Internal Revenue
bulletin

Bulletin No. 2000–4
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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. 2000–4, page 331.

Business expenses; capital expenditures; ISO 9000 costs. Cost incurred by a taxpayer to obtain, maintain, and renew ISO 9000 certification are deductible as ordinary and necessary business expenses under section 162 of the Code, except to the extent they result in the creation or acquisition of an asset having a useful life substantially beyond the taxable year (e.g., a quality manual). Rev. Proc. 99–49 modified and amplified.

T.D. 8853, page 377.

Final regulations under section 7701(l) of the Code recharacterize fast-pay stock arrangements. The regulations also impose reporting requirements on certain participants in fast-pay stock arrangements.

T.D. 8857, page 365.

Final regulations under section 832(b) of the Code relate to the determination of underwriting income by insurance companies other than life insurance companies by providing guidance for purposes of determining the amount of unearned premiums that are subject to the 20 percent reduction rule.

T.D. 8858, page 332.

Temporary regulations revise the rules governing allocation of purchase price in deemed and actual asset acquisitions, and other rules, under sections 338 and 1060 of the Code.

EMPLOYEE PLANS

Notice 2000–3, page 413.

This notice provides additional guidance on the safe harbor methods contained in sections 401(k)(12) and 401(m)(11) of the Code for satisfying the nondiscrimination tests contained in section 401(k) and 401(m). The notice also requests public comments on certain issues affecting cash or deferred arrangements. Notice 98–52 modified.

Notice 2000–8, page 420.

Weighted average interest rate update. The weighted average interest rate for January 2000 and the resulting permissible range of interest rates used to calculate current liability for purposes of the full funding limitation of section 412(c)(7) of the Code are set forth.

EXCISE TAX

T.D. 8855, page 374.

Final regulations under section 4251 of the Code relate to prepaid telephone cards.

Announcement 2000–5, page 427.

Comments are requested on proposed regulations relating to requirements for excise tax returns and deposits.

(Continued on the page following the Introduction)

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

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 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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For sale by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

ADMINISTRATIVE

Rev. Proc. 2000–12, page 387.

This procedure contains the qualified intermediary (QI) withholding agreement as well as guidance for entering into the agreement. The objective of the QI withholding agreement is to simplify withholding and reporting obligations for payments of income (including interest, dividends, royalties, and gross proceeds) made to an account holder through one or more foreign intermediaries. Rev. Proc. 98–27 superseded and Notice 99–8 obsoleted.

REG–105606–99, page 421.

Proposed regulations under section 41(f) of the Code relate to the computation and allocation of the credit for increasing research activities for members of a controlled group of taxpayers. A public hearing is scheduled for April 26, 2000.

Notice 2000–7, page 419.

Section 1504(d) elections; deferral of termination. This notice provides guidance regarding the effect of the repeal of certain Canadian banking legislation on elections under section 1504(d) of the Code.

Announcement 2000–6, page 428.

This announcement corrects final regulations T.D. 8845, 1999–51 I.R.B. 684, under section 6501 of the Code relating to the valuation of prior gifts in determining estate and gift tax liability, and to the period of assesing and collecting gift tax.

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

Section 162.–Trade or Business Expenses

26 CFR 1.162-1: Business expenses.
(Also §§ 263, 263A; §§ 1.263(a)-1, 1.263(a)–2, 1.263A–1)

Business expenses; capital expenditures; ISO 9000 costs. Costs incurred by a taxpayer to obtain, maintain, and renew ISO 9000 certification are deductible as ordinary and necessary business expenses under section 162 of the Code, except to the extent they result in the creation or acquisition of an asset having a useful life substantially beyond the taxable year (e.g., a quality manual). Rev. Proc. 99–49 modified and amplified.

Rev. Rul. 2000–4

ISSUE

Are costs incurred by a taxpayer to obtain, maintain, and renew ISO 9000 certification deductible as ordinary and necessary business expenses under § 162 of the Internal Revenue Code, or must they be capitalized under §§ 263 or 263A?

FACTS

ISO 9000 is a series of international standards for quality management systems that was developed by the International Organization for Standardization (ISO). The ISO 9000 series of standards is comprised of several specific requirements that are intended to ensure a quality process in providing services or products to an organization's customers.

To obtain ISO 9000 certification, an organization may incur internal and external costs to assess its current quality processes, create a quality manual, train its employees, and implement the new quality system. In addition, the organization incurs costs to obtain formal certification from an independent auditor (or "registrar") that its quality management system conforms to a specific ISO 9000 standard. This certification generally lasts from two to four years. After the initial certification, the organization incurs additional costs for periodic audits to maintain its certification and to renew the certification upon expiration of the initial certification period. All these expenditures are referred to herein as "ISO 9000 costs."

Although ISO 9000 certification is voluntary, it increasingly is a contractual requirement for doing business with many organizations, both public and private, worldwide. ISO 9000 certification also is an alternative to product certification in some foreign markets, particularly the European Union.

LAW AND ANALYSIS

Section 162 and § 1.162–1(a) of the Income Tax Regulations generally allow a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Courts generally have construed § 162 as containing five conditions that an expenditure must meet to qualify for deduction. The expenditure must be (1) an expense, (2) ordinary, (3) necessary, (4) paid or incurred during the taxable year, and (5) made to carry on a trade or business. *See Commissioner v. Lincoln Sav. and Loan Ass'n*, 403 U.S. 345 (1971).

Section 263(a) and § 1.263(a)–1(a) provide that no deduction is allowed for any amount paid out for permanent improvements or betterments made to increase the value of any property or estate. Section 1.263(a)–2(a) provides that capital expenditures include the cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year.

Section 263A provides that the direct and indirect costs properly allocable to real or tangible personal property produced by the taxpayer or real or personal property described in § 1221(1) that is acquired by the taxpayer for resale must be capitalized. Section 1.263A–1(e)(4)(iv)(F) cites quality control policy as an example of an indirect cost that generally is not allocated to production or resale activities.

Through provisions such as §§ 162(a), 263(a), and 263A, the Code generally endeavors to match expenses with the revenues of the taxable period to which the expenses are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes. *See, e.g.*, *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992); *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 16 (1974). Moreover, as the Supreme Court has specifically recognized, the "decisive distinctions [between capital and ordinary expenditures] are those of degree and not of kind," and a careful examination of the particular facts of each case is required. *Deputy v. du Pont*, 308 U.S. 488, 496 (1940); *Welch v. Helvering*, 290 U.S. 111, 114 (1933).

In determining whether a current deduction or capitalization is the appropriate tax treatment for an expenditure, it is important to consider the extent to which the expenditure will produce future benefits. *See INDOPCO*, 503 U.S. at 87–88. ISO 9000 certification potentially results in a number of benefits for a taxpayer. For example, certification may improve the overall quality of the taxpayer's business operations, give the taxpayer a marketing advantage by differentiating it from non-certified competitors, enable the taxpayer to retain customers that begin requiring their suppliers to be certified, and enable the taxpayer to expand its existing business to new markets and new customers that require their suppliers to be certified. These benefits generally both relate to the current taxable year and extend beyond the taxable year in which the taxpayer obtains ISO 9000 certification. Section 263(a), however, requires an examination of not only the duration of the benefits, but also the extent of the benefits. *See INDOPCO*, 503 U.S. at 87 (the mere presence of an incidental future benefit may not warrant capitalization). *See also* Rev. Rul. 96–62, 1996–2 C.B. 9 (training costs generally are deductible under § 162 even though they may have some future benefit); Rev. Rul. 94–12, 1994–1 C.B. 36 (incidental repair costs generally are deductible under § 162 even though they may have some future benefit); Rev. Rul. 92–80, 1992–2 C.B. 57 (advertising costs generally are deductible under § 162 even though they may have some future effect on business activities).

ISO 9000 certification does not result in future benefits that are more than incidental. The benefits derived from ISO 9000 certification are akin to the current benefits derived from advertising, training, and similar expenditures incurred in operating the taxpayer's business, retaining existing customers, or simply improving the overall quality or attractiveness of the taxpayer's business operations. Although the enhanced marketability of the taxpayer's services or products resulting from ISO 9000 certification may yield future benefits such as repeat business or increased market share, these future benefits are incidental to the primary benefit of current sales. Expenditures that primarily benefit current operations generally are deductible. *See, e.g., Van Iderstine Co. v. Commissioner*, 261 F.2d 211 (2nd Cir. 1958) (payments made to suppliers to ensure a continuing supply of raw materials were deductible); *Snow v. Commissioner*, 31 T.C. 585 (1958), *acq.*, 1959–2 C.B. 7 (payments made to protect and supplement the taxpayer's income from its existing law business were deductible). *See also T.J. Enterprises, Inc. v. Commissioner*, 101 T.C. 581 (1993) (expenses incurred to protect, maintain, or preserve a taxpayer's business generally are deductible).

Further, even if ISO 9000 certification facilitates the expansion of the taxpayer's existing business, the mere ability to sell in new markets and to new customers, without more, does not result in significant future benefits. *Compare Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775 (2nd Cir. 1973) (expenditures incurred by the taxpayer to develop a new market for wholesale customers, which gave the taxpayer little more than an expectation or hope of future sales, were deductible under § 162); *Sun Microsystems v. Commissioner*, T.C. Memo 1993–467 (costs incurred to promote sales of computer workstations were not capital expenditures because the anticipated long-term benefits from the customer relationship were "softer" and more speculative than the immediate benefits from the sales) *with FMR Corp. v. Commissioner*, 110 T.C. 402 (1998) (costs to develop and launch mutual funds, which resulted in new long-term management contracts, were capital expenditures).

Because ISO 9000 certification yields only incidental future benefits, ISO 9000 costs are distinguishable from costs incurred to obtain licenses, stock trading privileges, state bar certifications, and similar market-entry requirements that have been held to be capital expenditures. Unlike ISO 9000 certification, these requirements are an essential element to the establishment of the taxpayer's business and result either in a separate and distinct asset or in significant future benefits. *See, e.g., Nachman v. Commissioner*, 191 F.2d 934 (5th Cir. 1951) (payment to obtain liquor license was a capital expenditure); *Harman v. Commissioner*, 72 T.C. 362 (1979) (initiation fees required to obtain a seat on the New York Stock Exchange were capital expenditures); *Sharon v. Commissioner*, 66 T.C. 515 (1976), *aff'd*, 591 F.2d 1273 (9th Cir. 1978) (costs incurred by an attorney for admission to various bars were capital expenditures).

Accordingly, ISO 9000 certification does not itself result in the creation of an asset having a useful life substantially beyond the taxable year. To the extent the ISO 9000 certification *process* results in the creation of an asset, however, § 263(a) requires capitalizing the costs allocable to creating that asset. For example, the costs of creating a quality manual must be capitalized, even though costs of periodic updates to the manual may be deducted. § 263A; § 1.263A–2(a)(2)(ii), *Domestic Management Bureau v. Commissioner*, 38 B.T.A. 640 (1938) (costs of preparing and printing a training manual were capital expenditures); Rev. Rul. 96–62 (costs of routine updates of training materials are deductible). In addition, if the certification process requires the acquisition of an asset, such as machinery and equipment, the costs of that asset must be capitalized under § 263(a).

Further, ISO 9000 costs, other than costs incurred during the certification process that are allocable to creating an asset such as a quality manual, are not costs that are allocable to production or resale activities for purposes of the uniform capitalization rules of § 263A, and thus are not subject to the rules set forth in that section or the regulations thereunder. *See* § 1.263A–1(e)(4)(iv)(F) (quality control expenditures generally excepted from uniform capitalization rules).

HOLDING

Costs incurred by a taxpayer to obtain, maintain, and renew ISO 9000 certification are deductible as ordinary and necessary business expenses under § 162, except to the extent they result in the creation or acquisition of an asset having a useful life substantially beyond the taxable year (*e.g.*, a quality manual).

APPLICATION

Any change in a taxpayer's method of accounting to conform with this revenue ruling is a change in method of accounting to which the provisions of §§ 446 and 481 and the regulations thereunder apply. A taxpayer wanting to change its method of accounting to conform with the holding in this revenue ruling must follow the automatic change in accounting method provisions of Rev. Proc. 99–49, 1999–52 I.R.B. 725, except that the scope limitations in section 4.02 of Rev. Proc. 99-49 do not apply. However, if the taxpayer is under examination, before an appeals office, or before a federal court with respect to any income tax issue, the taxpayer must provide a copy of the Form 3115, Application for Change in Accounting Method, to the examining agent(s), appeals officer, or counsel for the government, as appropriate, at the same time that it files the copy of the Form 3115 with the national office. The Form 3115 must contain the name(s) and telephone number(s) of the examining agent(s), appeals officer, or counsel for the government, as appropriate.

EFFECT ON OTHER DOCUMENTS

Rev. Proc. 99–49 is modified and amplified to include the prospective change in accounting method in the APPENDIX.

DRAFTING INFORMATION

The principal author of this revenue ruling is Kimberly L. Koch of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Ms. Koch at (202) 622-4950 (not a toll-free call).

Section 263.—Capital Expenditures

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

Are costs incurred by a taxpayer to obtain, maintain, and renew ISO 9000 certification deductible as ordinary and necessary business expenses under §162, except to the extent they result in the creation or acquisition of an asset having a useful life substantially beyond the taxable year (e.g., a quality manual)? See Rev. Rul. 2000–4, page 331.

Section 338.—Certain Stock Purchases Treated As Asset Acquisitions

26 CFR 1.338–1T: General principles; status of old target and new target (temporary).

T.D. 8858

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

Purchase Price Allocations in Deemed and Actual Asset Acquisitions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to the allocation of purchase price in deemed and actual asset acquisitions. The temporary regulations determine the amount realized and the amount of basis allocated to each asset transferred in a deemed or actual asset acquisition and affect transactions reported on either Form 8023 or Form 8594. The intended effect of the temporary regulations is to remove and replace many of the current temporary and final regulations sections under sections 338 and 1060 and renumber others.

DATES: *Effective Date***:** These regulations are effective January 6, 2000.

Applicability Dates: For dates of applicability of these regulations, see §1.338(i)–1T and §1.1060–1T(a)(2).

FOR FURTHER INFORMATION CONTACT: Richard Starke of the Office of Assistant Chief Counsel (Corporate), (202) 622-7790 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these temporary regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under the control number 1545-1658.

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.

The collections of information in these temporary regulations are in §§1.338–2T(d), 1.338–2T(e)(4), 1.338–5T(d)(3), 1.338–10T(a)(4), 1.338(h)(10)–1T(d)(2), and 1.1060–1T(e)(ii)(A) and (B). The collections of information are necessary to make an election to treat a sale of stock as a sale of assets, to calculate and collect the appropriate amount of tax in a deemed or actual asset acquisition, and to determine the bases of assets acquired in a deemed or actual asset acquisition.

These collections of information are required to obtain a benefit. The likely respondents and/or recordkeepers are small businesses or organizations, businesses, or other for-profit institutions, and farms.

The regulation provides that a section 338 election is made by filing Form 8023. The burden for this requirement is reflected in the burden of Form 8023. The regulation also provides that both a seller and a purchaser must each file an asset acquisition statement on Form 8594. The burden for this requirement is reflected in the burden of Form 8594.

The burden for the collection of information in §1.338–2T(e)(4) is as follows:
Estimated total annual reporting/recordkeeping burden: 25 hours
Estimated average annual burden per respondent/recordkeeper: 0.56 hours
Estimated number of respondents/recordkeepers: 45
Estimated annual frequency of responses: On occasion

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224, and to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

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

Background

On August 10, 1999, the IRS and Treasury published in the **Federal Register** (REG–107069–97, 64 FR 43461 (1999–36 I.R.B. 346)) a notice of proposed rulemaking. The notice contained proposed regulations under sections 338 and 1060 of the Internal Revenue Code of 1986. The temporary and final regulations promulgated in this Treasury decision are substantively the same as the proposed regulations published on August 10, 1999. The Service and Treasury believe that the comments received on the proposed regulations warrant further consideration. For instance, the Service and the Treasury received several comments requesting reconsideration of (1) the provision in §1.338–3(b)(2)(ii) of the proposed regulations stating that a purchase of target stock occurs only so long as more than a nominal amount is paid for such share, and (2) the example in §1.338–1(a)(2) of the proposed regulations stating that if target is an insurance company for which a section 338 election is made, then the deemed asset sale will be characterized and taxed as an assumption-reinsurance transaction. The temporary regulations reserve the purchase issue addressed in §1.338–3(b)(2)(ii) of the proposed regulations pending further consideration of the comments. The temporary regulations retain the assumption-reinsurance example because the example properly illustrates the principles of the proposed and temporary regulations. The Service and Treasury will give further consideration to the interaction of section 338 and the assumption-reinsurance rules and the need for additional guidance on how the assumption-reinsurance rules should work in the context of a deemed asset sale.

Notwithstanding such comments, the proposed regulations generally were favorably received, and the Service and Treasury are convinced that, in general, the proposed regulations provide clearer guidance and better rules than the current final and temporary regulations under sections 338 and 1060. Accordingly, pending further review of the comments received on the proposed regulations, the Service and Treasury are replacing existing temporary and final regulations with the proposed rules published on August 10, 1999.

As soon as feasible, final regulations will be promulgated, replacing these new temporary regulations. All comments received in response to the requests for comments contained in the notice of August 10, 1999, will be considered in the course of preparing the final regulations.

Special Analyses

It has been determined that these temporary regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has been determined that a final regulatory flexibility analysis is required for the collection of information in this Treasury decision under 5 U.S.C. 604. This analysis is set forth below under the heading "Final Regulatory Flexibility Act Analysis." 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.

Final Regulatory Flexibility Act Analysis

This analysis is required under the Regulatory Flexibility Act (5 U.S.C. chapter 6). This regulatory action is intended to simplify and clarify the current rules relating to both deemed and actual asset acquisitions. The current rules were developed over a long period of time and have been repeatedly amended. The IRS and Treasury believe these temporary regulations will significantly improve the clarity of the rules relating to both deemed and actual asset acquisitions.

The major objective of these temporary regulations is to modify the rules for allocating purchase price in both deemed and actual asset acquisitions. In addition, these temporary regulations replace the general rules for electing to treat a stock sale as an asset sale.

These collections of information may affect small businesses if the stock of a corporation which is a small entity is acquired in a qualified stock purchase or if a trade or business which is also a small business is transferred in a taxable transaction. Form 8023 (on which an election to treat a stock sale as an asset sale is filed) has been submitted to and approved by the Office of Management and Budget. With respect to Form 8023, the IRS estimated that 201 forms would be filed each year and that each taxpayer would require 12.98 hours to comply. Form 8594 (on which a sale or acquisition of assets constituting a trade or business is reported) has also been submitted to and approved by the Office of Management and Budget. With respect to Form 8594, the IRS estimated that 20,000 forms would be filed each year and that each taxpayer would require 12.25 hours to comply. These estimates have been made available for public comment and no public comments have been received. The regulations do not impose new requirements on small businesses and, in fact, should lessen any difficulties associated with the existing reporting requirements by clarifying the rules associated with deemed and actual asset acquisitions.

The collections of information require taxpayers to file an election in order to treat a stock sale as an asset sale. In addition, taxpayers must file a statement regarding the amount of consideration allocated to each class of assets under the residual method. The professional skills that would be necessary to make the election or allocate the consideration would be the same as those required to prepare a return for the small business.

Consideration was given to limiting the reporting requirements under section 1060 to trades or businesses meeting a threshold level of business activity. However, any threshold derived without further information would be arbitrary. Instead, these regulations authorize the Commissioner to exclude certain transactions from the reporting requirements.

Drafting Information

The principal author of these regulations is Richard Starke, Office of the Assistant Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated extensively in their development.

* * * * *

Adoption of Amendments to the Regulations

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

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entries for 1.338(b)–1, 1.338(b)–3T, and 1.1060–1T and by adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *
Section 1.338–6T also issued under 26 U.S.C. 337(d), 338, and 1502.
Section 1.338–7T also issued under 26 U.S.C. 337(d), 338, and 1502.
Section 1.338–8 also issued under 26 U.S.C. 337(d), 338, and 1502.
Section 1.338–9 also issued under 26 U.S.C. 337(d), 338, and 1502.
Section 1.338–10T also issued under 26 U.S.C. 337(d), 338, and 1502.* * *
Section 1.1060–1T also issued under 26 U.S.C. 1060.* * *

Par. 2. In the list below, for each section indicated in the left column, remove the language in the middle column and add the language in the right column:

Section	*Remove*	*Add*
1.56(g)–1(k)(1)	of §1.338(b)–2T(b), if otherwise	of §1.338–6T(b), if otherwise
1.56(g)–1(k)(1)	of §§1.338(b)–2T(c)(1) and (2) also	of §1.338–6T(c)(1) and (2) also
1.368–1(a)	(k) and 1.338–2(c)(3).	(k) and 1.338–3T(c)(3).
1.368–1(e)(6), *Example 4*, paragraph (ii)	see §1.338–2(c)(3) (which	see §1.338–3T(c)(3) (which
1.597–2(d)(5)(iii)(B)	(see §1.338(b)–3T)	(see §1.338–7T)

1.597–5(c)(3)(i)	under §§1.338(b)–2T(b), (c)(1) and (2).	under §1.338–6T(b), (c)(1) and (2).
1.597–5(d)(2)(i)	under §§1.338(b)–2T(b), (c)(1) and (2).	under §1.338–6T(b), (c)(1) and (2).
1.921–1T(b)(1), A–1	and §1.338–1(d).	and §1.338–2T(d).
1.1031(d)–1T	see §1.1060–1T(b), (d), and (g) *Example (3).*	see §1.1060–1T(b), (c), and (d) *Example 1.*
1.1031(j)–1(b)(2)(iii)	in §1.1060–1T(d).	in §1.338–6T(b), to which reference is made by §1.1060–1T(c)(2).
1.1502–75(k)	See §1.338(h)(10)–1(e)(6) for	See §1.338(h)(10)–1T(d)(7) for
1.1502–76(b)(1)(ii)(A)(*1*)	See §1.338–1(e)(5) (deemed	See §1.338–10T(a)(5) (deemed

§1.338–0 through 1.338–3 [Removed]

Par. 3. Sections 1.338–0 through 1.338–3 are removed.

Par. 4. Sections 1.338–0T through 1.338–3T are added to read as follows:

§1.338–0T Outline of topics (temporary).

This section lists the captions contained in the regulations under section 338 as follows:

§1.338–1T General principles; status of old target and new target (temporary).

(a) In general.
(1) Deemed transaction.
(2) Application of other rules of law.
(3) Overview.
(b) Treatment of target under other provisions of the Internal Revenue Code.
(1) General rule for subtitle A.
(2) Exceptions for subtitle A.
(3) General rule for other provisions of the Internal Revenue Code.
(c) Anti-abuse rule.
(1) In general.
(2) Examples.

§1.338–2T Nomenclature and definitions; mechanics of the section 338 election (temporary).

(a) Scope.
(b) Nomenclature.
(c) Definitions.
(1) Acquisition date.
(2) Acquisition date assets.
(3) Affiliated group.
(4) Common parent.
(5) Consistency period.
(6) Deemed asset sale.
(7) Deemed sale gain.
(8) Deemed sale return.
(9) Domestic corporation.
(10) Old target's final return.
(11) Purchasing corporation.
(12) Qualified stock purchase.
(13) Related persons.
(14) Section 338 election.
(15) Section 338(h)(10) election.
(16) Selling group.
(17) Target; old target; new target.
(18) Target affiliate.
(19) 12-month acquisition period.
(d) Time and manner of making election.
(e) Special rules for foreign corporations or DISCs.
(1) Elections by certain foreign purchasing corporations.
(i) General rule.
(ii) Qualifying foreign purchasing corporation.
(iii) Qualifying foreign target.
(iv) Triggering event.
(v) Subject to United States tax.
(2) Acquisition period.
(3) Statement of section 338 may be filed by United States shareholders in certain cases.
(4) Notice requirement for U.S. persons holding stock in foreign market.
(i) General rule.
(ii) Limitation.
(iii) Form of notice.
(iv) Timing of notice.
(v) Consequence of failure to comply.
(vi) Good faith effort to comply.

§1.338–3T Qualification for the section 338 election (temporary).

(a) Scope.
(b) Rules relating to qualified stock purchases.
(1) Purchasing corporation requirement.
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§1.338–1T General principles; status of old target and new target (temporary).

(a) *In general*—(1) *Deemed transaction.* Elections are available under section 338 when a purchasing corporation acquires the stock of another corporation (the target) in a qualified stock purchase. One type of election, under section 338(g), is available to the purchasing corporation. Another type of election, under section 338(h)(10), is, in more limited circumstances, available jointly to the purchasing corporation and the sellers of the stock. (Rules concerning eligibility for these elections are contained in §§ 1.338–2T, 1.338–3T, and 1.338(h)(10)–1T.) Although target is a single corporation under corporate law, if a section 338 election is made, then two separate corporations, old target and new target, generally are considered to exist for purposes of subtitle A of the Internal Revenue Code. Old target is treated as transferring all of its assets to an unrelated person in exchange for consideration that includes the assumption of, or taking subject to, liabilities, and new target is treated as acquiring all of its assets from an unrelated person in exchange for consideration that includes the assumption of or taking subject to liabilities. (Such transaction is, without regard to its characterization for Federal income tax purposes, referred to as the deemed asset sale and the income tax consequences thereof as the deemed sale gain.) If a section 338(h)(10) election is made, old target is also deemed to liquidate following the deemed asset sale.

