate of withholding applicable to interest under the U.S.-Country X income tax treaty, assuming all other requirements for claiming treaty benefits are met.

Example 3. Interest paid by domestic reverse hybrid entity to related foreign interest holder where dividend is paid by a related entity. (i) *Facts*. The facts are the same as in *Example 2*, except the $100 dividend income received by A in year 1 is from A's wholly-owned subsidiary, S.

(ii) *Analysis*. The analysis is the same as in *Example 1* with respect to the $100 dividend payment from S to A. However, the $25 interest payment in year 2 by A to FC will be treated as a dividend for all purposes of the Internal Revenue Code and the U.S.-Country X income tax treaty because $25 does not exceed FC's share of the $100 dividend payment made by S to A ($85). Since FC is not fiscally transparent with respect to the payment as determined under paragraph (d)(2)(ii)(A) of this section, FC is entitled to the reduced rate applicable to dividends under the U.S.-Country X income tax treaty with respect to the $25 payment. Because the $25 payment in year 2 is recharacterized as a dividend for all purposes of the Internal Revenue Code and the U.S.-Country X income tax treaty, A is not entitled to an interest deduction with respect to that payment and FC is not entitled to claim the reduced rate of withholding applicable to interest.

Example 4. Definition of related foreign interest holder. (i) *Facts*. The facts are the same as in *Example 3*, except that A has two 50-percent shareholders, FC1 and FC2. In year 2, A makes an interest payment of $25 to both FC1 and FC2. FC1 is a corporation organized under the laws of Country X, which has an income tax treaty in effect with the United States. FC2 is a corporation organized under the laws of Country Y, which also has an income tax treaty in effect with the United States. FP owns 100-percent of both FC1 and FC2, and is organized under the laws of Country X. Under Country X law, FC1 is not fiscally transparent with respect to the dividend, as defined in paragraph (d)(3)(ii) of this section. Under Country X law, FC1 is treated as deriving $50 of the $100 dividend payment received by A because A is fiscally transparent under the laws of Country X, as determined under paragraph (d)(3)(iii) of this section. The applicable rate of tax on dividends under the U.S.-Country X income tax treaty is 5-percent with respect to a 10-percent or more corporate shareholder. Under Country Y law, FC2 is not treated as deriving any of the $100 dividend payment received by A because, under the laws of Country Y, A is not a fiscally transparent entity.

(ii) *Analysis*. The analysis is the same as in *Example 1* with respect to the $100 dividend payment from S to A. With respect to the $25 payment in year 2 by A to FC1, the payment will be treated as a dividend for all purposes of the Internal Revenue Code and the U.S.-Country X income tax treaty because FC1 is a related foreign interest holder as determined under paragraph (d)(2)(ii)(B)(*4*) of this section, and because $25 does not exceed FC1's share of the dividend payment made by S to A ($50). FC1 is a related foreign interest holder because FC1 is treated as owning the stock of A owned by FC2 under section 267(b)(3). Since FC1 is not fiscally transparent with respect to the payment as determined under paragraph (d)(2)(ii)(A) of this section, FC1 is entitled to the 5-percent reduced rate applicable to dividends under the U.S.-Country X income tax treaty with respect to the $25 payment. Because the $25 payment in year 2 is recharacterized as a dividend for all purposes of the Internal Revenue Code and the U.S.-Country X income tax treaty, A is not entitled to an interest deduction with respect to that payment. Even though FC2 is also a related foreign interest holder, the $25 interest payment by A to FC2 in year 2 is not recharacterized because A is not fiscally transparent under the laws of Country Y, and FC2 is not treated as deriving any of the $100 dividend payment received by A. Thus, the U.S.-Country Y income tax treaty is not implicated.

Example 5. Higher treaty withholding rate on dividends. (i) *Facts*. The facts are the same as in *Example 3*, except that under the U.S.-Country X income tax treaty, the rate of tax on interest is 10-percent and the rate of tax on dividends is 5-percent.

(ii) *Analysis*. The analysis is the same as in *Example 1* with respect to the $100 dividend payment from S to A. The analysis is the same as in *Example 3* with respect to the $25 interest payment in year 2 from A to FC.

Example 6. Foreign sister corporation the income and losses of which may offset the income and losses of related foreign interest holder. (i) *Facts*. The facts are the same as *Example 3*, except that in year 2, A makes the interest payment of $25 to FS, a subsidiary of FC also organized in Country X. Under the laws of Country X, FS is not fiscally transparent with respect to the interest payment, and the income and losses of FS may be used to offset the income and losses of FC.

(ii) *Analysis*. The analysis is the same as in *Example 1* with respect to the $100 dividend payment from S to A. With respect to the $25 interest payment from A to FS in year 2, FS is a person described in paragraph (d)(2)(ii)(B)(*1*)(*ii*) of this section because the income and losses of FS may be used under the laws of Country X to offset the income and losses of FC, the related foreign interest holder that derived its proportionate share of the payment from S to A. Therefore, paragraph (d)(2)(ii)(B) of this section applies, and the $25 interest payment in year 2 by A to FS is treated as a dividend for all purposes of the Internal Revenue Code and the U.S.-Country X income tax treaty because the $25 payment does not exceed FC's share of the $100 dividend payment made by S to A ($85). Since FS is not fiscally transparent with respect to the payment as determined under paragraph (d)(2)(ii)(A) of this section, FS is entitled to obtain the rate applicable to dividends under the U.S.-Country X income tax treaty with respect to the $25 payment. Because the $25 payment in year 2 is recharacterized as a dividend for all purposes of the Internal Revenue Code and the U.S.-Country X income tax treaty, A is not entitled to an interest deduction with respect to the payment and FS is not entitled to claim the reduced rate of withholding applicable to interest under the U.S.-Country X income tax treaty.

Example 7. Interest paid by domestic reverse hybrid entity to unrelated foreign bank. (i) *Facts*. The facts are the same as in *Example 3*, except that in year 2, A makes the interest payment of $25 to FB, a Country Y unrelated foreign bank, on a loan from FB to A.

(ii) *Analysis*. The analysis is the same as in *Example 1* with respect to the $100 dividend payment from S to A. With respect to the payment from A to FB, paragraph (d)(2)(ii)(B) of this section will not apply because, although A is related to S, the payor of the dividend income it received, A is not related to FB under paragraph (d)(2)(ii)(B)(*4*) of this section. Under paragraph (d)(2)(ii)(A) of this section, the $25 interest payment made from A to FB in year 2 is characterized as interest under the Internal Revenue Code.

Example 8. Interest paid by domestic reverse hybrid to an unrelated entity pursuant to a financing arrangement. (i) *Facts*. The facts are the same as in *Example 7*, except that in year 3, FB makes an interest payment of $25 to FC on a deposit made by FC with FB.

(ii) *Analysis*. The analysis is the same as in *Example 1* with respect to the $100 dividend payment from S to A. With respect to the $25 payment from A to FB in year 2, because the payment is made in connection with a transaction that consititutes a financing arrangement within the meaning of paragraph (d)(2)(ii)(C)(*2*) of this section, the payment may be treated by the Commissioner as being made directly to FC. If the Commissioner disregards

FB, then the analysis is the same as in *Example 3* with respect to the $25 interest payment in year 2 from A to FC.

Example 9. Royalty paid by related entity to domestic reverse hybrid entity. (i) *Facts*. The facts are the same as in *Example 3*, except the $100 income received by A from S in year 1 is a royalty payment under both the laws of the United States and the laws of Country X. The royalty rate under the treaty is 10 percent and the interest rate is 0 percent.

(ii) *Analysis*. The analysis as to the royalty payment from S to A is the same as in *Example 1* with respect to the $100 dividend payment from S to A. With respect to the $25 payment from A to FC, paragraph (d)(2)(ii)(B) of this section will not apply because the payment from S to A is not treated as a dividend under the Internal Revenue Code or the laws of Country X. Under paragraph (d)(2)(ii)(A) of this section, the $25 of interest paid by A to FC in year 2 is characterized as interest under the Internal Revenue Code. Accordingly, in year 2, FC may obtain the reduced rate of withholding applicable to interest under the U.S.-Country X income tax treaty, assuming all other requirements for claiming treaty benefits are met.

* * * * *

(6) *Effective dates*. This paragraph (d) applies to items of income paid on or after June 30, 2000, except paragraphs (d)(2)(ii) and (d)(2)(iii) of this section apply to items of income paid by a domestic reverse hybrid entity on or after June 12, 2002, with respect to amounts received by the domestic reverse hybrid entity on or after June 12, 2002.

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Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved June 3, 2002.

Pamela F. Olsen,
Acting Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on June 11, 2002, 8:45 a.m., and published in the issue of the Federal Register for June 12, 2002, 67 F.R. 40157)

Section 1233.—Gains and Losses From Short Sales

26 CFR 1.1233–1: Gains and losses from short sales.

The revenue ruling provides guidance on the recognition of gain or loss on a short sale when stock is purchased to close the short sale using a regular-way sale. See Rev. Rul. 2002–44, on this page.

Section 1259.—Constructive Sales Treatment for Appreciated Financial Positions

(Also § 1233; 26 CFR 1.1233–1.)

Short sale of stock. This ruling provides guidance on the timing of recognition of gain or loss on a short sale when stock is purchased to close the short sale using a regular-way sale.

Rev. Rul. 2002–44

ISSUE

If a taxpayer enters into a short sale of stock and directs its broker to purchase the stock sold short and close out the short sale, when is a gain or a loss on the short sale realized?

FACTS

Situation 1

In January of Year 1, Taxpayer *T* directs its broker to borrow 100 shares of XYZ stock and sell the 100 shares of XYZ stock in the market (the Short Sale). XYZ stock is traded on a registered securities exchange. *T* does not own any shares of XYZ stock. On December 31 of Year 1, when the value of XYZ stock has increased (and the value of *T*'s short position has depreciated) *T* directs its broker to purchase 100 shares of XYZ stock to close the Short Sale. The purchased XYZ shares are delivered to the lender of the XYZ stock on January 4 of Year 2. The purchase of the XYZ stock on December 31 of Year 1 is a regular-way sale as described in Rev. Rul. 93–84, 1993–2 C.B. 225, with December 31 of Year 1 as the trade date and January 4 of Year 2 as the settlement date.

Situation 2

The facts are the same as in *Situation 1* except that the XYZ stock has depreciated in value and the Short Sale is closed out at a gain.

LAW

Section 1.1233–1(a)(1) of the Income Tax Regulations provides that, for income tax purposes, a short sale is not deemed to be consummated until delivery of property to close the short sale. Under § 1.1233–1(a)(4), if the short sale is made through a broker and the broker borrows property to make a delivery, the short sale is not deemed to be consummated until the obligation of the seller created by the short sale is finally discharged by delivery of property to the broker to replace the property borrowed by the broker.

In the context of determining holding period, Rev. Rul. 66–97, 1966–1 C.B. 190, states that both stocks and bonds "are considered acquired or sold on the respective 'trade dates.'"

Analogously, Rev. Rul. 93–84 holds that the year of disposition for a regular-way sale of stock traded on an established securities market is the year that includes the trade date. In Rev. Rul. 93–84, the taxpayer placed a regular-way sale order on stock with his broker on December 31, 1992, but the taxpayer did not deliver the stock certificates or receive the proceeds from the sale until January 8, 1993. The revenue ruling holds that the year of disposition and realization is 1992.

Section 1259(a)(1) provides that if there is a constructive sale of an appreciated financial position, the taxpayer shall recognize gain as if such position were sold, assigned, or otherwise terminated at its fair market value on the date of such constructive sale. The term "appreciated financial position" is defined in § 1259(b)(1) to include any position with respect to stock if there would be gain were such position sold, assigned, or otherwise terminated at its fair market value. The term "position" is defined in § 1259(b)(3) to include a short sale. Pursuant to § 1259(c)(1)(D), in the case of an appreciated financial position that is a short sale, a taxpayer is treated as having

made a constructive sale of the appreciated financial position if the taxpayer acquires the same or substantially identical property.

ANALYSIS

Situation 1

Pursuant to § 1.1233–1(a)(1), the Short Sale is not consummated until the XYZ stock is delivered to close the Short Sale. Although *T* is treated as having acquired the XYZ stock on the trade date (*see* Rev. Rul. 66–97; *see also* Rev. Rul. 93–84), the XYZ stock will not be delivered to close the Short Sale until January 4 of Year 2. Therefore, *T* does not realize the loss on the Short Sale until January 4 of Year 2.

Situation 2

As in *Situation 1*, *T* is treated as having acquired the XYZ stock on the trade date, December 31 of Year 1. *See* Rev. Rul. 66–97; *see also* Rev. Rul. 93–84. At that time, unlike in *Situation 1*, the price of XYZ stock has decreased. Therefore, the value of *T*'s Short Sale has increased, and *T* holds an appreciated financial position within the meaning of § 1259(b)(1), that is, the short position. Section 1259(b)(3). Section 1259(c)(1)(D) provides that if a taxpayer holds an appreciated financial position that is a short sale, the acquisition of the same or substantially identical stock is a constructive sale transaction. Therefore, *T* has entered into a constructive sale transaction by acquiring the same or substantially identical stock as the stock underlying the Short Sale. Pursuant to § 1259(a)(1), *T* realizes gain on the Short Sale on December 31 of Year 1.

HOLDING

(1) In *Situation 1*, *T* realizes the loss on the Short Sale on January 4 of Year 2, the date the Short Sale is closed by delivery of the stock.

(2) In *Situation 2*, *T* has constructively sold the Short Sale on December 31 of Year 1. *T* realizes gain in Year 1 as if *T* had sold, assigned, or otherwise terminated the Short Sale at its fair market value on December 31 of Year 1.

DRAFTING INFORMATION

The principal author of this revenue ruling is Kate Sleeth of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling, contact Ms. Sleeth at (202) 622–3920 (not a toll-free call).

Section 1502.—Regulations (Consolidated Returns).

26 CFR 1.1502–77.—Agent for the group.

26 CFR 1.1502–77A.—Common parent agent for subsidiaries applicable for consolidated return years beginning before June 28, 2002.

The revenue procedure provides instructions relating to the determination of a substitute agent to act on behalf of a consolidated group, pursuant to section 1.1502–77(d) or section 1.1502–77A(d). Procedures are provided for automatic approval of requests by a terminating common parent to designate its qualifying successor as substitute agent. *See* §§ 1.1502–77(d) and 1.1502–77A(d), and Rev. Proc. 2002–43, page 99.

Section 4975:—Tax On Prohibited Transactions

26 CFR 54.4975–1: General rules relating to excise tax on prohibited transactions.

Rev. Rul. 2002–43

ISSUE

When a loan from a qualified plan that is a prohibited transaction spans successive taxable years, and thus constitutes multiple prohibited transactions, and during those years the first tier prohibited transaction excise tax rate under § 4975 of the Internal Revenue Code changes, how is the excise tax computed?

FACTS

X, Inc., is a Subchapter C corporation that sponsors Plan Y, a calendar year profit sharing plan qualified under § 401(a) of the Internal Revenue Code. Plan Y's plan year is the calendar year. On April 1, 1997, individual B, a disqualified person with respect to Plan Y, obtained a two-year loan in the amount of $10,000 from Plan Y's tax-exempt trust. The loan was secured solely by B's account balance in Plan Y. At the time of the loan, B's account balance was $12,000. According to the terms of the loan, B was to make substantially equal payments of principal and interest to Plan Y's trust on the first business day of every calendar quarter. The interest rate of the loan was 11%, compounded annually, which was equal to or greater than a fair market rate of interest for such a loan at that time. B made no payments on the loan until December 31, 1999, at which time B repaid the loan, including principal and accrued interest. The repayment constituted a "correction" within the meaning of § 4975(f)(5) of the Code. None of the Forms 5500 that were filed for Plan Y for 1997, 1998, or 1999 reflected a loan to B.

LAW AND ANALYSIS

Section 4975(a) of the Internal Revenue Code provides that an excise tax is imposed as a result of each prohibited transaction on any disqualified person who participates in the prohibited transaction (other than a fiduciary acting only as such). Section 4975(c)(1)(B) of the Code defines the term "prohibited transaction" as including any direct or indirect lending of money or other extension of credit between a plan and a disqualified person.

Section 4975(d)(1) provides a statutory exemption for a loan made to a disqualified person who is a participant or beneficiary of the plan if such loan (1) is available to all such participants or beneficiaries on a reasonably equivalent basis; (2) is not made available to highly compensated employees (within the meaning of § 414(q)) in an amount greater than the amount made available to other employees; (3) is made in accordance with specific provisions regarding such loans set forth in the plan; (4) bears a reasonable rate of interest; and (5) is adequately secured.

Under section 102(a) of Reorganization Plan No. 4 of 1978 (43 F. R. 47713, October 17, 1978, 1979–1 C.B. 480), the Secretary of Labor has the authority to issue regulations interpreting § 4975 (d)(1) of the Code and the parallel provision in section 408(b)(1) of the Employee Retirement Income Security Act of 1974 ("ERISA"). Under 29 C.F.R. 2550.408b–1(f)(2) of the Department of Labor's

regulations, a loan secured solely by more than 50 percent of the present value of a participant's vested accrued benefit is not adequately secured for purposes of determining whether the loan is exempt from the prohibited transaction excise tax.

Section 1453(a) of the Small Business Job Protection Act of 1996 increased the first tier excise tax rate of § 4975(a) of the Code from 5% to 10% of the amount involved for each year in the taxable period for prohibited transactions occurring after August 20, 1996. Section 1074(a) of the Taxpayer Relief Act of 1997 increased the first tier excise tax rate to 15% of the amount involved for each year in the taxable period for prohibited transactions occurring after August 5, 1997. Section 4975(f)(2) of the Code defines the term "taxable period" as the period beginning with the date on which the prohibited transaction occurs and ending on the earliest of (1) the date of the mailing of a statutory notice of deficiency, (2) the date on which the first tier excise tax is assessed, or (3) the date on which correction of the prohibited transaction is completed. Section 4975(f)(4) defines the term "amount involved," with respect to a prohibited transaction, as the greater of (1) the amount of money and the fair market value of the other property given or (2) the amount of money and the fair market value of the other property received in such transaction. For purposes of the first tier excise tax, the fair market value is determined as of the date on which the prohibited transaction occurs.