(2) *Application of other rules of law.* Other rules of law apply to determine the tax consequences to the parties as if they had actually engaged in the transactions deemed to occur under section 338 and §§1.338–0T through 1.338–7T, 1.338–8, 1.338–9, 1.338–10T, 1.338(h)(10)–1T, and 1.338(i)–1T except to the extent otherwise provided in §§1.338–0T through 1.338–7T, 1.338–8, 1.338–9, 1.338–10T, 1.338(h)(10)–1T, and 1.338(i)–1T. See also §1.338–6T(c)(2). Other rules of law may characterize the transaction as something other than or in addition to a sale and purchase of assets; however, it must be a taxable transaction. For example, if target is an insurance company for which a section 338 election is made, the deemed asset sale would be characterized and taxed as an assumption–reinsurance transaction under applicable Federal income tax law. See §1.817–4(d).

(3) *Overview.* Definitions and special nomenclature and rules for making the section 338 election are provided in §1.338–2T. Qualification for the section 338 election is addressed in §1.338–3T. The amount for which old target is treated as selling all of its assets (the aggregate deemed sale price, or ADSP) is addressed in §1.338–4T. The amount for which new target is deemed to have purchased all its assets (the adjusted grossed-up basis, or AGUB) is addressed in §1.338–5T. Section 1.338–6T addresses allocation both of ADSP among the assets old target is deemed to have sold and of AGUB among the assets new target is deemed to have purchased. Section 1.338–7T addresses allocation of ADSP or AGUB when those amounts change after the close of new target's first taxable year. Asset and stock consistency are addressed in §1.338–8. International aspects of section 338 are covered in §1.338–9. Rules for the filing of returns are provided in §1.338–10T. Eligibility for and treatment of section 338(h)(10) elections is addressed in §1.338(h)(10)–1T.

(b) *Treatment of target under other provisions of the Internal Revenue Code*—(1) *General rule for subtitle A.* Except as provided in this section, new target is treated as a new corporation that is unrelated to old target for purposes of subtitle A of the Internal Revenue Code. Thus—

(i) New target is not considered related to old target for purposes of section 168 and may make new elections under section 168 without taking into account the elections made by old target; and

(ii) New target may adopt, without obtaining prior approval from the Commissioner, any taxable year that meets the requirements of section 441 and any method of accounting that meets the requirements of section 446. Notwithstanding §1.441–1T(b)(2), a new target may adopt a taxable year on or before the last day for making the election under section 338 by filing its first return for the desired taxable year on or before that date.

(2) *Exceptions for subtitle A.* New target and old target are treated as the same corporation for purposes of—

(i) The rules applicable to employee benefit plans (including those plans described in sections 79, 104, 105, 106, 125, 127, 129, 132, 137, and 220), qualified pension, profit-sharing, stock bonus and annuity plans (sections 401(a) and 403(a)), simplified employee pensions (section 408(k)), tax qualified stock option plans (sections 422 and 423), welfare benefit funds (sections 419, 419A, 512(a)(3), and 4976), voluntary employee benefit associations (section 501(c)(9) and the regulations thereunder);

(ii) Sections 1311 through 1314 (relating to the mitigation of the effect of limitations) if a section 338(h)(10) election is not made for target;

(iii) Section 108(e)(5) (relating to the reduction of purchase money debt);

(iv) Section 45A (relating to the Indian Employment Credit), section 51 (relating to the Work Opportunity Credit), section 51A (relating to the Welfare to Work Credit), and section 1396 (relating to the Empowerment Zone Act);

(v) Sections 401(h) and 420 (relating to medical benefits for retirees);

(vi) Section 414 (relating to definitions and special rules);

and

(vii) Any other provision designated in the Internal Revenue Bulletin by the Internal Revenue Service. See §601.601(d)(2)(ii) of this chapter (relating to the Internal Revenue Bulletin). See §1.1001–3(e)(4)(F) providing that an election under section 338 does not result in the substitution of a new obligor on target's debt.

(3) *General rule for other provisions of the Internal Revenue Code.* Except as provided in the regulations under section 338 or in the Internal Revenue Bulletin by the Internal Revenue Service (see §601.601(d)(2)(ii) of this chapter), new target is treated as a continuation of old target for purposes other than subtitle A of the Internal Revenue Code. For example—

(i) New target is liable for old target's

Federal income tax liabilities, including the tax liability for the deemed sale gain and those tax liabilities of the other members of any consolidated group that included old target that are attributable to taxable years in which those corporations and old target joined in the same consolidated return (see §1.1502–6(a));

(ii) Wages earned by the employees of old target are considered wages earned by such employees from new target for purposes of sections 3101 and 3111 (Federal Insurance Contributions Act) and section 3301 (Federal Unemployment Tax Act); and

(iii) Old target and new target must use the same employer identification number.

(c) *Anti-abuse rule*—(1) *In general*. For purposes of applying the residual method of §§1.338–0T through 1.338–7T, 1.338–8, 1.338–9, 1.338–10T, 1.338(h)(10)–1T, and 1.338(i)–1T, the Commissioner is authorized to treat any property (including cash) transferred by old target in connection with the transactions resulting in the application of the residual method as, nonetheless, property of target at the close of the acquisition date if the property so transferred, within 24 months after the deemed asset sale, is owned by new target, or is owned, directly or indirectly, by a member of the affiliated group of which new target is a member and continues after the election to be held or used to more than an insignificant extent in connection with one or more of the activities of new target. The Commissioner is authorized to treat any property (including cash) transferred to old target in connection with the transactions resulting in the application of the residual method as, nonetheless, not being property of target at the close of the acquisition date if the property so transferred by the transferor is, within 24 months after the deemed asset sale, not owned by new target but owned, directly or indirectly, by a member of the affiliated group of which new target is a member or owned by new target but held or used to more than an insignificant extent in connection with an activity conducted, directly or indirectly, by another member of the affiliated group of which new target is a member in combination with other property acquired, directly or indirectly, from the transferor of the property (or a member of the same affiliated group) to old target. For purposes of this paragraph (c)(1), an interest in an entity is considered held or used in connection with an activity if property of the entity is so held or used. The authority under this paragraph (c)(1) includes the making of any necessary correlative adjustments.

(2) *Examples.* The following examples illustrate this paragraph (c):

Example 1. Prior to a qualified stock purchase under section 338, target transfers one of its assets to a related party. The purchasing corporation then purchases the target stock and also purchases the transferred asset from the related party. After its purchase of target, the purchasing corporation and target are members of the same affiliated group. A section 338 election is made. Under an arrangement with the purchaser, target continues to use the separately transferred asset to more than an insignificant extent in connection with its own activities. Applying the anti-abuse rule of this paragraph (c), the Commissioner may consider target to own the transferred asset for purposes of applying section 338 and its allocation rules.

Example 2. Target (T) owns all the stock of T1. T1 leases intellectual property to T, which T uses in connection with its own activities. P, a purchasing corporation, wishes to buy the T-T1 chain of corporations. P, in connection with its planned purchase of the T stock, contracts to consummate a purchase of all the stock of T1 on March 1 and of all the stock of T on March 2. Section 338 elections are thereafter made for both T and T1. Immediately after the purchases, P, T and T1 are members of the same affiliated group. T continues to lease the intellectual property from T1 and to use the property to more than an insignificant extent in connection with its own activities. Thus, an asset of T, the T1 stock, was removed from T 's own assets prior to the qualified stock purchase of the T stock, T1's own assets are used after the deemed asset sale in connection with T's own activities, and the T1 stock is after the deemed asset sale owned by P, a member of the same affiliated group of which T is a member. Applying the anti-abuse rule of this paragraph (c), the Commissioner may, for purposes of application of section 338 both to T and to T1, consider P to have bought only the stock of T, with T at the time of the qualified stock purchases of both T and T1 (the qualified stock purchase of T1 being triggered by the deemed sale under section 338 of T's assets) owning T1. The Commissioner would accordingly apply section 338 first at the T level and then at the T1 level.

§1.338–2T Nomenclature and definitions; mechanics of the section 338 election (temporary).

(a) *Scope*. This section prescribes rules relating to elections under section 338.

(b) *Nomenclature*. For purposes of the regulations under section 338 (except as otherwise provided):

(1) T is a domestic target corporation that has only one class of stock outstanding. Old T refers to T for periods ending on or before the close of T's acquisition date; new T refers to T for subsequent periods.

(2) P is the purchasing corporation.

(3) The P group is an affiliated group of which P is a member.

(4) P1, P2, etc., are domestic corporations that are members of the P group.

(5) T1, T2, etc., are domestic corporations that are target affiliates of T. These corporations (T1, T2, etc.) have only one class of stock outstanding and may also be targets.

(6) S is a domestic corporation (unrelated to P and B) that owns T prior to the purchase of T by P. (S is referred to in cases in which it is appropriate to consider the effects of having all of the outstanding stock of T owned by a domestic corporation.)

(7) A, a U.S. citizen or resident, is an individual (unrelated to P and B) who owns T prior to the purchase of T by P. (A is referred to in cases in which it is appropriate to consider the effects of having all of the outstanding stock of T owned by an individual who is a U.S. citizen or resident. Ownership of T by A and ownership of T by S are mutually exclusive circumstances.)

(8) B, a U.S. citizen or resident, is an individual (unrelated to T, S, and A) who owns the stock of P.

(9) F, used as a prefix with the other terms in this paragraph (b), connotes foreign, rather than domestic, status. For example, FT is a foreign corporation (as defined in section 7701(a)(5)) and FA is an individual other than a U.S. citizen or resident.

(10) CFC, used as a prefix with the other terms in this paragraph (b) referring to a corporation, connotes a controlled foreign corporation (as defined in section 957, taking into account section 953(c)). A corporation identified with the prefix F may be a controlled foreign corporation. The prefix CFC is used when the corporation's status as a controlled foreign corporation is significant.

(c) *Definitions*. For purposes of the regulations under section 338 (except as otherwise provided):

(1) *Acquisition date.* The term *acquisition date* has the same meaning as in section 338(h)(2).

(2) *Acquisition date assets*. *Acquisition date assets* are the assets of the target held

at the beginning of the day after the acquisition date (other than assets that were not assets of old target).

(3) *Affiliated group*. The term *affiliated group* has the same meaning as in section 338(h)(5). Corporations are affiliated on any day they are members of the same affiliated group.

(4) *Common parent*. The term *common parent* has the same meaning as in section 1504.

(5) *Consistency period*. The *consistency period* is the period described in section 338(h)(4)(A) unless extended pursuant to §1.338–8(j)(1).

(6) *Deemed asset sale*. The *deemed asset sale* is the transaction described in §1.338–1T(a)(1) that is deemed to occur for purposes of subtitle A of the Internal Revenue Code if a section 338 election is made.

(7) *Deemed sale gain*. *Deemed sale gain* refers to, in the aggregate, the Federal income tax consequences (generally, the income, gain, deduction, and loss) of the deemed asset sale. *Deemed sale gain* also refers to the Federal income tax consequences of the transfer of a particular asset in the deemed asset sale.

(8) *Deemed sale return*. The *deemed sale return* is the return on which target's deemed sale gain is reported that does not include any other items of target. Target files a deemed sale return when a section 338 election (but not a section 338(h)(10) election) is filed for target and target is a member of a selling group (defined in paragraph (c)(16) of this section) that files a consolidated return for the period that includes the acquisition date or is an S corporation. See §1.338–10T.

(9) *Domestic corporation*. A *domestic corporation* is a corporation—

(i) That is domestic within the meaning of section 7701(a)(4) or that is treated as domestic for purposes of subtitle A of the Internal Revenue Code (e.g., to which an election under section 953(d) or 1504(d) applies); and

(ii) That is not a DISC, a corporation described in section 1248(e), or a corporation to which an election under section 936 applies.

(10) *Old target's final return*. *Old target's final return* is the income tax return of old target for the taxable year ending at the close of the acquisition date that includes the deemed sale gain. If the disaffiliation rule of §1.338–10T(a)(2)(i) applies or if target is an S corporation, target's deemed sale return is considered old target's final return.

(11) *Purchasing corporation*. The term *purchasing corporation* has the same meaning as in section 338(d)(1). The purchasing corporation may also be referred to as purchaser. Unless otherwise provided, any reference to the purchasing corporation is a reference to all members of the affiliated group of which the purchasing corporation is a member. See sections 338(h)(5) and (8). Also, unless otherwise provided, any reference to the purchasing corporation is, with respect to a deemed purchase of stock under section 338(a)(2), a reference to new target with respect to its own deemed purchase of stock in another target.

(12) *Qualified stock purchase*. The term *qualified stock purchase* has the same meaning as in section 338(d)(3).

(13) *Related persons*. Two persons are related if stock in a corporation owned by one of the persons would be attributed under section 318(a) (other than section 318(a)(4)) to the other.

(14) *Section 338 election*. A *section 338 election* is an election to apply section 338(a) to target. A section 338 election is made by filing a statement of section 338 election pursuant to paragraph (d) of this section. The form on which this statement is filed is referred to in the regulations under section 338 as the Form 8023 Elections Under Section 338 for Corporations Making Qualified Stock Purchases.

(15) *Section 338(h)(10) election*. A *section 338(h)(10) election* is an election to apply section 338(h)(10) to target. A section 338(h)(10) election is made by making a joint election for target under §1.338(h)(10)–1T.

(16) *Selling group*. The *selling group* is the affiliated group (as defined in section 1504) eligible to file a consolidated return that includes target for the taxable period in which the acquisition date occurs. However, a selling group is not an affiliated group of which target is the common parent on the acquisition date.

(17) *Target; old target; new target*. *Target* is the target corporation as defined in section 338(d)(2). *Old target* refers to target for periods ending on or before the close of target's acquisition date. *New target* refers to target for subsequent periods.

(18) *Target affiliate*. The term *target affiliate* has the same meaning as in section 338(h)(6) (applied without section 338(h)(6)(B)(i)). Thus, a corporation described in section 338(h)(6)(B)(i) is considered a target affiliate for all purposes of section 338. If a target affiliate is acquired in a qualified stock purchase, it is also a target.

(19) *12–Month acquisition period*. The *12-month acquisition period* is the period described in section 338(h)(1), unless extended pursuant to §1.338–8(j)(2).

(d) *Time and manner of making election*. The purchasing corporation makes a section 338 election for target by filing a statement of section 338 election on Form 8023 in accordance with the instructions to the form. The section 338 election must be made not later than the 15th day of the 9th month beginning after the month in which the acquisition date occurs. A section 338 election is irrevocable. See §1.338(h)(10)–1T(c)(2) for section 338(h)(10) elections.

(e) *Special rules for foreign corporations or DISCs*—(1) *Elections by certain foreign purchasing corporations*—(i) *General rule*. A qualifying foreign purchasing corporation is not required to file a statement of section 338 election for a qualifying foreign target before the earlier of 3 years after the acquisition date and the 180th day after the close of the purchasing corporation's taxable year within which a triggering event occurs.

(ii) *Qualifying foreign purchasing corporation*. A purchasing corporation is a *qualifying foreign purchasing corporation* only if, during the acquisition period of a qualifying foreign target, all the corporations in the purchasing corporation's affiliated group are foreign corporations that are not subject to United States tax.

(iii) *Qualifying foreign target*. A target is a *qualifying foreign target* only if target and its target affiliates are foreign corporations that, during target's acquisition period, are not subject to United States tax (and will not become subject to United States tax during such period because of a section 338 election). A target affiliate is taken into account for purposes of the preceding sentence only if, during target's 12-month acquisition period, it is or becomes a member of the affiliated group that includes the purchasing corporation.

(iv) *Triggering event*. A *triggering event* occurs in the taxable year of the qualifying foreign purchasing corporation in which either that corporation or any corporation in its affiliated group becomes subject to United States tax.

(v) *Subject to United States tax*. For purposes of this paragraph (e)(1), a foreign corporation is considered subject to United States tax—

(A) For the taxable year for which that corporation is required under §1.6012–2(g) (other than §1.6012–2(g)(2)(i)(B)(2)) to file a United States income tax return; or

(B) For the period during which that corporation is a controlled foreign corporation, a passive foreign investment company for which an election under section 1295 is in effect, a foreign investment company, or a foreign corporation the stock ownership of which is described in section 552(a)(2).

(2) *Acquisition period*. For purposes of this paragraph (e), the term *acquisition period* means the period beginning on the first day of the 12-month acquisition period and ending on the acquisition date.

(3) *Statement of section 338 election may be filed by United States shareholders in certain cases.* The United States shareholders (as defined in section 951(b)) of a foreign purchasing corporation that is a controlled foreign corporation (as defined in section 957 (taking into account section 953(c))) may file a statement of section 338 election on behalf of the purchasing corporation if the purchasing corporation is not required under §1.6012–2(g) (other than §1.6012–2(g)(2)(i)(B)(2)) to file a United States income tax return for its taxable year that includes the acquisition date. Form 8023 must be filed as described in the form and its instructions and also must be attached to the Form 5471 (information return with respect to a foreign corporation) filed with respect to the purchasing corporation by each United States shareholder for the purchasing corporation's taxable year that includes the acquisition date (or, if paragraph (e)(1)(i) of this section applies to the election, for the purchasing corporation's taxable year within which it becomes a controlled foreign corporation). The provisions of §1.964–1(c) (including §1.964–1(c)(7)) do not apply to an election made by the United States shareholders.

(4) *Notice requirement for U.S. persons holding stock in foreign market*—(i) *General rule.* If a target subject to a section 338 election was a controlled foreign corporation, a passive foreign investment company, or a foreign personal holding company at any time during the portion of its taxable year that ends on its acquisition date, the purchasing corporation must deliver written notice of the election (and a copy of Form 8023, its attachments and instructions) to—

(A) Each U.S. person (other than a member of the affiliated group of which the purchasing corporation is a member (the purchasing group member)) that, on the acquisition date of the foreign target, holds stock in the foreign target; and

(B) Each U.S. person (other than a purchasing group member) that sells stock in the foreign target to a purchasing group member during the foreign target's 12-month acquisition period.

(ii) *Limitation.* The notice requirement of this paragraph (e)(4) applies only where the section 338 election for the foreign target affects income, gain, loss, deduction, or credit of the U.S. person described in paragraph (e)(4)(i) of this section under section 551, 951, 1248, or 1293.

(iii) *Form of notice*. The notice to U.S. persons must be identified prominently as a notice of section 338 election and must—

(A) Contain the name, address, and employer identification number (if any) of, and the country (and, if relevant, the lesser political subdivision) under the laws of which is organized, the purchasing corporation and the relevant target (i.e., target the stock of which the particular U.S. person held or sold under the circumstances described in paragraph (e)(4)(i) of this section);

(B) Identify those corporations as the purchasing corporation and the foreign target, respectively; and

(C) Contain the following declaration (or a substantially similar declaration): THIS DOCUMENT SERVES AS NOTICE OF AN ELECTION UNDER SECTION 338 FOR THE ABOVE CITED FOREIGN TARGET THE STOCK OF WHICH YOU EITHER HELD OR SOLD UNDER THE CIRCUMSTANCES DESCRIBED IN TREASURY REGULATIONS SECTION 1.338-2T(e)(4). FOR POSSIBLE UNITED STATES FEDERAL INCOME TAX CONSEQUENCES UNDER SECTION 551, 951, 1248, OR 1293 OF THE INTERNAL REVENUE CODE OF 1986 THAT MAY APPLY TO YOU, SEE TREASURY REGULATIONS SECTION 1.338-9(b). YOU MAY BE REQUIRED TO ATTACH THE INFORMATION ATTACHED TO THIS NOTICE TO CERTAIN RETURNS.

(iv) *Timing of notice.* The notice required by this paragraph (e)(4) must be delivered to the U.S. person on or before the later of the 120th day after the acquisition date of the particular target or the day on which Form 8023 is filed. The notice is considered delivered on the date it is mailed to the proper address (or an address similar enough to complete delivery), unless the date it is mailed cannot be reasonably determined. The date of mailing will be determined under the rules of section 7502. For example, the date of mailing is the date of U.S. postmark or the applicable date recorded or marked by a designated delivery service.

(v) *Consequence of failure to comply.* A statement of section 338 election is not valid if timely notice is not given to one or more U.S. persons described in this paragraph (e)(4). If the form of notice fails to comply with all requirements of this paragraph (e)(4), the section 338 election is valid, but the waiver rule of §1.338-10T(b)(1) does not apply.

(vi) *Good faith effort to comply.* The purchasing corporation will be considered to have complied with this paragraph (e)(4), even though it failed to provide notice or provide timely notice to each person described in this paragraph (e)(4), if the Commissioner determines that the purchasing corporation made a good faith effort to identify and provide timely notice to those U.S. persons.

§1.338-3T Qualification for the section 338 election (temporary).

(a) *Scope.* This section provides rules on whether certain acquisitions of stock are qualified stock purchases and on other miscellaneous issues under section 338.

(b) *Rules relating to qualified stock purchases*—(1) *Purchasing corporation requirement.* An individual cannot make a qualified stock purchase of target. Section 338(d)(3) requires, as a condition of a qualified stock purchase, that a corporation purchase the stock of target. If an individual forms a corporation (new P) to acquire target stock, new P can make a qualified stock purchase of target if new P is considered for tax purposes to purchase the target stock. Facts that may indicate that new P does not purchase the target stock include new P's merging downstream into target, liquidating, or otherwise disposing of the target stock following the purported qualified stock purchase.

(2) *Purchase*—(i) *Definition*. The term *purchase* has the same meaning as in section 338(h)(3).

(ii) *Purchase of target.* [Reserved]

(iii) *Purchase of target affiliate*. Stock in a target affiliate acquired by new target in the deemed asset sale of target's assets is considered purchased if, under general principles of tax law, new target is considered to own stock of the target affiliate meeting the requirements of section 1504(a)(2), notwithstanding that no amount may be allocated to target's stock in the target affiliate.

(3) *Acquisitions of stock from related corporations*—(i) *In general.* Stock acquired by a purchasing corporation from a related corporation (R) is generally not considered acquired by purchase. See section 338(h)(3)(A)(iii).

(ii) *Time for testing relationship.* For purposes of section 338(h)(3)(A)(iii), a purchasing corporation is treated as related to another person if the relationship specified in section 338(h)(3)(A)(iii) exists—

(A) In the case of a single transaction, immediately after the purchase of Target stock;

(B) In the case of a series of acquisitions otherwise constituting a qualified stock purchase within the meaning of section 338(d)(3), immediately after the last acquisition in such series; and

(C) In the case of a series of transactions effected pursuant to an integrated plan to dispose of Target stock, immediately after the last transaction in such series.

(iii) *Cases where section_338(h)(3)(C) applies—acquisitions treated as purchases*. If section 338(h)(3)(C) applies and the purchasing corporation is treated as acquiring stock by purchase from R, solely for purposes of determining when the stock is considered acquired, target stock acquired from R is considered to have been acquired by the purchasing corporation on the day on which the purchasing corporation is first considered to own that stock under section 318(a) (other than section 318(a)(4)).

(iv) *Examples*. The following examples illustrate this paragraph (b)(3):

Example 1. (i) S is the parent of a group of corporations that are engaged in various businesses. Prior to January 1, Year 1, S decided to discontinue its involvement in one line of business. To accomplish this, S forms a new corporation, Newco, with a nominal amount of cash. Shortly thereafter, on January 1, Year 1, S transfers all the stock of the subsidiary conducting the unwanted business (Target) to Newco in exchange for 100 shares of Newco common stock and a Newco promissory note. Prior to January 1, Year 1, S and Underwriter (U) had entered into a binding agreement pursuant to which U would purchase 60 shares of Newco common stock from S and then sell those shares in an Initial Public Offering (IPO). On January 6, Year 1, the IPO closes.

(ii) Newco's acquisition of Target stock is one of a series of transactions undertaken pursuant to one integrated plan. The series of transactions ends with the closing of the IPO and the transfer of all the shares of stock in accordance with the agreements. Immediately after the last transaction effected pursuant to the plan, S owns 40 percent of Newco, which does not give rise to a relationship described in section 338(h)(3)(A)(iii). See §1.338–2T(b)(3)(ii)(C). Accordingly, S and Newco are not related for purposes of section 338(h)(3)(A)(iii).

(iii) Further, because Newco's basis in the Target stock is not determined by reference to S's basis in the Target stock and because the transaction is not an exchange to which section 351, 354, 355, or 356 applies, Newco's acquisition of the Target stock is a purchase within the meaning of section 338(h)(3).

Example 2. (i) On January 1 of Year 1, P purchases 75 percent in value of the R stock. On that date, R owns 4 of the 100 shares of T stock. On June 1 of Year 1, R acquires an additional 16 shares of T stock. On December 1 of Year 1, P purchases 70 shares of T stock from an unrelated person and 12 of the 20 shares of T stock held by R.

(ii) Of the 12 shares of T stock purchased by P from R on December 1 of Year 1, 3 of those shares are deemed to have been acquired by P on January 1 of Year 1, the date on which 3 of the 4 shares of T stock held by R on that date were first considered owned by P under section 318(a)(2)(C) (i.e., 4 (.75). The remaining 9 shares of T stock purchased by P from R on December 1 of Year 1, are deemed to have been acquired by P on June 1 of Year 1, the date on which an additional 12 of the 20 shares of T stock owned by R on that date were first considered owned by P under section 318(a)(2)(C) (i.e., (20 (.75) -3). Because stock acquisitions by P sufficient for a qualified stock purchase of T occur within a 12-month period (i.e., 3 shares constructively on January 1 of Year 1, 9 shares constructively on June 1 of Year 1, and 70 shares actually on December 1 of Year 1), a qualified stock purchase is made on December 1 of Year 1.

Example 3. (i) On February 1 of Year 1, P acquires 25 percent in value of the R stock from B (the sole shareholder of P). That R stock is not acquired by purchase. See section 338(h)(3)(A)(iii). On that date, R owns 4 of the 100 shares of T stock. On June 1 of Year 1, P purchases an additional 25 percent in value of the R stock, and on January 1 of Year 2, P purchases another 25 percent in value of the R stock. On June 1 of Year 2, R acquires an additional 16 shares of the T stock. On December 1 of Year 2, P purchases 68 shares of the T stock from an unrelated person and 12 of the 20 shares of the T stock held by R.

(ii) Of the 12 shares of the T stock purchased by P from R on December 1 of Year 2, 2 of those shares are deemed to have been acquired by P on June 1 of Year 1, the date on which 2 of the 4 shares of the T stock held by R on that date were first considered owned by P under section 318(a)(2)(C) (i.e., 4 (.5). For purposes of this attribution, the R stock need not be acquired by P by purchase. See section 338(h)(1). (By contrast, the acquisition of the T stock by P from R does not qualify as a purchase unless P has acquired at least 50 percent in value of the R stock by purchase. Section 338(h)(3)(C)(i).) Of the remaining 10 shares of the T stock purchased by P from R on December 1 of Year 2, 1 of those shares is deemed to have been acquired by P on January 1 of Year 2, the date on which an additional 1 share of the 4 shares of the T stock held by R on that date was first considered owned by P under section 318(a)(2)(C) (i.e., (4 (.75) –2). The remaining 9 shares of the T stock purchased by P from R on December 1 of Year 2, are deemed to have been acquired by P on June 1 of Year 2, the date on which an additional 12 shares of the T stock held by R on that date were first considered owned by P under section 318(a)(2)(C) (i.e., (20 (.75) –3). Because a qualified stock purchase of T by P is made on December 1 of Year 2, only if all 12 shares of the T stock purchased by P from R on that date are considered acquired during a 12-month period ending on that date (so that, in conjunction with the 68 shares of the T stock P purchased on that date from the unrelated person, 80 of T's 100 shares are acquired by P during a 12-month period) and because 2 of those 12 shares are considered to have been acquired by P more than 12 months before December 1 of Year 2 (i.e., on June 1 of Year 1), a qualified stock purchase is not made. (Under §1.338–8(j)(2), for purposes of applying the consistency rules, P is treated as making a qualified stock purchase of T if, pursuant to an arrangement, P purchases T stock satisfying the requirements of section 1504(a)(2) over a period of more than 12 months.)

Example 4. Assume the same facts as in *Example 3*, except that on February 1 of Year 1, P acquires 25 percent in value of the R stock by purchase. The result is the same as in *Example 3*.

(4) *Acquisition date for tiered targets*—(i) *Stock sold in deemed asset sale*. If an election under section 338 is made for target, old target is deemed to sell target's assets and new target is deemed to acquire those assets. Under section 338(h)(3)(B), new target's deemed purchase of stock of another corporation is a purchase for purposes of section 338(d)(3) on the acquisition date of target. If new target's deemed purchase causes a qualified stock pur-

chase of the other corporation and if a section 338 election is made for the other corporation, the acquisition date for the other corporation is the same as the acquisition date of target. However, the deemed sale and purchase of the other corporation's assets is considered to take place after the deemed sale and purchase of target's assets.

(ii) *Examples*. The following examples illustrate this paragraph (b)(4):

Example 1. A owns all of the T stock. T owns 50 of the 100 shares of X stock. The other 50 shares of X stock are owned by corporation Y, which is unrelated to A, T, or P. On January 1 of Year 1, P makes a qualified stock purchase of T from A and makes a section 338 election for T. On December 1 of Year 1, P purchases the 50 shares of X stock held by Y. A qualified stock purchase of X is made on December 1 of Year 1, because the deemed purchase of 50 shares of X stock by new T because of the section 338 election for T and the actual purchase of 50 shares of X stock by P are treated as purchases made by one corporation. Section 338(h)(8). For purposes of determining whether those purchases occur within a 12-month acquisition period as required by section 338(d)(3), T is deemed to purchase its X stock on T's acquisition date, i.e., January 1 of Year 1.

Example 2. On January 1 of Year 1, P makes a qualified stock purchase of T and makes a section 338 election for T. On that day, T sells all of the stock of T1 to A. Although T held all of the T1 stock on T's acquisition date, T is not considered to have purchased the T1 stock because of the section 338 election for T. In order for T to be treated as purchasing the T1 stock, T must hold the T1 stock when T's deemed asset sale occurs. The deemed asset sale is considered the last transaction of old T at the close of T's acquisition date. Accordingly, the T1 stock actually disposed of by T on the acquisition date is not included in the deemed asset sale. Thus, T does not make a qualified stock purchase of T1.

(5) *Effect of redemptions*—(i) *General rule*. Except as provided in this paragraph (b)(5), a qualified stock purchase is made on the first day on which the percentage ownership requirements of section 338(d)(3) are satisfied by reference to target stock that is both—

(A) Held on that day by the purchasing corporation; and

(B) Purchased by the purchasing corporation during the 12-month period ending on that day.

(ii) *Redemptions from persons unrelated to the purchasing corporation*. Target stock redemptions from persons unrelated to the purchasing corporation that occur during the 12-month acquisition period are taken into account as reductions in target's outstanding stock for purposes of determining whether target stock purchased by the purchasing corporation in the 12-month acquisition period satisfies the percentage ownership requirements of section 338(d)(3).

(iii) *Redemptions from the purchasing corporation or related persons during 12-month acquisition period*—(A) *General rule*. For purposes of the percentage ownership requirements of section 338(d)(3), a redemption of target stock during the 12-month acquisition period from the purchasing corporation or from any person related to the purchasing corporation is not taken into account as a reduction in target's outstanding stock.

(B) *Exception for certain redemptions from related corporations*. A redemption of target stock during the 12-month acquisition period from a corporation related to the purchasing corporation is taken into account as a reduction in target's outstanding stock to the extent that the redeemed stock would have been considered purchased by the purchasing corporation (because of section 338(h)(3)(C)) during the 12-month acquisition period if the redeemed stock had been acquired by the purchasing corporation from the related corporation on the day of the redemption. See paragraph (b)(3) of this section.

(iv) *Examples*. The following examples illustrate this paragraph (b)(5):

Example 1. QSP on stock purchase date; redemption from unrelated person during 12-month period. A owns all 100 shares of T stock. On January 1 of Year 1, P purchases 40 shares of the T stock from A. On July 1 of Year 1, T redeems 25 shares from A. On December 1 of Year 1, P purchases 20 shares of the T stock from A. P makes a qualified stock purchase of T on December 1 of Year 1, because the 60 shares of T stock purchased by P within the 12-month period ending on that date satisfy the 80-percent ownership requirements of section 338(d)(3) (i.e., 60/75 shares), determined by taking into account the redemption of 25 shares.

Example 2. QSP on stock redemption date; redemption from unrelated person during 12-month period. The facts are the same as in *Example 1*, except that P purchases 60 shares of T stock on January 1 of Year 1 and none on December 1 of Year 1. P makes a qualified stock purchase of T on July 1 of Year 1, because that is the first day on which the T stock purchased by P within the preceding 12-month period satisfies the 80-percent ownership requirements of section 338(d)(3) (i.e., 60/75 shares), determined by taking into account the redemption of 25 shares.

Example 3. Redemption from purchasing corporation not taken into account. On December 15 of Year 1, T redeems 30 percent of its stock from P. The redeemed stock was held by P for several years and constituted P's total interest in T. On December 1 of Year 2, P purchases the remaining T stock from A. P does not make a qualified stock purchase of T on December 1 of Year 2. For purposes of the 80-percent ownership requirements of section 338(d)(3), the redemption of P's T stock on December 15 of Year 1 is not taken into account as a reduction in T's outstanding stock.

Example 4. Redemption from related person taken into account. On January 1 of Year 1, P purchases 60 of the 100 shares of X stock. On that date, X owns 40 of the 100 shares of T stock. On April 1 of Year 1, T redeems X's T stock and P purchases the remaining 60 shares of T stock from an unrelated person. For purposes of the 80-percent ownership requirements of section 338(d)(3), the redemption of the T stock from X (a person related to P) is taken into account as a reduction in T's outstanding stock. If P had purchased the 40 redeemed shares from X on April 1 of Year 1, all 40 of the shares would have been considered purchased (because of section 338(h)(3)(C)(i)) during the 12-month period ending on April 1 of Year 1 (24 of the 40 shares would have been considered purchased by P on January 1 of Year 1 and the remaining 16 shares would have been considered purchased by P on April 1 of Year 1). See paragraph (b)(3) of this section. Accordingly, P makes a qualified stock purchase of T on April 1 of Year 1, because the 60 shares of T stock purchased by P on that date satisfy the 80-percent ownership requirements of section 338(d)(3) (i.e., 60/60 shares), determined by taking into account the redemption of 40 shares.

(c) *Effect of post-acquisition events on eligibility for section 338 election*— (1) *Post-acquisition elimination of target.* (i) The purchasing corporation may make an election under section 338 for target even though target is liquidated on or after the acquisition date. If target liquidates on the acquisition date, the liquidation is considered to occur on the following day and immediately after new target's deemed purchase of assets. The purchasing corporation may also make an election under section 338 for target even though target is merged into another corporation, or otherwise disposed of by the purchasing corporation provided that, under the facts and circumstances, the purchasing corporation is considered for tax purposes as the purchaser of the target stock.

(ii) The following examples illustrate this paragraph (c)(1):

Example 1. On January 1 of Year 1, P purchases 100 percent of the outstanding common stock of T. On June 1 of Year 1, P sells the T stock to an unrelated person. Assuming that P is considered for tax purposes as the purchaser of the T stock, P remains eligible, after June 1 of Year 1, to make a section 338 election for T that results in a deemed asset sale of T's assets on January 1 of Year 1.

Example 2. On January 1 of Year 1, P makes a qualified stock purchase of T. On that date, T owns the stock of T1. On March 1 of Year 1, T sells the T1 stock to an unrelated person. On April 1 of Year 1, P makes a section 338 election for T. Notwithstanding that the T1 stock was sold on March 1 of Year 1, the section 338 election for T on April 1 of Year 1 results in a qualified stock purchase by T of

T1 on January 1 of Year 1. See paragraph (b)(4)(i) of this section.

(2) *Post-acquisition elimination of the purchasing corporation*. An election under section 338 may be made for target after the acquisition of assets of the purchasing corporation by another corporation in a transaction described in section 381(a), provided that the purchasing corporation is considered for tax purposes as the purchaser of the target stock. The acquiring corporation in the section 381(a) transaction may make an election under section 338 for target.

(3) *Consequences of post-acquisition elimination of target*—(i) *Scope*. The rules of this paragraph (c)(3) apply to the transfer of target assets to the purchasing corporation (or another member of the same affiliated group as the purchasing corporation) (the transferee) following a qualified stock purchase of target stock, if the purchasing corporation does not make a section 338 election for target. Notwithstanding the rules of this paragraph (c)(3), section 354(a) (and so much of section 356 as relates to section 354) cannot apply to any person other than the purchasing corporation or another member of the same affiliated group as the purchasing corporation unless the transfer of target assets is pursuant to a reorganization as determined without regard to this paragraph (c)(3).

(ii) *Continuity of interest*. By virtue of section 338, in determining whether the continuity of interest requirement of §1.368-1(b) is satisfied on the transfer of assets from target to the transferee, the purchasing corporation's target stock acquired in the qualified stock purchase represents an interest on the part of a person who was an owner of the target's business enterprise prior to the transfer that can be continued in a reorganization.

(iii) *Control requirement*. By virtue of section 338, the acquisition of target stock in the qualified stock purchase will not prevent the purchasing corporation from qualifying as a shareholder of the target transferor for the purpose of determining whether, immediately after the transfer of target assets, a shareholder of the transferor is in control of the corporation to which the assets are transferred within the meaning of section 368(a)(1)(D).

(iv) *Example*. The following example illustrates this paragraph (c)(3):

Example. (i) *Facts*. P, T, and X are domestic corporations. T and X each operate a trade or business. A and K, individuals unrelated to P, own 85 and 15 percent, respectively, of the stock of T. P owns all of the stock of X. The total adjusted basis of T's property exceeds the sum of T's liabilities plus the amount of liabilities to which T's property is subject. P purchases all of A's T stock for cash in a qualified stock purchase. P does not make an election under section 338(g) with respect to its acquisition of T stock. Shortly after the acquisition date, and as part of the same plan, T merges under applicable state law into X in a transaction that, but for the question of continuity of interest, satisfies all the requirements of section 368(a)(1)(A). In the merger, all of T's assets are transferred to X. P and K receive X stock in exchange for their T stock. P intends to retain the stock of X indefinitely.

(ii) *Status of transfer as a reorganization*. By virtue of section 338, for the purpose of determining whether the continuity of interest requirement of §1.368–1(b) is satisfied, P's T stock acquired in the qualified stock purchase represents an interest on the part of a person who was an owner of T's business enterprise prior to the transfer that can be continued in a reorganization through P's continuing ownership of X. Thus, the continuity of interest requirement is satisfied and the merger of T into X is a reorganization within the meaning of section 368(a)(1)(A). Moreover, by virtue of section 338, the requirement of section 368(a)(1)(D) that a target shareholder control the transferee immediately after the transfer is satisfied because P controls X immediately after the transfer. In addition, all of T's assets are transferred to X in the merger and P and K receive the X stock exchanged therefor in pursuance of the plan of reorganization. Thus, the merger of T into X is also a reorganization within the meaning of section 368(a)(1)(D).

(iii) *Treatment of T and X*. Under section 361(a), T recognizes no gain or loss in the merger. Under section 362(b), X's basis in the assets received in the merger is the same as the basis of the assets in T's hands. X succeeds to and takes into account the items of T as provided in section 381.

(iv) *Treatment of P*. By virtue of section 338, the transfer of T assets to X is a reorganization. Pursuant to that reorganization, P exchanges its T stock solely for stock of X, a party to the reorganization. Because P is the purchasing corporation, section 354 applies to P's exchange of T stock for X stock in the merger of T into X. Thus, P recognizes no gain or loss on the exchange. Under section 358, P's basis in the X stock received in the exchange is the same as the basis of P's T stock exchanged therefor.

(v) *Treatment of K*. Because K is not the purchasing corporation (or an affiliate thereof), section 354 cannot apply to K's exchange of T stock for X stock in the merger of T into X unless the transfer of T's assets is pursuant to a reorganization as determined without regard to this paragraph (c)(3). Under general principles of tax law applicable to reorganizations, the continuity of interest requirement is not satisfied because P's stock purchase and the merger of T into X are pursuant to an integrated transaction in which A, the owner of 85 percent of the stock of T, received solely cash in exchange for A's T stock. See, e.g., *Yoc Heating v. Commissioner*, 61 T.C. 168 (1973); *Kass v. Commissioner*, 60 T.C. 218 (1973), aff'd, 491 F.2d 749 (3d Cir. 1974). Thus, the requisite continuity of interest under §1.368–1(b) is lacking and section 354 does not apply to K's exchange of T stock for X stock. K recognizes gain or loss, if any, pursuant to section 1001(c) with respect to its T stock.

§§1.338–4 and 1.338–5 [Redesignated as §§1.338–8 and 1.338–9]

Par. 5. Sections 1.338–4 and 1.338–5 are redesignated as §§1.338–8 and 1.338–9, respectively.

Par. 6. New §§1.338–4T and 1.338–5T are added to read as follows:

§1.338–4T Aggregate deemed sale price; various aspects of taxation of the deemed asset sale (temporary).

(a) *Scope*. This section provides rules under section 338(a)(1) to determine the aggregate deemed sale price (ADSP) for target. ADSP is the amount for which old target is deemed to have sold all of its assets in the deemed asset sale. ADSP is allocated among target's assets in accordance with §1.338–6T to determine the amount for which each asset is deemed to have been sold. When an increase or decrease with respect to an element of ADSP is required, under general principles of tax law, after the close of new target's first taxable year, redetermined ADSP is allocated among target's assets in accordance with §1.338–7T. This section also provides rules regarding the recognition of gain or loss on the deemed sale of target affiliate stock. Notwithstanding section 338(h)(6)(B)(ii), stock held by a target affiliate in a foreign corporation or in a corporation that is a DISC or that is described in section 1248(e) is not excluded from the operation of section 338.

(b) *Determination of ADSP*—(1) *General rule*. ADSP is the sum of—

(i) The grossed-up amount realized on the sale to the purchasing corporation of the purchasing corporation's recently purchased target stock (as defined in section 338(b)(6)(A)); and

(ii) The liabilities of old target.

(2) *Time and amount of ADSP*—(i) *Original determination*. ADSP is initially determined at the beginning of the day after the acquisition date of target. General principles of tax law apply in determining the timing and amount of the elements of ADSP.

(ii) *Redetermination of ADSP*. ADSP is redetermined at such time and in such amount as an increase or decrease would be required, under general principles of tax law, for the elements of ADSP. For example, ADSP is redetermined because of an increase or decrease in the amount realized for recently purchased stock or because liabilities not originally taken into account in determining ADSP are subsequently taken into account. An increase or decrease to one element of ADSP may cause an increase or decrease to the other element of ADSP. For example, if an increase in the amount realized for recently purchased stock of target is taken into account after the acquisition date, any increase in the tax liability of target for the deemed sale gain is also taken into account when ADSP is redetermined. Increases or decreases with respect to the elements of ADSP that are taken into account before the close of new target's first taxable year are taken into account for purposes of determining ADSP and the deemed sale gain as if they had been taken into account at the beginning of the day after the acquisition date. Increases or decreases with respect to the elements of ADSP that are taken into account after the close of new target's first taxable year result in the reallocation of ADSP among target's assets under §1.338–7T.

(iii) *Example*. The following example illustrates this paragraph (b)(2):

Example. In Year 1, T, a manufacturer, purchases a customized delivery truck from X with purchase money indebtedness having a stated principal amount of $100,000. P acquires all of the stock of T in Year 3 for $700,000 and makes a section 338 election for T. Assume T has no liabilities other than its purchase money indebtedness to X. In Year 4, when T is neither insolvent nor in a title 11 case, T and X agree to reduce the amount of the purchase money indebtedness to $80,000. Assume further that the reduction would be a purchase price reduction under section 108(e)(5). T and X's agreement to reduce the amount of the purchase money indebtedness would not, under general principles of tax law that would apply if the deemed asset sale had actually occurred, change the amount of liabilities of old target taken into account in determining its amount realized. Accordingly, ADSP is not redetermined at the time of the reduction. See §1.338–5T(b)(2)(iii) Example 1 for the effect on AGUB.

(c) *Grossed-up amount realized on the sale to the purchasing corporation of the purchasing corporation's recently purchased target stock*—(1) *Determination of amount*. The grossed-up amount realized on the sale to the purchasing corporation of the purchasing corporation's recently purchased target stock is an amount equal to—

(i) The amount realized on the sale to the purchasing corporation of the purchasing corporation's recently purchased target stock determined as if old target were the selling shareholder and the installment method were not available and determined without regard to the selling costs taken into account in paragraph (c)(1)(iii) of this section;

(ii) Divided by the percentage of target stock (by value, determined on the acquisition date) attributable to that recently purchased target stock;

(iii) Less the selling costs incurred by the selling shareholders in connection with the sale to the purchasing corporation of the purchasing corporation's recently purchased target stock that reduce their amount realized on the sale of the stock (e.g., brokerage commissions and any similar costs to sell the stock).

(2) *Example*. The following example illustrates this paragraph (c):

Example. T has two classes of stock outstanding, voting common stock and preferred stock not taken into account for purposes of section 1504(a)(2). On March 1 of Year 1, P purchases 40 percent of the outstanding T stock from S1 for $500, 20 percent of the outstanding T stock from S2 for $225, and 20 percent of the outstanding T stock from S3 for $275. On that date, the fair market value of all the T voting common stock is $1,250 and the preferred stock $750. S1, S2, and S3 respectively incur $40, $35, and $25 of selling costs. S1 continues to own the remaining 20 percent of the outstanding T stock. The grossed-up amount realized on the sale to P of P's recently purchased T stock is calculated as follows: The total amount realized (without regard to selling costs) is $1,000 (500 + 225 + 275). The percentage of T stock by value on the acquisition date attributable to the recently purchased T stock is 50% (1,000/(1,250 + 750)). The selling costs are $100 (40 + 35 + 25). The grossed-up amount realized is $1,900 (1,000/.5 å100).

(d) *Liabilities of old target*—(1) *In general*. The liabilities of old target are the liabilities of target (and the liabilities to which target's assets are subject) as of the beginning of the day after the acquisition date (other than liabilities that were neither liabilities of old target nor liabilities to which old target's assets were subject). In order to be taken into account in ADSP, a liability must be a liability of target that is properly taken into account in amount realized under general principles of tax law that would apply if old target had sold its assets to an unrelated person for consideration that included that person's assumption of, or taking subject to, the liability. Thus, ADSP takes into account both tax credit recapture liability arising because of the deemed asset sale and the tax liability for the deemed sale gain unless the tax liability is borne by some person other than the target. For example, ADSP would not take into account the tax liability for the deemed sale gain when a section 338(h)(10) election is made for a target S corporation because the S corporation shareholders bear that liability. However, if a target S corporation is subject to a tax under section 1374 or 1375, the liability for tax imposed by those sections is a liability of target taken into account in ADSP (unless the S corporation shareholders expressly assume that liability).

(2) *Time and amount of liabilities*. The time for taking into account liabilities of old target in determining ADSP and the amount of the liabilities taken into account is determined as if old target had sold its assets to an unrelated person for consideration that included the unrelated person's assumption of or taking subject to the liabilities. For example, if no amount of a target liability is properly taken into account in amount realized as of the beginning of the day after the acquisition date, the liability is not initially taken into account in determining ADSP (although it may be taken into account at some later date). As a further example, an increase or decrease in a liability that does not affect the amount of old target's basis, deductions, or noncapital nondeductible items arising from the incurrence of the liability is not taken into account in redetermining ADSP.

(3) *Interaction with deemed sale gain*. Though deemed sale gain increases or decreases ADSP by creating or reducing a tax liability, the amount of the tax liability itself is a function of the size of the deemed sale gain. Thus, the determination of ADSP may require trial and error computations.

(e) *Calculation of deemed sale gain*. Deemed sale gain on each asset is computed by reference to the ADSP allocated to that asset.

(f) *Other rules apply in determining ADSP*. ADSP may not be applied in such a way as to contravene other applicable rules. For example, a capital loss cannot be applied to reduce ordinary income in calculating the tax liability on the deemed sale for purposes of determining ADSP.

(g) *Examples*. The following examples illustrate this section. For purposes of the examples in this paragraph (g), unless otherwise stated, T is a calendar year taxpayer that files separate returns and that has no loss, tax credit, or other carryovers to Year

1. Depreciation for Year 1 is not taken into account. T has no liabilities other than the Federal income tax liability resulting from the deemed asset sale, and the T shareholders have no selling costs. Assume that T's tax rate for any ordinary income or net capital gain resulting from the deemed sale of assets is 34 percent and that any capital loss is offset by capital gain. On July 1 of Year 1, P purchases all of the stock of T and makes a section 338 election for T. The examples are as follows:

Example 1. One class. (i) On July 1 of Year 1, T's only asset is an item of section 1245 property with an adjusted basis to T of $50,400, a recomputed basis of $80,000, and a fair market value of $100,000. P purchases all of the T stock for $75,000, which also equals the amount realized for the stock determined as if old target were the selling shareholder.

(ii) ADSP is determined as follows (In the following formula, G is the grossed-up amount realized on the sale to P of P's recently purchased T stock, L is T's liabilities other than T's tax liability for the deemed sale gain, T_R is the applicable tax rate, and B is the adjusted basis of the asset deemed sold):

$ADSP = G + L + T_R \times (ADSP - B)$

$ADSP = (\$75,000/1) + \$0 + .34 \times (ADSP - \$50,400)$

$ADSP = \$75,000 + .34ADSP - \$17,136$

$.66ADSP = \$57,864$

$ADSP = \$87,672.72$

(iii) Because ADSP for T ($87,672.72) does not exceed the fair market value of T's asset ($100,000), a Class V asset, T's entire ADSP is allocated to that asset. Thus, T has deemed sale gain of $37,272.72 (consisting of $29,600 of ordinary income and $7,672.72 of capital gain).

(iv) The facts are the same as in paragraph (i) of this *Example 1*, except that on July 1 of Year 1, P purchases only 80 of the 100 shares of T stock for $60,000. The grossed-up amount realized on the sale to P of P's recently purchased T stock (G) is $75,000 ($60,000/.8). Consequently, ADSP and deemed sale gain are the same as in paragraphs (ii) and (iii) of this *Example 1*.

(v) The facts are the same as in paragraph (i) of this *Example 1*, except that T also has goodwill (a Class VII asset) with an appraised value of $10,000. The results are the same as in paragraphs (ii) and (iii) of this *Example 1.* Because ADSP does not exceed the fair market value of the Class V asset, no amount is allocated to the Class VII asset (goodwill).