Section 141.4975–13 of the Temporary Pension Excise Tax Regulations provides that until superseded by permanent regulations under paragraphs (4) and (5) of § 4975(f) of the Code, § 53.4941(e)–1 of the Foundation Excise Tax Regulations will be controlling to the extent those regulations describe terms appearing both in § 4941(e) and § 4975(f). The term "amount involved" appears in both § 4941(e) and § 4975(f).

Section 53.4941(e)–1(b)(2)(ii) of the Foundation Excise Tax Regulations provides that, where the transaction involves the use of money, the amount involved is the greater of the amount paid for such use or the fair market value of such use for the period for which the money or other property is used and the amount involved is determined for the entire period that the money is used. In addition, § 53.4941(e)–1(e)(1) provides that, in the instance of a prohibited transaction that is a loan, an additional prohibited transaction is deemed to occur on the first day of each taxable year in the taxable period after the taxable year in which the loan occurred.

The interest amount for each year under the facts described above is computed as follows:

Year	**Principal**	**Rate**	**Time**	**Interest Amount**
1997 (4/1–12/31)	$10,000.00	11.00%	275/365 year	$ 828.77
1998	$10,828.77	11.00%	1 year	1,191.16
1999	12,019.93	11.00%	1 year	1,322.19

Under the facts described above, and applying the rule in § 53.4941(e)–1(e)(1), there are three prohibited transactions that result from this loan. The first prohibited transaction occurs on the date of the loan (April 1, 1997), the second prohibited transaction occurs on January 1,1998 (the first day of the next taxable year) and the third prohibited transaction occurs on January 1, 1999. The taxable period for each of these prohibited transactions begins on the date that the prohibited transaction occurs (April 1, 1997, for the first prohibited transaction, January 1, 1998, for the second prohibited transaction, and January 1, 1999, for the third prohibited transaction). The taxable periods for all three prohibited transactions end on the date on which the prohibited transactions were corrected (December 31, 1999). The amount involved for each prohibited transaction is the interest amount, as computed in the preceding table, for the first taxable year in the taxable period for that prohibited transaction. Therefore, the first-tier prohibited transaction excise tax for each prohibited transaction is computed as follows:

Year	**1st Prohibited Transaction Excise Tax**	**2nd Prohibited Transaction Excise Tax**	**3rd Prohibited Transaction Excise Tax**
1997	$ 828.77 x .10 = $ 82.88	--------------------------------	--------------------------------
1998	828.77 x .10 = 82.88	$1,191.16 x .15 = $178.67	--------------------------------
1999	828.77 x .10 = 82.88	1,191.16 x .15 = 178.67	$1,322.19 x .15 = $198.33
1st tier tax	$248.64	$357.34	$198.33

Total for All Prohibited Transactions = $804.31.

HOLDING

When a loan from a qualified plan that is a prohibited transaction spans successive taxable years, and thus constitutes multiple prohibited transactions, and during those years the first tier prohibited transaction excise tax rate changes, the first tier excise tax liability for each prohibited transaction is the sum of the products resulting from multiplying the amount involved for each year in the taxable period for that prohibited transaction by the excise tax rate in effect at the beginning of that taxable period.

Drafting Information

The principal author of this revenue ruling is Michael Rubin of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this revenue ruling, please contact the Employee Plans' taxpayer assistance telephone service at 1–877–829–5500 (a toll-free number), between the hours of 8:00 a.m. and 6:30 p.m. Eastern Time, Monday through Friday. Mr. Rubin can be reached at 1–202–283–9888 (not a toll-free number).

Section 4980F.—Failure of Applicable Plans Reducing Benefit Accruals to Satisfy Notice Requirements

Whether the notice required by section 4980F of the Code and section 204(h) ERISA, as amended, must be provided to the affected individuals in a money purchase pension plan that is merged or converted into a profit-sharing plan. See Rev. Rul. 2002–42, page 76.

Section 6011.—General Requirement of Return, Statement, or List

26 CFR 1.6011–4T: Requirement of statement disclosing participation in certain transactions by taxpayers (Temporary).

T.D. 9000

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1 and 301

Modification of Tax Shelter Rules III

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: These regulations modify the rules relating to the filing by certain taxpayers of a statement with their Federal income tax returns under section 6011(a) and the registration of confidential corporate tax shelters under section 6111(d). These rules also affect the list maintenance requirement under section 6112. These regulations affect taxpayers participating in certain reportable transactions, persons responsible for registering confidential corporate tax shelters, and persons responsible for maintaining lists of investors in potentially abusive tax shelters. The text of these regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking (REG–103735–00; REG–110311–98) on this subject on page 109 of this issue of the Bulletin.

DATES: *Effective Date*: These regulations are effective June 14, 2002.

Applicability Date: For dates of applicability, see § 1.6011–4T(g) and § 301.6111–2T(h).

FOR FURTHER INFORMATION CONTACT: Danielle M. Grimm or Tara P. Volungis, 202–622–3080 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these regulations have been previously reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545–1685.

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

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

Background

This document amends 26 CFR parts 1 and 301 to provide modified rules relating to the disclosure of reportable transactions by certain individuals, trusts, partnerships, S corporations, and other corporations on their Federal income tax returns under section 6011 and the registration of confidential corporate tax shelters under section 6111.

On February 28, 2000, the IRS issued temporary and proposed regulations regarding section 6011 (T.D. 8877, 2000–1 C.B. 747; REG–103735–00, 2000–1 C.B. 770), section 6111 (T.D. 8876, 2000–1 C.B. 753; REG–110311–98, 2000–1 C.B. 767), and section 6112 (T.D. 8875, 2000–1 C.B. 761; REG–103736–00, 2000–1 C.B. 768) (collectively, the February regulations). The February regulations were published in the **Federal Register** (65 FR 11205, 65 FR 11215, 65 FR 11211) on March 2, 2000. On August 11, 2000, the IRS issued temporary and proposed regulations regarding sections 6011, 6111, and 6112 (T.D. 8896, 2000–2 C.B. 249; REG–103735–00, REG–110311–98, REG–103736–00, 2000–2 C.B. 258) (collectively, the August 2000 regulations). The August 2000 regulations were published in the **Federal Register** (65 FR 49909) on August 16, 2000, modifying the February regulations. On August 2, 2001, the IRS issued temporary and proposed regulations regarding sections 6011, 6111, and 6112 (T.D. 8961, 2001–35 I.R.B. 194; REG–103735–00, REG–110311–98, REG–103736–00, 2001–35 I.R.B. 204) (collectively, the August 2001 regulations). The August 2001 regulations were published in the **Federal Register** (66 FR

41133) on August 7, 2001, further modifying the February 2000 regulations.

The rules under sections 6011, 6111, and 6112 are designed to provide the IRS and Treasury with information needed to evaluate potentially abusive transactions. The IRS and Treasury have considered and evaluated compliance with the disclosure, registration, and list maintenance requirements under sections 6011, 6111, and 6112 and have determined that certain additional changes to the temporary and proposed regulations are necessary to improve compliance with the regulations and to carry out the purposes of sections 6011, 6111, and 6112. The IRS and Treasury continue to evaluate all the comments and recommendations received. Moreover, the IRS and Treasury intend to make substantial additional changes to the rules under sections 6011, 6111, and 6112 in order to establish a more effective disclosure regime and to improve compliance as announced in Treasury's Plan to Combat Abusive Tax Avoidance Transactions (PO–2018), released on March 20, 2002. See *http://www.treas.gov/press/releases/po2018.htm.*

Explanation of Provisions

1. *Application of § 1.6011–4T to Individuals, Trusts, Partnerships, and S Corporations*

Section 1.6011–4T generally provides that certain corporate taxpayers must disclose their participation in listed and other reportable transactions that meet the projected tax effect test by attaching a written statement to their Federal income tax returns. It has been determined that a number of these transactions are entered into by noncorporate taxpayers. Accordingly, in order to obtain information regarding potentially abusive transactions entered into by noncorporate taxpayers, the requirement to disclose under § 1.6011–4T is extended to individuals, trusts, partnerships, and S corporations that participate, directly or indirectly, in listed transactions. Thus, if a partnership or an S corporation participates in a listed transaction, that partnership or S corporation must disclose its participation under § 1.6011–4T and the partners and shareholders of the partnership or S corporation, respectively, also must disclose their participation under § 1.6011–4T. The IRS and Treasury plan to extend in future guidance the requirement to disclose under § 1.6011–4T to other reportable transactions entered into by individuals, trusts, partnerships, and S corporations.

2. *Indirect Participants*

Section 1.6011–4T makes reference to taxpayers who participate directly or indirectly in reportable transactions. In order to obtain information about potentially abusive transactions entered into by taxpayers, the IRS and Treasury have provided clarification regarding indirect participation in a reportable transaction. A taxpayer will have indirectly participated in a reportable transaction if the taxpayer knows or has reason to know that the tax benefits claimed from the taxpayer's transaction are derived from a reportable transaction. However, this clarification does not imply that a taxpayer's participation in a transaction did not otherwise qualify as indirect participation in a reportable transaction for purposes of § 1.6011–4T, as in effect prior to June 14, 2002.

For example, Notice 95–53 (1995–2 C.B. 334), describes a lease stripping transaction in which one party (the transferor) assigns the right to receive future payments under a lease of tangible property and receives consideration which the transferor treats as current income. The transferor later transfers the property subject to the lease in a transaction intended to qualify as a substituted basis transaction, for example, a transaction described in section 351. In return, the transferor receives stock (with low value and high basis) from the transferee corporation. The transferee corporation claims the deductions associated with the high basis property subject to the lease. The transferor and transferee corporation have directly participated in the listed transaction. If the transferor subsequently transfers the high basis/low value stock to a taxpayer in another transaction intended to qualify as a substituted basis transaction and the taxpayer uses the stock to generate a loss, and if the taxpayer knows or has reason to know that the tax loss claimed was derived from the lease stripping transaction, then the taxpayer is indirectly participating in a reportable transaction. Accordingly, the taxpayer must disclose the reportable transaction and the manner of the taxpayer's indirect participation in the reportable transaction under the provisions of § 1.6011–4T.

3. *Substantially Similar Transactions*

Sections 1.6011–4T and 301.6111–2T make reference to *substantially similar* transactions. Some taxpayers and promoters have applied the *substantially similar* standard in an overly narrow manner to avoid disclosure. For instance, some taxpayers and promoters have made subtle and insignificant changes to a listed transaction in order to claim that their transactions are not subject to disclosure. Others have taken the position that their transaction is not substantially similar to a listed transaction because they have an opinion concluding that their transaction is proper. The IRS and Treasury believe that these interpretations are improper. Accordingly, the regulations are modified in § 1.6011–4T and § 301.6111–2T to clarify that the term *substantially similar* includes any transaction that is expected to obtain the same or similar types of tax benefits and that is either factually similar or based on the same or similar tax strategy. Further, the term *substantially similar* must be broadly construed in favor of disclosure. This modification does not imply that a transaction was not otherwise the same as or substantially similar to a listed transaction prior to this modification.

For example, Notice 2000–44, 2000–2 C.B. 255, sets forth a listed transaction involving offsetting options transferred to a partnership where the taxpayer claims basis in the partnership for the cost of the purchased options but does not reduce basis under section 752 as a result of the partnership's assumption of the taxpayer's obligation with respect to the options. Transactions using short sales, futures, derivatives or any other type of offsetting obligations to inflate basis in a partnership interest would be the same as or substantially similar to the transaction described in Notice 2000–44. Moreover, use of the inflated basis in the partnership interest to diminish gain that would otherwise be recognized on the transfer of a partnership asset would also be the same as or substantially similar to the transaction described in Notice 2000–44.

As another example, Notice 2001–16, 2001–1 C.B. 730, sets forth a listed transaction involving a seller (X) who desires to sell stock of a corporation (T), an intermediary corporation (M), and a buyer (Y) who desires to purchase the assets (and not the stock) of T. M agrees to facilitate the sale to prevent the recognition of the gain that T would otherwise report. Notice 2001–16 describes M as a member of a consolidated group that has a loss within the group or as a party not subject to tax. Transactions utilizing different intermediaries to prevent the recognition of gain would be the same as or substantially similar to the transaction described in Notice 2001–16. An example is a transaction in which M is a corporation that does not file a consolidated return but which buys T stock, liquidates T, sells assets of T to Y, and offsets the gain recognized on the sale of those assets with currently generated losses.

4. *Projected Tax Effect Test for Listed Transactions*

Section 1.6011–4T provides that a reportable transaction is a transaction that meets the projected tax effect test and is either a listed transaction or a transaction that has at least two of five specified characteristics. Under § 1.6011–4T, the projected tax effect test for listed transactions is met if the taxpayer reasonably estimates that the transaction will reduce the taxpayer's Federal income tax liability by more than $1 million in any single taxable year or by a total of more than $2 million for any combination of taxable years in which the transaction is expected to have the effect of reducing the taxpayer's Federal income tax liability. The IRS and Treasury have determined that the projected tax effect test for listed transactions results in inadequate disclosure. Accordingly, the projected tax effect test will no longer apply to listed transactions. Thus, any individual, trust, partnership, S corporation, or other corporation that participates in a listed transaction must report it under the provisions of § 1.6011–4T.

5. *Time of Providing Disclosure*

In general, the disclosure statement for a reportable transaction must be attached to the taxpayer's Federal income tax return for each taxable year for which the taxpayer's Federal income tax liability is affected by the taxpayer's participation in the transaction. In the case of a taxpayer that is a partnership or an S corporation, the disclosure statement for a listed transaction must be attached to the taxpayer's Federal income tax return for each taxable year ending with or within the taxable year of any partner or shareholder whose income tax liability is affected or is reasonably expected to be affected by the partnership's or the S corporation's participation in the transaction. In addition, at the same time that the disclosure statement is first attached to the taxpayer's Federal income tax return, the taxpayer must file a copy of that disclosure statement with the Office of Tax Shelter Analysis.

If a transaction becomes a reportable transaction (*e.g.*, the transaction subsequently becomes one identified in published guidance as a listed transaction described in § 1.6011–4T(b)(2), or there is a change in facts affecting the expected Federal income tax effect of the transaction) on or after the date the taxpayer has filed the return for the first taxable year for which the transaction affected the taxpayer's or a partner's or a shareholder's Federal income tax liability, the disclosure statement must be filed as an attachment to the taxpayer's Federal income tax return next filed after the date the transaction becomes a reportable transaction (whether or not the transaction affects the taxpayer's or any partner's or shareholder's Federal income tax liability for that year) and at that time a copy of that disclosure statement must be filed with the Office of Tax Shelter Analysis. Notwithstanding the effective date of these regulations, for purposes of § 1.6011–4T, as in effect prior to June 14, 2002, a corporate taxpayer was required to disclose a transaction that later became reportable on the corporation's next filed Federal income tax return even if the transaction did not affect the corporation's Federal income tax liability for that year.

Regardless of whether the taxpayer plans to disclose the transaction under other published guidance, for example, Rev. Proc. 94–69, 1994–2 C.B. 804, the taxpayer also must disclose the transaction in the time and manner provided for under the provisions of this regulation. Notwithstanding the effective date of these regulations, a corporate taxpayer was required to disclose a transaction in the time and manner provided for in § 1.6011–4T in effect prior to June 14, 2002, regardless of whether the taxpayer planned to disclose the transaction under other published guidance.

Effective Dates

The regulations are applicable June 14, 2002.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that the time required to prepare or retain the disclosure is minimal and will not have a significant impact on those small entities that are required to provide disclosure. 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, these regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal authors of these regulations are Danielle M. Grimm and Tara P. Volungis, Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 301 are amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.6011–4T is amended as follows:

1. The heading of § 1.6011–4T is amended by removing the language "corporate".

2. The heading of paragraph (a) is revised.

3. Paragraph (a) is amended by adding "(1) *In general.*" after the heading.

4. Newly designated paragraph (a)(1) is amended by adding the language "corporate" before "taxpayer" in the first sentence, and by removing the second sentence and adding three new sentences in its place.

5. Paragraphs (a)(2) and (a)(3) are added.

6. Paragraph (b)(1) is amended by revising the first sentence.

7. Paragraphs (b)(1)(i) and (b)(1)(ii) are added.

8. Paragraph (b)(4)(i) is amended by removing the first sentence.

9. Paragraph (b)(5) *Example 3* is amended by revising the seventh sentence.

10. Paragraphs(c)(1)(iii) and (c)(1)(v) are revised.

11. Paragraph (c)(2) *Example* is amended by adding the language "*Example.*" after "of this section:" in the first sentence and by adding "as in effect at that time." to the end of the third sentence.

12. Paragraph (d)(1) is revised.

13. Paragraph (e) is amended by removing the language "corporation's" in the first sentence and adding "taxpayer's" in its place.

14. Paragraph (g) is revised.

The revisions and additions read as follows:

§ 1.6011–4T Requirement of statement disclosing participation in certain transactions by taxpayers (Temporary).

(a) *Disclosure requirement*—(1) *In general*. * * * Every individual, trust, partnership, and S corporation that has participated, directly or indirectly, in a reportable transaction within the meaning of paragraph (b)(2) of this section must attach to its return for the taxable year described in paragraph (d) of this section a disclosure statement in the form prescribed by paragraph (c) of this section. For this purpose, a taxpayer will have indirectly participated in a reportable transaction if the taxpayer's Federal income tax liability is affected (or in the case of a partnership or an S corporation, if a partner's or shareholder's Federal income tax liability is reasonably expected to be affected) by the transaction even if the taxpayer is not a direct party to the transaction (*e.g.*, the taxpayer participates as a partner in a partnership, as a shareholder in an S corporation, or through a controlled entity). Moreover, a taxpayer will have indirectly participated in a reportable transaction if the taxpayer knows or has reason to know that the tax benefits claimed from the taxpayer's transaction are derived from a reportable transaction. * * *

(2) *Example of indirect participation*. Notice 95–53, 1995–2 C.B. 334, (see § 601.601(d)(2) of this chapter), describes a lease stripping transaction in which one party (the transferor) assigns the right to receive future payments under a lease of tangible property and receives consideration which the transferor treats as current income. The transferor later transfers the property subject to the lease in a transaction intended to qualify as a substituted basis transaction, for example, a transaction described in section 351. In return, the transferor receives stock (with low value and high basis) from the transferee corporation. The transferee corporation claims the deductions associated with the high basis property subject to the lease. The transferor and transferee corporation have directly participated in the listed transaction. If the transferor subsequently transfers the high basis/low value stock to a taxpayer in another transaction intended to qualify as a substituted basis transaction and the taxpayer uses the stock to generate a loss, and if the taxpayer knows or has reason to know that the tax loss claimed was derived from the lease stripping transaction, then the taxpayer is indirectly participating in a reportable transaction. Accordingly, the taxpayer must disclose the reportable transaction and the manner of the taxpayer's indirect participation in the reportable transaction under the rules of this section.