Example 2. More than one class. (i) P purchases all of the T stock for $140,000, which also equals the amount realized for the stock determined as if old target were the selling shareholder. On July 1 of Year 1, T has liabilities (not including the tax liability for the deemed sale gain) of $50,000, cash (a Class I asset) of $10,000, actively traded securities (a Class II asset) with a basis of $4,000 and a fair market value of $10,000, goodwill (a Class VII asset) with a basis of $3,000, and the following Class V assets:

Asset	*Basis*	*FMV*	*Ratio of asset fmv to total Class V fmv*
Land	$ 5,000	$ 35,000	.14
Building	10,000	50,000	.20
Equipment A (Recomputed basis $80,000)	5,000	90,000	.36
Equipment B (Recomputed basis $20,000)	10,000	75,000	.30
Totals	$ 30,000	$ 250,000	1.00

(ii) ADSP exceeds $20,000. Thus, $10,000 of ADSP is allocated to the cash and $10,000 to the actively traded securities. The amount allocated to an asset (other than a Class VII asset) cannot exceed its fair market value (however, the fair market value of any property subject to nonrecourse indebtedness is treated as being not less than the amount of such indebtedness; see §1.338–6T(a)(2)). See §1.338–6T(c)(1) (relating to fair market value limitation).

(iii) The portion of ADSP allocable to the Class V assets is preliminarily determined as follows (in the formula, the amount allocated to the Class I assets is referred to as I and the amount allocated to the Class II assets as II):

$ADSP_V = (G - (I + II)) + L + T_R ([(II - B_{II}) + (ADSP_V - B_V)]$

$ADSP_V = (\$140,000 - (\$10,000 + \$10,000)) + \$50,000 + .34 ([(\$10,000 - \$4,000) + (ADSP_V - (\$5,000 + \$10,000 + \$5,000 + \$10,000))]$

$ADSP_V = \$161,840 + .34\ ADSP_V$

$.66\ ADSP_V = \$161,840$

$ADSP_V = \$245,212.12$

(iv) Because, under the preliminary calculations of ADSP, the amount to be allocated to the Class I, II, III, IV, V, and VI assets does not exceed their aggregate fair market value, no ADSP amount is allocated to goodwill. Accordingly, the deemed sale of the goodwill results in a capital loss of $3,000. The portion of ADSP allocable to the Class V assets is finally determined by taking into account this loss as follows:

$ADSP_V = (G \text{ å } (I + II)) + L + T_R ([(II \text{ å } B_{II}) + (ADSP_V \text{ å } B_V) + (ADSP_{VII} \text{ å } B_{VII})]$

$ADSP_V = (\$140,000 \text{ å } (\$10,000 + \$10,000)) + \$50,000 + .34 ([(\$10,000 \text{ å } \$4,000) + (ADSP_V \text{ å } \$30,000) + (\$0 \text{ å } \$3,000)]$

$ADSP_V = \$160,820 + .34\ ADSP_V$

$.66\ ADSP_V = \$160,820$

$ADSP_V = \$243,666.67$

(v) The allocation of $ADSP_V$ among the Class V assets is in proportion to their fair market values, as follows:

Asset	*ADSP*	*Gain*
Land	$ 34,113.33	$ 29,113.33 (capital gain)
Building	48,733.34	38,733.34 (capital gain)
Equipment A	87,720.00	82,720.00 (75,000 ordinary income 7,720 capital gain)
Equipment B	73,100.00	63,100.00 (10,000 ordinary income 53,100 capital gain)
Totals	$ 243,666.67	$ 213,666.67

Example 3. More than one class. (i) The facts are the same as in *Example 2*, except that P purchases the T stock for $150,000, rather than $140,000. The amount realized for the stock determined as if old target were the selling shareholder is also $150,000.

(ii) As in *Example 2*, ADSP exceeds $20,000. Thus, $10,000 of ADSP is allocated to the cash and $10,000 to the actively traded securities.

(iii) The portion of ADSP allocable to the Class V assets as preliminarily determined under the formula set forth in paragraph (iii) of *Example 2* is $260,363.64. The amount allocated to the Class V assets cannot exceed their aggregate fair market value ($250,000). Thus, preliminarily, the ADSP amount allocated to Class V assets is $250,000.

(iv) Based on the preliminary allocation, the ADSP is determined as follows (in the formula, the amount allocated to the Class I assets is referred to as I, the amount allocated to the Class II assets as II, and the amount allocated to the Class V assets as V):

$ADSP = G + L + T_R\ ([(II - B_{II}) + (V - B_V) + (ADSP - (I + II + V+ B_{VII}))]$

ADSP = $150,000 + $50,000 + .34 ([($10,000 - $4,000) + ($250,000 - $30,000) + (ADSP - ($10,000 + $10,000 + $250,000 + $3,000))]

ADSP = $200,000 + .34ADSP - $15,980

.66ADSP = $184,020

ADSP = $278,818.18

(v) Because ADSP as determined exceeds the aggregate fair market value of the Class I, II, III, IV, V, and VI assets, the $250,000 amount preliminarily allocated to the Class V assets is appropriate. Thus, the amount of ADSP allocated to Class V assets equals their aggregate fair market value ($250,000), and the allocated ADSP amount for each Class V asset is its fair market value. Further, because there are no Class VI assets, the allocable ADSP amount for the Class VII asset (goodwill) is $8,818.18 (the excess of ADSP over the aggregate ADSP amounts for the Class I, II, III, IV, V and VI assets).

Example 4. Amount allocated to T1 stock. (i) The facts are the same as in *Example 2*, except that T owns all of the T1 stock (instead of the building), and T1's only asset is the building. The T1 stock and the building each have a fair market value of $50,000, and the building has a basis of $10,000. A section 338 election is made for T1 (as well as T), and T1 has no liabilities other than the tax liability for the deemed sale gain. T is the common parent of a consolidated group filing a final consolidated return described in §1.338–10T(a)(1).

(ii) ADSP exceeds $20,000. Thus, $10,000 of ADSP is allocated to the cash and $10,000 to the actively traded securities.

(iii) Because T does not recognize any gain on the deemed sale of the T1 stock under paragraph (h)(2) of this section, appropriate adjustments must be made to reflect accurately the fair market value of the T and T1 assets in determining the allocation of ADSP among T's Class V assets (including the T1 stock). In preliminarily calculating $ADSP_V$ in this case, the T1 stock can be disregarded and, because T owns all of the T1 stock, the T1 asset can be treated as a T asset. Under this assumption, $ADSP_V$ is $243,666.67. See paragraph (iv) of *Example 2*.

(iv) Because the portion of the preliminary ADSP allocable to Class V assets ($243,666.67) does not exceed their fair market value ($250,000), no amount is allocated to Class VII assets for T. Further, this amount ($243,666.67) is allocated among T's Class V assets in proportion to their fair market values. See paragraph (v) of *Example 2*. Tentatively, $48,733.34 of this amount is allocated to the T1 stock.

(v) The amount tentatively allocated to the T1 stock, however, reflects the tax incurred on the deemed sale of the T1 asset equal to $13,169.34 (.34 (($48,733.34 å $10,000)). Thus, the ADSP allocable to the Class V assets of T, and the ADSP allocable to the T1 stock, as preliminarily calculated, each must be reduced by $13,169.34. Consequently, these amounts, respectively, are $230,497.33 and $35,564.00. In determining ADSP for T1, the grossed-up amount realized on the deemed sale to new T of new T's recently purchased T1 stock is $35,564.00.

(vi) The facts are the same as in paragraph (i) of this *Example 4*, except that the T1 building has a $12,500 basis and a $62,500 value, all of the outstanding T1 stock has a $62,500 value, and T owns 80 percent of the T1 stock. In preliminarily calculating $ADSP_V$, the T1 stock can be disregarded but, because T owns only 80 percent of the T1 stock, only 80 percent of T1 asset basis and value should be taken into account in calculating T's ADSP. By taking into account 80 percent of these amounts, the remaining calculations and results are the same as in paragraphs (ii), (iii), (iv), and (v) of this *Example 4*, except that the grossed-up amount realized on the sale of the recently purchased T1 stock is $44,455.00 ($35,564.00/0.8).

(h) *Deemed sale of target affiliate stock*—(1) *Scope*. This paragraph (h) prescribes rules relating to the treatment of gain or loss realized on the deemed sale of stock of a target affiliate when a section 338 election (but not a section 338(h)(10) election) is made for the target affiliate. For purposes of this paragraph (h), the definition of domestic corporation in §1.338–2T(c)(9) is applied without the exclusion therein for DISCs, corporations described in section 1248(e), and corporations to which an election under section 936 applies.

(2) *In general*. Except as otherwise provided in this paragraph (h), if a section 338 election is made for target, target recognizes no gain or loss on the deemed sale of stock of a target affiliate having the same acquisition date and for which a section 338 election is made if—

(i) Target directly owns stock in the target affiliate satisfying the requirements of section 1504(a)(2);

(ii) Target and the target affiliate are members of a consolidated group filing a final consolidated return described in §1.338-10T(a)(1); or

(iii) Target and the target affiliate file a combined return under §1.338–10T(a)(4).

(3) *Deemed sale of foreign target affiliate by a domestic target.* A domestic target recognizes gain or loss on the deemed sale of stock of a foreign target affiliate. For the proper treatment of such gain or loss, see, e.g., sections 1246, 1248, 1291 et seq., and 338(h)(16) and §1.338–9.

(4) *Deemed sale producing effectively connected income.* A foreign target recognizes gain or loss on the deemed sale of stock of a foreign target affiliate to the extent that such gain or loss is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States.

(5) *Deemed sale of insurance company target affiliate electing under section 953(d)*. A domestic target recognizes gain (but not loss) on the deemed sale of stock of a target affiliate that has in effect an election under section 953(d) in an amount equal to the lesser of the gain realized or the earnings and profits described in section 953(d)(4)(B).

(6) *Deemed sale of DISC target affiliate.* A foreign or domestic target recognizes gain (but not loss) on the deemed sale of stock of a target affiliate that is a DISC or a former DISC (as defined in section 992(a)) in an amount equal to the lesser of the gain realized or the amount of accumulated DISC income determined with respect to such stock under section 995(c). Such gain is included in gross income as a dividend as provided in sections 995(c)(2) and 996(g).

(7) *Anti-stuffing rule*. If an asset the adjusted basis of which exceeds its fair market value is contributed or transferred to a target affiliate as transferred basis property (within the meaning of section 7701(a)(43)) and a purpose of such transaction is to reduce the gain (or increase the loss) recognized on the deemed sale of such target affiliate's stock, the gain or loss recognized by target on the deemed sale of stock of the target affiliate is determined as if such asset had not been contributed or transferred.

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

Example 1. (i) P makes a qualified stock purchase of T and makes a section 338 election for T. T's sole asset, all of the T1 stock, has a basis of $50 and a fair market value of $150. T's deemed purchase of the T1 stock results in a qualified stock purchase of T1 and a section 338 election is made for T1. T1's assets have a basis of $50 and a fair market value of $150.

(ii) T realizes $100 of gain on the deemed sale of the T1 stock, but the gain is not recognized because T directly owns stock in T1 satisfying the requirements of section 1504(a)(2) and a section 338 election is made for T1.

(iii) T1 recognizes gain of $100 on the deemed sale of its assets.

Example 2. The facts are the same as in *Example 1*, except that P does not make a section 338 election for T1. Because a section 338 election is not made for T1, the $100 gain realized by T on the deemed sale of the T1 stock is recognized.

Example 3. (i) P makes a qualified stock purchase of T and makes a section 338 election for T. T owns all of the stock of T1 and T2. T's deemed purchase of the T1 and T2 stock results in a qualified stock purchase of T1 and T2 and section 338 elections are made for T1 and T2. T1 and T2 each own 50 percent of the vote and value of T3 stock. The deemed purchases by T1 and T2 of the T3 stock result in a qualified stock purchase of T3 and a section 338 election is made for T3. T is the common parent of a consolidated group and all of the deemed asset sales are reported on the T group's final consolidated return. See §1.338–10T(a)(1).

(ii) Because T, T1, T2 and T3 are members of a consolidated group filing a final consolidated return, no gain or loss is recognized by T, T1 or T2 on their respective deemed sales of target affiliate stock.

Example 4. (i) T's sole asset, all of the FT1 stock, has a basis of $25 and a fair market value of $150. FT1's sole asset, all of the FT2 stock, has a basis of $75 and a fair market value of $150. FT1 and FT2 each have $50 of accumulated earnings and profits for purposes of section 1248(c) and (d). FT2's assets have a basis of $125 and a fair market value of $150, and their sale would not generate subpart F income under section 951. The sale of the FT2 stock or assets would not generate income effectively connected with the conduct of a trade or business within the United States. FT1 does not have an election in effect under section 953(d) and neither FT1 nor FT2 is a passive foreign investment company.

(ii) P makes a qualified stock purchase of T and makes a section 338 election for T. T's deemed purchase of the FT1 stock results in a qualified stock purchase of FT1 and a section 338 election is made for FT1. Similarly, FT1's deemed purchase of the FT2 stock results in a qualified stock purchase of FT2 and a section 338 election is made for FT2.

(iii) T recognizes $125 of gain on the deemed sale of the FT1 stock under paragraph (h)(3) of this section. FT1 does not recognize $75 of gain on the deemed sale of the FT2 stock under paragraph (h)(2) of this section. FT2 recognizes $25 of gain on the deemed sale of its assets. The $125 gain T recognizes on the deemed sale of the FT1 stock is included in T's income as a dividend under section 1248, because FT1 and FT2 have sufficient earnings and profits for full recharacterization ($50 of accumulated earnings and profits in FT1, $50 of accumulated earnings and profits in FT2, and $25 of deemed sale earnings and profits in FT2). §1.338–9(b). For purposes of sections 901 through 908, the source and foreign tax credit limitation basket of $25 of the recharacterized gain on the deemed sale of the FT1 stock is determined under section 338(h)(16).

§1.338–5T Adjusted grossed-up basis (temporary).

(a) *Scope.* This section provides rules under section 338(b) to determine the adjusted grossed-up basis (AGUB) for target. AGUB is the amount for which new target is deemed to have purchased all of its assets in the deemed purchase under section 338(a)(2). AGUB is allocated among target's assets in accordance with §1.338–6T to determine the price at which the assets are deemed to have been purchased. When an increase or decrease with respect to an element of AGUB is required, under general principles of tax law, after the close of new target's first taxable year, redetermined AGUB is allocated among target's assets in accordance with §1.338–7T.

(b) *Determination of AGUB*—(1) *General rule.* AGUB is the sum of—

(i) The grossed-up basis in the purchasing corporation's recently purchased target stock;

(ii) The purchasing corporation's basis in nonrecently purchased target stock; and

(iii) The liabilities of new target.

(2) *Time and amount of AGUB*—(i) *Original determination.* AGUB is initially determined at the beginning of the day after the acquisition date of target. General principles of tax law apply in determining the timing and amount of the elements of AGUB.

(ii) *Redetermination of AGUB.* AGUB is redetermined at such time and in such amount as an increase or decrease would be required, under general principles of tax law, with respect to an element of AGUB. For example, AGUB is redetermined because of an increase or decrease in the amount paid or incurred for recently purchased stock or nonrecently purchased stock or because liabilities not originally taken into account in determining AGUB are subsequently taken into account. An increase or decrease to an element of ADSP may cause an increase or decrease to an element of AGUB. For example, if an increase in the amount realized for recently purchased stock of target is taken into account after the acquisition date, any increase in tax liability of target for the deemed sale gain is also taken into account when AGUB is redetermined. An increase or decrease to one element of AGUB may also cause an increase or decrease to another element of AGUB. For example, if there is an increase in the amount paid or incurred for recently purchased stock after the acquisition date, any increase in the basis of nonrecently purchased stock because a gain recognition election was made is also taken into account when AGUB is redetermined. Increases or decreases with respect to the elements of AGUB that are taken into account before the close of new target's first taxable year are taken into account for purposes of determining AGUB and the basis of target's assets as if they had been taken into account at the beginning of the day after the acquisition date. Increases or decreases with respect to the elements of AGUB that are taken into account after the close of new target's first taxable year result in the reallocation of AGUB among target's assets under §1.338–7T.

(iii) *Examples.* The following examples illustrate this paragraph (b)(2):

Example 1. In Year 1, T, a manufacturer, purchases a customized delivery truck from X with purchase money indebtedness having a stated principal amount of $100,000 . P acquires all of the stock of T in Year 3 for $700,000 and makes a section 338 election for T. Assume T has no liabilities other than its purchase money indebtedness to X. In Year 4, when T is neither insolvent nor in a title 11 case, T and X agree to reduce the amount of the purchase money indebtedness to $80,000. Assume that the reduction would be a purchase price reduction under section 108(e)(5). T and X's agreement to reduce the amount of the purchase money indebtedness would, under general principles of tax law that would apply if the deemed asset sale had actually occurred, change the amount of liabilities of old target taken into account in determining its basis. Accordingly, AGUB is redetermined at the time of the reduction. See paragraph (e)(2) of this section. Thus the purchase price reduction affects the basis of the truck only indirectly, through the mechanism of §§1.338–6T and 1.338–7T. See §1.338–4T(b)(2)(iii) *Example* for the effect on ADSP.

Example 2. T, an accrual basis taxpayer, is a chemical manufacturer. In Year 1, T is obligated to remediate environmental contamination at the site of one of its plants. Assume that all the events have occurred that establish the fact of the liability and the amount of the liability can be determined with reasonable accuracy but economic performance has not occurred with respect to the liability within the meaning of section 461(h). P acquires all of the stock of T in Year 1 and makes a section 338 election for T. Assume that, if a corporation unrelated to T had actually purchased T's assets and assumed T's obligation to remediate the contamination, the corporation would not satisfy the economic performance requirements until Year 5. Under section 461(h), the assumed liability would not be treated as incurred and taken into account in basis until that time. The incurrence of the liability in Year 5 under the economic performance rules is an increase in the amount of liabilities properly taken into account in basis and results in the redetermination of AGUB. (Respecting ADSP, compare §1.461–4(d)(5), which provides that economic performance occurs for old T as the amount of the liability is properly taken into account in amount realized on the deemed asset sale. Thus ADSP is not redetermined when new T satisfies the economic performance requirements.)

(c) *Grossed-up basis of recently purchased stock.* The purchasing corporation's grossed-up basis of recently purchased target stock (as defined in section 338(b)(6)(A)) is an amount equal to—

(1) The purchasing corporation's basis in recently purchased target stock at the beginning of the day after the acquisition date determined without regard to the acquisition costs taken into account in paragraph (c)(3) of this section;

(2) Multiplied by a fraction, the numerator of which is 100 percent minus the percentage of target stock (by value, determined on the acquisition date) attributable to the purchasing corporation's nonrecently purchased target stock, and the denominator of which is the percentage of target stock (by value, determined on the acquisition date) attributable to the purchasing corporation's recently purchased target stock;

(3) Plus the acquisition costs the purchasing corporation incurred in connection with its purchase of the recently purchased stock that are capitalized in the basis of such stock (e.g., brokerage commissions and any similar costs incurred by the purchasing corporation to acquire the stock).

(d) *Basis of nonrecently purchased stock; gain recognition election*—(1) *No gain recognition election.* In the absence of a gain recognition election under section 338(b)(3) and this section, the purchasing corporation retains its basis in the nonrecently purchased stock.

(2) *Procedure for making gain recognition election.* A gain recognition election may be made for nonrecently purchased stock of target (or a target affiliate) only if a section 338 election is made for target (or the target affiliate). The gain recognition election is made by attaching a gain recognition statement to a timely filed Form 8023 for target. The gain recognition statement must contain the information specified in the form and its instructions. The gain recognition election is irrevocable. If a section 338(h)(10) election is made for target, see §1.338(h)(10)–1T(d)(1) (providing that the purchasing corporation is automatically deemed to have made a gain recognition election for its nonrecently purchased T stock).

(3) *Effect of gain recognition election*—(i) *In general.* If the purchasing corporation makes a gain recognition election, then for all purposes of the Internal Revenue Code—

(A) The purchasing corporation is treated as if it sold on the acquisition date the nonrecently purchased target stock for the basis amount determined under paragraph (d)(3)(ii) of this section; and

(B) The purchasing corporation's basis on the acquisition date in nonrecently purchased target stock immediately following the deemed sale in paragraph (d)(3)(i)(A) of this section is the basis amount.

(ii) *Basis amount.* The basis amount is equal to the amount in paragraph (c)(1) of this section (the purchasing corporation's basis in recently purchased target stock at the beginning of the day after the acquisition date determined without regard to the acquisition costs taken into account in paragraph (c)(3) of this section) multiplied by a fraction the numerator of which is the percentage of target stock (by value, determined on the acquisition date) attributable to the purchasing corporation's nonrecently purchased target stock and the denominator of which is 100 percent minus the numerator amount. Thus, if target has a single class of outstanding stock, the purchasing corporation's basis in each share of nonrecently purchased target stock after the gain recognition election is equal to the average price per share of the purchasing corporation's recently purchased target stock.

(iii) *Losses not recognized.* Only gains (unreduced by losses) on the nonrecently purchased target stock are recognized.

(iv) *Stock subject to election.* The gain recognition election applies to—

(A) All nonrecently purchased target stock; and

(B) Any nonrecently purchased stock in a target affiliate having the same acquisition date as target if such target affiliate stock is held by the purchasing corporation on such date.

(e) *Liabilities of new target*—(1) *In general.* The liabilities of new target are the liabilities of target (and the liabilities to which target's assets are subject) as of the beginning of the day after the acquisition date (other than liabilities that were neither liabilities of old target nor liabilities to which old target's assets were subject). In order to be taken into account in AGUB, a liability must be a liability of target that is properly taken into account in basis under general principles of tax law that would apply if new target had acquired its assets from an unrelated person for consideration that included the assumption of, or taking subject to, the liability. See §1.338–4T(d)(1) for examples of when tax liabilities are considered liabilities assumed by new target.

(2) *Time and amount of liabilities.* The time for taking into account liabilities of old target in determining AGUB and the amount of the liabilities taken into account is determined as if new target had acquired its assets from an unrelated person for consideration that included the assumption of, or taking subject to, the liabilities. For example, an increase or decrease in a liability that does not affect the amount of new target's basis arising from the assumption of, or taking subject to, the liability is not taken into account in redetermining AGUB.

(3) *Interaction with deemed sale gain.* See §1.338–4T(d)(3).

(f) *Adjustments by the Internal Revenue Service.* In connection with the examination of a return, the District Director may increase (or decrease) AGUB under the authority of section 338(b)(2) and allocate such amounts to target's assets under the authority of section 338(b)(5) so that AGUB and the basis of target's assets properly reflect the cost to the purchasing corporation of its interest in target's assets. Such items may include distributions from target to the purchasing corporation, capital contributions from the purchasing corporation to target during the 12-month acquisition period, or acquisitions of target stock by the purchasing corporation after the acquisition date from minority shareholders.

(g) *Examples.* The following examples illustrate this section. For purposes of the examples in this paragraph (g), T has no liabilities other than the tax liability for the deemed sale gain, T shareholders incur no costs in selling the T stock, and P incurs no costs in acquiring the T stock. The examples are as follows:

Example 1. (i) Before July 1 of Year 1, P purchases 10 of the 100 shares of T stock for $5,000. On July 1 of Year 2, P purchases 80 shares of T stock for $60,000 and makes a section 338 election for T. As of July 1 of Year 2, T's only asset is raw land with an adjusted basis to T of $50,400 and a fair market value of $100,000. T has no loss or tax credit carryovers to Year 2. T's marginal tax rate for any ordinary income or net capital gain resulting from the deemed asset sale is 34 percent. The 10 shares purchased before July 1 of Year 1 constitute nonrecently purchased T stock with respect to P's qualified stock purchase of T stock on July 1 of Year 2.

(ii) The ADSP formula as applied to these facts is the same as in §1.338–4T(g) *Example 1*. Accordingly, the ADSP for T is \$87,672.72. The existence of nonrecently purchased T stock is irrelevant for purposes of the ADSP formula, because that formula treats P's nonrecently purchased T stock in the same manner as T stock not held by P.

(iii) The total tax liability resulting from T's deemed asset sale, as calculated under the ADSP formula, is \$12,672.72.

(iv) If P does not make a gain recognition election, the AGUB of new T's assets is \$85,172.72, determined as follows (In the following formula below, GRP is the grossed-up basis in P's recently purchased T stock, BNP is P's basis in nonrecently purchased T stock, L is T's liabilities, and X is P's acquisition costs for the recently purchased T stock):

AGUB = GRP + BNP + L + X

AGUB = \$60,000 ([(1 - .1)/.8] + \$5,000 + \$12,672.72 + 0

AGUB = \$85,172.72

(v) If P makes a gain recognition election, the AGUB of new T's assets is \$87,672.72, determined as follows:

AGUB = \$60,000 ([(1 - .1)/.8] + \$60,000 ([(1 - .1)/.8] ([.1/(1 - .1)] + \$12,672.72

AGUB = \$87,672.72

(vi) The calculation of AGUB if P makes a gain recognition election may be simplified as follows:

AGUB = \$60,000/.8 + \$12,672.72

AGUB = \$87,672.72

(vii) As a result of the gain recognition election, P's basis in its nonrecently purchased T stock is increased from \$5,000 to \$7,500 (i.e., \$60,000 ([(1 å .1)/.8] ([.1/(1 å .1)]). Thus, P recognizes a gain in Year 2 with respect to its nonrecently purchased T stock of \$2,500 (i.e., \$7,500 å \$5,000).

Example 2. On January 1 of Year 1, P purchases one-third of the T stock. On March 1 of Year 1, T distributes a dividend to all of its shareholders. On April 15 of Year 1, P purchases the remaining T stock and makes a section 338 election for T. In appropriate circumstances, the District Director may decrease the AGUB of T to take into account the payment of the dividend and properly reflect the fair market value of T's assets deemed purchased.

Example 3. (i) T's sole asset is a building worth \$100,000. At this time, T has 100 shares of stock outstanding. On August 1 of Year 1, P purchases 10 of the 100 shares of T stock for \$8,000. On June 1 of Year 2, P purchases 50 shares of T stock for \$50,000. On June 15 of Year 2, P contributes a tract of land to the capital of T and receives 10 additional shares of T stock as a result of the contribution. Both the basis and fair market value of the land at that time are \$10,800. On June 30 of Year 2, P purchases the remaining 40 shares of T stock for \$40,000 and makes a section 338 election for T. The AGUB of T is \$108,800.

(ii) To prevent the shifting of basis from the contributed property to other assets of T, the District Director may allocate \$10,800 of the AGUB to the land, leaving \$98,000 to be allocated to the building. See paragraph (f) of this section. Otherwise, applying the allocation rules of §1.338–6T would, on these facts, result in an allocation to the recently contributed land of an amount less than its value of \$10,800, with the difference being allocated to the building already held by T.

Par. 7. Sections 1.338–6T and 1.338–7T are added to read as follows:

§1.338–6T Allocation of ADSP and AGUB among target assets (temporary).

(a) *Scope*—(1) *In general*. This section prescribes rules for allocating ADSP and AGUB among the acquisition date assets of a target for which a section 338 election is made.

(2) *Fair market value*—(i) *In general*. Generally, the fair market value of an asset is its gross fair market value (i.e., fair market value determined without regard to mortgages, liens, pledges, or other liabilities). However, for purposes of determining the amount of old target's deemed sale gain, the fair market value of any property subject to a nonrecourse indebtedness will be treated as being not less than the amount of such indebtedness. (For purposes of the preceding sentence, a liability that was incurred because of the acquisition of the property is disregarded to the extent that such liability was not taken into account in determining old target's basis in such property.)

(ii) *Transaction costs*. Transaction costs are not taken into account in allocating ADSP or AGUB to assets in the deemed sale (except indirectly through their effect on the total ADSP or AGUB to be allocated).

(iii) *Internal Revenue Service authority*. In connection with the examination of a return, the Internal Revenue Service may challenge the taxpayer's determination of the fair market value of any asset by any appropriate method and take into account all factors, including any lack of adverse tax interests between the parties. For example, in certain cases the Internal Revenue Service may make an independent showing of the value of goodwill and going concern value as a means of calling into question the validity of the taxpayer's valuation of other assets.

(b) *General rule for allocating ADSP and AGUB*—(1) *Reduction in the amount of consideration for Class I assets*. Both ADSP and AGUB, in the respective allocation of each, are first reduced by the amount of Class I acquisition date assets. Class I assets are cash and general deposit accounts (including savings and checking accounts) other than certificates of deposit held in banks, savings and loan associations, and other depository institutions. If the amount of Class I assets exceeds AGUB, new target will immediately realize ordinary income in an amount equal to such excess. The amount of ADSP or AGUB remaining after the reduction is to be allocated to the remaining acquisition date assets.

(2) *Other assets*—(i) *In general*. Subject to the limitations and other rules of paragraph (c) of this section, ADSP and AGUB (as reduced by the amount of Class I assets) are allocated among Class II acquisition date assets of target in proportion to the fair market values of such Class II assets at such time, then among Class III assets so held in such proportion, then among Class IV assets so held in such proportion, then among Class V assets so held in such proportion, then among Class VI assets so held in such proportion, and finally to Class VII assets.

(ii) *Class II assets*. Class II assets are actively traded personal property within the meaning of section 1092(d)(1) and §1.1092(d)–1 (determined without regard to section 1092(d)(3)). In addition, Class II assets include certificates of deposit and foreign currency even if they are not actively traded personal property. Examples of Class II assets include U.S. government securities and publicly traded stock.

(iii) *Class III assets*. Class III assets are accounts receivable, mortgages, and credit card receivables from customers which arise in the ordinary course of business.

(iv) *Class IV assets*. Class IV assets are stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business.

(v) *Class V assets*. Class V assets are all assets other than Class I, II, III, IV, VI, and VII assets.

(vi) *Class VI assets*. Class VI assets are all section 197 intangibles, as defined in section 197, except goodwill and going concern value.

(vii) *Class VII assets*. Class VII assets are goodwill and going concern value (whether or not the goodwill or going concern value qualifies as a section 197 intangible).

(3) *Other items designated by the Internal Revenue Service*. Similar items may be added to any class described in this paragraph (b) by designation in the Internal Revenue Bulletin by the Internal Revenue Ser-

vice (see §601.601(d)(2) of this Chapter).

(c) *Certain limitations and other rules for allocation to an asset*—(1) *Allocation not to exceed fair market value*. The amount of ADSP or AGUB allocated to an asset (other than Class VII assets) cannot exceed the fair market value of that asset at the beginning of the day after the acquisition date.

(2) *Allocation subject to other rules.* The amount of ADSP or AGUB allocated to an asset is subject to other provisions of the Internal Revenue Code or general principles of tax law in the same manner as if such asset were transferred to or acquired from an unrelated person in a sale or exchange. For example, if the deemed asset sale is a transaction described in section 1056(a) (relating to basis limitation for player contracts transferred in connection with the sale of a franchise), the amount of AGUB allocated to a contract for the services of an athlete cannot exceed the limitation imposed by that section. As another example, the amount of AGUB allocated to an amortizable section 197 intangible resulting from an assumption-reinsurance transaction is determined under section 197(f)(5).

(3) *Special rule for allocating AGUB when purchasing corporation has nonrecently purchased stock*—(i) *Scope*. This paragraph (c)(3) applies if at the beginning of the day after the acquisition date—

(A) The purchasing corporation holds nonrecently purchased stock for which a gain recognition election under section 338(b)(3) and §1.338–5T(d) is not made; and

(B) The hypothetical purchase price determined under paragraph (c)(3)(ii) of this section exceeds the AGUB determined under §1.338–5T(b).

(ii) *Determination of hypothetical purchase price*. Hypothetical purchase price is the AGUB that would result if a gain recognition election were made.

(iii) *Allocation of AGUB*. Subject to the limitations in paragraphs (c)(1) and (2) of this section, the portion of AGUB (after reduction by the amount of Class I assets) to be allocated to each Class II, III, IV, V, VI, and VII asset of target held at the beginning of the day after the acquisition date is determined by multiplying—

(A) The amount that would be allocated to such asset under the general rules of this section were AGUB equal to the hypothetical purchase price; by

(B) A fraction, the numerator of which is actual AGUB (after reduction by the amount of Class I assets) and the denominator of which is the hypothetical purchase price (after reduction by the amount of Class I assets).

(4) *Liabilities taken into account in determining amount realized on subsequent disposition*. In determining the amount realized on a subsequent sale or other disposition of property deemed purchased by new target, the entire amount of any liability taken into account in AGUB is considered to be an amount taken into account in determining new target's basis in property that secures the liability for purposes of applying §1.1001–2(a). Thus, if a liability is taken into account in AGUB, §1.1001–2(a)(3) does not prevent the amount of such liability from being treated as discharged within the meaning of §1.1001–2(a)(4) as a result of new target's sale or disposition of the property which secures such liability.

(d) *Examples*. The following examples illustrate §§1.338–4T, 1.338–5T, and this section:

Example 1. (i) T owns 90 percent of the outstanding T1 stock. P purchases 100 percent of the outstanding T stock for $2,000. There are no acquisition costs. P makes a section 338 election for T and, as a result, T1 is considered acquired in a qualified stock purchase. A section 338 election is made for T1. The grossed-up basis of the T stock is $2,000 (i.e., $2,000 (1/1).

(ii) The liabilities of T as of the beginning of the day after the acquisition date (including the tax liability for the deemed sale gain) that would, under general principles of tax law, be properly taken into account before the close of new T's first taxable year, are as follows:

Liabilities (nonrecourse mortgage plus unsecured liabilities)	$ 700
Taxes Payable	300
Total	$ 1,000

(iii) The AGUB of T is determined as follows:

Grossed-up basis	$2,000
Total liabilities	1,000
AGUB	$ 3,000

(iv) Assume that ADSP is also $3,000.

(v) Assume that, at the beginning of the day after the acquisition date, T's cash and the fair market values of T's Class II, III, IV, and V assets are as follows:

Asset Class	*Asset*	*Fair market value*
I	Cash	$ 200*
II	Portfolio of actively traded securities	300
III	Accounts receivable	600
IV	Inventory	300
V	Building	800
V	Land	200
V	Investment in T1	450
	Total	$ 2,850

*Amount.

(vi) Under paragraph (b)(1) of this section, the amount of ADSP and AGUB allocable to T's Class II, III, IV, and V assets is reduced by the amount of cash to $2,800, i.e., $3,000 å $200. $300 of ADSP and of AGUB is then allocated to actively traded securities. $600 of ADSP and of AGUB is then allocated to accounts receivable. $300 of ADSP and of AGUB is then allocated to the inventory. Since the remaining amount of ADSP and of AGUB is $1,600 (i.e., $3,000 å ($200 + $300 + $600 + $300)), an amount which exceeds the sum of the fair market values of T's Class V assets, the amount of ADSP and of AGUB allocated to each Class V asset is its fair market value:

Building	800
Land	200
Investment in T1	450
Total	$ 1,450

(vii) T has no Class VI assets. The amount of ADSP and of AGUB allocated to T's Class VII assets (goodwill and going concern value) is $150, i.e., $1,600 - $1,450.

(viii) The grossed-up basis of the T1 stock is $500, i.e., $450 (1/.9.

(ix) The liabilities of T as of the beginning of the day after the acquisition date (including the tax liability for the deemed sale gain) that would, under general principles of tax law, be properly taken into account before the close of new T's first taxable year, are as follows:

General Liabilities	$ 100
Taxes Payable	20
Total	$ 120

(x) The AGUB of T1 is determined as follows:

Grossed-up basis of T1 Stock	$ 500
Liabilities	120
AGUB	$ 620

(xi) Assume that ADSP is also $620.

(xii) Assume that at the beginning of the day after the acquisition date, T1's cash and the fair market values of its Class IV and VI assets are as follows:

Asset Class	*Asset*	*Fair Market Value*
I	Cash	$ 50*
IV	Inventory	200
VI	Patent	350
	Total	$ 600

* Amount.

(xiii) The amount of ADSP and of AGUB allocable to T1's Class IV and VI assets is first reduced by the $50 of cash.

(xiv) Because the remaining amount of ADSP and of AGUB ($570) is an amount which exceeds the fair market value of T1's only Class IV asset, the inventory, the amount allocated to the inventory is its fair market value ($200). After that, the remaining amount of ADSP and of AGUB ($370) exceeds the fair market value of T1's only Class VI asset, the patent. Thus, the amount of ADSP and of AGUB allocated to the patent is its fair market value ($350).

(xv) The amount of ADSP and of AGUB allocated to T1's Class VII assets (goodwill and going concern value) is $20, i.e., $570 å $550.

Example 2. (i) Assume that the facts are the same as in *Example 1* except that P has, for five years, owned 20 percent of T's stock, which has a basis in P's hands at the beginning of the day after the acquisition date of $100, and P purchases the remaining 80 percent of T's stock for $1,600. P does not make a gain recognition election under section 338(b)(3).

(ii) Under §1.338–5T(c), the grossed-up basis of recently purchased T stock is $1,600, i.e., $1,600 ((1 - .2)/.8.

(iii) The AGUB of T is determined as follows:

Grossed-up basis of recently purchased stock as determined under §1.338–5T(c) ($1,600 x (1 - .2)/.8)	$ 1,600
Basis of nonrecently purchased stock	100
Liabilities	1,000
AGUB	$ 2,700

(iv) Since P holds nonrecently purchased stock, the hypothetical purchase price of the T stock must be computed and is determined as follows:

Grossed-up basis of recently purchased stock as determined under §1.338–5T(c) ($1,600 ((1 - .2)/.8)	$ 1,600
Basis of nonrecently purchased stock as if the gain recognition election under §1.338–5T(d)(2) had been made ($1,600 (.2/(1 å .2))	400
Liabilities	1,000
Total	$ 3,000

(v) Since the hypothetical purchase price ($3,000) exceeds the AGUB ($2,700) and no gain recognition election is made under section 338(b)(3), AGUB is allocated under paragraph (c)(3) of this section.

(vi) First, an AGUB amount equal to the hypothetical purchase price ($3,000) is allocated among the assets under the general rules of this section. The allocation is set forth in the column below entitled *Original Allocation.* Next, the allocation to each asset in Class II through Class VII is multiplied by a fraction having a numerator equal to the actual AGUB reduced by the amount of Class I assets ($2,700 å $200 = $2,500) and a denominator equal to the hypothetical purchase price reduced by the amount of Class I assets ($3,000 å $200 = $2,800), or 2,500/2,800. This produces the *Final Allocation:*

Class	*Asset*	*Original Allocation*	*Final Allocation*
I	Cash	$ 200	$ 200
II	Portfolio of actively traded securities	300	268*
III	Accounts receivable	600	536
IV	Inventory	300	268
V	Building	800	714
V	Land	200	178
V	Investment in T1	450	402
VII	Goodwill and going concern value	150	134
	Total	$ 3,000	$ 2,700

* All numbers rounded for convenience.

§1.338–7T Allocation of redetermined ADSP and AGUB among target assets (temporary).

(a) *Scope.* ADSP and AGUB are redetermined at such time and in such amount as an increase or decrease would be required under general principles of tax law for the elements of ADSP or AGUB. This section provides rules for allocating redetermined ADSP or AGUB when increases or decreases with respect to the elements of ADSP or AGUB are required after the close of new target's first taxable year. For determining and allocating ADSP or AGUB when increases or decreases are required with respect to the elements of ADSP or AGUB before the close of new target's first taxable year, see §§1.338–4T, 1.338–5T, and 1.338–6T.

(b) *Allocation of redetermined ADSP and AGUB.* When ADSP or AGUB is redetermined, a new allocation of ADSP or AGUB is made by allocating the redetermined ADSP or AGUB amount under the rules of §1.338–6T. If the allocation of the redetermined ADSP or AGUB amount under §1.338–6T to a given asset is different from the original allocation to it, the difference is added to or subtracted from the original allocation to the asset, as appropriate. Amounts allocable to an acquisition date asset (or with respect to a disposed-of acquisition date asset) are subject to all the asset allocation rules (for example, the fair market value limitation in §1.338–6T(c)(1)) as if the redetermined ADSP or AGUB were the ADSP or AGUB on the acquisition date.

(c) *Special rules for ADSP*—(1) *In-*

creases or decreases in deemed sale gain taxable notwithstanding old target ceases to exist. To the extent general principles of tax law would require a seller in an actual asset sale to account for events relating to the sale that occur after the sale date, target must make such an accounting. Target is not precluded from realizing additional deemed sale gain because the target is treated as a new corporation after the acquisition date.

(2) *Procedure for transactions in which section 338(h)(10) is not elected*— (i) *Deemed sale gain included in new target's return*. If an election under section 338(h)(10) is not made, any additional deemed sale gain of old target resulting from an increase or decrease in the ADSP is included in new target's income tax return for new target's taxable year in which the increase or decrease is taken into account. For example, if after the acquisition date there is an increase in the allocable ADSP of section 1245 property for which the recomputed basis (but not the adjusted basis) exceeds the portion of the ADSP allocable to that particular asset on the acquisition date, the additional gain is treated as ordinary income to the extent it does not exceed such excess amount. See paragraph (c)(2)(ii) of this section for the special treatment of old target's carryovers and carrybacks. Although included in new target's income tax return, the deemed sale gain is separately accounted for as an item of old target and may not be offset by income, gain, deduction, loss, credit, or other amount of new target. The amount of tax on income of old target resulting from an increase or decrease in the ADSP is determined as if such deemed sale gain had been recognized in old target's taxable year ending at the close of the acquisition date.

(ii) *Carryovers and carrybacks*—(A) *Loss carryovers to new target taxable years*. A net operating loss or net capital loss of old target may be carried forward to a taxable year of new target, under the principles of section 172 or 1212, as applicable, but is allowed as a deduction only to the extent of any recognized income of old target for such taxable year, as described in paragraph (c)(2)(i) of this section. For this purpose, however, taxable years of new target are not taken into account in applying the limitations in section 172(b)(1) or 1212(a)(1)(B) (or other similar limitations). In applying sections 172(b) and 1212(a)(1), only income, gain, loss, deduction, credit, and other amounts of old target are taken into account. Thus, if old target has an unexpired net operating loss at the close of its taxable year in which the deemed asset sale occurred that could be carried forward to a subsequent taxable year, such loss may be carried forward until it is absorbed by old target's income.

(B) *Loss carrybacks to taxable years of old target*. An ordinary loss or capital loss accounted for as a separate item of old target under paragraph (c)(2)(i) of this section may be carried back to a taxable year of old target under the principles of section 172 or 1212, as applicable. For this purpose, taxable years of new target are not taken into account in applying the limitations in section 172(b) or 1212(a) (or other similar limitations).

(C) *Credit carryovers and carrybacks.* The principles described in paragraphs (c)(2)(ii)(A) and (B) of this section apply to carryovers and carrybacks of amounts for purposes of determining the amount of a credit allowable under part IV, subchapter A, chapter 1 of the Internal Revenue Code. Thus, for example, credit carryovers of old target may offset only income tax attributable to items described in paragraph (c)(2)(i) of this section.

(3) *Procedure for transactions in which section 338(h)(10) is elected*. If an election under section 338(h)(10) is made, any additional deemed sale gain resulting from an increase or decrease in the ADSP is accounted for in determining the taxable income (or other amount) of the member of the selling consolidated group, the selling affiliate, or the S corporation shareholders to which such income, loss, or other amount is attributable for the taxable year in which such increase or decrease is taken into account.

(d) *Special rules for AGUB*—(1) *Effect of disposition or depreciation of acquisition date assets.* If an acquisition date asset has been disposed of, depreciated, amortized, or depleted by new target before an amount is added to the original allocation to the asset, the increased amount otherwise allocable to such asset is taken into account under general principles of tax law that apply when part of the cost of an asset not previously taken into account in basis is paid or incurred after the asset has been disposed of, depreciated, amortized, or depleted. A similar rule applies when an amount is subtracted from the original allocation to the asset. For purposes of the preceding sentence, an asset is considered to have been disposed of to the extent that its allocable portion of the decrease in AGUB would reduce its basis below zero.

(2) *Section 38 property*. Section 1.47–2(c) applies to a reduction in basis of section 38 property under this section.

(e) *Examples*. The following examples illustrate this section. Any amount described in the following examples is exclusive of interest. For rules characterizing deferred contingent payments as principal or interest, see §§1.483–4, 1.1274–2(g), and 1.1275–4(c). The examples are as follows:

Example 1. (i)(A) T's assets other than goodwill and going concern value, and their fair market values at the beginning of the day after the acquisition date, are as follows:

Asset Class	*Asset*	*Fair Market Value*
V	Building	$ 100
V	Stock of X (not a target)	200
	Total	$ 300

(B) T has no liabilities other than a contingent liability that would not be taken into account under general principles of tax law in an asset sale between unrelated parties when the buyer assumed the liability or took property subject to it.

(ii)(A) On September 1, 2000, P purchases all of the outstanding stock of T for $270 and makes a section 338 election for T. The grossed-up basis of the T stock and T's AGUB are both $270. The AGUB is ratably allocated among T's Class V assets in proportion to their fair market values as follows:

Asset	*Basis*
Building ($270 (100/300)	$ 90
Stock ($270 (200/300)	180
Total	$270

(B) No amount is allocated to the Class VII assets. New T is a calendar year taxpayer. Assume that the X stock is a capital asset in the hands of new T.

(iii) On January 1, 2001, new T sells the X stock and uses the proceeds to purchase inventory.

(iv) Pursuant to events on June 30, 2002, the contingent liability of old T is at that time properly taken into account under general principles of tax law. The amount of the liability is $60.

(v) T's AGUB increases by $60 from $270 to $330. This $60 increase in AGUB is first allocated among T's acquisition date assets in accordance with the provisions of §1.338–6T. Because the redetermined AGUB for T ($330) exceeds the sum of the fair market values at the beginning of the day after the acquisition date of the Class V acquisition date assets ($300), AGUB allocated to those assets is limited to those fair market values under §1.338-

6T(c)(1). As there are no Class VI assets, the remaining AGUB of $30 is allocated to goodwill and going concern value (Class VII assets). The amount of increase in AGUB allocated to each acquisition date asset is determined as follows:

Asset	*Original AGUB*	*Redetermined AGUB*	*Increase*
Building	$ 90	$ 100	$ 10
X Stock	180	200	20
Goodwill and going concern value	0	30	30
Total	$ 270	$ 330	$ 60

(vi) Since the X stock was disposed of before the contingent liability was properly taken into account for tax purposes, no amount of the increase in AGUB attributable to such stock may be allocated to any T asset. Rather, such amount ($20) is allowed as a capital loss to T for the taxable year 2002 under the principles of *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952). In addition, the $10 increase in AGUB allocated to the building and the $30 increase in AGUB allocated to the goodwill and going concern value are treated as basis redeterminations in 2002. See paragraph (d)(1) of this section.

Example 2. (i) On January 1, 2002, P purchases all of the outstanding stock of T and makes a section 338 election for T. Assume that ADSP and AGUB of T are both $500 and are allocated among T's acquisition date assets as follows:

Asset Class	*Asset*	*Basis*
V	Machinery	$ 150
V	Land	250
VII	Goodwill and going....... concern value	100
	Total	$ 500

(ii) On September 30, 2004, P filed a claim against the selling shareholders of T in a court of appropriate jurisdiction alleging fraud in the sale of the T stock.

(iii) On January 1, 2007, the former shareholders refund $140 of the purchase price to P in a settlement of the lawsuit. Assume that, under general principles of tax law, both the seller and the buyer properly take into account such refund when paid. Assume also that the refund has no effect on the tax liability for the deemed sale gain. This refund results in a decrease of T's ADSP and AGUB of $140, from $500 to $360.

(iv) The redetermined ADSP and AGUB of $360 is allocated among T's acquisition date assets. Because ADSP and AGUB do not exceed the fair market value of the Class V assets, the ADSP and AGUB amounts are allocated to the Class V assets in proportion to their fair market values at the beginning of the day after the acquisition date. Thus, $135 ($150 (($360/($150 + $250))) is allocated to the machinery and $225 ($250 (($360/($150 + $250))) is allocated to the land. Accordingly, the basis of the machinery is reduced by $15 ($150 original allocation å $135 redetermined allocation) and the basis of the land is reduced by $25 ($250 original allocation å $225 redetermined allocation). No amount is allocated to the Class VII assets. Accordingly, the basis of the goodwill and going concern value is reduced by $100 ($100 original allocation å $0 redetermined allocation).

(v) Assume that, as a result of deductions under section 168, the adjusted basis of the machinery immediately before the decrease in AGUB is zero. The machinery is treated as if it were disposed of before the decrease is taken into account. In 2007, T recognizes income of $15, the character of which is determined under the principles of *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952), and the tax benefit rule. No adjustment to the basis of T's assets is made for any tax paid on this amount. Assume also that, as a result of amortization deductions, the adjusted basis of the goodwill and going concern value immediately before the decrease in AGUB is $40. A similar adjustment to income is made in 2007 with respect to the $60 of previously amortized goodwill and going concern value.

(vi) In summary, the basis of T's acquisition date assets, as of January 1, 2007, is as follows:

Asset	*Basis*
Machinery	$ 0
Land	225
Goodwill and going concern value	0

Example 3. (i) Assume that the facts are the same as §1.338–6T(d) *Example 2* except that the recently purchased stock is acquired for $1,600 plus additional payments that are contingent upon T's future earnings. Assume that, under general principles of tax law, such later payments are properly taken into account when paid. Thus, T's AGUB, determined as of the beginning of the day after the acquisition date (after reduction by T's cash of $200), is $2,500 and is allocated among T's acquisition date assets under §1.338–6T(c)(3)(iii) as follows:

Class	*Asset*	*Final Allocation*
I	Cash	$ 200
II	Portfolio of actively traded securities	268*
III	Accounts receivable ..	536
IV	Inventory	268
V	Building	714
V	Land	178
V	Investment in T1	402
VII	Goodwill and going concern value	134
	Total	$ 2,700

* All numbers rounded for convenience.

(ii) After the close of new target's first taxable year, P pays an additional $200 for its recently purchased T stock. Assume that the additional consideration paid would not increase T's tax liability for the deemed sale gain.

(iii) T's AGUB increases by $200, from $2,700 to $2,900. This $200 increase in AGUB is accounted for in accordance with the provisions of §1.338–6T(c)(3)(iii).

(iv) The hypothetical purchase price of the T stock is redetermined as follows:

Grossed-up basis of recently purchased stock as determined under §1.338–5T(c) ($1,800 ((1 - .2)/.8)	$ 1,800
Basis of nonrecently purchased stock as if the gain recognition election under §1.338–5T(d)(2) had been made ($1,800 (.2/(1 å .2))	450
Liabilities	1,000
Total	$ 3,250

(v) Since the redetermined hypothetical purchase price ($3,250) exceeds the redetermined AGUB ($2,900) and no gain recognition election was made under section 338(b)(3), the rules of §1.338–6T(c)(3)(iii) are reapplied using the redetermined hypothetical purchase price and the redetermined AGUB.