(3) *Definition of taxpayer*. For purposes of paragraphs (b)(3) and (4) of this section, the term *taxpayer* means a corporation required to file a return under section 11, 594, 801, or 831. For all other purposes of this section, the term *taxpayer* also includes an individual, trust, partnership, or S corporation.

(b) *Definition of reportable transaction*—(1) *In general*. A reportable transaction is either a transaction that is described in paragraph (b)(2) of this section, or is a transaction that is described in paragraph (b)(3) of this section and that meets the projected tax effect test in paragraph (b)(4) of this Section. * * *

(i) *Definition of substantially similar*. For purposes of this section, the term *substantially similar* includes any transaction that is expected to obtain the same or similar types of tax benefits and that is either factually similar or based on the same or similar tax strategy. Receipt of an opinion concluding that the tax benefits from the taxpayer's transaction are allowable is not relevant to the determination of whether the taxpayer's transaction is the same as or substantially similar to a listed transaction. Further, the term *substantially similar* must be broadly construed in favor of disclosure.

(ii) *Examples*. The following examples illustrate situations where a transaction is the same as or substantially similar to a listed transaction:

Example 1. Notice 2000–44, 2000–2 C.B. 255, (see § 601.601(d)(2) of this chapter), sets forth a listed transaction involving offsetting options transferred to a partnership where the taxpayer claims basis in the partnership for the cost of the purchased options but does not reduce basis under section 752 as a result of the partnership's assumption of the taxpayer's obligation with respect to the options. Transactions using short sales, futures, derivatives or any other type of offsetting obligations to inflate basis in a partnership interest would be the same as or substantially similar to the transaction described in Notice 2000–44. Moreover, use of the inflated basis in the partnership interest to diminish gain that would otherwise be recognized on the transfer of a partnership asset would also be the same as or substantially similar to the transaction described in Notice 2000–44.

Example 2. Notice 2001–16, 2001–1 C.B. 730, (see § 601.601(d)(2) of this chapter), sets forth a listed transaction involving a seller (X) who desires to sell stock of a corporation (T), an intermediary corporation (M), and a buyer (Y) who desires to purchase the assets (and not the stock) of T. M agrees to facilitate the sale to prevent the recognition of the gain that T would otherwise report. Notice 2001–16 describes M as a member of a consolidated group that has a loss within the group or

as a party not subject to tax. Transactions utilizing different intermediaries to prevent the recognition of gain would be the same as or substantially similar to the transaction described in Notice 2001–16. An example is a transaction in which M is a corporation that does not file a consolidated return but which buys T stock, liquidates T, sells assets of T to Y, and offsets the gain recognized on the sale of those assets with currently generated losses.

* * * * *

(5) * * *

Example 3. * * * However, E does reasonably determine that the terms of the leases are consistent with customary commercial form in the leasing industry, and that there is a generally accepted understanding that the combination of Federal income tax consequences it is claiming with respect to the leases are allowable under the Internal Revenue Code for substantially similar transactions. * * *

* * * * *

(c) * * *(1) * * *

(iii) A brief description of the principal elements of the transaction that give rise to the expected tax benefits, including the manner of the taxpayer's direct or indirect participation in the transaction.

* * * * *

(v) An identification of each taxable year (including prior taxable years) for which the transaction is expected to have the effect of reducing the Federal income tax liability of the taxpayer, or of any partner or shareholder of the taxpayer, and an estimate of the amount by which the transaction is expected to reduce the Federal income tax liability of the taxpayer, or of any partner or shareholder of the taxpayer, for each such taxable year.

* * * * *

(d) *Time of providing disclosure*—(1) *In general*. The disclosure statement for a reportable transaction must be attached to the taxpayer's Federal income tax return for each taxable year for which the taxpayer's Federal income tax liability is affected by the taxpayer's participation in the transaction. In the case of a taxpayer that is a partnership or an S corporation, the disclosure statement for a listed transaction must be attached to the taxpayer's Federal income tax return for each taxable year ending with or within the taxable year of any partner or shareholder whose income tax liability is affected or is reasonably expected to be affected by the partnership's or the S corporation's participation in the transaction. In addition, at the same time that any disclosure statement is first attached to the taxpayer's Federal income tax return, the taxpayer must file a copy of that disclosure statement with the Office of Tax Shelter Analysis (OTSA) at: Internal Revenue Service LM:PFTG:OTSA, Large & Mid-Size Business Division, 1111 Constitution Ave., NW, Washington, DC 20224. Regardless of whether the taxpayer plans to disclose the transaction under other published guidance, for example, Rev. Proc. 94–69, 1994–2 C.B. 804, (see § 601.601(d)(2) of this chapter), the taxpayer also must disclose the transaction in the time and manner provided for under the provisions of this section. If a transaction becomes a reportable transaction (*e.g.*, the transaction subsequently becomes one identified in published guidance as a listed transaction described in (b)(2) of this section, or there is a change in facts affecting the expected Federal income tax effect of the transaction) on or after the date the taxpayer has filed the return for the first taxable year for which the transaction affected the taxpayer's or a partner's or a shareholder's Federal income tax liability, the disclosure statement must be filed as an attachment to the taxpayer's Federal income tax return next filed after the date the transaction becomes a reportable transaction (whether or not the transaction affects the taxpayer's or any partner's or shareholder's Federal income tax liability for that year). If a disclosure statement is required as an attachment to a Federal income tax return that is filed after June 14, 2002, but on or before 180 days after June 14, 2002, the taxpayer must either attach the disclosure statement to the return, or file the disclosure statement as an amendment to the return no later than 180 days after June 14, 2002.

* * * * *

(g) *Effective date*. This section applies to Federal income tax returns filed after February 28, 2000. However, paragraphs (a)(1), (a)(2), (a)(3), (b)(1), (b)(4)(i), (b)(5) *Example 3*, (c)(1)(iii), (c)(1)(v), (c)(2) *Example*, (d)(1), and (e) of this section apply to any transaction entered into on or after January 1, 2001, unless such transaction is reported on a tax return of the taxpayer that is filed on or before June 14, 2002. Taxpayers may rely on the rules in paragraphs (a)(1), (a)(2), (a)(3), (b)(1), (b)(4)(i), (b)(5) *Example 3*, (c)(1)(iii), (c)(1)(v), (c)(2) *Example*, (d)(1), and (e) of this section for Federal income tax returns filed after February 28, 2000. Otherwise, the rules that apply with respect to transactions entered into before January 1, 2001, and with respect to any transaction entered into on or after January 1, 2001, and reported on a tax return of the taxpayer that is filed on or before June 14, 2002, are contained in § 1.6011–4T in effect prior to June 14, 2002, (see 26 CFR part 1 revised as of April 1, 2002).

Par. 3. In § 1.6031(a)–1, paragraph(a)(1) is amended by adding a sentence to the end of the paragraph to read as follows:

§ 1.6031(a)–1 Return of partnership income.

(a) * * *

(1) * * * For the rules requiring the disclosure of certain transactions, see § 1.6011–4T.

* * * * *

Par. 4. In § 1.6037–1, paragraph (c) is amended by adding a sentence to the end of the paragraph to read as follows:

§ 1.6037–1 Return of electing small business corporation.

* * * * *

(c) * * * For the rules requiring the disclosure of certain transactions, see § 1.6011–4T.

* * * * *

PART 301—PROCEDURE AND ADMINISTRATION

Par. 5. The authority citation for part 301 continues to read in part as follows:

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

Par. 6. Section 301.6111–2T is amended as follows:

1. Paragraph (a)(3) is amended by adding four sentences to the end of the paragraph.

2. The paragraph heading for (h) is revised and the entire text after the second sentence is removed and four new sentences are added in their place.

The revision and additions read as follows:

§ 301.6111–2T Confidential corporate tax shelters (Temporary).

(a) * * *

(3) * * * For purposes of this section, the term *substantially similar* includes any transaction that is expected to obtain the same or similar types of tax benefits and that is either factually similar or based on the same or similar tax strategy. Receipt of an opinion concluding that the tax benefits from the taxpayer's transaction are allowable is not relevant to the determination of whether the taxpayer's transaction is the same as or substantially similar to a listed transaction. Further, the term *substantially similar* must be broadly construed in favor of disclosure. For examples, see § 1.6011–4T(b)(1)(ii) of this chapter.

* * * * *

(h) *Effective dates*. * * * However, paragraph (a)(3) of this section applies to confidential corporate tax shelters in which any interests are offered for sale after June 14, 2002. The rule in paragraph (a)(3) of this section may be relied upon for confidential corporate tax shelters in which any interests are offered for sale after February 28, 2000. Otherwise, the rules that apply to confidential corporate tax shelters in which any interests are offered for sale after February 28, 2000, and on or before June 14, 2002, are contained in this § 301.6111–2T in effect prior to June 14, 2002. (See 26 CFR part 301 revised as of April 1, 2002).

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved June 11, 2002.

Pamela F. Olson,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on June 14, 2002, 11:32 a.m., and published in the issue of the Federal Register for June 18, 2002, 67 F.R. 41324)

Part III. Administrative, Procedural, and Miscellaneous

Health Reimbursement Arrangements

Notice 2002–45

PURPOSE

This notice provides basic information about a type of employer-provided health reimbursement arrangement (HRA) described below. Published elsewhere in this bulletin is a revenue ruling providing guidance involving an HRA.

This notice is divided into eight parts. Part I of the notice describes HRAs and their general tax treatment. Part II of the notice outlines the benefits that may be offered under an HRA. Part III details who may be covered under an HRA. Part IV deals with the interaction between HRAs and cafeteria plans. Part V covers ordering rules for reimbursement from HRAs and § 125 health flexible spending arrangements. Part VI relates to the applicability of § 105(h) non-discrimination rules to HRAs. Part VII explains how to provide COBRA continuation coverage under HRAs. Part VIII addresses certain other matters.

I. Tax Treatment of HRAs Generally

An HRA is an arrangement that: (1) is paid for solely by the employer and not provided pursuant to salary reduction election or otherwise under a § 125 cafeteria plan; (2) reimburses the employee for medical care expenses (as defined by § 213(d) of the Internal Revenue Code) incurred by the employee and the employee's spouse and dependents (as defined in § 152); and (3) provides reimbursements up to a maximum dollar amount for a coverage period and any unused portion of the maximum dollar amount at the end of a coverage period is carried forward to increase the maximum reimbursement amount in subsequent coverage periods. To the extent that an HRA is an employer-provided accident or health plan, coverage and reimbursements of medical care expenses of an employee and the employee's spouse and dependents are generally excludable from the employee's gross income under §§ 106 and 105. Assuming that the maximum amount of reimbursement which is reasonably available to a participant under an HRA is not substantially in excess of the value of coverage under the HRA, an HRA is a flexible spending arrangement (FSA) as defined in § 106(c)(2).

II. Benefits under an HRA

To qualify for the exclusions under §§ 106 and 105, an HRA may only provide benefits that reimburse expenses for medical care as defined in § 213(d). Each medical care expense submitted for reimbursement must be substantiated. An HRA may not reimburse a medical care expense that is attributable to a deduction allowed under § 213 for any prior taxable year. Additionally, an HRA may neither reimburse a medical care expense that is incurred before the date the HRA is in existence nor reimburse a medical care expense that is incurred before the date an employee first becomes enrolled under the HRA. Reimbursements for insurance covering medical care expenses as defined in § 213(d)(1)(D) are allowable reimbursements under an HRA, including amounts paid for premiums for accident or health coverage for current employees, retirees, and COBRA qualified beneficiaries. However, see Part IV for a discussion relating to cases in which an employer provides an HRA in conjunction with another accident or health plan. If an HRA is an FSA, reimbursable medical care expenses may not include expenses for qualified long-term care services as defined in § 7702B(c). See §§ 106(c) and 213(d)(1)(C).

An HRA does not qualify for the exclusion under § 105(b) if any person has the right to receive cash or any other taxable or non-taxable benefit under the arrangement other than the reimbursement of medical care expenses. If any person has such a right under an arrangement currently or for any future year, all distributions to all persons made from the arrangement in the current tax year are included in gross income, even amounts paid to reimburse medical care expenses. For example, if an arrangement pays a death benefit without regard to medical care expenses, no amounts paid under the arrangement to any person are reimbursements for medical care expenses excluded under § 105(b). See § 1.105–2 of the Income Tax Regulations. Arrangements formally outside the HRA that provide for the adjustment of an employee's compensation or an employee's receipt of any other benefit will be considered in determining whether the arrangement is an HRA and whether the benefits are eligible for the exclusions under §§ 106 and 105(b). If, for example, in the year an employee retires, the employee receives a bonus and the amount of the bonus is related to that employee's maximum reimbursement amount remaining in an HRA at the time of retirement, no amounts paid under the arrangement are reimbursements for medical care expenses for purposes of § 105(b). Similarly, if an employer provides severance pay only to employees who have reimbursement amounts remaining in a purported HRA at the time of termination of employment, no amounts paid under the arrangement are reimbursements for medical care expenses for purposes of § 105(b).

III. Coverage under an HRA

Medical care expense reimbursements under an HRA are excludable under § 105(b) to the extent the reimbursements are provided to the following individuals: current and former employees (including retired employees), their spouses and dependents (as defined in § 152 as modified by the last sentence of § 105(b)), and the spouses and dependents of deceased employees. The term "employee" does not include a self-employed individual as defined in § 401(c). See § 105(g).

An HRA may continue to reimburse former employees or retired employees for medical care expenses after termination of employment or retirement (even if the employee does not elect COBRA continuation coverage). For example, an HRA may have a provision that reimburses a former employee for medical care expenses only up to an amount equal to the unused reimbursement amount remaining at retirement or other termination of employment. The plan may also provide that the maximum reimbursement

amount available after retirement or other termination of employment is reduced for any administrative costs of continuing such coverage. Additionally, an HRA may or may not provide for an increase in the amount available for reimbursement of medical care expenses after the employee retires or otherwise terminates employment (even if the employee does not elect COBRA continuation coverage).

IV. HRAs and Cafeteria Plans

Employer contributions to an HRA may not be attributable to salary reduction or otherwise provided under a § 125 cafeteria plan. An accident or health plan funded pursuant to salary reduction is not an HRA and is subject to the rules under § 125. However, an HRA is not considered to be paid for pursuant to salary reduction merely because it is provided in conjunction with a cafeteria plan. Additionally, if an employer offers employees a choice between employer-provided nontaxable benefits (*e.g.*, coverage under an HRA and coverage under a health maintenance organization (HMO)), with no cash or other taxable benefits available to employees, the choice is not an election to which § 125 applies.

If an employer provides an HRA only in conjunction with another accident or health plan and that other plan is provided pursuant to a salary reduction election under a cafeteria plan, then all the facts and circumstances are considered in determining whether the salary reduction is attributable to the HRA. Assuming that the terms of the salary reduction election indicate that the salary reduction is used only to pay for the specified accident or health plan offered in conjunction with the HRA and not to pay for the HRA itself, the mere fact that an employee may participate in the HRA only if the employee participates in a specified accident or health plan funded pursuant to a salary reduction election does not necessarily result in the salary reduction being attributed to the HRA. In such situations, if the salary reduction election for a coverage period to fund the specified accident or health plan offered in conjunction with the HRA exceeds the actual cost of the specified accident or health plan coverage for such coverage period, the salary reduction is attributable to the HRA. For purposes of this rule, "salary reduction" includes a choice to forgo receipt of any benefits that would be taxable but for the fact they are offered under a § 125 cafeteria plan.

For any coverage period, for purposes solely of determining whether a salary reduction election exceeds the cost of coverage, the actual cost of the specified accident or health plan coverage for the coverage period may be determined pursuant to the rules for determining the COBRA applicable premium under § 4980B(f)(4). For example, assume that an employer offers an HRA and an employee who participates in the HRA must also participate in the corresponding employee-only or family coverage offered in a high-deductible accident and health plan. If the COBRA applicable premium for the high-deductible accident and health coverage would be $1,800 for the employee-only coverage and $4,500 for family coverage if such coverage were offered separately from the HRA, then the annual maximum allowable salary reduction election in this case is $1,800 for employee-only coverage and $4,500 for family coverage in order for the salary reduction to be treated as not attributable to the HRA.

An arrangement is not treated as an HRA if the arrangement interacts with a cafeteria plan in such a way as to permit employees to use salary reduction indirectly to fund the HRA. Therefore, where an employee who participates in a reimbursement arrangement has a choice among two or more specified accident or health plans to be used in conjunction with the reimbursement arrangement (or a choice among various maximum reimbursement amounts credited for a coverage period) and there is a correlation between the maximum reimbursement amount available under the HRA for the coverage period (disregarding amounts carried forward from previous coverage periods) and the amount of salary reduction election for the specified accident and health plan, then the salary reduction is attributed to the reimbursement arrangement even if the amount of salary reduction election is equal to or less than the actual cost of the other accident or health coverage.

For example, assume an employer offers a reimbursement arrangement plus other specified accident or health plan coverage with the actual cost for family coverage for the specified accident or health plan being $4,500 and the employee having a choice to salary reduce $2,500 or $3,500 to fund this coverage. An employee who elects family coverage and $2,500 salary reduction receives a $1,000 maximum reimbursement amount under the reimbursement arrangement for the coverage period and an employee who elects family coverage and $3,500 salary reduction receives a $2,000 maximum reimbursement amount under the reimbursement arrangement for the coverage period. In this case, although the maximum allowable salary reduction is not exceeded, a portion of the salary reduction is attributed to the reimbursement arrangement because the increase in salary reduction election is related to a larger maximum reimbursement amount in the reimbursement arrangement for the coverage period. This arrangement is not an HRA and is subject to § 125.