(vi) First, an AGUB amount equal to the redetermined hypothetical purchase price ($3,250) is allocated among the assets under the general rules of §1.338–6T. The allocation is set forth in the column below entitled *Hypothetical Allocation*. Next, the allocation to each asset in Class II through Class VII is multiplied by a fraction with a numerator equal to the actual redetermined AGUB reduced by the amount of Class I assets ($2,900 å $200 = $2,700) and a denominator equal to the redetermined hypothetical purchase price reduced by the amount of Class I assets ($3,250 å $200 = $3,050), or 2,700/3,050. This produces the *Final Allocation*:

Class	*Asset*	*Hypothetical Allocation*	*Final Allocation*
I	Cash	$ 200	$ 200
II	Portfolio of actively traded securities	300	266*
III	Accounts receivable	600	531
IV	Inventory	300	266
V	Building	800	708
V	Land	200	177
V	Investment in T1	450	398
VII	Goodwill and going concern value	400	354
	Total	$ 3,250	$ 2900

* All numbers rounded for convenience.

(vii) As illustrated by this example, reapplying §1.338–6T(c)(3) results in a basis increase for some assets and a basis decrease for other assets. The amount of redetermined AGUB allocated to each acquisition date asset is determined as follows:

Asset	*Original (c)(3) allocation*	*Redetermined (c)(3) allocation*	*Increase (decrease)*
Portfolio of actively traded securities	$ 268	$ 266	$ (2)
Accounts receivable	536	531	(5)
Inventory	268	266	(2)
Building	714	708	(6)
Land	178	177	(1)
Investment in T1	402	398	(4)
Goodwill and going concern value	134	354	220
Total	$ 2,500	$ 2,700	$ 200

Example 4. (i) On January 1, 2001, P purchases all of the outstanding T stock and makes a section 338 election for T. P pays $700 of cash and promises also to pay a maximum $300 of contingent consideration at various times in the future. Assume that, under general principles of tax law, such later payments are properly taken into account by P when paid. Assume also, however, that the current fair market value of the contingent payments is reasonably ascertainable. The fair market value of T's assets (other than goodwill and going concern value) as of the beginning of the following day is as follows:

Asset Class	*Assets*	*Fair market value*
V	Equipment	$ 200
V	Non-actively traded securities	100
V	Building	500
	Total	800

(ii) T has no liabilities. The AGUB is $700. In calculating ADSP, assume that, under §1.1001–1, the current amount realized attributable to the contingent consideration is $200. ADSP is therefore $900 ($700 cash plus $200).

(iii) (A) The AGUB of $700 is ratably allocated among T's Class V acquisition date assets in proportion to their fair market values as follows:

Asset	*Basis*
Equipment ($700 (200/800)	$175.00
Non-actively traded securities ($700 (100/800)	87.50
Building ($700 (500/800)	437.50
Total	$700.00

(B) No amount is allocated to goodwill or going concern value.

(iv) (A) The ADSP of $900 is ratably allocated among T's Class V acquisition date assets in proportion to their fair market values as follows:

Asset	*Basis*
Equipment	$200
Non-actively traded securities	100
Building	500
Total	$800

(B) The remaining ADSP, $100, is allocated to goodwill and going concern value (Class VII).

(v) P and T file a consolidated return for 2001 and each following year with P as the common parent of the affiliated group.

(vi) In 2004, a contingent amount of $120 is paid by P. Assume that, under general principles of tax law, the payment is properly taken into account by P at the time made. In 2004, there is an increase in T's AGUB of $120. The amount of the increase allocated to each acquisition date asset is determined as follows:

Asset	*Original AGUB*	*Redetermined AGUB*	*Increase*
Equipment	$ 175.00	$ 200.00	$ 25.00
Land	87.50	100.00	12.50
Building	437.50	500.00	62.50
Goodwill and going concern value	0.00	20.00	20.00
Total	$ 700.00	$ 820.00	$ 120.00

Par. 8. Section 1.338–10T is added to read as follows:

§1.338–10T Filing of returns (temporary).

(a) *Returns including tax liability from deemed asset sale*—(1) *In general.* Except as provided in paragraphs (a)(2) and (3) of this section, any deemed sale gain is reported on the final return of old target filed for old target's taxable year that ends at the close of the acquisition date. If old target is the common parent of an affiliated group, the final return may be a consolidated return (any such consolidated return must also include any deemed sale gain of any members of the consolidated group that are acquired by the purchasing corporation on the same acquisition date as old target).

(2) *Old target's final taxable year otherwise included in consolidated return of selling group*—(i) *General rule.* If the selling group files a consolidated return for the period that includes the acquisition date, old target is disaffiliated from that group immediately before the deemed asset sale and must file a deemed sale return separate from the group that includes only the deemed sale gain and the carryover items specified in paragraph (a)(2)(iii) of this section. The deemed asset sale occurs at the close of the acquisition date and is the last transaction of old target. Any transactions of old target occurring on the acquisition date other than the deemed asset sale are included in the selling group's consolidated return. A deemed sale return includes a combined deemed sale return as defined in paragraph (a)(4) of this section.

(ii) *Separate taxable year.* The deemed asset sale included in the deemed sale return under this paragraph (a)(2) occurs in a separate taxable year, except that old target's taxable year of the sale and the consolidated year of the selling group that includes the acquisition date are treated as the same year for purposes of determining the number of years in a carryover or carryback period.

(iii) *Carryover and carryback of tax attributes.* Target's attributes may be carried over to, and carried back from, the deemed sale return under the rules applicable to a corporation that ceases to be a member of a consolidated group.

(iv) *Old target is a component member of purchasing corporation's controlled group.* For purposes of its deemed sale return, target is a component member of the controlled group of corporations including the purchasing corporation unless target is treated as an excluded member under section 1563(b)(2).

(3) *Old target is an S corporation*. If target is an S corporation for the period that ends on the day before the acquisition date, old target must file a deemed sale return as a C corporation. For this purpose, the principles of paragraph (a)(2) of this section apply. This paragraph (a)(3) does not apply if an election under section 338(h)(10) is made for the S corporation.

(4) *Combined deemed sale return*—(i) *General rule*. Under section 338(h)(15), a combined deemed sale return (combined return) may be filed for all targets from a single selling consolidated group (as defined in §1.338(h)(10)–1T(b)(3)) that are acquired by the purchasing corporation on the same acquisition date and that otherwise would be required to file separate deemed sale returns. The combined return must include all such targets. For example, T and T1 may be included in a combined return if—

(A) T and T1 are directly owned subsidiaries of S;

(B) S is the common parent of a consolidated group; and

(C) P makes qualified stock purchases of T and T1 on the same acquisition date.

(ii) *Gain and loss offsets.* Gains and losses recognized on the deemed asset sales by targets included in a combined return are treated as the gains and losses of a single target. In addition, loss carryovers of a target that were not subject to the separate return limitation year restrictions (SRLY restrictions) of the consolidated return regulations while that target was a member of the selling consolidated group may be applied without limitation to the gains of other targets included in the combined return. If, however, a target has loss carryovers that were subject to the SRLY restrictions while that target was a member of the selling consolidated group, the use of those losses in the combined return continues to be subject to those restrictions, applied in the same manner as if the combined return were a consolidated return. A similar rule applies, when appropriate, to other tax attributes.

(iii) *Procedure for filing a combined return*. A combined return is made by filing a single corporation income tax return in lieu of separate deemed sale returns for all targets required to be included in the combined return. The combined return reflects the deemed asset sales of all targets required to be included in the combined return. If the targets included in the combined return constitute a single affiliated group within the meaning of section 1504(a), the income tax return is signed by an officer of the common parent of that group. Otherwise, the return must be signed by an officer of each target included in the combined return. Rules similar to the rules in §1.1502–75(j) apply for purposes of preparing the combined return. The combined return must include an attachment prominently identified as an "ELECTION TO FILE A COMBINED RETURN UNDER SECTION 338(h)(15)." The attachment must—

(A) Contain the name, address, and employer identification number of each target required to be included in the combined return;

(B) Contain the following declaration (or a substantially similar declaration): EACH TARGET IDENTIFIED IN THIS ELECTION TO FILE A COMBINED RETURN CONSENTS TO THE FILING OF A COMBINED RETURN;

(C) For each target, be signed by a person who states under penalties of perjury that he or she is authorized to act on behalf of such target.

(iv) *Consequences of filing a combined return*. Each target included in a combined return is severally liable for any tax associated with the combined return. See §1.338–1T(b)(3).

(5) *Deemed sale excluded from purchasing corporation's consolidated return*. Old target may not be considered a member of any affiliated group that includes the purchasing corporation with respect to its deemed asset sale.

(6) *Due date for old target's final return*—(i) *General rule.* Old target's final return is generally due on the 15th day of the third calendar month following the month in which the acquisition date occurs. See section 6072 (time for filing income tax returns).

(ii) *Application of §1.1502–76(c)*—(A) *In general*. Section 1.1502–76(c) applies to old target's final return if old target was a member of a selling group that did not file consolidated returns for the taxable year of the common parent that precedes the year that includes old target's acquisition date. If the selling group has not filed a consolidated return that includes old target's taxable period that ends on the acquisition date, target may, on or before the final return due date (including extensions), either—

(*1*) File a deemed sale return on the assumption that the selling group will file the consolidated return; or

(*2*) File a return for so much of old target's taxable period as ends at the close of the acquisition date on the assumption that the consolidated return will not be filed.

(B) *Deemed extension*. For purposes of applying §1.1502–76(c)(2), an extension of time to file old target's final return is considered to be in effect until the last date for making the election under section 338.

(C) *Erroneous filing of deemed sale return*. If, under this paragraph (a)(6)(ii), target files a deemed sale return but the selling group does not file a consolidated return, target must file a substituted return for old target not later than the due date (including extensions) for the return of the common parent with which old target would have been included in the consolidated return. The substituted return is for so much of old target's taxable year as ends at the close of the acquisition date. Under §1.1502–76(c)(2), the deemed sale return is not considered a return for purposes of section 6011 (relating to the general requirement of filing a return) if a substituted return must be filed.

(D) *Erroneous filing of return for regular tax year*. If, under this paragraph (a)(6)(ii), target files a return for so much of old target's regular taxable year as ends at the close of the acquisition date but the selling group files a consolidated return, target must file an amended return for old target not later than the due date (including extensions) for the selling group's consolidated return. (The amended return is a deemed sale return.)

(E) *Last date for payment of tax.* If either a substituted or amended final return of old target is filed under this paragraph (a)(6)(ii), the last date prescribed for payment of tax is the final return due date (as defined in paragraph (a)(6)(i) of this section).

(7) *Examples.* The following examples illustrate this paragraph (a):

Example 1. (i) S is the common parent of a consolidated group that includes T. The S group files calendar year consolidated returns. At the close of June 30 of Year 1, P makes a qualified stock purchase of T from S. P makes a section 338 election for T, and T's deemed asset sale occurs as of the close of T's acquisition date (June 30).

(ii) T is considered disaffiliated for purposes of reporting the deemed sale gain. Accordingly, T is included in the S group's consolidated return through T's acquisition date except that the tax liability for the deemed sale gain is reported in a separate deemed sale return of T. Provided that T is not treated as an excluded member under section 1563(b)(2), T is a component member of P's controlled group for the taxable year of the deemed asset sale, and the taxable income bracket amounts available in calculating tax on the deemed sale return must be limited accordingly.

(iii) If P purchased the stock of T at 10 a.m. on June 30 of Year 1, the results would be the same. See paragraph (a)(2)(i) of this section.

Example 2. The facts are the same as in *Example 1,* except that the S group does not file consolidated returns. T must file a separate return for its taxable year ending on June 30 of Year 1, which return includes the deemed asset sale.

(b) *Waiver*—(1) *Certain additions to tax*. An addition to tax or additional amount (addition) under subchapter A of chapter 68 of the Internal Revenue Code arising on or before the last day for making the election under section 338 because of circumstances that would not exist but for an election under section 338, is waived if—

(i) Under the particular statute the addition is excusable upon a showing of reasonable cause; and

(ii) Corrective action is taken on or before the last day.

(2) *Notification*. The Internal Revenue Service should be notified at the time of correction (e.g., by attaching a statement to a return that constitutes corrective action) that the waiver rule of this paragraph (b) is being asserted.

(3) *Elections or other actions required to be specified on a timely filed return*—(i) *In general*. If paragraph (b)(1) of this section applies or would apply if there were an underpayment, any election or other action that must be specified on a timely filed return for the taxable period covered by the late filed return described in paragraph (b)(1) of this section is considered timely if specified on a late-filed return filed on or before the last day for making the election under section 338.

(ii) *New target in purchasing corporation's consolidated return*. If new target is includible for its first taxable year in a consolidated return filed by the affiliated group of which the purchasing corporation is a member on or before the last day for making the election under section 338, any election or other action that must be specified in a timely filed return for new target's first taxable year (but which is not specified in the consolidated return) is considered timely if specified in an amended return filed on or before such last day, at the place where the consolidated return was filed.

(4) *Examples*. The following examples illustrate this paragraph (b):

Example 1. T is an unaffiliated corporation with a tax year ending March 31. At the close of September 20 of Year 1, P makes a qualified stock purchase of T. P does not join in filing a consolidated return. P makes a section 338 election for T on or before June 15 of Year 2, which causes T's taxable year to end as of the close of September 20 of Year 1. An income tax return for T's taxable period ending on September 20 of Year 1 was due on December 15 of Year 1. Additions to tax for failure to file a return and to pay tax shown on a return will not be imposed if T's return is filed and the tax paid on or before June 15 of Year 2. (This waiver applies even if the acquisition date coincides with the last day of T's former taxable year, i.e., March 31 of Year 2.) Interest on any underpayment of tax for old T's short taxable year ending September 20 of Year 1 runs from December 15 of Year 1. A statement indicating that the waiver rule of this paragraph is being asserted should be attached to T's return.

Example 2. Assume the same facts as in *Example 1*. Assume further that new T adopts the calendar year by filing, on or before June 15 of Year 2, its first return (for the period beginning on September 21 of Year 1 and ending on December 31 of Year 1) indicating that a calendar year is chosen. See §1.338-1T(b)(1). Any additions to tax or amounts described in this paragraph (b) that arise because of the late filing of a return for the period ending on December 31 of Year 1 are waived, because they are based on circumstances that would not exist but for the section 338 election. Notwithstanding this waiver, however, the return is still considered due March 15 of Year 2, and interest on any underpayment runs from that date.

Example 3. Assume the same facts as in *Example 2,* except that T's former taxable year ends on October 31. Although prior to the election old T had a return due on January 15 of Year 2 for its year ending October 31 of Year 1, that return need not be filed because a timely election under section 338 was made. Instead, old T must file a final return for the period ending on September 20 of Year 1, which is due on December 15 of Year 1.

§§1.338(b)–1, 1.338(b)–2T, 1.338(b)–3T, and 1.338(h)(10)–1 [Removed]

Par. 9. Sections 1.338(b)–1, 1.338(b)–2T, and 1.338(b)–3T, and 1.338(h)(10)–1 are removed.

Par. 10. Section 1.338(h)(10)–1T is added to read as follows:

§1.338(h)(10)–1T Deemed asset sale and liquidation (temporary).

(a) *Scope*. This section prescribes rules for qualification for a section 338(h)(10) election and for making a section 338(h)(10) election. This section also prescribes the consequences of such election. The rules of this section are in addition to the rules of §§1.338–0T through 1.338–7T, 1.338–8, 1.338–9, 1.338–10T, and 1.338(i)–1T and, in appropriate cases, apply instead of the rules of §§1.338–0T through 1.338–7T, 1.338–8, 1.338–9, 1.338–10T, and 1.338(i)–1T.

(b) *Definitions*—(1) *Consolidated target*. A *consolidated target* is a target that is a member of a consolidated group within the meaning of §1.1502–1(h) on the acquisition date and is not the common parent of the group on that date.

(2) *Selling consolidated group.* A *selling consolidated group* is the consolidated group of which the consolidated target is a member on the acquisition date.

(3) *Selling affiliate; affiliated target.* A *selling affiliate* is a domestic corporation that owns on the acquisition date an amount of stock in a domestic target, which amount of stock is described in section 1504(a)(2), and does not join in filing a consolidated return with the target. In such case, the target is an *affiliated target*.

(4) *S corporation target*. An *S corporation target* is a target that is an S corporation immediately before the acquisition date.

(5) *S corporation shareholders. S corporation shareholders* are the S corporation target's shareholders. Unless otherwise indicated, a reference to S corporation shareholders refers both to S corporation shareholders who do and those who do not sell their target stock.

(6) *Liquidation*. Any reference in this section to a *liquidation* is treated as a reference to the transfer described in paragraph (d)(4) of this section notwithstanding its ultimate characterization for Federal income tax purposes.

(c) *Section 338(h)(10) election*—(1) *In general*. A section 338(h)(10) election may be made for T if P acquires stock meeting the requirements of section 1504(a)(2) from a selling consolidated group, a selling affiliate, or the S corporation shareholders in a qualified stock purchase.

(2) *Simultaneous joint election requirement*. A section 338(h)(10) election is made jointly by P and the selling consolidated group (or the selling affiliate or the S corporation shareholders) on Form

8023 in accordance with the instructions to the form. S corporation shareholders who do not sell their stock must also consent to the election. The section 338(h)(10) election must be made not later than the 15th day of the 9th month beginning after the month in which the acquisition date occurs.

(3) *Irrevocability*. A section 338(h)(10) election is irrevocable. If a section 338(h)(10) election is made for T, a section 338 election is deemed made for T.

(4) *Effect of invalid election*. If a section 338(h)(10) election for T is not valid, the section 338 election for T is also not valid.

(d) *Certain consequences of section 338(h)(10) election*. For purposes of subtitle A of the Internal Revenue Code (except as provided in §1.338–1T(b)(2)), the consequences to the parties of making a section 338(h)(10) election for T are as follows:

(1) *P*. P is automatically deemed to have made a gain recognition election for its nonrecently purchased T stock, if any. The effect of a gain recognition election includes a taxable deemed sale by P on the acquisition date of any nonrecently purchased target stock. See §1.338–5T(d).

(2) *New T*. The AGUB for new T's assets is determined under §1.338–5T and is allocated among the acquisition date assets under §§1.338–6T and 1.338–7T. Notwithstanding paragraph (d)(4) of this section (deemed liquidation of old T), new T remains liable for the tax liabilities of old T (including the tax liability for the deemed sale gain). For example, new T remains liable for the tax liabilities of the members of any consolidated group that are attributable to taxable years in which those corporations and old T joined in the same consolidated return. See §1.1502–6(a).

(3) *Old T—deemed sale—(i) In general*. Old T is treated as transferring all of its assets to an unrelated person in exchange for consideration that includes the assumption of or taking subject to liabilities in a single transaction at the close of the acquisition date (but before the deemed liquidation). See §1.338–1T(a) regarding the tax characterization of the deemed asset sale. ADSP for old T is determined under §1.338–4T and allocated among the acquisition date assets under §§1.338–6T and 1.338–7T. Old T realizes the deemed sale gain from the deemed asset sale before the close of the acquisition date while old T is a member of the selling consolidated group (or owned by the selling affiliate or owned by the S corporation shareholders). If T is an affiliated target, or an S corporation target, the principles of §§1.338–2T(c)(10) and 1.338–10T(a)(1), (5), and (6)(i) apply to the return on which the deemed sale gain is reported. When T is an S corporation target, T's S election continues in effect through the close of the acquisition date (including the time of the deemed asset sale and the deemed liquidation) notwithstanding section 1362(d)(2)(B). Also, when T is an S corporation target, any direct and indirect subsidiaries of T which T has elected to treat as qualified subchapter S subsidiaries under section 1361(b)(3) remain qualified subchapter S subsidiaries through the close of the acquisition date. No similar rule applies when a qualified subchapter S subsidiary, as opposed to the S corporation that is its owner, is the target the stock of which is actually purchased.

(ii) *Tiered targets*. In the case of parent-subsidiary chains of corporations making elections under section 338(h)(10), the deemed asset sale of a parent corporation is considered to precede that of its subsidiary. See §1.338–3T(4)(i).

(4) *Old T and selling consolidated group, selling affiliate, or S corporation shareholders—deemed liquidation; tax characterization*—(i) *In general*. Old T is treated as if, before the close of the acquisition date, after the deemed asset sale in paragraph (d)(3) of this section, and while old T is a member of the selling consolidated group (or owned by the selling affiliate or owned by the S corporation shareholders), it transferred all of its assets to members of the selling consolidated group, the selling affiliate, or S corporation shareholders and ceased to exist. The transfer from old T is characterized for Federal income tax purposes in the same manner as if the parties had actually engaged in the transactions deemed to occur because of this section and taking into account other transactions that actually occurred or are deemed to occur. For example, the transfer may be treated as a distribution in pursuance of a plan of reorganization, a distribution in complete cancellation or redemption of all its stock, one of a series of distributions in complete cancellation or redemption of all its stock in accordance with a plan of liquidation, or part of a circular flow of cash. In most cases, the transfer will be treated as a distribution in complete liquidation to which section 336 or 337 applies.

(ii) *Tiered targets*. In the case of parent-subsidiary chains of corporations making elections under section 338(h)(10), the deemed liquidation of a subsidiary corporation is considered to precede the deemed liquidation of its parent.

(5) *Selling consolidated group, selling affiliate, or S corporation shareholders*—(i) *In general*. If T is an S corporation target, S corporation shareholders (whether or not they sell their stock) take their pro rata share of the deemed sale gain into account under section 1366 and increase or decrease their basis in T stock under section 1367. Members of the selling consolidated group, the selling affiliate, or S corporation shareholders are treated as if, after the deemed asset sale in paragraph (d)(3) of this section and before the close of the acquisition date, they received the assets transferred by old T in the transaction described in paragraph (d)(4)(i) of this section. In most cases, the transfer will be treated as a distribution in complete liquidation to which section 331 or 332 applies.

(ii) *Basis and holding period of T stock not acquired*. A member of the selling consolidated group (or the selling affiliate or an S corporation shareholder) retaining T stock is treated as acquiring the stock so retained on the day after the acquisition date for its fair market value. The holding period for the retained stock starts on the day after the acquisition date. For purposes of this paragraph, the fair market value of all of the T stock equals the grossed-up amount realized on the sale to P of P's recently purchased target stock. See §1.338–4T(c).

(iii) *T stock sale*. Members of the selling consolidated group (or the selling affiliate or S corporation shareholders) recognize no gain or loss on the sale or exchange of T stock included in the qualified stock purchase (although they may recognize gain or loss on the T stock in the deemed liquidation).

(6) *Nonselling minority shareholders other than nonselling S corporation shareholders*—(i) *In general*. This paragraph (d)(6) describes the treatment of shareholders of old T other than the following: members of the selling consolidated group, the selling affiliate, S corporation shareholders (whether or not they sell their stock), and P. For a description of the treatment of S corporation shareholders, see paragraph (d)(5) of this section. A shareholder to which this paragraph (d)(6) applies is called a minority shareholder.

(ii) *T stock sale*. A minority shareholder recognizes gain or loss on the shareholder's sale or exchange of T stock included in the qualified stock purchase.

(iii) *T stock not acquired*. A minority shareholder does not recognize gain or loss under this section with respect to shares of T stock retained by the shareholder. The shareholder's basis and holding period for that T stock is not affected by the section 338(h)(10) election.

(7) *Consolidated return of selling consolidated group*. If P acquires T in a qualified stock purchase from a selling consolidated group—

(i) The selling consolidated group must file a consolidated return for the taxable period that includes the acquisition date;

(ii) A consolidated return for the selling consolidated group for that period may not be withdrawn on or after the day that a section 338(h)(10) election is made for T; and

(iii) Permission to discontinue filing consolidated returns cannot be granted for, and cannot apply to, that period or any of the immediately preceding taxable periods during which consolidated returns continuously have been filed.

(8) *Availability of the section 453 installment method*. Solely for purposes of applying sections 453, 453A, and 453B, and the regulations thereunder (the installment method) to determine the consequences to old T in the deemed asset sale and to old T (and its shareholders, if relevant) in the deemed liquidation, the rules in paragraphs (d)(1) through (7) of this section are modified as follows:

(i) *In deemed asset sale*. Old T is treated as receiving in the deemed asset sale new T installment obligations, the terms of which are identical (except as to the obligor) to P installment obligations issued in exchange for recently purchased stock of T. Old T is treated as receiving in cash all other consideration in the deemed asset sale other than the assumption of, or taking subject to, old T liabilities. For example, old T is treated as receiving in cash any amounts attributable to the grossing-up of amount realized under §1.338–4T(c). The amount realized for recently purchased stock taken into account in determining ADSP is adjusted (and, thus, ADSP is redetermined) to reflect the amounts paid under an installment obligation for the stock when the total payments under the installment obligation are greater or less than the amount realized.

(ii) *In deemed liquidation*. Old T is treated as distributing in the deemed liquidation the new T installment obligations that it is treated as receiving in the deemed asset sale. The members of the selling consolidated group, the selling affiliate, or the S corporation shareholders are treated as receiving in the deemed liquidation the new T installment obligations that correspond to the P installment obligations they actually received individually in exchange for their recently purchased stock. The new T installment obligations may be recharacterized under other rules. See for example §1.453–11(a)(2) which, in certain circumstances, treats the new T installment obligations deemed distributed by old T as if they were issued by new T in exchange for the members' of the selling consolidated group, the selling affiliate's, or the S corporation shareholders' stock in old T. The members of the selling consolidated group, the selling affiliate, or the S corporation shareholders are treated as receiving all other consideration in the deemed liquidation in cash.

(9) *Treatment consistent with an actual asset sale*. Old T may not assert any provision in section 338(h)(10) or this section to obtain a tax result that would not be obtained if the parties had actually engaged in the transactions deemed to occur because of this section and taking into account other transactions that actually occurred or are deemed to occur.

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

Example 1. (i) S1 owns all of the T stock and T owns all of the stock of T1 and T2. S1 is the common parent of a consolidated group that includes T, T1, and T2. P makes a qualified stock purchase of all of the T stock from S1. S1 joins with P in making a section 338(h)(10) election for T and for the deemed purchase of T1. A section 338 election is not made for T2.

(ii) S1 does not recognize gain or loss on the sale of the T stock and T does not recognize gain or loss on the sale of the T1 stock because section 338(h)(10) elections are made for T and T1. Thus, for example, gain or loss realized on the sale of the T or T1 stock is not taken into account in earnings and profits. However, because a section 338 election is not made for T2, T must recognize any gain or loss realized on the deemed sale of the T2 stock. See §1.338–4T(h).

(iii) The results would be the same if S1, T, T1, and T2 are not members of any consolidated group, because S1 and T are selling affiliates.

Example 2. (i) S and T are solvent corporations. S owns all of the outstanding stock of T. S and P agree to undertake the following transaction: T will distribute half its assets to S, and S will assume half of T's liabilities. Then, P will purchase the stock of T from S. S and P will jointly make a section 338(h)(10) election with respect to the sale of T. The corporations then complete the transaction as agreed.

(ii) Under section 338(a), the assets present in T at the close of the acquisition date are deemed sold by old T to new T. Under paragraph (d)(4) of this section, the transactions described in paragraph (d) of this section are treated in the same manner as if they had actually occurred. Because S and P had agreed that, after T's actual distribution to S of part of its assets, S would sell T to P pursuant to an election under section 338(h)(10), and because paragraph (d)(4) of this section deems T subsequently to have transferred all its assets to its shareholder, T is deemed to have adopted a plan of complete liquidation under section 332. T's actual transfer of assets to S is treated as a distribution pursuant to that plan of complete liquidation.

Example 3. (i) S1 owns all of the outstanding stock of both T and S2. All three are corporations. S1 and P agree to undertake the following transaction. T will transfer substantially all of its assets and liabilities to S2, with S2 issuing no stock in exchange therefor, and retaining its other assets and liabilities. Then, P will purchase the stock of T from S1. S1 and P will jointly make a section 338(h)(10) election with respect to the sale of T. The corporations then complete the transaction as agreed.

(ii) Under section 338(a), the assets present in T at the close of the acquisition date are deemed sold by old T to new T. Under paragraph (d)(4) of this section, the transactions described in this section are treated in the same manner as if they had actually occurred. Because old T transferred substantially all of its assets to S2, and is deemed to have distributed all its remaining assets and gone out of existence, the transfer of assets to S2, taking into account the related transfers, deemed and actual, qualifies as a reorganization under section 368(a)(1)(D). Section 361(c)(1) and not section 332 applies to T's deemed liquidation.

Example 4. (i) T owns two assets: an actively traded security (Class II) with a fair market value of \$100 and an adjusted basis of \$100, and inventory (Class IV) with a fair market value of \$100 and an adjusted basis of \$100. T has no liabilities. S is negotiating to sell all the stock in T to P for \$100 cash and contingent consideration. Assume that under generally applicable tax accounting rules, P's adjusted basis in the T stock immediately after the purchase would be $100, because the contingent consideration is not taken into account. Thus, under the rules of §1.338–5T, AGUB would be $100. Under the allocation rules of §1.338–6T, the entire $100 would be allocated to the Class II asset, the actively traded security, and no amount would be allocated to the inventory. P, however, plans immediately to cause T to sell the inventory, but not the actively traded security, so it requests that, prior to the stock sale, S cause T to create a new subsidiary, Newco, and contribute the actively traded security to the capital of Newco. Because the stock in Newco, which would not be actively traded, is a Class V asset, under the rules of §1.338–6T $100 of AGUB would be allocated to the inventory and no amount of AGUB would be allocated to the Newco stock. Newco's own AGUB, $0 under the rules of §1.338–5T, would be allocated to the actively traded security. When P subsequently causes T to sell the inventory, T would realize no gain or loss instead of realizing gain of $100.

(ii) Assume that, if the T stock had not itself been sold but T had instead sold both its inventory and the Newco stock to P, T would for tax purposes be deemed instead to have sold both its inventory and actively traded security directly to P, with P deemed then to have created Newco and contributed the actively traded security to the capital of Newco. Section 338, if elected, generally recharacterizes a stock sale as a deemed sale of assets. The tax results of the deemed sale of assets should, where possible, be like those of an actual asset sale. Hence, the deemed sale of assets under section 338(h)(10) should be treated as one of the inventory and actively traded security themselves, not of the inventory and Newco stock. That is the substance of the transaction. The anti-abuse rule of §1.338–1T(c) does not apply, because the substance of the deemed sale of assets is a sale of the inventory and the actively traded security themselves, not of the inventory and the Newco stock. Otherwise, the anti-abuse rule might apply.

Example 5. (i) T, a member of a selling consolidated group, has only one class of stock, all of which is owned by S1. On March 1 of Year 2, S1 sells its T stock to P for $80,000, and joins with P in making a section 338(h)(10) election for T. There are no selling costs or acquisition costs. On March 1 of Year 2, T owns land with a $50,000 basis and $75,000 fair market value and equipment with a $30,000 adjusted basis, $70,000 recomputed basis, and $60,000 fair market value. T also has a $40,000 liability. S1 pays old T's allocable share of the selling group's consolidated tax liability for Year 2 including the tax liability for the deemed sale gain (a total of $13,600).

(ii) ADSP of $120,000 ($80,000 + $40,000 + 0) is allocated to each asset as follows:

Assets	*Basis*	*FMV*	*Fraction*	*Allocable ADSP*
Land	$ 50,000	$ 75,000	5/9	$ 66,667
Equipment	30,000	60,000	4/9	53,333
Total	$ 80,000	$ 135,000	1	$ 120,000

(iii) Under paragraph (d)(3) of this section, old T has gain on the deemed sale of $40,000 (consisting of $16,667 of capital gain and $23,333 of ordinary income).

(iv) Under paragraph (d)(5)(iii) of this section, S1 recognizes no gain or loss upon its sale of the old T stock to P. S1 also recognizes no gain or loss upon the deemed liquidation of T. See paragraph (d)(4) of this section and section 332.

(v) P's basis in new T stock is P's cost for the stock, $80,000. See section 1012.

(vi) Under §1.338–5T, the AGUB for new T is $120,000, i.e., P's cost for the old T stock ($80,000) plus T's liability ($40,000). This AGUB is allocated as basis among the new T assets under §§1.338–6T and 1.338–7T.

Example 6. (i) The facts are the same as in *Example 5*, except that S1 sells 80 percent of the old T stock to P for $64,000, rather than 100 percent of the old T stock for $80,000.

(ii) The consequences to P, T, and S1 are the same as in *Example 5*, except that:

(A) P's basis for its 80-percent interest in the new T stock is P's $64,000 cost for the stock. See section 1012.

(B) Under §1.338–5T, the AGUB for new T is $120,000 (i.e., $64,000/.8 + $40,000 + $0).

(C) Under paragraph (d)(4) of this section, S1 recognizes no gain or loss with respect to the retained stock in T. See section 332.

(D) Under paragraph (d)(5)(ii) of this section, the basis of the T stock retained by S1 is $16,000 (i.e., $120,000 å $40,000 (the ADSP amount for the old T assets over the sum of new T's liabilities immediately after the acquisition date) (.20 (the proportion of T stock retained by S1)).

Example 7. (i) The facts are the same as in *Example 6*, except that K, a shareholder unrelated to T or P, owns the 20 percent of the T stock that is not acquired by P in the qualified stock purchase. K's basis in its T stock is $5,000.

(ii) The consequences to P, T, and S1 are the same as in *Example 6*.

(iii) Under paragraph (d)(6)(iii) of this section, K recognizes no gain or loss, and K's basis in its T stock remains at $5,000.

Example 8. (i) The facts are the same as in *Example 5*, except that the equipment is held by T1, a wholly–owned subsidiary of T, and a section 338(h)(10) election is also made for T1. The T1 stock has a fair market value of $60,000. T1 has no assets other than the equipment and no liabilities. S1 pays old T's and old T1's allocable shares of the selling group's consolidated tax liability for Year 2 including the tax liability for T and T1's deemed sale gain.

(ii) ADSP for T is $120,000, allocated $66,667 to the land and $53,333 to the stock. Old T's deemed sale gain is $16,667 (the capital gain on its deemed sale of the land). Under paragraph (d)(5)(iii) of this section, old T does not recognize gain or loss on its deemed sale of the T1 stock. See section 332.

(iii) ADSP for T1 is $53,333 (i.e., $53,333 + $0 + $0). On the deemed sale of the equipment, T1 recognizes ordinary income of $23,333.

(iv) Under paragraph (d)(5)(iii) of this section, S1 does not recognize gain or loss upon its sale of the old T stock to P.

Example 9. (i) The facts are the same as in *Example 8*, except that P already owns 20 percent of the T stock, which is nonrecently purchased stock with a basis of $6,000, and that P purchases the remaining 80 percent of the T stock from S1 for $64,000.

(ii) The results are the same as in *Example 8*, except that under paragraph (d)(1) of this section and §1.338-5T(d), P is deemed to have made a gain recognition election for its nonrecently purchased T stock. As a result, P recognizes gain of $10,000 and its basis in the nonrecently purchased T stock is increased from $6,000 to $16,000. P's basis in all the T stock is $80,000 (i.e., $64,000 + $16,000). The computations are as follows:

(A) P's grossed-up basis for the recently purchased T stock is $64,000 (i.e., $64,000 (the basis of the recently purchased T stock) ((1 å .2)/(.8) (the fraction in section 338(b)(4))).

(B) P's basis amount for the nonrecently purchased T stock is $16,000 (i.e., $64,000 (the grossed-up basis in the recently purchased T stock) ((.2)/(1.0 å .2) (the fraction in section 338(b)(3)(B))).

(C) The gain recognized on the nonrecently purchased stock is $10,000 (i.e., $16,000 å $6,000).

Example 10. (i) T is an S corporation whose sole class of stock is owned 40 percent each by A and B and 20 percent by C. T, A, B, and C all use the cash method of accounting. A and B each has an adjusted basis of $10,000 in the stock. C has an adjusted basis of $5,000 in the stock. A, B, and C hold no installment obligations to which section 453A applies. On March 1 of Year 1, A sells its stock to P for $40,000 in cash and B sells its stock to P for a $25,000 note issued by P and real estate having a fair market value of $15,000. The $25,000 note, due in full in Year 7, is not publicly traded and bears adequate stated interest. A and B have no selling expenses. T's sole asset is real estate, which has a value of $110,000 and an adjusted basis of $35,000. Also, T's real estate is encumbered by long-outstanding purchase-money indebtedness of $10,000. The real estate does not have built-in gain subject to section 1374. A, B, and C join with P in making a section 338(h)(10) election for T.

(ii) Solely for purposes of application of sections 453, 453A, and 453B, old T is considered in its deemed asset sale to receive back from new T the $25,000 note (considered issued by new T) and $75,000 of cash (total consideration of $80,000 paid for all the stock sold, which is then divided by .80 in the grossing-up, with the resulting figure of $100,000 then reduced by the amount of the installment note). Absent an election under section 453(d), gain is reported by old T under the installment method.

(iii) In applying the installment method to old T's deemed asset sale, the contract price for old T's assets deemed sold is $100,000, the $110,000 selling price reduced by the indebtedness of $10,000 to which the assets are subject. (The $110,000 selling price is itself the sum of the $80,000 grossed-up in paragraph (ii) above to $100,000 and the $10,000 liability.) Gross profit is $75,000 ($110,000 selling price å old T's basis of $35,000). Old T's gross profit ratio is 0.75 (gross profit of $75,000 â $100,000 contract price). Thus, $56,250 (0.75 (the $75,000 cash old T is deemed to receive in Year 1) is Year 1 gain attributable to the sale, and $18,750 ($75,000 å $56,250) is recovery of basis.

(iv) In its liquidation, old T is deemed to distribute the $25,000 note to B, since B actually sold the stock partly for that consideration. To the extent of the remaining liquidating distribution to B, it is deemed to receive, along with A and C, the balance of old T's liquidating assets in the form of cash. Under section 453(h), B, unless it makes an election under section 453(d), is not required to treat the receipt of the note as a payment for the T stock; P's payment of the $25,000 note in Year 7 to B is a payment for the T stock. Because section 453(h) applies to B, old T's deemed liquidating distribution of the note is, under section 453B(h), not treated as a taxable disposition by old T.

(v) Under section 1366, A reports 40 percent, or $22,500, of old T's $56,250 gain recognized in Year 1. Under section 1367, this increases A's $10,000 adjusted basis in the T stock to $32,500. Next, in old T's deemed liquidation, A is considered to receive $40,000 for its old T shares, causing it to recognize an additional $7,500 gain in Year 1.

(vi) Under section 1366, B reports 40 percent, or $22,500, of old T's $56,250 gain recognized in Year 1. Under section 1367, this increases B's $10,000 adjusted basis in its T stock to $32,500. Next, in old T's deemed liquidation, B is considered to receive the $25,000 note and $15,000 of other consideration. Applying section 453, including section 453(h), to the deemed liquidation, B's selling price and contract price are both $40,000. Gross profit is $7,500 ($40,000 selling price å B's basis of $32,500). B's gross profit ratio is 0.1875 (gross profit of $7,500 â $40,000 contract price). Thus, $2,812.50 (0.1875 ($15,000) is Year 1 gain attributable to the deemed liquidation. In Year 7, when the $25,000 note is paid, B has $4,687.50 (0.1875 ($25,000) of additional gain.

(vii) Under section 1366, C reports 20 percent, or $11,250, of old T's $56,250 gain recognized in Year 1. Under section 1367, this increases C's $5,000 adjusted basis in its T stock to $16,250. Next, in old T's deemed liquidation, C is considered to receive $20,000 for its old T shares, causing it to recognize an additional $3,750 gain in Year 1. Finally, under paragraph (d)(5)(ii) of this section, C is considered to acquire its stock in T on the day after the acquisition date for $20,000 (fair market value = grossed-up amount realized of $100,000 (20%). C's holding period in the stock deemed received in new T begins at that time.

(f) *Inapplicability of provisions.* The provisions of section 6043, §1.331– 1(d), and §1.332–6 (relating to information returns and recordkeeping requirements for corporate liquidations) do not apply to the deemed liquidation of old T under paragraph (d)(4) of this section.

(g) *Required information.* The Commissioner may exercise the authority granted in section 338(h)(10)(C)(iii) to require provision of any information deemed necessary to carry out the provisions of section 338(h)(10) by requiring submission of information on any tax reporting form.

§1.338(i)–1 [Removed]

Par. 11. Section 1.338(i)–1 is removed.

Par. 12. Section 1.338(i)–1T is added to read as follows:

§1.338(i)–1T Effective dates (temporary).

The provisions of §§1.338–0T through 1.338–7T, 1.338–10T and 1.338(h)(10)–1T apply to any qualified stock purchase occurring after January 5, 2000. For rules applicable to qualified stock purchases on or before January 5, 2000, see §§1.338–0 through 1.338–5, 1.338(b)–1, 1.338(b)–2T, 1.338(b)–3T, 1.338(h)(10)–1, and 1.338(i)–1 in effect prior to January 6, 2000 (see 26 CFR part 1 revised April 1, 1999).

Par. 13. Section 1.1060–1T is revised to read as follows:

§1.1060–1T Special allocation rules for certain asset acquisitions (temporary).

(a) *Scope*—(1) *In general.* This section prescribes rules relating to the requirements of section 1060, which, in the case of an applicable asset acquisition, requires the transferor (the seller) and the transferee (the purchaser) each to allocate the consideration paid or received in the transaction among the assets transferred in the same manner as amounts are allocated under section 338(b)(5) (relating to the allocation of adjusted grossed-up basis among the assets of the target corporation when a section 338 election is made). In the case of an applicable asset acquisition described in paragraph (b)(1) of this section, sellers and purchasers must allocate the consideration under the residual method as described in §§1.338–6T and 1.338–7T in order to determine, respectively, the amount realized from, and the basis in, each of the transferred assets. For rules relating to distributions of partnership property or transfers of partnership interests which are subject to section 1060(d), see §1.755–2T.

(2) *Effective date.* The provisions of this section apply to any asset acquisition occurring after January 5, 2000. For rules applicable to asset acquisitions on or before January 5, 2000, see §1.1060–1T in effect prior to January 6, 2000 (see 26 CFR part 1 revised April 1, 1999).

(3) *Outline of topics.* In order to facilitate the use of this section, this paragraph (a)(3) lists the major paragraphs in this section as follows:

(b) *Applicable asset acquisition*—(1) *In general.* An applicable asset acquisition is any transfer, whether direct or indirect, of a group of assets if the assets transferred constitute a trade or business in the hands of either the seller or the purchaser and, except as provided in paragraph (b)(8) of this section, the purchaser's basis in the transferred assets is determined wholly by reference to the purchaser's consideration.

(2) *Assets constituting a trade or business*—(i) *In general.* For purposes of this section, a group of assets constitutes a trade or business if—

(A) The use of such assets would constitute an active trade or business under section 355; or

(B) Its character is such that goodwill

or going concern value could under any circumstances attach to such group.

(ii) *Goodwill or going concern value.* Goodwill is the value of a trade or business attributable to the expectancy of continued customer patronage. This expectancy may be due to the name or reputation of a trade or business or any other factor. Going concern value is the additional value that attaches to property because of its existence as an integral part of an ongoing business activity. Going concern value includes the value attributable to the ability of a trade or business (or a part of a trade or business) to continue functioning or generating income without interruption notwithstanding a change in ownership. It also includes the value that is attributable to the immediate use or availability of an acquired trade or business, such as, for example, the use of the revenues or net earnings that otherwise would not be received during any period if the acquired trade or business were not available or operational.

(iii) *Factors indicating goodwill or going concern value.* In making the determination in this paragraph (b)(2), all the facts and circumstances surrounding the transaction are taken into account. Whether sufficient consideration is available to allocate to goodwill or going concern value after the residual method is applied is not relevant in determining whether goodwill or going concern value could attach to a group of assets. Factors to be considered include—

(A) The presence of any intangible assets (whether or not those assets are section 197 intangibles), provided, however, that the transfer of such an asset in the absence of other assets will not be a trade or business for purposes of section 1060;

(B) The existence of an excess of the total consideration over the aggregate book value of the tangible and intangible assets purchased (other than goodwill and going concern value) as shown in the financial accounting books and records of the purchaser; and

(C) Related transactions, including lease agreements, licenses, or other similar agreements between the purchaser and seller (or managers, directors, owners, or employees of the seller) in connection with the transfer.

(3) *Examples.* The following examples illustrate paragraphs (b)(1) and (2) of this section:

Example 1. S is a high grade machine shop that manufactures microwave connectors in limited quantities. It is a successful company with a reputation within the industry and among its customers for manufacturing unique, high quality products. Its tangible assets consist primarily of ordinary machinery for working metal and plating. It has no secret formulas or patented drawings of value. P is a company that designs, manufactures, and markets electronic components. It wants to establish an immediate presence in the microwave industry, an area in which it previously has not been engaged. P is acquiring assets of a number of smaller companies and hopes that these assets will collectively allow it to offer a broad product mix. P acquires the assets of S in order to augment its product mix and to promote its presence in the microwave industry. P will not use the assets acquired from S to manufacture microwave connectors. The assets transferred are assets that constitute a trade or business in the hands of the seller. Thus, P's purchase of S's assets is an applicable asset acquisition. The fact that P will not use the assets acquired from S to continue the business of S does not affect this conclusion.

Example 2. S, a sole proprietor who operates a car wash, both leases the building housing the car wash and sells all of the car wash equipment to P. S's use of the building and the car wash equipment constitute a trade or business. P begins operating a car wash in the building it leases from S. Because the assets transferred together with the asset leased are assets which constitute a trade or business, P's purchase of S's assets is an applicable asset acquisition.

Example 3. S, a corporation, owns a retail store business in State X and conducts activities in connection with that business enterprise that meet the active trade or business requirement of section 355. P is a minority shareholder of S. S distributes to P all the assets of S used in S's retail business in State X in complete redemption of P's stock in S held by P. The distribution of S's assets in redemption of P's stock is treated as a sale or exchange under sections 302(a) and 302(b)(3), and P's basis in the assets distributed to it is determined wholly by reference to the consideration paid, the S stock. Thus, S's distribution of assets constituting a trade or business to P is an applicable asset acquisition.

Example 4. S is a manufacturing company with an internal financial bookkeeping department. P is in the business of providing a financial bookkeeping service on a contract basis. As part of an agreement for P to begin providing financial bookkeeping services to S, P agrees to buy all of the assets associated with S's internal bookkeeping operations and provide employment to any of S's bookkeeping department employees who choose to accept a position with P. In addition to selling P the assets associated with its bookkeeping operation, S will enter into a long term contract with P for bookkeeping services. Because assets transferred from S to P, along with the related contract for bookkeeping services, are a trade or business in the hands of P, the sale of the bookkeeping assets from S to P is an applicable asset acquisition.

(4) *Asymmetrical transfers of assets.* If, under general principles of tax law, a seller is not treated as transferring the same assets as the purchaser is treated as acquiring, the assets acquired by the purchaser constitute a trade or business, and, except as provided in paragraph (b)(8) of this section, the purchaser's basis in the transferred assets is determined wholly by reference to the purchaser's consideration, then the purchaser is subject to section 1060.

(5) *Related transactions.* Whether the assets transferred constitute a trade or business is determined by aggregating all transfers from the seller to the purchaser in a series of related transactions. Except as provided in paragraph (b)(8) of this section, all assets transferred from the seller to the purchaser in a series of related transactions are included in the group of assets among which the consideration paid or received in such series is allocated under the residual method. The principles of §1.338–1T(c) are also applied in determining which assets are included in the group of assets among which the consideration paid or received is allocated under the residual method.

(6) *More than a single trade or business.* If the assets transferred from a seller to a purchaser include more than one trade or business, then, in applying this section, all of the assets transferred (whether or not transferred in one transaction or a series of related transactions and whether or not part of a trade or business) are treated as a single trade or business.

(7) *Covenant entered into by the seller.* If, in connection with an applicable asset acquisition, the seller enters into a covenant (e.g., a covenant not to compete) with the purchaser, that covenant is treated as an asset transferred as part of a trade or business.

(8) *Partial non-recognition exchanges.* A transfer may constitute an applicable asset acquisition notwithstanding the fact that no gain or loss is recognized with respect to a portion of the group of assets transferred. All of the assets transferred, including the non-recognition assets, are taken into account in determining whether the group of assets constitutes a trade or business. The allocation of consideration under paragraph (c) of this section is done without taking into account either the non-recognition assets or the amount of money or other property that is treated as transferred in exchange for the non-recog

nition assets (together, the non-recognition exchange property). The basis in and gain or loss recognized with respect to the non-recognition exchange property are determined under such rules as would otherwise apply to an exchange of such property. The amount of the money and other property treated as exchanged for non-recognition assets is the amount by which the fair market value of the non-recognition assets transferred by one party exceeds the fair market value of the non-recognition assets transferred by the other (to the extent of the money and the fair market value of property transferred in the exchange). The money and other property that are treated as transferred in exchange for the non-recognition assets (and which are not included among the assets to which section 1060 applies) are considered to come from the following assets in the following order: first from Class I assets, then from Class II assets, then from Class III assets, then from Class IV assets, then from Class V assets, then from Class VI assets, and then from Class VII assets. For this purpose, liabilities assumed (or to which a non-recognition exchange property is subject) are treated as Class I assets. See *Example 1* in paragraph (d) of this section for an example of the application of section 1060 to a single transaction which is, in part, a non-recognition exchange.

(c) *Allocation of consideration among assets under the residual method* — (1) *Consideration.* The seller's consideration is the amount, in the aggregate, realized from selling the assets in the applicable asset acquisition under section 1001(b). The purchaser's consideration is the amount, in the aggregate, of its cost of purchasing the assets in the applicable asset acquisition that is properly taken into account in basis.

(2) *Allocation of consideration among assets.* For purposes of determining the seller's amount realized for each of the assets sold in an applicable asset acquisition, the seller allocates consideration to all the assets sold by using the residual method under §§1.338–6T and 1.338–7T, substituting consideration for ADSP. For purposes of determining the purchaser's basis in each of the assets purchased in an applicable asset acquisition, the purchaser allocates consideration to all the assets purchased by using the residual method under §§1.338–6T and 1.338–7T, substituting consideration for AGUB. In allocating consideration, the rules set forth in paragraphs (c)(3) and (4) of this section apply in addition to the rules in §§1.338–6T and 1.338–7T.

(3) *Certain costs.* The seller and purchaser each adjusts the amount allocated to an individual asset to take into account the specific identifiable costs incurred in transferring that asset in connection with the applicable asset acquisition (e.g., real estate transfer costs or security interest perfection costs). Costs so allocated increase, or decrease, as appropriate, the total consideration that is allocated under the residual method. No adjustment is made to the amount allocated to an individual asset for general costs associated with the applicable asset acquisition as a whole or with groups of assets included therein (e.g., non-specific appraisal fees or accounting fees). These latter amounts are taken into account only indirectly through their effect on the total consideration to be allocated.