Similarly, assume an employer provides a reimbursement arrangement in conjunction with another accident or health plan. Employees participating in the reimbursement arrangement are reimbursed up to $1,000 each year for substantiated § 213(d) medical care expenses and unused amounts remaining at the end of the year are carried forward for reimbursements in later years. The employee-share of the annual premium for the other accident or health plan is $1,500. Employees have a choice either to use amounts in the reimbursement arrangement to pay for the premium for the other accident or health plan or to pay that premium pursuant to a salary reduction election. Under this plan, the reimbursement arrangement does not reimburse any portion of the premium paid by salary reduction. Because an employee may use the reimbursement arrangement to pay a portion of the premium in lieu of electing to salary reduce, the reimbursement arrangement is indirectly funded pursuant to salary reduction. This arrangement does not meet the definition of an HRA because it is funded by salary reduction and it is subject to the rules under § 125.

Further, if the amount credited to a reimbursement arrangement is directly or indirectly based on the amount forfeited under a § 125 FSA, the arrangement will be treated as funded by salary reduction.

For purposes of making this determination, facts and circumstances taken into consideration include the manner in which salary reduction is implemented for other accident or health plans offered by the employer.

Because an HRA is paid for solely by the employer and not pursuant to salary reduction, the following restrictions on health FSAs under § 125 are not applicable to HRAs: (1) the prohibition against a benefit that defers compensation by permitting employees to carry over unused elective contributions or plan benefits from one plan year to another plan year; (2) the requirement that the maximum amount of reimbursement must be available at all times during the coverage period; (3) the mandatory twelve-month period of coverage; and (4) except as otherwise provided in this notice, the limitation that medical expenses reimbursed must be incurred during the period of coverage. As a result, the maximum reimbursement amount for a coverage period (not including amounts carried forward from previous coverage periods) need not be available at all times during the coverage period. Also, an HRA may specify a coverage period for a reimbursement amount that is less than a year. Although claims incurred during one coverage period may be reimbursed in a later coverage period, an unreimbursed claim may be reimbursed in a later coverage period only if the individual was covered under the HRA when the claim was incurred. Additionally, the maximum reimbursement amount credited under the HRA in the future (not including amounts carried forward from previous coverage periods) may be increased or decreased. However, see § 1.105–11(c)(3)(ii) regarding operational discrimination in favor of highly compensated individuals (as defined in § 105(h)). Thus, if an increase in maximum reimbursement amounts in an HRA favors one or more highly compensated individuals, the HRA may violate these non-discrimination rules.

V. Ordering Rules for HRAs and § 125 Health FSAs

A medical care expense may not be reimbursed from a § 125 health FSA if the expense has been reimbursed or is reimbursable under any other accident or health plan. If coverage is provided under both an HRA and a § 125 health FSA for the same medical care expenses, amounts available under an HRA must be exhausted before reimbursements may be made from the FSA. However, a § 125 health FSA will not violate this rule if coverage is provided under both an HRA and a § 125 health FSA and the FSA reimburses a medical care expense which is not reimbursable by the HRA. In no case may an employee be reimbursed for the same medical care expense by both an HRA and a § 125 health FSA.

Consistent with these rules, before a § 125 health FSA plan year begins, the plan document for the HRA may specify that coverage under the HRA is available only after expenses exceeding the dollar amount of the § 125 FSA have been paid. For example, if an employer sponsors a § 125 health FSA and an HRA, both of which provide coverage for the same medical care expenses, and the HRA plan document includes a provision that the HRA is not available for reimbursements of medical care expenses that are covered by the § 125 health FSA until after expenses exceeding the dollar amount of the § 125 FSA have been paid, then those medical care expenses may be reimbursed first from the § 125 health FSA and then from the HRA when the amount available under the § 125 FSA is exhausted.

VI. Nondiscrimination Rules Applicable to HRAs

Section 105(h) sets forth nondiscrimination rules for self-insured medical expense reimbursement plans. To the extent an HRA is a self-insured medical expense reimbursement plan, the nondiscrimination rules under § 105(h) apply to the HRA. See § 1.105–11.

VII. COBRA Continuation Coverage

An HRA is a group health plan generally subject to the COBRA continuation coverage requirements. If an individual elects COBRA continuation coverage, an HRA complies with these COBRA requirements by providing for the continuation of the maximum reimbursement amount for an individual at the time of the COBRA qualifying event and by increasing that maximum amount at the same time and by the same increment that it is increased for similarly situated non-COBRA beneficiaries (and by decreasing it for claims reimbursed). Premiums are determined under the existing rules in § 4980B. An HRA complies with the COBRA requirements for calculating the applicable premium under § 4980B if the applicable premium is the same for qualified beneficiaries with different total reimbursement amounts available from the HRA (and otherwise also satisfies the requirements of § 4980B). For example, if the annual additional reimbursement amount credited under an HRA is $1,000 and the maximum reimbursement amount remaining for two similarly situated qualified beneficiaries at the time of their qualifying events is $500 and $5,000, the applicable premium is the same for each individual.

The plan rules of an HRA may provide for continued reimbursements after a COBRA qualifying event regardless of whether a qualified beneficiary elects continuation coverage. For example, an HRA might allow reimbursements up to the unused maximum reimbursement amount following termination of employment. In such a situation, an HRA subject to COBRA must still comply with the COBRA continuation coverage requirements. If a qualified beneficiary elects COBRA continuation coverage in addition to the continued reimbursement amount already available, an HRA complies with the COBRA requirements by increasing the maximum reimbursement amount at the same time and by the same increment that it is increased for similarly situated non-COBRA beneficiaries (and by decreasing it for claims reimbursed).

VIII. Other Matters

Accident or health plans that meet the definition of an HRA are subject to a variety of statutory rules and provisions, many of which are not addressed in this notice. Among the statutory provisions not addressed in this notice are:

- The deduction limitations under §§ 419 and 419A (for employer contributions to welfare benefit funds) and under § 404 (for amounts paid or accrued under plans providing for deferred benefits that are not provided through a welfare benefit fund).
- The application of the nondiscrimination requirements under the Health

- Insurance Portability and Accountability Act of 1996 (HIPAA), including the extent to which underwritten individual health insurance policies purchased and reimbursed by an HRA are treated as health insurance coverage offered under a group health plan.
- Other requirements under HIPAA, including the requirement that a group health plan provide certificates of creditable coverage.
- The requirements for welfare benefit plans under the Employee Retirement Income Security Act of 1974 (ERISA).

The proposed regulations relating to health FSAs under § 125 state that certain requirements apply whether or not the health FSA is part of a cafeteria plan. Future guidance will modify the proposed regulation under § 125 to clarify that while those rules continue to apply to health FSAs provided pursuant to salary reduction election under a § 125 cafeteria plan, they do not apply to HRAs.

COMMENTS REQUESTED

Comments are requested about the rules set forth in this notice. Send comments to : CC:DOM:CORP:R (Notice 2002–45), Room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Comments may be hand-delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (Notice 2002–45), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, D.C. Alternatively, taxpayers may submit comments electronically at: *Notice.Comments@irscounsel.treas.gov* (a Service comments e-mail address).

DRAFTING INFORMATION

The principal author of this notice is Lorianne D. Masano of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice, contact Lorianne D. Masano at (202) 622–6080 (not a toll-free call).

Request for Comments Containing Suggestions for Future Proposed Regulations Concerning Permitted Elimination of Optional Forms of Benefit From Defined Benefit Plans

Notice 2002–46

The Internal Revenue Service and the Treasury Department request comments on regulations that are expected to be proposed under § 411(d)(6) of the Internal Revenue Code concerning the elimination of optional forms of benefit from defined benefit plans, including the types of situations in which the retention of particular optional forms of benefit under a defined benefit plan results in significant burdens and complexities for sponsors of retirement plans and for participants and the conditions under which these optional forms of benefit are of *de minimis* value to participants.

BACKGROUND

Section 411(d)(6) generally provides that a plan is treated as not satisfying the requirements of § 411 if the accrued benefit of a participant is decreased by a plan amendment.[1] Under § 411(d)(6)(B), a plan amendment that eliminates or reduces an early retirement benefit, a retirement-type subsidy, or an optional form of benefit is treated as reducing accrued benefits to the extent that the amendment applies to benefits accrued as of the later of the adoption date or the effective date of the amendment. However, § 411(d)(6)(B) permits the Secretary of Treasury to issue regulations that permit the elimination of optional forms of benefit. Pursuant to this authority, regulatory exceptions to the application of § 411(d)(6) to optional forms of benefit have been developed in the past to address certain specific practical problems and to permit elimination of most optional forms of benefit in many defined contribution plans. See A–2 and A–10 of § 1.411(d)–4 of the Income Tax Regulations.

Prior to the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), 115 Stat. 38 (2001), the authority to permit elimination of an optional form of benefit did not apply if the optional form constituted an early retirement benefit or retirement-type subsidy. EGTRRA amended § 411(d)(6)(B) to provide for the Secretary of Treasury to issue regulations under which § 411(d)(6)(B) would not apply to any plan amendment which reduces or eliminates benefits or subsidies that create significant burdens or complexities for the plan and plan participants, unless such amendment adversely affects the rights of any participant in a more than *de minimis* manner. Under section 645(b)(3) of EGTRRA, these regulations are to be issued by December 31, 2003 and are to apply to plan years beginning after December 31, 2003 or an earlier date.

COMMENTS REQUESTED

The Service and Treasury intend to issue proposed regulations under § 411(d)(6) of the Code with respect to optional forms of benefit under defined benefit plans. Consequently, comments are requested on which optional forms of benefit (including early retirement benefits and retirement-type subsidies) should be permitted to be eliminated and the circumstances under which they should be permitted to be eliminated, consistent with § 411(d)(6)(B) as amended by EGTRRA. In particular, comments are requested on when particular optional forms of benefit (whether or not subsidized) result in significant burdens and complexities for sponsors of

[1] Section 204(g)(2) of the Employee Retirement Income Security Act of 1974 (ERISA), Public Law 93–406, (88 Stat. 829), provides a parallel rule to § 411(d)(6)(B) of the Internal Revenue Code that applies under Title I of ERISA, and authorizes the Secretary of the Treasury to provide exceptions to this parallel ERISA requirement. Thus, Treasury regulations issued under § 411(d)(6)(B) of the Internal Revenue Code apply as well for purposes of § 204(g)(2) of ERISA.

retirement plans and for participants and when these optional forms of benefit are of *de minimis* value to a participant. Comments are also requested on which optional forms of benefit should remain protected. Finally, comments are requested on any other issues relating to the treatment of optional forms of benefit under defined benefit plans under § 411 (d)(6) on which guidance is needed.

The authority to provide exceptions to the restrictions of § 411(d)(6) does not apply to other requirements of the Internal Revenue Code. Thus, for example, the upcoming regulations will not permit a defined benefit plan to be amended to eliminate a distribution form required by §§ 401(a)(11) and 417 and will not affect the requirements of § 401(a)(31) (relating to direct rollovers).

Comments should be submitted by September 30, 2002, in writing, and should reference Notice 2002–46.

Comments may be submitted to CC: ITA:RU (Notice 2002–46), room 5226, Internal Revenue Service, POB 7604 Ben Franklin Station, Washington, DC 20044. Comments may be hand delivered between the hours of 8 a.m. and 5 p.m., Monday through Friday to: CC:ITA:RU (Notice 2002–46), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, D.C. Alternatively, comments may be submitted via the Internet at *Notice.Comments@ irscounsel.treas.gov.* All comments will be available for public inspection and copying.

DRAFTING INFORMATION

The principal authors of this notice are Linda Marshall of the Office of the Associate Chief Counsel (Tax Exempt and Government Entities) and Andrew Zuckerman of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this notice, contact the Employee Plans taxpayer assistance telephone service between the hours of 8:00 a.m. and 6:30 p.m. Eastern Time, Monday through Friday by calling 1–877–829–5500 (a toll-free number). Ms. Marshall can be reached at (202) 622–6090 and Mr. Zuckerman can be reached at (202) 283–9655 (not toll-free numbers).

Application of Employment Taxes to Statutory Stock Options

Notice 2002–47

I. Purpose and Overview

This notice provides that until Treasury and the Service issue further guidance, in the case of a statutory stock option, *i.e.*, an incentive stock option (ISO) described in section 422(b) of the Internal Revenue Code (Code) or an option granted under an employee stock purchase plan (ESPP) described in section 423(b), the Service will not assess the Federal Insurance Contributions Act (FICA) tax or Federal Unemployment Tax Act (FUTA) tax, or apply federal income tax withholding obligations, upon either the exercise of the option or the disposition of the stock acquired by an employee pursuant to the exercise of the option. This notice further announces that Treasury and the Service anticipate that any final guidance that would apply employment taxes to statutory stock options will not apply to any exercise of a statutory stock option that occurs before the January 1 of the year that follows the second anniversary of the publication of the final guidance. This notice does not relieve individual taxpayers of the obligation to include compensation in income upon a disposition of stock acquired pursuant to the exercise of a statutory stock option and does not relieve employers of any of their reporting obligations.

II. Background

A. Notice 2001–14

On January 18, 2001, the Internal Revenue Service (Service) issued Notice 2001–14, 2001–1 C.B. 516, addressing the application of employment taxes to statutory stock options. Notice 2001–14 provides that, in the case of a statutory stock option exercised before January 1, 2003, the Service will not assess FICA or FUTA taxes upon the exercise of the option, and will not treat the disposition of stock acquired by an employee pursuant to the exercise of the option as subject to federal income tax withholding. The notice further provides that information reporting requirements continue to be applicable. The notice also announced the intention to issue administrative guidance clarifying the application of employment taxes to statutory stock options.

B. Proposed Regulations and Related Guidance

On November 13, 2001, the Service and the Treasury Department issued proposed regulations addressing the application of employment taxes to statutory stock options (66 Fed. Reg. 57023 (Nov. 14, 2001)). The proposed regulations provide that FICA and FUTA taxes apply when an individual exercises a statutory stock option and that federal income tax withholding does not apply when an individual exercises a statutory stock option. As proposed, the regulations would have been effective for exercises of statutory stock options occurring on or after January 1, 2003.

On November 13, 2001, the Service also issued two related notices containing proposed guidance: Notice 2001–72, 2001–49 I.R.B. 548, and Notice 2001–73, 2001–49 I.R.B. 549. In Notice 2001–72, the Service provides proposed rules regarding an employer's federal income tax withholding and reporting obligations upon the disposition of stock acquired by an individual pursuant to the exercise of a statutory stock option. The rules would exempt the employer from any federal income tax withholding in such cases. However, under the proposed rules, an employer generally would still be required to make reasonable efforts to report any income on an employee's or former employee's Form W–2.

In Notice 2001–73, the Service provides proposed rules of administrative convenience intended to lessen the administrative burdens related to the application of FICA and FUTA taxes at the time of exercise of a statutory stock option. The rules would allow employers to deem the wages paid due to the exercise of a statutory stock option as being paid at any subsequent date or dates during the calendar year of the date of exercise. In addition, under the proposed rules, an employer would be allowed to spread the deemed wage payments over a

period of dates. Notice 2001–73 also proposes other rules of administrative convenience that are intended to assist employers and employees in meeting their employment tax obligations.

III. Comments Received

The Service requested comments as to the proposed regulations and the proposed rules in the accompanying notices. Comments were submitted on a wide variety of issues raised by the application of employment taxes to statutory stock options, including whether imposition of the FICA and FUTA taxes upon an exercise of a statutory stock option was the correct interpretation of the law, and the extent of the administrative burdens upon employers and employees in administering the payments of the taxes. Recognizing the complexity of the issues raised by the proposed guidance and comments, Treasury and the Service have determined that an extension of the moratorium is needed to provide adequate time to consider those issues.

IV. Interim Guidance

The Service and Treasury will continue to consider all of the comments received on the proposed regulations. However, until that review is completed and further guidance is issued, the Service (1) will not assess FICA or FUTA taxes upon the exercise of a statutory stock option or the disposition of stock acquired by an employee pursuant to the exercise of a statutory stock option, and (2) will not treat the exercise of a statutory stock option, or the disposition of stock acquired by an employee pursuant to the exercise of a statutory stock option, as subject to federal income tax withholding.

This Part IV does not relieve individual taxpayers of the obligation to include any compensation in income upon a disposition of stock acquired pursuant to the exercise of a statutory stock option and does not relieve employers of any of their reporting obligations. Regarding the reporting obligations, § 1.6041–2(a)(1) of the Income Tax Regulations requires that, under certain circumstances, a payment made by an employer to an employee be reported on Form W–2 even if the payment is not subject to income tax withholding. Specifically, § 1.6041–2(a)(1) generally requires reporting of a payment on the Form W–2 if the total amount of the payment, and any other payment of remuneration (including wages, if any) made to the employee (or former employee) that are required to be reported on Form W–2, aggregate at least $600 in a calendar year. Therefore, a disqualifying disposition of stock acquired pursuant to the exercise of a statutory stock option which results in ordinary income generally will result in a reporting obligation on the Form W–2.

V. Effect on Other Documents

In recognition of the need of employers and statutory stock option plan administrators for adequate time to implement any guidance that may be forthcoming, the Service and Treasury anticipate that any final guidance that would apply employment taxes to statutory stock options will not apply to exercises of statutory stock options that occur before the January 1 of the year that follows the second anniversary of the publication of the final guidance.

VI. Drafting Information

The principal author of this notice is Stephen Tackney of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice, contact Stephen Tackney at (202) 622–6040 (not a toll-free call).

Partnership Straddle Tax Shelter

Notice 2002–50

The Internal Revenue Service and the Treasury Department have become aware of a type of transaction, described below, that is being used by taxpayers for the purpose of generating deductions. This notice alerts taxpayers and their representatives that the tax benefits purportedly generated by these transactions are not allowable for federal income tax purposes. This notice also alerts taxpayers, their representatives, and promoters of these transactions of certain responsibilities that may arise from participating in these transactions.

FACTS

This transaction involves partnerships manipulated through a series of steps carried out in the following order. No § 754 election is in effect at any relevant time. *Step 1*: Corporation acquires a majority interest in an upper tier partnership (UTP) at fair market value. *Step 2*: UTP acquires a majority interest in a lower tier partnership (LTP) at fair market value. *Step 3*: LTP enters into straddles on foreign currencies and may acquire other assets. *Step 4*: LTP terminates the gain leg of a foreign currency straddle. LTP allocates a *pro rata* share of the gain to UTP, which in turn allocates a *pro rata* share of the gain to Corporation. This gain increases the basis of each partnership interest. *Step 5*: Corporation sells its interest in UTP to Taxpayer at fair market value. This results in a loss to Corporation sufficient to offset the gain that was allocated to Corporation. *Step 6*: Taxpayer purchases UTP's interest in LTP at fair market value. UTP realizes a loss on this sale, but the loss is disallowed under § 707(b)(1)(A) because Taxpayer owns more than 50% of UTP. *Step 7*: LTP engages in a transaction that is intended to increase Taxpayer's basis in the LTP interest. For example, LTP may incur a liability that Taxpayer guarantees. LTP then terminates the loss leg of the foreign currency straddle and allocates a *pro rata* share of the loss to Taxpayer. *Step 8*: Taxpayer sells the interest in LTP at its fair market value and realizes gain (for example, from the relief of liability). Taxpayer then claims that this gain is offset under § 267(d) by the amount of the loss that was disallowed to UTP under § 707(b)(1)(A).

ANALYSIS

The transaction described in this notice has been designed to use a straddle, a tiered partnership structure, a transitory partner, and the absence of a § 754 election to allow Taxpayer to claim a permanent non-economic loss. The Service intends to challenge the purported tax benefits from this transaction on a number of grounds. First, the Service expects that the partnership anti-abuse rule contained in § 1.701–2(b) of the Income Tax

Regulations will generally disallow the deduction claimed by the Taxpayer upon the termination of the loss leg of the straddle. *See* § 1.701–2(d) (Ex. 8) (disallowing duplication of a built-in loss deduction attributable to the absence of a § 754 election). Second, the Service may challenge the allowance of the loss deduction based on other statutory provisions, including § 988, and judicial doctrines, including the step transaction doctrine and the doctrines of economic substance, business purpose, and substance over form. Third, the Service may assert that, where a loss is disallowed on the sale of a partnership interest under § 267(a)(1) or § 707(b)(1), § 267(d) must be applied under an aggregate approach rather than an entity approach. See § 1.701–2(e) (requiring aggregate treatment of partnerships for certain purposes). Because the gain realized by Taxpayer on the sale of its interest in LTP does not correspond to any increase in the value of the assets within LTP, the disallowed loss realized on the sale of LTP by UTP cannot be used to offset the gain under an aggregate approach.

Transactions that are the same as, or substantially similar to, the transaction described in this notice are identified as "listed transactions" for purposes of § 1.6011–4T(b)(2) of the temporary Income Tax Regulations and § 301.6111–2T(b)(2) of the temporary Procedure and Administration Regulations. *See also* § 301.6112–1T, A–4. For purposes of § 1.6011–4T(b)(2) and § 301.6111–2T(b)(2), a transaction will be considered the same as, or substantially similar to, the transaction described in this notice even if, at the time relevant for making such determination, the taxpayer in such transaction has not engaged in a step having the effect of Step 8.

Persons who are required to satisfy the registration requirement of § 6111 with respect to the transaction described in this notice and who fail to do so may be subject to the penalty under § 6707(a). Persons who are required to satisfy the list-keeping requirement of § 6112 with respect to the transaction and who fail to do so may be subject to the penalty under § 6708(a). In addition, the Service may impose penalties on participants in this transaction or substantially similar transactions or, as applicable, on persons who participate in the promotion or reporting of this transaction or substantially similar transactions, including the accuracy-related penalty under § 6662, the return preparer penalty under § 6694, the promoter penalty under § 6700, and the aiding and abetting penalty under § 6701.

The principal author of this notice is Heather Faught of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice, contact Ms. Faught at (202) 622–3060 (not a toll-free call).

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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, §§ 1502; 1.1502–77, 1.1502–77A.)

Rev. Proc. 2002–43

Determination of Substitute Agent for a Consolidated Group When the Common Parent Ceases to Exist

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SECTION 1. PURPOSE

This revenue procedure provides instructions for all communications relating to the determination of a substitute agent to act on behalf of a consolidated group pursuant to §1.1502–77(d) or § 1.1502–77A(d) of the Income Tax Regulations. This revenue procedure is the exclusive procedure under §§ 1.1502–77(d) and 1.1502–77A(d) for submitting the communications identified in section 3 of this revenue procedure. This revenue procedure also provides for the automatic approval of requests by a terminating common parent to designate its qualifying successor as substitute agent.

SECTION 2. GENERAL BACKGROUND

In general, the corporation that is the common parent of a consolidated group for a taxable year is the sole agent for the group with regard to the group's income tax liability for that taxable year. The original common parent generally remains the agent for the group for that taxable year, even if another corporation is the common parent of the group in a later year or the group later terminates. However, the original common parent cannot act as sole agent if its own existence terminates. In that case, the group may require a substitute agent to function with respect to prior open taxable years for which the original common parent was the group's agent. Sections 1.1502–77(d) and 1.1502–77A(d) provide rules regarding a substitute agent to replace a terminating or terminated common parent. This revenue procedure sets forth the procedures under those rules. These procedures also apply when a substitute

agent's existence terminates. In this revenue procedure, references to a terminating or terminated common parent include a substitute agent going out of existence.

SECTION 3. SPECIFIC BACKGROUND INFORMATION REGARDING DIFFERENT MEANS OF DETERMINING A SUBSTITUTE AGENT

.01 Sections 1.1502–77(d)(1) and 1.1502–77A(d) provide for several different means of determining a substitute agent to act on behalf of a consolidated group. Each method is described below. Some can apply only to consolidated return years beginning on or after June 28, 2002, some can apply only to years beginning before June 28, 2002, and some can apply to any or all open years. If the terminating common parent is agent for any open years beginning before June 28, 2002, the Internal Revenue Service (IRS) recommends that the terminating common parent designate a substitute agent, because that is the only single procedure applicable to all open years. Designation by the terminating common parent affords the group the greatest choice as to the selection of its substitute agent and ensures the least interruption of communication with the IRS.

.02 A terminating common parent may designate a substitute agent. See §§ 1.1502–77(d)(1) and 1.1502–77A(d). Designation by a terminating common parent is available for any and all taxable years for which the terminating common parent is agent for the group. This revenue procedure provides different procedures depending on whether the terminating common parent designates its qualifying successor (see section 6 of this revenue procedure) or another corporation (see section 7 of this revenue procedure).

(1) If the terminating common parent designates its qualifying successor in accordance with the procedures of this revenue procedure, that designation is automatically approved without further communication from the IRS, and will be effective on the later of the termination of the common parent or the filing of the designation with the IRS. See section 6.02 of this revenue procedure for the definition of a qualifying successor. Designation by the terminating common parent of its qualifying successor as substitute agent is generally available for any consolidated return year.

(2) The terminating common parent may also designate certain corporations other than its qualifying successor as substitute agent (see section 7 of this revenue procedure). Such a designation is subject to approval by the IRS. Designation of a corporation other than the terminating common parent's qualifying successor as substitute agent is generally available for any consolidated return year.

.03 If the terminating common parent does not designate a substitute agent, the remaining members may designate a substitute agent, but only for consolidated return years beginning before June 28, 2002. See § 1.1502–77A(d). The designation must be filed in the manner specified in section 8 of this revenue procedure, and is not effective until the IRS approves the designation.

.04 If the terminating common parent does not designate a substitute agent, its qualifying successor, if any, may notify the IRS that it is the substitute agent by default, but only for consolidated return years beginning on or after June 28, 2002. See § 1.1502–77(d)(2). IRS approval is not required, but the IRS is not required to send communications to, or act on communications from, the successor until it provides notification to the IRS of its status as a default substitute agent under section 9 of this revenue procedure.

.05 If the terminating common parent does not designate a substitute agent and has no qualifying successor, one or more members of the group may request the IRS to designate a substitute agent, but only for consolidated return years beginning on or after June 28, 2002. See § 1.1502–77(d)(3)(i). The request is made pursuant to section 10 of this revenue procedure. If the group does not request designation of a substitute agent in this situation, the IRS may nevertheless (if it has reason to believe there is no default substitute agent) designate any group member or successor of a member as the substitute agent for the group.

.06 If the IRS designated a substitute agent for consolidated return years beginning on or after June 28, 2002, one or more members of the group may request that the IRS replace the previously designated substitute with another member (or successor of a member), in accordance with the procedures of section 11 of this revenue procedure.

SECTION 4. SCOPE

.01 *In general*. This revenue procedure applies to any designation of a substitute agent under §§ 1.1502–77(d)(1) or 1.1502–77A(d), notification of the existence of a default substitute agent under § 1.1502–77(d)(2), request under § 1.1502–77(d)(3)(i) for the designation of a substitute agent, and request under § 1.1502–77(d)(3)(ii) for replacement of a previously designated substitute agent.

.02 *References to IRS*. References in this revenue procedure to the IRS include any official to whom the Commissioner's authority under §§ 1.1502–77(d) or 1.1502–77A(d) has been duly delegated.

SECTION 5. WHERE TO FILE

Except as provided in section 11 of this revenue procedure, all documents described in this revenue procedure are filed at the following address:

Ogden Submission Processing Center
P.O. Box 9941
Mail Stop 4912
Ogden, UT 84409

SECTION 6. DESIGNATION BY A TERMINATING COMMON PARENT OF ITS QUALIFYING SUCCESSOR AS SUBSTITUTE AGENT

.01 *In general*. A terminating common parent may designate a substitute agent. See §§ 1.1502–77(d)(1), 1.1502–77(h)(1)(ii), and 1.1502–77A(d). Designation by a terminating common parent is available for any and all taxable years for which the terminating common parent is agent for the group. If the terminating common parent designates its qualifying successor in accordance with the procedures of this section 6, that designation is automatically approved without further communication from the IRS, and no written approval will be provided. Such designation will be effective on the later of the termination of the common parent or the filing of the designation with the IRS. Designation by a terminating common parent of its qualifying successor as

substitute agent with respect to consolidated return years beginning before June 28, 2002, requires the terminating common parent to elect to apply § 1.1502–77(d)(1) pursuant to § 1.1502–77(h)(1)(ii) in accordance with subsection .04(5) of this section 6. A designation by a common parent, before its existence terminates, of its qualifying successor as substitute agent for the group must be filed in accordance with the requirements set forth in this section 6.

.02 *Qualifying Successor*. For purposes of this revenue procedure, a "qualifying successor" must be (i) the sole entity that is primarily liable under applicable law (without regard to §§ 1.1502–1(f)(4) or 1.1502–6(a)) for the common parent's Federal income tax liability and (ii) a domestic corporation for Federal income tax purposes. Qualifying successors usually result from the merger of a terminating common parent into another domestic corporation.

.03 *When to file*. (1) *In general*. A terminating common parent's designation of its qualifying successor as substitute agent must be executed by the common parent before its existence terminates and, except as provided in paragraph (2) of this subsection .03, filed promptly.

(2) *Special rule*. If the qualifying successor does not come into existence before the common parent's existence terminates, the common parent must still execute the designation before its existence terminates, and the qualifying successor must promptly complete the designation after it comes into existence by executing the statement required in subsection .04(9) of this section 6 and filing the designation.

.04 *Contents*. The terminating common parent's designation of its qualifying successor as substitute agent must be in writing and contain the following information:

(1) The heading "REV. PROC. 2002–43: COMMON PARENT'S DESIGNATION OF ITS QUALIFYING SUCCESSOR AS SUBSTITUTE AGENT" must be typed or legibly printed at the top of the designation;

(2) Name, address, and employer identification number of the common parent making the designation;

(3) Name, address, and employer identification number of the common parent's qualifying successor and the consolidated return year(s) for which the designation applies (or a statement that it applies to all consolidated return years ending on or before the date of termination of the common parent);

(4) The name and employer identification number of the common parent under which the return(s) for which the designation applies was (were) filed, if different from the common parent named in paragraph (2) of this subsection .04;

(5) If the designation applies to any consolidated return year(s) beginning before June 28, 2002, a statement that the common parent elects pursuant to § 1.1502–77(h)(1)(ii) to apply § 1.1502–77(d)(1) with respect to such year(s);

(6) The Internal Revenue Service Center where the consolidated return(s) was (were) or will be filed, as the case may be, for the year(s) for which the designation applies;

(7) The expected date of termination of the common parent;

(8) The name, address, and phone number of any Examination Team Manager, Appeals Officer or Counsel Attorney who currently has jurisdiction of consolidated return year(s) for which the designation applies; and

(9) A statement on behalf of the qualifying successor in which it:

(a) Agrees to serve as the group's substitute agent pursuant to the common parent's designation; and

(b) If it was not a member of the group during the consolidated return year(s) for which it is designated, acknowledges that it is or will be primarily liable as a successor of the common parent of the group for the consolidated tax liability for such consolidated return year(s).

.05 *Signature requirements*. (1) The terminating common parent's designation of its qualifying successor as substitute agent must contain the following declaration, signed by a duly authorized officer of the common parent: **Under penalties of perjury, I declare that I am authorized to make this designation on behalf of the common parent and that, to the best of my knowledge, the information provided is true, correct, and complete.**

(2) The statement required under subsection .04(9) of this section 6 must contain the following declaration, signed by a duly authorized officer of the terminating common parent's qualifying successor: **Under penalties of perjury, I declare that I am authorized to sign this statement on behalf of the qualifying successor and that, to the best of my knowledge, the information provided is true, correct, and complete.**

SECTION 7. DESIGNATION BY A TERMINATING COMMON PARENT OF A CORPORATION OTHER THAN ITS QUALIFYING SUCCESSOR AS SUBSTITUTE AGENT

.01 *In general*. A terminating common parent may designate a substitute agent. See §§ 1.1502–77(d)(1), 1.1502–77(h)(1)(ii), and 1.1502–77A(d). Designation by a terminating common parent is available for any and all taxable years for which the terminating common parent is agent for the group. If the terminating common parent designates a corporation other than its qualifying successor as substitute agent, that designation is subject to approval by the IRS and is not effective unless and until it is approved. The designation must be made in accordance with the procedures of this section 7. The terminating common parent may designate:

(1) Any corporation that was a member of the group during any part of the consolidated return year for which the designation applies and has not subsequently been disregarded as an entity separate from its owner or reclassified as a partnership for Federal tax purposes; or

(2) Any successor of such a corporation, if such successor is a domestic corporation and is not disregarded as an entity separate from its owner or classified as a partnership for Federal tax purposes, including a corporation that will become a successor at the time that the common parent's existence terminates. The designation of a successor of a member as substitute agent is available for consolidated return years beginning before June 28, 2002, only if the terminating common parent elects to apply § 1.1502–77(d)(1) pursuant to § 1.1502–77(h)(1)(ii) in accordance with subsection .03(5) of this section 7. (See section 6 of this revenue procedure regarding the terminating common parent's designation of its qualifying successor as substitute agent.)

.02 *When to file*. (1) *In general*. A terminating common parent's designation of a corporation other than its qualifying successor as substitute agent under §§ 1.1502–77(d)(1) or 1.1502–77A(d) must be executed by the common parent before its existence terminates and, except as provided in paragraph (2) of this subsection .02, filed promptly.

(2) *Special rule*. If the substitute agent designated by the terminating common parent under this section 7 does not come into existence before the common parent's existence terminates, the common parent must still execute the designation before its existence terminates, and the designated substitute agent must promptly complete the designation after it comes into existence by executing the statement required in subsection .03(10) of this section 7 and filing the designation.

.03 *Contents*. The terminating common parent's designation of a corporation other than its qualifying successor as substitute agent must be in writing and contain the following information:

(1) The heading "REV. PROC. 2002–43: DESIGNATION OF SUBSTITUTE AGENT BY COMMON PARENT" must be typed or legibly printed at the top of the designation;

(2) Name, address, and employer identification number of the common parent making the designation;

(3) Name, address, and employer identification number of the designated substitute agent and the consolidated return year(s) for which the designation applies (or a statement that it applies to all consolidated return years ending on or before the date of termination of the common parent);

(4) The name and employer identification number of the common parent under which the return(s) for which the designation applies was (were) filed, if different from the common parent named in paragraph (2) of this subsection .03;

(5) If the common parent elects pursuant to § 1.1502–77(h)(1)(ii) to apply § 1.1502–77(d)(1) with respect to consolidated return years beginning before June 28, 2002, a statement making an election;

(6) The Internal Revenue Service Center where the consolidated return(s) was (were) or will be filed, as the case may be, for the year(s) for which the designation applies;

(7) The expected date of termination of the common parent;

(8) The name and address of the corporation(s) (or other person(s)) that have (or will have) custody of the books and records with respect to the consolidated return year(s) for which the designation applies, if different from the designated substitute agent named in paragraph (3) of this subsection .03, and if so, a description of the arrangements available to the designated substitute agent for access to the books and records;

(9) The name, address, and phone number of the Examination Team Manager, Appeals Officer or Counsel Attorney, if any, who currently has jurisdiction of the consolidated return year(s) for which the designation applies; and

(10) A statement on behalf of the substitute agent in which it:

(a) Agrees to serve as the group's substitute agent pursuant to the common parent's designation; and

(b) If it was not a member of the group during the consolidated return year(s) for which it is designated, acknowledges that it is or will be primarily liable as a successor of a member of the group for the consolidated tax liability for such consolidated return year(s).

.04 *Signature requirements*. (1) The terminating common parent's designation of a corporation other than its qualifying successor as substitute agent must contain the following declaration, signed by a duly authorized officer of the common parent: **Under penalties of perjury, I declare that I am authorized to make this designation on behalf of the common parent and that, to the best of my knowledge, the information provided is true, correct, and complete.**

(2) The statement required under subsection .03(10) of this section 7 must contain the following declaration, signed by a duly authorized officer of the substitute agent: **Under penalties of perjury, I declare that I am authorized to sign this statement on behalf of the designated substitute agent and that, to the best of my knowledge, the information provided is true, correct, and complete.**

.05 *Designations solely for consolidated return years subject to § 1.1502–77A(d)*. If the designation applies only to one or more consolidated return years beginning before June 28, 2002, and the designated substitute agent was a member (but not a successor of a member) of the group for the year(s) for which the designation applies, the election in paragraph (5) of subsection .03 and the statement signed on behalf of the designated substitute agent in paragraph (10) of subsection .03 are not applicable and are therefore not required.

.06 *Approval*. (1) The IRS may approve or disapprove for any reason a designation of a substitute agent under this section 7. Approval of such designation is in the sole discretion of the IRS.

(2) No designation by a terminating common parent under this section 7 applies unless and until it is approved by the IRS. Approval of a terminating common parent's designation under this section 7 will not be effective before the existence of the common parent making the designation terminates.

(3) The IRS will approve or disapprove any designation under this section 7 in writing to the terminating common parent and the substitute agent. Unless written approval is received from the IRS, taxpayers may not assume that the substitute agent has the authority to act on behalf of the group.

SECTION 8. DESIGNATION BY REMAINING MEMBERS OF THE GROUP UNDER § 1.1502–77A(d).

.01. *In general*. If a terminating common parent does not designate a substitute agent for any consolidated return year(s) beginning before June 28, 2002, the remaining members of the group may designate a substitute agent pursuant to § 1.1502–77A(d) for such year(s). The remaining members may designate as substitute agent any corporation that was a member of the group for any part of a consolidated return year for which the designation applies. The designation must be filed in accordance with the requirements set forth in this section 8.

.02 *When to file*. The designation of a substitute agent by the remaining members of the group under § 1.1502–

77A(d)(1) may be filed at any time after the common parent's existence terminates.

.03 *Contents*. The remaining members' designation of a substitute agent must be in writing and contain the following information:

(1) The heading "REV. PROC. 2002–43: DESIGNATION BY GROUP MEMBERS UNDER § 1.1502–77A(d)" must be typed or legibly printed at the top of the designation;

(2) Name, address, and employer identification number of the terminated common parent for which a substitute agent is being designated;

(3) Name, address, and employer identification number of the designated substitute agent and the consolidated return year(s) for which the designation applies (or a statement that it applies to all consolidated return years ending on or before the date of termination of the common parent);

(4) The name and employer identification number of the common parent under which the return(s) for which the designation applies was (were) filed, if different from the common parent named in paragraph (2) of this subsection .03;

(5) The Internal Revenue Service Center where the consolidated return(s) was (were) or will be filed, as the case may be, for the year(s) for which the designation applies;

(6) The date of termination of the common parent;

(7) The name and address of the corporation(s) (or other person(s)) that have (or will have) custody of the books and records with respect to the consolidated return year(s) for which the designation applies, if different from the designated substitute agent named in paragraph (3) of this subsection .03, and if so, a description of the arrangements available to the designated substitute agent for access to the books and records;

(8) A representation that the corporations signing the designation constitute all of the remaining members of the group; and

(9) The name, address, and phone number of the Examination Team Manager, Appeals Officer or Counsel Attorney, if any, who currently has jurisdiction of the consolidated return year(s) for which the designation applies.

.04 *Signature requirements*. The designation must contain the following declaration, signed by a duly authorized officer of each remaining member of the group for the consolidated return year(s) for which the designation applies: **Under penalties of perjury, I declare that I am authorized to make this designation on behalf of the named member of the group and that, to the best of my knowledge, the information provided is true, correct, and complete.** For purposes of this subsection .04, the designation may be submitted as a single document containing all required signatures or as multiple documents each signed by a duly authorized officer of a remaining member of the group.

.05 *Approval*. (1) The IRS may approve or disapprove for any reason a designation of a substitute agent under this section 8. Approval of such designation is in the sole discretion of the IRS.

(2) No designation under this section 8 applies unless and until it is approved by the IRS.

(3) The IRS will approve or disapprove any designation under this section 8 in writing to the member designated as substitute agent in subsection .03(3) of this section 8. Unless written approval is received from the IRS, taxpayers may not assume that the substitute agent has the authority to act on behalf of the group.

SECTION 9. NOTIFICATION BY DEFAULT SUBSTITUTE AGENT UNDER § 1.1502–77(d)(2)

.01 *In general*. If a terminating common parent that does not designate a substitute agent pursuant to § 1.1502–77(d)(1) has a qualifying successor (as defined in section 6.02 of this revenue procedure), such qualifying successor is the default substitute agent under § 1.1502–77(d)(2) for consolidated return years beginning on or after June 28, 2002. Such default substitute agent must provide notification to the IRS pursuant to the filing requirements set forth in this section 9 to insure that it will receive communications from the IRS to the group and to insure that the IRS will act on its communications to the IRS on behalf of the group.

.02 *When to file*. Notification by the default substitute agent should be filed promptly after the existence of the common parent terminates.

.03 *Contents*. The notification by the default substitute agent under § 1.1502–77(d)(2) must be in writing and contain the following information:

(1) The heading "REV. PROC. 2002–43: NOTIFICATION BY DEFAULT SUBSTITUTE AGENT UNDER § 1.1502–77(d)(2)" must be typed or legibly printed at the top of the notification;

(2) Name, address, and employer identification number of the terminated common parent;

(3) Name, address, and employer identification number of the default substitute agent and the consolidated return year(s) for which it is the substitute agent;

(4) The name and employer identification number of the common parent under which the return(s) for which the default substitute agent is the substitute agent was (were) filed, if different from the common parent named in paragraph (2) of this subsection .03;

(5) The Internal Revenue Service Center where the consolidated return(s) was (were) or will be filed, as the case may be, for the consolidated return year(s) for which the default substitute agent is the substitute agent;

(6) The date of termination of the common parent;

(7) The name, address, and phone number of the Examination Team Manager, Appeals Officer or Counsel Attorney, if any, who currently has jurisdiction of the consolidated return year(s) for which the default substitute agent is the substitute agent; and

(8) A statement in which the default substitute agent:

(a) Agrees to serve as the group's substitute agent; and

(b) If it was not a member of the group during the consolidated return year(s) for which it is the default substitute agent, acknowledges that it is primarily liable as a successor of the former common parent of the group for the consolidated tax liability for such consolidated return year(s).

.04 *Signature requirements*. The notification by a default substitute agent must contain the following declaration, signed by a duly authorized officer of the default substitute agent: **Under penalties of perjury, I declare that I am authorized to**

submit this notification on behalf of the default substitute agent and that, to the best of my knowledge, the information provided is true, correct, and complete.

.05 *No approval required*. IRS approval is not required for a default substitute agent, but the IRS is not required to send communications to, or act on communications from, a default substitute agent until it provides notification under this section 9.

SECTION 10. MEMBER'S REQUEST FOR THE IRS TO DESIGNATE A SUBSTITUTE AGENT UNDER § 1.1502–77(d)(3)(i)

.01 *In general*. If a terminating common parent does not designate a substitute agent and there is no default substitute agent under § 1.1502–77(d)(2), one or more members of the group may request that the IRS designate a substitute agent pursuant to § 1.1502–77(d)(3)(i) for consolidated return years beginning on or after June 28, 2002. Such request may (but is not required to) propose a member (or a successor of a member) for the IRS to designate as substitute agent.

.02 *When to file*. A request by a member of the group that the IRS designate a substitute agent may be filed at any time after the common parent's existence terminates and before the IRS designates a substitute agent.

.03 *Contents*. A request for designation of a substitute agent must be in writing and contain the following information:

(1) The heading "REV. PROC. 2002–43: REQUEST FOR DESIGNATION OF SUBSTITUTE AGENT UNDER § 1.1502–77(d)(3)" must be typed or legibly printed at the top of the designation;

(2) Name, address, and employer identification number of the terminated common parent;

(3) Name, address, and employer identification number of the proposed substitute agent, if any, and the consolidated return year(s) for which the designation is requested;

(4) The name and employer identification number of the common parent under which the return(s) for which the designation is requested was (were) filed, if different from the common parent named in paragraph (2) of this subsection .03;

(5) The Internal Revenue Service Center where the consolidated return(s) was (were) or will be filed, as the case may be, for the year(s) for which the designation is requested;

(6) The date the common parent's existence terminated and the circumstances under which it terminated (*e.g.*, dissolution under state law or merger into a limited liability company);

(7) The name and address of the corporation(s) (or other person(s)) that have custody of the books and records with respect to the consolidated return year(s) for which the designation is requested, if different from any proposed substitute agent named in paragraph (3) of this subsection .03, and if so, a description of the arrangements available to the proposed substitute agent for access to the books and records; and

(8) The name, address, and phone number of the Examination Team Manager, Appeals Officer or Counsel Attorney, if any, who currently has jurisdiction of the consolidated return year(s) for which the designation is requested.

.04 *Signature requirement*. A request under this section 10 must contain the following declaration, signed by a duly authorized officer of at least one of the requesting members which was a member of the group for the consolidated return year(s) for which the designation is requested: **Under penalties of perjury, I declare that I am authorized to make this request on behalf of the named member of the group and that, to the best of my knowledge, the information provided is true, correct, and complete.**

.05 *Designation by the IRS*. (1) In response to a request under this section 10, the IRS may, in its sole discretion, designate as the substitute agent the member (or successor of the member) proposed by the request, if any, or another member (or successor of another member).

(2) The IRS will notify in writing the designated substitute agent.

SECTION 11. REQUEST THAT IRS REPLACE A PREVIOUSLY DESIGNATED SUBSTITUTE AGENT

.01 *In general*. If the IRS designates a substitute agent pursuant to § 1.1502–77(d)(3)(i), one or more members of the group may request pursuant to § 1.1502–77(d)(3)(ii) that the IRS replace the previously designated substitute agent with another member (or successor of another member). Such request may (but is not required to) propose a substitute agent to replace the previously designated substitute agent.

.02 *When to file*. A request by a member of the group that the IRS replace a previously designated substitute agent may be filed at any time after the IRS designates the substitute agent that the request seeks to have replaced.

.03 *Contents*. A request that the IRS replace a previously designated substitute agent must be in writing and contain the following information:

(1) The heading "REV. PROC. 2002–43: REQUEST FOR IRS TO REPLACE PREVIOUSLY DESIGNATED SUBSTITUTE AGENT UNDER § 1.1502–77(d)(3)" must be typed or legibly printed at the top of the designation;

(2) Name, address, and employer identification number of the previously designated substitute agent;

(3) Name, address, and employer identification number of the proposed substitute agent, if any, to replace the previously designated substitute agent and the consolidated return year(s) for which the replacement designation is requested;

(4) The name and employer identification number of the common parent under which the return(s) for which the replacement designation is requested was (were) filed;

(5) The Internal Revenue Service Center where the consolidated return(s) was (were) or will be filed, as the case may be, for the year(s) for which the replacement designation is requested;

(6) The date the common parent's existence terminated and the circumstances under which it terminated (*e.g.*, dissolution under state law or merger into a limited liability company);

(7) The name and address of the corporation(s) (or other person(s)) that have custody of the books and records with respect to the consolidated return years for which the replacement designation is requested, if different from the proposed replacement substitute agent named in paragraph (3) of this subsection .03, and if so, a description of the arrangements available to the proposed replacement substitute agent for access to the books and records;

(8) The name, address, and phone number of the Examination Team Manager, Appeals Officer or Counsel Attorney, if any, who currently has jurisdiction of the consolidated return years for which the replacement designation is requested; and

(9) The reason(s) for the request to replace the previously designated substitute agent.

.04 *Signature requirement*. A request under this section 11 must contain the following declaration, signed by a duly authorized officer of at least one of the requesting members which was a member of the group for the consolidated return year(s) for which the replacement designation is requested: **Under penalties of perjury, I declare that I am authorized to make this request on behalf of the named member of the group and that, to the best of my knowledge, the information provided is true, correct, and complete.**

.05 *Where to file*. Notwithstanding the instructions in section 4 of this revenue procedure, a request under this section 11 must be filed with the office that made the designation of the substitute agent that the request seeks to replace.

.06 *Designation by the IRS*. (1) In response to a request under this section 11, the IRS may, in its sole discretion, replace the previously designated substitute agent with the member (or successor of the member) proposed by the request or another member (or successor of another member).

(2) If the IRS replaces the previously designated substitute agent, it will notify in writing the previously designated substitute agent and the replacement substitute agent of the change in the substitute agent.

SECTION 12. EFFECTIVE DATE

This revenue procedure applies to designations of substitute agents and notifications of the existence of default substitute agents, and to requests for designation of a substitute agent or for replacement of a previously designated substitute agent made after June 28, 2002.

SECTION 13. PAPERWORK REDUCTION ACT

The collection of information contained in this revenue procedure has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control numbers 1545–1699 and 1545–1793.

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

The collections of information in this revenue procedure are in sections 6 through 11. These collections of information are required (i) for the common parent to notify the IRS of the designation of a substitute agent for the consolidated group when the common parent's existence is about to terminate and for the designated corporation to confirm that it agrees to serve as the group's substitute agent and qualifies to be the group's substitute agent, (ii) for the common parent's successor to notify the IRS that it qualifies as a default substitute agent, or (iii) for a member of a consolidated group to request that the IRS designate a substitute agent or replace a previously designated substitute agent. This information will be used (i) to determine whether to approve the designation of the substitute agent, (ii) to update IRS records with the name of the substitute agent, or (iii) to designate or replace a substitute agent. The collections of information are required to obtain a benefit in the case of a designation by the common parent or notification by a default substitute agent, and voluntary in the case of requests by members to designate or replace a substitute agent. The likely respondents are business or other for-profit institutions.

The estimated total annual reporting burden is 400 hours.

The estimated annual burden per respondent varies from one hour to 3 hours, depending on individual circumstances, with an estimated average of two hours. The estimated number of respondents is 200.

The estimated annual frequency of responses is on occasion.

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

SECTION 14. INQUIRIES

Inquiries regarding this revenue procedure may be addressed to the Commissioner of Internal Revenue, ATTN: CC:CORP:BO2, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044.

DRAFTING INFORMATION

The principal authors of this revenue procedure are George R. Johnson and Gerald B. Fleming of the Office of Associate Chief Counsel (Corporate). For further information regarding this revenue procedure, contact Mr. Johnson at (202) 622–7930 or Mr. Fleming at (202) 622–7770 (not toll-free numbers).

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26 CFR 601.204: Changes in accounting periods and methods of accounting.
(Also Part I, § 832; 1.832–4; 1.832–5.)

Rev. Proc. 2002–46

SECTION 1. PURPOSE

This revenue procedure provides certain insurance companies subject to tax under § 831 of the Internal Revenue Code with a safe harbor method of accounting for premium acquisition expenses. This revenue procedure also provides a procedure for insurance companies to obtain automatic consent of the Commissioner to change to this safe harbor method.

SECTION 2. BACKGROUND

.01 Section 832(b)(1) provides that the gross income of an insurance company subject to tax under § 831 includes the company's "underwriting income."

.02 Section 832(b)(3) defines "underwriting income" as "premiums earned on insurance contracts during the taxable year, less losses incurred and expenses incurred."

.03 Section 832(b)(4) provides that to compute premiums earned, an insurance company reduces the amount of gross premiums written on insurance contracts

during the taxable year by return premiums and premiums paid for reinsurance. Subject to the exceptions in §§ 832(b)(7), (b)(8), and 833, this amount is increased by 80 percent of the unearned premiums on outstanding insurance contracts at the end of the preceding taxable year, and is decreased by 80 percent of the unearned premiums on outstanding insurance contracts at the end of the current year. This 20 percent reduction in the amount of an insurance company's deduction for increases in unearned premiums is intended to represent the allocable portion of the company's expenses incurred in generating the unearned premiums. S. Rep. No. 313, 99th Cong. 2d Sess. 496 (1986), 1986–3 (Vol. 3) C.B. 496; H. Rep. No. 426, 99th Cong. 1st Sess. 669 (1985), 1986–3 (Vol. 2) C.B. 669.

.04 Sections 1.832–4(a)(3) through (11) of the Income Tax Regulations, effective for taxable years beginning after December 31, 1999, prescribe specific rules regarding the manner in which an insurance company determines gross premiums written, return premiums, and unearned premiums for purposes of the calculation of premiums earned under § 832(b)(4). These rules apply regardless of the accounting practices used by the insurance company to record gross premiums written and unearned premiums on its annual statement filed for state regulatory reporting purposes. Section 1.832–4(a)(4) defines "gross premiums written" as "all amounts payable for the effective period of the insurance contract." Section 1.832–4(a)(5)(i) generally requires the insurance company to report gross premiums written "for the earlier of the taxable year that includes the effective date of the insurance contract or the year in which the company receives all or a portion of the gross premium for the insurance contract." In some situations, this rule may result in gross premiums written being taken into account in the calculation of premiums earned under § 832(b)(4) for a taxable year earlier than the year in which those written premiums are reported on the company's annual statement.

.05 Section 1.832–4(a)(5) provides special methods of reporting gross premiums written for certain categories of insurance contracts with installment premiums, including contracts for which an advance premium installment is received prior to the effective date of the underlying contract, cancellable accident and health insurance contracts, and certain multi-year insurance contracts with premiums payable at guaranteed rates. To use one of these special methods of reporting gross premiums written, the insurance company must satisfy an annual *pro rata* expense limitation with regard to the amount of premium acquisition expenses deducted for the underlying contract. Section 1.832–4(a)(5)(vii). This annual *pro rata* expense limitation ensures that the company does not deduct the premium acquisition expenses for the insurance contract more rapidly than the company includes the gross premiums written for the associated contract in the calculation of premiums earned under § 832(b)(4).

.06 Section 832(b)(6) provides that "expenses incurred" means all expenses shown on the insurance company's annual statement. Expenses incurred generally are calculated as the sum of the expenses paid during the taxable year, plus the increase in unpaid expenses during the taxable year. To be included in expenses incurred, an expense listed on the annual statement also must be an allowable deduction under § 832(c). Section 832(c) lists various categories of allowable deductions, including "all ordinary and necessary expenses incurred, as provided in § 162 (relating to trade or business expenses)." *See* § 832(c)(1).

.07 The 20 percent reduction in the deduction for increases in unearned premiums under § 832(b)(4) was intended to correct the mismatching that results from the deferral of unearned premium income and the current deduction of premium acquisition expenses. S. Rep. No. 313, at 496 (1986); H. Rep. No. 426, at 668–69 (1985). Consistent with this intent, the Internal Revenue Service will allow insurance companies within the scope of this revenue procedure to account for premium acquisition expenses using the safe harbor method described in section 5.02 of this revenue procedure.

SECTION 3. DEFINITIONS

The following definitions apply solely for purposes of this revenue procedure.

.01 *Premium acquisition expenses*. A premium acquisition expense is an expense that is primarily related to the production of gross premiums written on an insurance contract and directly varies with the amount of gross premiums written on the underlying contract. For example, agent and broker commissions, premium taxes, and premium-based assessments generally qualify as premium acquisition expenses because these expenses vary with and are primarily related to the acquisition of gross premiums written on new and renewal insurance contracts. An annual expense allowance payable by a reinsurer to assume all or a portion of the risk on insurance contracts of another insurance company is treated as a premium acquisition expense to the extent that this expense allowance reflects the reinsurer's reimbursement of the premium acquisition expenses incurred by the direct writing company. However, expenditures with respect to salaried personnel and general administrative costs typically will not qualify as premium acquisition expenses. Although a portion of these costs may be associated with activities relating to the issuance of insurance contracts, these expenditures do not vary directly based on the amount of gross premiums written for the associated contracts.

.02 *Pro forma premium acquisition expenses*. A *pro forma* premium acquisition expense is any unpaid premium acquisition expense that is not shown on the insurance company's annual statement for the year in which the insurance company includes the gross premiums written to which that expense relates in the calculation of premiums earned under § 832(b)(4).

.03 *Pro forma unearned premium reserve*. The *pro forma* unearned premium reserve is the portion of an insurance company's year-end unearned premiums (other than amounts to which special rules in §§ 832(b)(7)(A) and 832(b)(8) apply) attributable to gross premiums written that are not shown on the company's annual statement, but which the company is required to report in the calculation of premiums earned under § 832(b)(4) for the taxable year in accordance with the provisions of § 1.832–4.

.04 *Unearned premium reserve offset amount*. (i) Except as otherwise provided in paragraph 3.04(ii), an insurance company determines the unearned premium offset amount for a taxable year by multiplying—

(A) The amount, if any, by which the company's *pro forma* unearned premium reserve at the end of the taxable year exceeds its *pro forma* unearned premium reserve at the end of the preceding taxable year, by

(B) .20.

(ii) In the case of a financial guaranty insurer to which the special rules in § 832(b)(7)(B) apply, the unearned premium reserve offset amount is determined by multiplying the amount, if any, by which the company's *pro forma* unearned premium reserve for financial guaranty contracts at the end of the taxable year exceeds its *pro forma* unearned premium reserve for financial guaranty contracts at the end of the preceding taxable year by .10.

SECTION 4. SCOPE

.01 Except as otherwise provided in section 4.02 of this revenue procedure, this revenue procedure applies to any insurance company that is subject to tax under § 831(a) and determines its premiums earned for insurance contracts during the taxable year under § 832(b)(4) in accordance with the provisions of § 1.832–4.

.02 This revenue procedure does not apply to an existing Blue Cross or Blue Shield organization or any other organization to which § 833 applies.

SECTION 5. SAFE HARBOR METHOD

.01 Taxpayers within the scope of this revenue procedure are permitted to account for premium acquisition expenses incurred for taxable years beginning after December 31, 1999, using the safe harbor method described in section 5.02 of this revenue procedure.

.02 *Description of Safe Harbor Method*. (i) Except as provided in section 5.02(ii) of this revenue procedure, an insurance company is permitted to treat as premium acquisition expenses incurred for the taxable year an amount equal to the sum of —

(A) The amount of premium acquisition expenses paid during the taxable year;

(B) The difference between the unpaid premium acquisition expenses shown on the company's annual statement for the taxable year and the unpaid premium acquisition expenses shown on the company's annual statement for the preceding taxable year; and

(C) The difference between the amount of the insurance company's *pro forma* premium acquisition expenses at the end of the taxable year and the company's *pro forma* premium acquisition expenses at the end of the preceding taxable year.

(ii) *Limitation on current deductibility of certain pro forma expenses*. For purposes of calculating the premium acquisition expenses incurred for the taxable year under section 5.02(i) of this revenue procedure, the amount taken into account as a net increase in *pro forma* premium acquisition expenses during the year under section 5.02(i)(C) cannot exceed the insurance company's unearned premium reserve offset amount for that year. If the amount taken into account as a net increase in *pro forma* premium acquisition expenses during the year under section 5.02(i)(C) is reduced as a result of this limitation, the reduction amount is carried forward and increases the company's *pro forma* premium acquisition expenses at the end of the succeeding taxable year.

SECTION 6. APPLICATION OF SAFE HARBOR METHOD TO CERTAIN CONTRACTS WITH INSTALLMENT PREMIUMS

An insurance company using one of the special methods of reporting gross premiums written in § 1.832–4(a)(5) for a category of insurance contracts with installment premiums may apply the safe harbor method to determine the amount of premium acquisition expenses treated as incurred for the taxable year with regard to those contracts. The company's premium acquisition expenses treated as incurred for the taxable year with regard to those contracts, however, cannot exceed the annual *pro rata* expense limitation of § 1.832–4(a)(5)(vii). If the insurance company is required to reduce the amount of premium acquisition expenses that would otherwise be treated as incurred for a taxable year in order to meet the annual *pro rata* expense limitation of § 1.832–4(a)(5)(vii), the reduction amount is carried forward and is taken into account in determining the company's premium acquisition expenses incurred with regard to those contracts for the succeeding taxable year.

SECTION 7. CHANGE IN METHOD OF ACCOUNTING

.01 *In general*. A change to the safe harbor method provided in section 5.02 of this revenue procedure is a change in method of accounting to which the provisions of §§ 446 and 481 and the regulations thereunder apply. Thus, in order to change to the safe harbor method, an insurance company must complete Form 3115, *Application for Change In Method of Accounting*, and otherwise comply with the procedures in this section 7.

.02 *Automatic change*. A taxpayer that wants to change its method of accounting for premium acquisition expenses to the safe harbor method provided by section 5.02 of this revenue procedure must follow the automatic change in method of accounting provisions of Rev. Proc. 2002–9, 2002–3 I.R.B. 327 (or its successor), as modified by Rev. Proc. 2002–19, 2002–13 I.R.B. 696, with the following modifications:

(1) The scope limitations in section 4.02 of Rev. Proc. 2002–9 do not apply.

(2) To assist the Service in processing changes in method of accounting under this section of the revenue procedure, and to ensure proper handling, section 6.02(4)(a) of Rev. Proc. 2002–9 is modified to require that a Form 3115 filed under this revenue procedure include the statement: "Automatic Change Filed Under Rev. Proc. 2002–46." This statement should be legibly printed or typed on the appropriate line of any Form 3115 filed under this revenue procedure.

.03 *Automatic change for the first taxable year beginning after December 31, 1999*. A taxpayer that wants to change to the safe harbor method for its first taxable year beginning after December 31, 1999, is not subject to the filing requirements in section 6.02(3)(a) or the effective date provision in section 13.01 of Rev. Proc.

2002–9, provided that the taxpayer complies with the following filing requirements. The taxpayer must complete and file a Form 3115 in duplicate. The original must be filed with the taxpayer's amended federal income tax return for its first taxable year beginning after December 31, 1999. A copy of the Form 3115 must be filed with the national office (see Rev. Proc. 2002–9 for the address) no later than when the taxpayer's amended return is filed. The amended return must be filed no later than January 21, 2003. A taxpayer that wants to change to the safe harbor method for a taxable year earlier than its first taxable year ending on or after December 31, 2001, must take into account the § 481(a) adjustment required as a result of the change over a four-year adjustment period. See sections 4.01 and 4.04(1) of Rev. Proc. 2002–19.

.04 *Pending applications with national office*. If a taxpayer filed an application or ruling request with the national office to make a change in method of accounting for premium acquisition expenses for a taxable year beginning before January 1, 2002, and the application or ruling request is pending with the national office on June 20, 2002, the taxpayer may make the method change under this revenue procedure. However, the national office will process the application or ruling request in accordance with the authority under which it was filed, unless prior to September 20, 2002, the taxpayer notifies the national office that it wants to make the method change under this revenue procedure. If the taxpayer timely notifies the national office that it wants to make the method change under this revenue procedure, the application or ruling request will be considered closed and any user fee that was submitted with the application or ruling request will be returned to the taxpayer.

SECTION 8. EXAMPLE

The following example illustrates the manner in which an insurance company applies the safe harbor method to determine the amount of premium acquisition expenses treated as incurred for the taxable year.

Example.

(i) IC is an insurance company taxable as described in section 4 of this revenue procedure that files its returns on a calendar year basis. IC writes automobile insurance policies which provide insurance coverage for a one-year period beginning on January 1st and ending on December 31st. The premiums for the policies are payable on a monthly installment basis. For annual statement reporting purposes, IC reports gross premiums written for these insurance policies based on the calendar year in which the related coverage commences. For purposes of calculating its premiums earned under § 832(b)(4), IC is required by § 1.832–4(a)(5)(i) to report gross premiums written for the policies for the earlier of the taxable year that includes the effective date of the related policies or the year in which all or a portion of the premiums for the policies are received. However, pursuant to § 1.832–4(a)(5)(iii), IC has adopted the method of reporting advance premium installments in gross premiums written for the taxable year of receipt.

(ii) As of December 31, 2002, IC has collected $250 of advance premium installments during the year with respect to insurance policies with effective dates in 2003. IC determines that the premium acquisition expenses attributable to these advance premium installments are $62.50 and that the total amount of premium acquisition expenses expected to be incurred over the effective period of the related insurance policies is $750. On its 2002 annual statement, IC reports total amount of premium acquisition expenses of $1,250, consisting of $1,000 of paid expenses plus a $250 increase in unpaid expenses. The expenses shown on IC's 2002 annual statement did not include the $62.50 of premium acquisition expenses attributable to $250 of advance premium installments that IC collected in 2002 with respect to policies with effective dates in 2003, but did include $50 of premium acquisition expenses attributable to $200 of advance premium installments that IC collected in 2001 with respect to policies with effective dates in 2002. Pursuant to § 1.832–4(a)(5)(iii), IC had already included those $200 of advance premium installments in gross premiums written and unearned premiums when calculating the amount of premiums earned under § 832(b)(4) for the 2001 taxable year.

(iii) For the taxable year ending December 31, 2002, IC changes to the safe harbor method of deducting premium acquisition expenses described in section 5.02 of this revenue procedure. To determine the deductible premium acquisition expenses for the 2002 taxable year, IC adds the amount of premium acquisition expenses paid during the taxable year ($1,000) to the increase in unpaid expenses as shown on the 2002 annual statement ($250). The increase in *pro forma* premium acquisition expenses for the taxable year equals $12.50 ($62.50 - $50.00 = $12.50). For the 2002 taxable year, IC's unearned premium reserve offset amount equals $10 (($250 x .20 = $50) - ($200 x .20 = $40)). Accordingly, IC's deductible premium acquisition expenses for the 2002 taxable year equal $1,260 ($1,000 + 250 +10). The $2.50 of *pro forma* premium acquisition expenses which cannot be deducted in 2002 as a result of the limitation in section 5.02(ii) is added to IC's *pro forma* premium acquisition expenses at the end of the 2003 taxable year.

(iv) To determine the amount of premium acquisition expenses deductible under the safe harbor method, IC also must apply the annual *pro rata* expense limitation of § 1.832–4(a)(5)(vii) with respect to those insurance policies for which IC collected advance premium installments during 2002. For this purpose, IC compares the ratio of the amount of expenses allowable under the safe harbor method over the total premium acquisition expenses for the related insurance policies (($62.50 - 2.50 = $60)/$750 = .08) with the ratio of the advance premium installments over the total gross premiums written for the related insurance policies ($250/$2,000 = .125). As .08 is less than .125, the amount of premium acquisition expenses determined under the safe harbor method satisfies the annual *pro rata* expense limitation of § 1.832–4(a)(5)(vii).

(v) On its 2002 federal income tax return, IC follows the general automatic change procedures of Rev. Proc. 2002–9, as modified by this revenue procedure, to change to the safe harbor method. This change in method of accounting results in a negative § 481(a) adjustment of $50, the *pro forma* acquisition expenses attributable to the $200 of advance premium installments received by IC for the 2001 taxable year. Pursuant to section 5.04 of Rev. Proc. 2002–9, as modified by Rev. Proc. 2002–19, IC takes the $50 negative § 481(a) adjustment into account in one-year in computing its taxable income for the taxable year ending December 31, 2002.

SECTION 9. EFFECTIVE DATE

This revenue procedure is effective for changes in method of deducting premium acquisition expenses for the taxable years ending after December 31, 1999.

SECTION 10. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2002–9 is modified and amplified to include this automatic method change in section 5 of the APPENDIX.

DRAFTING INFORMATION

The principal authors of this revenue procedure are Gary Geisler and Melissa Luxner of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue procedure, contact Ms. Luxner at (202) 622–3970 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations.

Modification of Tax Shelter Rules III

REG–103735–00; REG–110311–98

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: These proposed rules provide the public with additional guidance needed to comply with the disclosure rules under section 6011(a) and the registration requirement under section 6111(d). These rules also affect the list maintenance requirement under section 6112. The proposed rules affect taxpayers participating in certain reportable transactions, persons responsible for registering confidential corporate tax shelters, and organizers of potentially abusive tax shelters. In the rules and regulations portion of the **Federal Register**, the IRS is issuing temporary regulations (T.D. 9000 on page 87 of this Bulletin) modifying the rules relating to the requirement that certain taxpayers file a statement with their Federal income tax returns under section 6011(a), and the registration of confidential corporate tax shelters under section 6111(d). The text of those temporary regulations also serves as the text of these proposed regulations.

DATES: Written or electronic comments and requests for a public hearing must be received by September 16, 2002.

ADDRESSES: Send submissions to: CC:ITA:RU (REG–103735–00; REG–110311–98), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU (REG–103735–00; REG–110311–98), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit electronic comments directly to the IRS Internet site at *www.irs.gov/regs.*

FOR FURTHER INFORMATION CONTACT: Danielle M. Grimm or Tara P. Volungis, 202–622–3080 (not a toll-free number); concerning submissions, Sonya Cruse, 202–622–7180 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in this notice of proposed rulemaking have been previously reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545–1685.

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

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

Background

The temporary regulations amend 26 CFR part 1 regarding rules relating to the filing and records requirements for certain taxpayers under section 6011. The temporary regulations also amend 26 CFR part 301 regarding the registration of confidential corporate tax shelters under section 6111.

The text of the temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the regulations.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that the time required to prepare or retain the disclosure is minimal and will not have a significant impact on those small entities that are required to provide disclosure. 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, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (preferably a signed original and eight (8) copies) or electronically generated comments that are submitted timely to the IRS. The IRS and Treasury request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register.**

Drafting Information

The principal authors of these regulations are Danielle M. Grimm and Tara P. Volungis, Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 301, which were proposed to be amended at 66 FR 41133 (August 7, 2001), are proposed to be further amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.6011–4, as proposed at 66 FR 41169 (August 7, 2001), is amended as follows:

1. The heading of § 1.6011–4 is amended by removing the language "corporate".

2. The heading of paragraph (a) is revised.

3. Paragraph (a) is amended by adding "(1) *In general*." after the heading.

4. Newly designated paragraph (a)(1) is amended by adding the language "corporate" before "taxpayer" in the first sentence, and by removing the second sentence and adding three new sentences in its place.

5. Paragraphs (a)(2) and (a)(3) are added.

6. Paragraph (b)(1) is amended by revising the first sentence.

7. Paragraphs (b)(1)(i) and (b)(1)(ii) are added.

8. Paragraph (b)(4)(i) is amended by removing the first sentence.

9. Paragraph (b)(5) *Example 3* is amended by revising the seventh sentence.

10. Paragraphs (c)(1)(iii) and (c)(1)(v) are revised.

11. Paragraph (c)(2) *Example* is amended by adding the language "*Example*." after "of this section:" in the first sentence and by adding "as in effect at that time." to the end of the third sentence.

12. Paragraph (d)(1) is revised.

13. Paragraph (e) is amended by removing the language "corporation's" in the first sentence and adding "taxpayer's" in its place.

14. Paragraph (g) is revised.

The revisions and additions read as follows:

§ 1.6011–4 Requirement of statement disclosing participation in certain transactions by taxpayers.

[The text of the amendments to this proposed section is the same as the text of the amendments to § 1.6011–4T published elsewhere in this issue of the **Federal Register.**]

PART 301—PROCEDURE AND ADMINISTRATION

Par. 3. The authority citation for part 301 continues to read in part as follows:

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

Par. 4. Section 301.6111–2, as proposed to be added at 66 FR 41169 (August 7, 2001), is amended as follows:

1. Paragraph (a)(3) is amended by adding four sentences to the end of the paragraph.

2. The heading for paragraph (h) is revised and the entire text after the second sentence is removed and four new sentences are added in their place.

The revision and additions read as follows:

§ 301.6111–2 Confidential corporate tax shelters.

[The text of the amendments to this proposed section is the same as the text of the amendments to § 301.6111–2T published elsewhere in this issue of the **Federal Register.**]

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on June 14, 2002, 11:32 a.m., and published in the issue of the Federal Register for June 18, 2002, 67 F.R. 41362)

Notice of Proposed Rulemaking and Notice of Public Hearing

Guidance Under Section 6050P Regarding Cancellation of Indebtedness

REG–107524–00

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the information reporting requirement under section 6050P of the Internal Revenue Code (Code) for cancellation of indebtedness. The proposed regulations reflect the enactment of section 6050P(c)(2)(D) by the Ticket to Work and Work Incentives Improvement Act of 1999. Section 6050P(c)(2)(D) requires organizations a significant trade or business of which is the lending of money to report discharges of indebtedness. The proposed regulations also conform the existing regulations to statutory changes made by the Debt Collection Improvement Act of 1996. In addition, under the proposed regulations, if an organization that is required to report under section 6050P (an applicable entity) forms, or avails itself of, some other entity for the principal purpose of holding loans acquired by the applicable entity, then, for purposes of section 6050P, the entity so formed or availed of is treated as having a significant trade or business of lending money. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by September 17, 2002. Requests to speak (with outlines of oral comments) at a public hearing scheduled for October 8, 2002, at 10:00 a.m., must be received by September 17, 2002.

ADDRESSES: Send submissions to: CC:ITA:RU (REG–107524–00), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU (REG–107524–00), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically directly to the IRS Internet site at: *www.irs.gov/regs*. The public hearing will be held in Room 4718, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Donna J. Welch at (202) 622–4910;

concerning submissions and delivery of comments, and the hearing, Treena Garrett at (202) 622–7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) defining an organization a significant trade or business of which is the lending of money under section 6050P(c)(2)(D). Section 6050P(c)(2)(D) was enacted by section 553(a) of the Ticket to Work and Work Incentives Improvement Act of 1999, Public Law No. 106–170, 113 Stat. 1860, 1931 (1999) ("the Act"), effective for discharges of indebtedness occurring after December 31, 1999. Generally, section 6050P(a) requires organizations that are subject to that section (applicable entities) to file returns with the Service and to provide statements to persons whose names are required to be shown on the returns ("payees"), setting forth certain information regarding discharges of indebtedness of $600 or more. Section 553(a) of the Act amended section 6050P of the Code by expanding the types of entities that are required to report discharges of indebtedness to include any organization "a significant trade or business of which is the lending of money." Notice 2000–22, 2000–1 C.B. 902, provides that penalties under sections 6721 and 6722 will not be imposed on the lending organizations newly required to report discharges of indebtedness for failures to report discharges of indebtedness occurring before January 1, 2001. In addition, Notice 2001–8, 2001–1 C.B. 374, extended that suspension of penalties for failures to file information returns for any discharge of indebtedness that occurs prior to the first calendar year beginning at least two months after the date that appropriate guidance is issued.

This document also contains proposed amendments to the Income Tax Regulations (26 CFR part 1) conforming the existing regulations under section 6050P to statutory changes made by the Debt Collection Improvement Act of 1996.

Explanation of Provisions

Under section 6050P(c)(2)(D), any organization "a significant trade or business of which is the lending of money" is required to report discharges of indebtedness. These proposed regulations provide guidance on when a trade or business is the lending of money and when that trade or business is significant. In general, the proposed regulations provide that the lending of money is a significant trade or business if money is lent on a regular and continuing basis. The regulations provide three safe harbors under which organizations will not be considered to have a significant trade or business of lending money. The IRS and the Treasury Department believe that these safe harbors satisfy the information reporting objectives of the statute while minimizing the administrative burden on taxpayers.

The first safe harbor applies to organizations that were not required to report under section 6050P in the previous calendar year. Such an organization will be considered not to have a significant trade or business of lending money for the calendar year if its gross income from lending money in the most recent test year (the most recent taxable year ending before July 1 of the previous calendar year) is less than both 15 percent of the organization's gross income and $5 million.

The second safe harbor applies to organizations that were required to report under section 6050P for the previous calendar year. Such an organization will be considered not to have a significant trade or business of lending money for the calendar year if, for each of the three most recent test years, its gross income from lending money is less than both 10 percent of the organization's gross income and $3 million. The IRS and the Treasury Department believe that a stricter safe harbor is appropriate for taxpayers that have been subject to section 6050P in a prior year and, therefore, presumably have systems in place to comply with the information reporting requirements of the statute.

The third safe harbor applies to certain newly formed organizations. Except for an entity that is formed or availed of for the principal purpose of holding loans acquired by an applicable entity (as defined in section 6050P), an organization that does not have a test year is considered not to have a significant trade or business of lending money even if the organization lends money on a regular and continuing basis. This safe harbor and the use of a "test year" in determining whether a taxpayer fits within the other safe harbors provides taxpayers with some advance notice (*i.e.*, at least six months) of whether they will need to establish systems to track and report discharges of indebtedness.

In addition to the safe harbors discussed above, the proposed regulations provide a general exception to information reporting for entities whose principal trade or business is the sale of nonfinancial goods or the provision of nonfinancial services. Such entities are not considered to have a significant trade or business of lending money with respect to lending or credit extended in connection with the purchase by customers of those goods and services. This is consistent with the legislative history, which indicates that, in amending section 6050P, Congress was concerned with credit card and finance companies. S. Rpt. No. 201, 106th Cong., 1st Sess. 28 (1999). The IRS and the Treasury Department believe that Congress did not mean to extend the reporting requirement to retailers and other entities who extend credit to customers in connection with the purchase of nonfinancial goods and services. However, consistent with applying the tests under section 6050P on an entity-by-entity basis, this exception is not available to a separate financing subsidiary of such a retailer. In addition, if such a retailer is subject to section 6050P regardless of its accounts receivable, it is required to report discharges of indebtedness of accounts receivable as well as other debt.

The proposed regulations also provide that, for purposes of section 6050P(c)(2)(D), lending money includes acquiring a loan, and gross income arising from that loan is gross income from lending money. Therefore, an organization that buys and holds loans is treated as an organization that lends money. This is consistent with the temporary regulations under section 6050J (relating to information returns for acquisitions and

abandonments of property that is security for indebtedness). See § 1.6050J–1T, Q&A–22.

Finally, the proposed regulations amend § 1.6050P–1 to provide a new rule applicable to all entities subject to section 6050P, not just those newly made subject to section 6050P by the 1999 amendment. The current regulations under section 6050P (§ 1.6050P–1(e)(2)) contain rules respecting the reporting requirements of debtors when indebtedness is owned by more than one creditor. Each creditor that is an applicable entity is required to report with respect to any discharge of indebtedness of $600 or more allocable to that creditor. For purposes of this rule, indebtedness owned by a partnership is treated as owned by the partners, with the result that reporting may be required of the partners with respect to a cancellation of debt held by the partnership. Rules respecting compliance with this pass-through reporting requirement by holders of interests in certain pass-through securitized indebtedness arrangements and REMICs were reserved. § 1.6050P–1(e)(2)(iii) & (iv). The preamble to those regulations states that penalties will not be imposed for nonreporting by holders of interests in these entities.

Conceivably, an entity that otherwise would be required to report under section 6050P with respect to its debt (for example, an entity that regularly and continuously lends money and does not meet the safe harbors of these proposed regulations), could transfer debt that it originates to a special purpose subsidiary or trust in a single transaction. Through this structure, the originator could possibly avoid application of section 6050P by arguing that the reservation of rules in the regulations for pass-through securitized indebtedness arrangements absolves them of any reporting obligation and that the transferee entity does not meet the requirements of regular and continuous lending activity.

To address the foregoing concern, the amendment to § 1.6050P–1 by the proposed regulations provides that an entity formed or availed of by an applicable entity for the principal purpose of holding loans acquired or originated by the applicable entity is treated as having a significant trade or business of lending money. Accordingly, the transferee entity itself is treated as an applicable entity for purposes of section 6050P(c)(2)(D). If the entity formed or availed of by the applicable entity is a REMIC or a pass-through securitized indebtedness arrangement as defined in § 1.6050P–1(e)(2)(iii)(B), the REMIC or pass-through securitized indebtedness arrangement will be treated as an applicable entity for purposes of section 6050P(c)(2)(D), despite the reservation in § 1.6050P–1(e)(2)(iii) and (iv) of the application of section 6050P to holders of interests in REMICs and pass-through securitized indebtedness arrangements.

Proposed Effective Date

The regulations, as proposed, apply to any discharge of indebtedness occurring in any calendar year beginning at least two months after the date that the final regulations are published in the **Federal Register**. Regardless of when the final regulations are made effective, the rules in these proposed regulations may be relied on for prior taxable periods.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. The information collection referenced in this proposed rule (Form 1099–C) has been previously reviewed and approved by the **Office of Management and Budget** under OMB Control Number 1545–1424. An agency may not collect or sponsor the collection of information unless it displays a valid OMB Control Number. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic or written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for October 8, 2002, beginning at 10 a.m. in Room 4718 of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Because of access restrictions, visitors must enter at the main entrance, located at 1111 Constitution Avenue, NW. All visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" portion of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments must submit electronic or written comments and an outline of the topic to be discussed and time to be devoted to each topic (preferably a signed original and eight (8) copies) by September 17, 2002. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is Sharon L. Hall, Office of Associate Chief Counsel (Income Tax & Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendment to the Regulations

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

PART 1—INCOME TAXES

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

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

Section 1.6050P–1 and 1.6050P–2 also issued under 26 U.S.C. 6050P. * * *

Par. 2. Section 1.6050P–0 is amended as follows:

1. The introductory text is amended by adding the language "and § 1.6050P–2" immediately after the language "§ 1.6050P–1".

2. The heading for § 1.6050P–1 is amended by removing the word "financial".

3. The entry for § 1.6050P–1(e)(2)(v) is added.

4. The entries for §§ 1.6050P–1(e)(5) through (e)(8) are redesignated as entries for §§ 1.6050P–1(e)(6) through (e)(9) and a new entry for § 1.6050P–1(e)(5) is added.

5. The entries for § 1.6050P–2 are added.

The additions read as follows:

§ 1.6050P–0 Table of Contents.

* * * * *

§ 1.6050P–1 Information reporting for discharges of indebtedness for certain entities.

*****

(e)***
(2)***
(v) No double reporting.

*****

(5) Entity formed or availed of to hold indebtedness.

*****

§ 1.6050P–2 Organizations a significant trade or business of which is the lending of money.

(a) In general.
(b) Safe harbors.
(1) Organizations not subject to section 6050P in the previous calendar year.
(2) Safe harbor for organizations that were subject to section 6050P in the previous calendar year.
(3) No test year.
(c) Seller financing.
(d) Gross income from lending of money.
(e) Acquisition of indebtedness by subsequent holder.
(f) Test year.
(g) Predecessor organization.
(h) Examples.
(i) Effective date.

Par. 3. Section 1.6050P–1 is amended as follows:

1. The heading for § 1.6050P–1 is amended by removing the word "financial".

2. Paragraphs (a)(1), (b)(2)(i)(F), (c), (e)(2)(i), (e)(3), (e)(7), (f)(1) introductory text, (f)(1)(ii) and (f)(2) are amended by removing the word "financial".

3. The first sentence of paragraph (c) is amended by adding "and section 1.6050P–2" immediately after the word "section".

4. Paragraph (e)(2)(v) is added.

5. Paragraph (e)(4) is amended by removing "6050P(c)(1)(A)" each time it appears and adding "6050P(c)(2)(A)" in its place and by removing "6050P(c)(1)(C)" and adding "6050P(c)(2)(C)" in its place.

6. Paragraphs(e)(5) through (e)(8) are redesignated as (e)(6) through (e)(9) and a new paragraph (e)(5) is added.

7. Paragraph (e)(7)(i), as redesignated, is amended by removing "(e)(6)" where it appears and adding "(e)(7)" and paragraph (e)(7)(ii), as redesignated, is amended by removing "(e)(6)(i)" where it appears and adding "(e)(7)(i)" in its place.

8. Paragraph (h)(1) is amended by adding "and, except paragraph (e)(5) of this section, which applies to discharges of indebtedness occurring in any calendar year beginning at least two months after the date that the final regulations are published in the **Federal Register.**", immediately after the language "1994".

The additions read as follows:

§ 1.6050P–1 Information reporting for discharges of indebtedness by certain entities.

*****

(e)***

(2)***

(v) *No double reporting*. If multiple creditors are considered to hold interests in an indebtedness under paragraph (e)(2) of this section, and an entity is required to report a discharge of that indebtedness under paragraph (e)(5) of this section, then such multiple creditors are not required to report the discharge of indebtedness.

*****

(5) *Entity formed or availed of to hold indebtedness*. Notwithstanding § 1.6050P–2(b)(3), if an entity (the transferee entity) is formed or availed of by an applicable entity (within the meaning of section 6050P(c)(1)) for the principal purpose of holding indebtedness acquired (including originated) by the applicable entity, then, for purposes of section 6050P(c)(2)(D), the transferee entity has a significant trade or business of lending money.

*****

Par. 4. A new § 1.6050P–2 is added as follows:

§ 1.6050P–2 Organization a significant trade or business of which is the lending of money.

(a) *In general*. For purposes of section 6050P(c)(2)(D), the lending of money is a significant trade or business of an organization in a calendar year if the organization lends money on a regular and continuing basis during the calendar year.

(b) *Safe harbors*—(1) *Organizations not subject to section 6050P in the previous calendar year*. For an organization that was not required to report under section 6050P in the previous calendar year, the lending of money will not be treated as a significant trade or business for the calendar year in which the lending occurs if gross income from lending money in the organization's most recent test year (as defined in paragraph (f) of this section) is both less than $5 million and less than 15 percent of the organization's gross income for that test year.

(2) *Organizations that were subject to section 6050P in the previous calendar year*. For an organization that was required to report under section 6050P for the previous calendar year, the lending of money will not be treated as a significant trade or business for the calendar year in which the lending occurs if gross income

from lending money in each of the organization's three most recent test years is both less than $3 million and less than 10 percent of the organization's gross income for that test year.

(3) *No test year*. The lending of money will not be treated as a significant trade or business for an organization for the calendar year in which the lending occurs if the organization does not have a test year for that calendar year.

(c) *Seller financing*. If the principal trade or business of an organization is selling nonfinancial goods or providing nonfinancial services and if the organization extends credit to the purchasers of those goods or services in order to finance the purchases, then, for purposes of section 6050P(c)(2)(D), these extensions of credit are not a significant trade or business of lending money.

(d) *Gross income from lending of money*. For purposes of this section, gross income from lending of money includes income from interest, fees, penalties, merchant discount, interchange and gains arising from the sale of an indebtedness.

(e) *Acquisition of indebtedness by subsequent holder*. For purposes of this section, lending money includes acquiring an indebtedness, and gross income arising from such an acquired indebtedness is treated as gross income from lending money, without regard to whether the indebtedness was originated by either an applicable entity or a related party.

(f) *Test year*. For any calendar year, a *test year* is a taxable year of the organization that ends before July 1 of the previous calendar year.

(g) *Predecessor organization*. If an organization acquires substantially all of the property that was used in a trade or business of some other organization (the predecessor) (including when two or more corporations are parties to a merger agreement under which the surviving corporation becomes the owner of all the assets and assumes all the liabilities of the absorbed corporations(s)) or was used in a separate unit of the predecessor, then whether the organization at issue qualifies for one of the safe harbors in paragraph (b) of this section is determined by also taking into account the test years, reporting obligations, and gross income of the predecessor.

(h) *Examples*. The rules of this section are illustrated by the following examples.

Example 1. Finance Company A, a calendar year taxpayer, was formed in Year 1 as a non-bank subsidiary of Manufacturing Company and has no predecessor. A lends money to purchasers of Manufacturing Company's products on a regular and continuing basis to finance the purchase of those products. A's gross income from interest in Year 1 is $4.7 million. A's gross income from fees and penalties related to the lending activity in Year 1 is $.5 million. Section 6050P does not require A to report discharges of indebtedness occurring in Years 1 or 2, because A has no test year for those years. Notwithstanding that A lends money in those years on a regular and continuing basis, under paragraph (b)(3) of this section, A does not have a significant trade or business of lending money in those years for purposes of section 6050P(c)(2)(D). However, for Year 3, A's test year is Year 1. A's gross income from lending in Year 1 is not less than $5 million for purposes of the applicable safe harbor of paragraph (b)(1) of this section. Because A lends money on a regular and continuing basis and does not meet the applicable safe harbor, section 6050P requires A to report discharges of indebtedness occurring in Year 3.

Example 2. The facts are the same as in *Example 1*, except that A is a division of Manufacturing Company, rather than a separate subsidiary. Manufacturing Company's principal activity is the manufacture and sale of non-financial products, and other than financing the purchase of those products Manufacturing Company does not extend credit or otherwise lend money. Accordingly, under paragraph (c) of this section, that financing activity is not a significant trade or business of lending money for purposes of section 6050P(c)(2)(D), and section 6050P does not require Manufacturing Company to report discharges of indebtedness.

Example 3. Company B, a calendar year taxpayer, is formed in Year 1. B has no predecessor and a part of its activities consists of the lending of money. B packages and sells part of the indebtedness it originates and holds the remainder. B is engaged in these activities on a regular and continuing basis. For Year 1, B's gross income from sales of the indebtedness, combined with interest income, fees, and penalties related to the lending activity is only $4.8 million, but it is 16% of B's gross income in Year 1. Because B lends money on a regular and continuing basis and does not meet the applicable safe harbor of paragraph (b)(1) of this section, section 6050P requires B to report discharges of indebtedness occurring in Year 3. B is not required to report discharges of indebtedness in years 1 and 2 because B has no test year for years 1 and 2.

Example 4. The facts are the same as in *Example 3*. In addition, in each of Years 2, 3, and 4, B's gross income from sales of the indebtedness combined with interest income, fees, and penalties related to the lending activity is less than both $3 million and 10% of B's gross income. Because B was required to report under section 6050P for Year 3, the applicable safe harbor for Year 4 is paragraph (b)(2) of this section, which is satisfied only if B's gross income from lending activities for each of the three most recent test years is less than both $3 million and 10% of B's gross income. For Year 4, even though B has only two test years, B's gross income in one of those test years, Year 1, causes B to fail to meet this safe harbor. Accordingly, B is required to report discharges of indebtedness under section 6050P in Year 4. For Year 5, B's three most recent test years are Years 1, 2, and 3. However, B's gross income from lending activities in Year 1 is not less than $3 million and 10% of B's gross income. Accordingly, section 6050P requires B to report discharges of indebtedness in Year 5. For Year 6, B satisfies the applicable safe harbor requirements of paragraph (b)(2) for each of the three most recent test years (Years 2, 3, and 4). Therefore, section 6050P does not require B to report discharges of indebtedness in Year 6. Because B is not required to report for Year 6, the applicable safe harbor for Year 7 is the one contained in paragraph (b)(1) of this section, and thus the only relevant test year is year 5.

(i) *Effective date*. This section is effective for discharges of indebtedness occurring in any calendar year beginning at least two months after the date that the final regulations are published in the **Federal Register.**

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on June 12, 2002, 8:45 a.m., and published in the issue of the Federal Register for June 13, 2002, 67 F.R. 40629)

Section 7428(c) Validation of Certain Contributions Made During Pendency of Declaratory Judgment Proceedings

This announcement serves notice to potential donors that the organization listed below has recently filed timely declaratory judgment suit under section 7428 of the Code, challenging revocation of it's status as an eligible donee under section 170(c)(2).

Protection under section 7428(c) of the Code begins on the date that the notice of revocation is published in the Internal Revenue Bulletin and ends on the date on which a court first determines that an organization is not described in section 170(c)(2), as more particularly set forth in section 7428(c)(1). In the case of individual contributors, the maximum amount of contributions protected during this period is limited to $1,000.00, with a husband and wife being treated as one contributor. This protection is not extended to any individual who was responsible, in whole or in part, for the acts or omissions

of the organization that were the basis for the revocation. This protection also applies (but without limitation as to amount) to organizations described in section 170(c)(2) which are exempt from tax under section 501(a). If the organization ultimately prevails in its declaratory judgment suit, deductibility of contributions would be subject to the normal limitations set forth under section 170.

T. L. C. Environmental
Encinitas, CA

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 Contributions 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.—Intemal 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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[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2002–1 through 2002–25 is in Internal Revenue Bulletin 2002–26, dated July 1, 2002.

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[1] A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2002–1 through 2002–25 is in Internal Revenue Bulletin 2002–26, dated July 1, 2002.