(4) *Effect of agreement between parties.* If, in connection with an applicable asset acquisition, the seller and purchaser agree in writing as to the allocation of any amount of consideration to, or as to the fair market value of, any of the assets, such agreement is binding on them to the extent provided in this paragraph (c)(4). Nothing in this paragraph (c)(4) restricts the Commissioner's authority to challenge the allocations or values arrived at in an allocation agreement. This paragraph (c)(4) does not apply if the parties are able to refute the allocation or valuation under the standards set forth in *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir.), *cert. denied*, 389 U.S. 858 (1967) (a party wishing to challenge the tax consequences of an agreement as construed by the Commissioner must offer proof that, in an action between the parties to the agreement, would be admissible to alter that construction or show its unenforceability because of mistake, undue influence, fraud, duress, etc.).

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

Example 1. (i) On January 1, 2001, A transfers assets X, Y, and Z to B in exchange for assets D, E, and F plus $1,000 cash.

(ii) Assume the exchange of assets constitutes an exchange of like-kind property to which section 1031 applies. Assume also that goodwill or going concern value could under any circumstances attach to each of the DEF and XYZ groups of assets and, therefore, each group constitutes a trade or business under section 1060.

(iii) Assume the fair market values of the assets and the amount of money transferred are as follows:

By A		*By B*	
Asset	*Fair Market Value*	*Asset*	*Fair Market Value*
X	$ 400	D	$ 40
Y	400	E	30
Z	200	F	30
		Cash (amount)	1,000
Total	$ 1,000	Total	$ 1,100

(iv) Under paragraph (b)(8) of this section, for purposes of allocating consideration under paragraph (c) of this section, the like-kind assets exchanged and any money or other property that are treated as transferred in exchange for the like-kind property are excluded from the application of section 1060.

(v) Since assets X, Y, and Z are like-kind property, they are excluded from the application of the section 1060 allocation rules.

(vi) Since assets D, E, and F are like-kind property, they are excluded from the application of the section 1060 allocation rules. In addition, $900 of the $1,000 cash B gave to A for A's like-kind assets is treated as transferred in exchange for the like-kind property in order to equalize the fair market values of the like-kind assets. Therefore, $900 of the cash is excluded from the application of the section 1060 allocation rules.

(vii) $100 of the cash is allocated under section 1060 and paragraph (c) of this section.

(viii) A, as transferor of assets X, Y, and Z, received $100 that must be allocated under section 1060 and paragraph (c) of this section. Since A transferred no Class I, II, III, IV, V, or VI assets to which section 1060 applies, in determining its amount realized for the part of the exchange to which section 1031 does not apply, the $100 is allocated to Class VII assets (goodwill and going concern value).

(ix) A, as transferee of assets D, E, and F, gave consideration only for assets to which section 1031 applies. Therefore, the allocation rules of section 1060 and paragraph (c) of this section are not applied to determine the bases of the assets A received.

(x) B, as transferor of assets D, E, and F, received consideration only for assets to which section 1031 applies. Therefore, the allocation rules of section 1060 do not apply in determining B's gain or loss.

(xi) B, as transferee of assets X, Y, and Z, gave A $100 that must be allocated under section 1060 and paragraph (c) of this section. Since B received from A no Class I, II, III, IV, V, or VI assets to which section 1060 applies, the $100 consideration is allocated by B to Class VII assets (goodwill and going concern value).

Example 2. (i) On January 1, 2001, S, a sole proprietor, sells to P, a corporation, a group of assets that constitutes a trade or business under paragraph (b)(2) of this section. S, who plans to retire immediately, also executes in P's favor a covenant not to compete. P pays S $3,000 in cash and assumes $1,000 in liabilities. Thus, the total consideration is $4,000.

(ii) On the purchase date, P and S also execute a separate agreement that states that the fair market values of the Class II, Class III, Class V, and Class VI assets S sold to P are as follows:

Asset Class	*Asset*	*Fair Market Value*
II	Actively traded securities	$ 500
	Total Class II	500
III	Accounts receivable	200
	Total Class III	200
V	Furniture and fixtures	800
	Building	800
	Land	200
	Equipment	400
	Total Class V	2,200
VI	Covenant not to compete	900
	Total Class VI	900

(iii) P and S each allocate the consideration in the transaction among the assets transferred under paragraph (c) of this section in accordance with the agreed upon fair market values of the assets, so that $500 is allocated to Class II assets, $200 is allocated to the Class III asset, $2,200 is allocated to Class V assets, $900 is allocated to Class VI assets, and $200 ($4,000 total consideration less $3,800 allocated to assets in Classes II, III, V, and VI) is allocated to the Class VII assets (goodwill and going concern value).

(iv) In connection with the examination of P's return, the District Director, in determining the fair market values of the assets transferred, may disregard the parties' agreement. Assume that the District Director correctly determines that the fair market value of the covenant not to compete was $500. Since the allocation of consideration among Class II, III, V, and VI assets results in allocation up to the fair market value limitation, the $600 of unallocated consideration resulting from the District Director's redetermination of the value of the covenant not to compete is allocated to Class VII assets (goodwill and going concern value).

(e) *Reporting requirements*—(1) *Applicable asset acquisitions*—(i) *In general*. Unless otherwise excluded from this requirement by the Commissioner, the seller and the purchaser in an applicable asset acquisition each must report information concerning the amount of consideration in the transaction and its allocation among the assets transferred. They also must report information concerning subsequent adjustments to consideration.

(ii) *Time and manner of reporting*—(A) *In general*. The seller and the purchaser each must file asset acquisition statements on Form 8594 with their income tax returns or returns of income for the taxable year that includes the first date assets are sold pursuant to an applicable asset acquisition. This reporting requirement applies to all asset acquisitions described in this section. For reporting requirements relating to asset acquisitions occurring before January 6, 2000, as described in paragraph (a)(2) of this section, see the temporary regulations under section 1060 in effect prior to January 6, 2000 (§1.1060–1T as contained in 26 CFR part 1 revised April 1, 1999).

(B) *Additional reporting requirement*. When an increase or decrease in consideration is taken into account after the close of the first taxable year that includes the first date assets are sold in an applicable asset acquisition, the seller and the purchaser each must file a supplemental asset acquisition statement on Form 8594 with the income tax return or return of income for the taxable year in which the increase (or decrease) is properly taken into account.

(2) *Transfers of interests in partnerships*. For reporting requirements relating to the transfer of a partnership interest, see §1.755–2T(c).

PART 602—OMB CONTROL NUMBERS UNDER PAPERWORK REDUCTION ACT

Par. 14. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 15. In §602.101, paragraph (b) is amended by removing the entries for §§1.338–1, 1.338(b)–1, 1.338(h)(10)–1, and 1.1060–1T from the tables and adding new entries to the table in numerical order to read as follows:

§602.101 OMB Control numbers.

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(b) * * *

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved December 22, 1999.

Jonathan Talisman,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on January 5, 2000, 8:45 a.m., and published in the issue of the Federal Register for January 7, 2000, 65 F.R. 1235)

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.338–2T	1545-1658
1.338–5T	1545-1658
1.338–10T	1545-1658
1.338–(h)(10)–1T	1545-1658
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Section 832.—Insurance Company Taxable Income

26 CFR 1.832–4: Gross Income.

T.D. 8857

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Determination of Underwriting Income

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the determination of underwriting income by insurance companies other than life insurance companies. In computing underwriting income, non-life insurance companies are required to reduce by 20 percent their deductions for increases in unearned premiums. This requirement was enacted as part of the Tax Reform Act of 1986. These regulations provide guidance to non-life insurance companies for purposes of determining the amount of unearned premiums that are subject to the 20 percent reduction rule.

DATES: The regulations are effective January 5, 2000**.**

FOR FURTHER INFORMATION CONTACT: Gary Geisler, (202) 622-3970 (not a toll-free number)

SUPPLEMENTARY INFORMATION:

Background

On January 2, 1997, the IRS published in the **Federal Register** a notice of proposed rulemaking (REG–209839–96, 1997–1 C.B. 780 [62 F.R. 72]) proposing amendments to the Income Tax Regulations (26 CFR part 1) under section 832(b) of the Internal Revenue Code. The IRS received a number of written comments on the proposed regulations. On April 30, 1997, the IRS held a public hearing on the proposed regulations. After consideration of all written and oral comments regarding the proposed regulations, those regulations are adopted as revised by this Treasury decision.

Explanation of Revisions and Summary of Comments

Underwriting income

A non-life insurance company's underwriting income equals its premiums earned on insurance contracts during the taxable year less its losses incurred on insurance contracts and its expenses incurred.[1] *See* section 832(b)(3). To compute premiums earned, the company starts with the gross premiums written on insurance contracts during the taxable year, subtracts return premiums and premiums paid for reinsurance, and makes an adjustment to reflect the change in its unearned premiums over the course of the taxable year. *See* section 832(b)(4). This computation results in premiums being recognized in underwriting income over the term of the insurance contract, rather than in the taxable year in which the premiums are billed or received from the policyholder.

Prior to 1987, 100 percent of the change in unearned premiums during the taxable year was taken into account as an increase or decrease to written premiums in computing premiums earned. This treatment "generally reflect[ed]" the accounting conventions (often referred to as "statutory accounting principles") used to prepare a non-life insurance company's annual statement for state insurance regulatory purposes. *See* 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-354 (1986), 1986–3 C.B. (Vol. 4) 354; S. Rep. No. 313, 99th Cong., 2d Sess. 495 (1986), 1986–3 C.B. (Vol. 3) 495, H.R. Rep. No. 426, 99th Cong., 1st Sess. 668 (1985), 1986–3 C.B. (Vol. 2) 668. Because unearned premiums are computed on the basis of the gross premiums for an insurance contract, the amount of unearned premiums reflects not only the portion of the gross premium allocable to future insurance claims but also the portion allocable to the insurance company's expenses and profit on the insurance contract.

In 1986, Congress determined that deferring unearned premium income and currently deducting premium acquisition expenses attributable to unearned premiums resulted in a mismatch of an insurance company's net income and expense. Congress decided to require a better measurement of net income for Federal income tax purposes. *See* H.R. Rep. No. 426, 1986–3 C.B. (Vol. 2) at 669; S. Rep. No. 313, 1986–3 C.B. (Vol. 3) at 496. Rather than defer the deduction for premium acquisition expenses attributable to unearned premiums, Congress reduced by 20 percent the adjustment for unearned premiums. For taxable years beginning on or after January 1, 1993, a non-life insurance company's premiums earned is an amount equal to: (1) its gross premiums written, less both return premiums and premiums paid for reinsurance; plus (2) 80 percent of unearned premiums at the end of the prior taxable year, less 80 percent of unearned premiums at the end of the current taxable year. Section 832(b)(4). The acceleration of income that is typically generated by the 20 percent reduction of unearned premiums is intended to be roughly equivalent to denying current deductibility for the portion of the insurance company's premium acquisition expenses allocable to the unearned premiums. *See* 2 H.R. Conf. Rep. No. 841, 1986–3 C.B. (Vol. 4) at 354–55; S. Rep. No. 313, 1986–3 C.B. (Vol. 3) at 495–98; H.R. Rep. No. 426, 1986–3 C.B. (Vol. 2) at 668–70.

Role of the annual statement

The proposed regulations provide definitions of the items used to determine premiums earned under section 832(b)(4) and timing rules for taking these items into account for Federal income tax purposes. The treatment provided in the proposed regulations would apply regardless of the classification or method of reporting the items used on an insurance company's annual statement.

Several comments questioned whether there is legal authority to require an insurance company to use a method to cal-

[1]For this purpose, expenses incurred generally refers to the expenses reported on the company's annual statement approved by the National Association of Insurance Commissioners (NAIC) and filed for state insurance regulatory purposes, less expenses incurred which are not allowed as deductions under section 832(c). *See* section 832(b)(6). Expenses incurred generally include premium acquisition expenses attributable to unearned premiums on insurance contracts.

culate premiums earned for Federal income tax purposes that differs from the method that the company is permitted to use to calculate premiums earned on its annual statement. As noted in the preamble to the proposed regulations, the existing regulations under §1.832–4(a)(2) state that the annual statement ". . . insofar as it is not inconsistent with the provisions of the Code . . ." will be recognized and used as a basis for computing the net income of a non-life insurance company. Also, if statutory accounting principles permit alternative practices, one or more of which do not clearly reflect income as defined by the Code, the company is required for Federal income tax purposes to use a method that clearly reflects income. Section 446(b) and §1.446–1(a)(2).

Gross premiums written

The proposed regulations generally define gross premiums written as the total amounts payable for insurance coverage under insurance or reinsurance contracts issued or renewed during the taxable year. The proposed regulations, however, do not address situations where the amounts charged for insurance coverage may change due to increases or decreases in coverage limits, additions or deletions in property or risks covered, changes in location or status of insureds, or other similar factors.

The final regulations define an insurance company's "gross premiums written" on insurance contracts (which includes premiums attributable to reinsurance contracts) as amounts payable for insurance coverage for the effective periods of the contracts. The label placed on a payment in a contract does not determine whether an amount is a gross premiums written. The effective period of a contract is the period over which one or more rates for insurance coverage are guaranteed in the contract. If a new rate for insurance coverage is guaranteed after the effective date of an insurance contract, the making of the guarantee generally is treated as the issuance of a new insurance contract with an effective period equal to the duration of the new guaranteed rate for insurance coverage.

Under the final regulations, gross premiums written include: (1) additional premiums resulting from increases in risk exposure during the effective period of an insurance contract; (2) amounts subtracted from a premium stabilization reserve that are used to pay premiums; and (3) consideration for assuming insurance liabilities under contracts not issued by the insurance company (that is, a payment or transfer of property in an assumption reinsurance transaction). Gross premiums written, however, do not include other items of gross income described in section 832(b)(1)(C). To the extent that amounts paid or payable to an insurance company with respect to an arrangement are not gross premiums written, the insurance company may not treat amounts payable to customers with respect to the applicable portion of such arrangements as losses incurred described in section 832(b)(5).

Method of reporting gross premiums written

The proposed regulations provide that a non-life insurance company reports the full amount of gross premiums written for an insurance contract for the earlier of the taxable year which includes the effective date of the contract or the year in which all or a portion of the premium for the contract is received. A variety of comments were received with respect to the application of this timing rule to insurance contracts with installment premiums. In response to comments, the final regulations provide a number of exceptions from the general rule with respect to when an insurance company reports gross premiums written.

Advance premiums

Under the proposed regulations, a non-life insurance company that receives a portion of the premium for an insurance contract prior to the effective date of the contract includes the full amount of the premium in gross premiums written for the taxable year during which the portion of the premium was received.

Several comments addressed the treatment of advance premiums in the proposed regulations. One comment endorsed the proposed treatment of advance premiums, noting that it is proper under statutory accounting principles to record the full amount of gross premiums written and expenses incurred with respect to a casualty insurance policy for the year in which an advance premium is received.[2] Other comments argued that since the policyholder may demand a refund of an advance premium prior to the policy's effective date, the company should be permitted to treat an advance premium as a nontaxable deposit until such time as coverage begins under the contract. Alternatively, these comments urged that the company be permitted to report only the advance premium (rather than the entire gross premium for the contract) in gross premiums written for the taxable year of receipt, and to report the remainder of the gross premium for the taxable year that includes the contract's effective date. These comments also indicated that companies generally do not deduct the full amount of premium acquisition expenses for the contract in the taxable year in which they receive advance premiums.

In response to comments, the final regulations permit an insurance company that receives part of the gross premium for an insurance contract prior to the effective date of the contract to report only the advance premium (rather than the full amount of the gross premium written for the contract) in gross premiums written for the taxable year of receipt. The remainder of the gross premium for the insurance contract is included in gross premiums written for the taxable year which includes the effective date of the contract. This method of reporting gross premiums written is available only if the company's deduction for premium acquisition expenses attributable to the contract does not exceed a limitation specified in the regulations, which is intended to ensure that a company does not deduct premium acquisition expenses attributable to an insurance contract more rapidly than the company includes premiums for the insurance contract in its gross premiums written. Companies that adopt this method of reporting gross pre-

[2]Prior to 1989, advance premiums were required to be reported in written premiums and unearned premiums on a non-life insurance company's annual statement. However, statutory accounting principles were later modified to permit advance premiums to be accumulated in a suspense account and reported as a write-in liability on the annual statement. A company electing to use this alternative treatment would not report advance premiums in either written premiums or unearned premiums on its annual statement until the effective date of the underlying coverage.

miums written must use this method for all insurance contracts with advance premiums.

Accident and health insurance contracts

The proposed regulations have no special rules for determining gross premiums written with respect to accident and health insurance contracts. Several comments indicated that the longstanding practice of insurance companies that issue accident and health insurance contracts with installment premiums is to include amounts in gross premiums written for the taxable year in which the installment premiums become due under the contracts. These comments also stated that companies generally do not deduct premium acquisition expenses allocable to installment premiums not yet due or received with respect to accident and health insurance contracts.

In response to comments, the final regulations permit a non- life insurance company that either issues or proportionally reinsures cancellable accident and health insurance contracts with installment premiums to report the installment premiums in gross premiums written for the earlier of the taxable year in which the installment premiums become due under the terms of the contract or the taxable year in which the installment premiums are received. This method of reporting gross premiums written for cancellable accident and health insurance contracts with installment premiums is available only if the company's deduction for premium acquisition expenses attributable to those contracts does not exceed the matching limitation specified in the regulations. Companies that adopt this method of reporting gross premiums written must use it for all cancellable accident and health insurance contracts with installment premiums.

Multi-year contracts with installment premiums

The final regulations also provide an exception with respect to the reporting of gross premiums written for a multi-year insurance contract for which the gross premium is payable in installments over the effective period of the contract. Under the final regulations, a company may treat this type of multi-year insurance contract as a series of separate insurance contracts. The first insurance contract in the series will be treated as having an effective period of 12 months. Subsequent insurance contracts in the series will be treated as having an effective period equal to the lesser of 12 months or the remainder of the period for which the rates for insurance coverage are guaranteed in the multi-year insurance contract.

This method of reporting gross premium written for a multi-year insurance contract with installment premiums is available only if the company's deduction for premium acquisition expenses attributable to the contract does not exceed the matching limitation specified in the regulations. Companies that adopt this method of reporting gross premiums written for a multi-year insurance contract must use it for all multi-year contracts with installment premiums.

Contracts that give rise to life insurance reserves

Some insurance companies that are taxable under Part II of Subchapter L issue or reinsure risks relating to guaranteed renewable accident and health insurance contracts or other contracts that give rise to "life insurance reserves" (as defined in section 816(b)). For these companies, section 832(b)(4) provides that unearned premiums includes the amount of the company's life insurance reserves, as determined under section 807. However, under section 832(b)(7), the unearned premiums for contracts giving rise to life insurance reserves are not reduced by 20 percent. Instead, an amount of otherwise deductible expenses equal to a percentage of the net premiums for the contracts must be capitalized and amortized as specified policy acquisition expenses under section 848.[3] For purposes of determining the amount of specified policy acquisition expenses under section 848, a non-life insurance company computes net premiums for the contracts in accordance with section 811(a). *See* section 848(d)(2). Thus, with respect to contracts described in section 832(b)(7), a non-life insurance company does not take into account unpaid premiums attributable to insurance coverage not yet provided (such as deferred and uncollected premium installments) in determining the amount of specified policy acquisition expenses required to be amortized under section 848. The proposed regulations do not provide special rules for determining gross premiums written with respect to contracts described in section 832(b)(7). Under the final regulations, a non-life insurance company that issues or reinsures the risks related to a contract described in section 832(b)(7) may report gross premiums written for the contract in the manner required for life insurance companies under sections 803 and 811. This method of reporting gross premiums written for contracts described in section 832(b)(7) is available only if the company also determines its deduction for premium acquisition expenses for the contracts in accordance with section 811(a), as adjusted by the amount required to be amortized under section 848 based on the net premiums of the contracts. Thus, the final regulations ensure that the rules for determining premium income and amortizing premium acquisition expenses for contracts described in section 832(b)(7) operate consistently, whether the issuing company is a non-life insurance company or a life insurance company.

Fluctuating risk contracts

The method of reporting gross premiums written for certain insurance contracts covering fluctuating risks is reserved in the proposed regulations. Some comments requested that the final regulations not address the method of reporting gross premiums written for insurance contracts covering fluctuating risks, noting that the method of recording gross written premiums for these policies for annual statement reporting purposes was being considered by the NAIC as part of its project to codify statutory accounting principles. Subsequently, the NAIC issued guidance permitting an insurance company for annual statement purposes to report written premiums on workers' compensation policies (but not on other casualty contracts involving "fluctuating risks," such as commercial automobile liability and product liability policies) either on the effective date of the insurance contract or based on installment billings to the policyholder. By contrast, with re-

[3]Under section 848(e)(5), a contract that reinsures a contract subject to section 848 is treated in the same manner as the reinsured contract.

spect to other types of casualty insurance policies, the NAIC reaffirmed the general rule that gross premiums with respect to these policies must be recorded on the annual statement on the effective date of the insurance contract.

The final regulations do not permit a non-life insurance company to report gross premiums written for a fluctuating risk contract based on installment billings to the policyholder. Rather, the final regulations require a company generally to report the gross premiums written for the contract for the earlier of the taxable year which includes the effective date of the contract or the year in which all or a portion of the premium for the contract is received, with special rules for advance premiums, cancellable accident and health contracts, multi-year insurance contracts, and contracts described in section 832(b)(7). The company reports any additional premiums resulting from an increase in risk exposure in gross premiums written for the taxable year in which the change in risk exposure occurs. Unless the increase in risk exposure is of temporary duration, the company determines the additional premium resulting from a change in risk exposure based on the remainder of the effective period of the contract.

Return premiums

The proposed regulations define return premiums as amounts (other than policyholder dividends or claims and benefit payments) paid or credited to the policyholder in accordance with the terms of an insurance contract. Under the final regulations, return premiums are amounts previously included in an insurance company's gross premiums written, which are refundable to the policyholder (or the ceding company with respect of a reinsurance agreement) if the amounts are fixed by the insurance contract and do not depend on the experience of the insurance company or the discretion of its management. This rule incorporates a specific definition of policyholder dividends.

The final regulations list a number of items which are included in return premiums, to the extent they have previously been included in gross premiums written. These items include: (1) amounts that are refundable due to policy cancellations or decreases in risk exposure during the effective period of an insurance contract; (2) the unearned portion of unpaid premiums for an insurance contract that is canceled or for which there is a decrease in risk exposure during its effective period; and (3) amounts that are either refundable or that reflect the unearned portion of unpaid premiums for an insurance contract, arising from the redetermination of the premium due to correction of posting or other similar errors.

In addition, the final regulation provides timing rules for the deduction of return premiums. If a contract is canceled, the return premium arising from that cancellation is deducted in the taxable year in which the contract is canceled. If there is a reduction in risk exposure under an insurance contract that gives rise to a return premium, such return premium is deductible in the taxable year in which the reduction in risk exposure occurs.

Retrospectively rated insurance contracts

The proposed regulations provide that gross written premiums include an insurance company's estimate of additional premiums (retro debits) to be received with regard to the expired portion of a retrospectively rated insurance or reinsurance contract. The proposed regulations also provide that return premiums include an insurance company's estimate of amounts to be refunded to policyholders (retro credits) with regard to the expired portion of a retrospectively rated insurance or reinsurance contract. The proposed regulations, therefore, would modify the treatment of retro credits under §1.832–4(a)(3)(ii) of the existing regulations, which treat retro credits as unearned premiums. At the option of the taxpayer, however, the proposed regulations permit a company to continue to include gross retro credits (but not gross retro debits) in the amount of unearned premiums subject to the 20 percent reduction under section 832(b)(4)(B).

A variety of comments were received with respect to the treatment of retro debits and retro credits in the proposed regulations. Most comments approved of the proposed rule to modify the treatment of retro credits in §1.832–4(a)(3)(ii) and, instead, to permit retro credits to be accounted for as part of return premiums. Some comments contended, however, that the method of netting retro debits and retro credits as an adjustment to unearned premiums was required under NAIC accounting rules, prior case law, and the Service's published rulings interpreting §1.832–4(a)(3)(ii). These comments argued that the enactment of the 20 percent reduction rule in 1986 did not authorize the Service to change the items included in unearned premiums, including the historical treatment of retro debits and retro credits as part of unearned premiums. Other comments contended that retro debits (but not retro credits) should be discounted using the applicable discount factors for unpaid losses under section 846. These comments argued that there is a direct correlation between amounts reported by an insurance company as retro debits and the company's related liabilities for unpaid losses and unpaid loss adjustment expenses. Therefore, the comments urged that, to achieve proper matching of these items, a non-life insurance company should be permitted either to report retro debits as a subtraction from unearned premiums or to discount the retro debits using the applicable discount factors under section 846 for the related line of business.

The treatment of retro debits and retro credits in the proposed regulations was premised on the assumptions that retrospectively rated arrangements could qualify as insurance contracts for tax purposes, and that all amounts payable under such arrangements could be considered to have been paid for insurance coverage. The final regulations provide that gross premiums are amounts paid for insurance coverage. Similarly, unearned premiums and return premiums only include amounts included in gross written premiums. The final regulations also provide that retro credits are not included in unearned premiums, and retro debits cannot be subtracted from unearned premiums. The final regulations do not permit amounts includable in gross premiums written to be discounted, regardless of when such amounts are paid to the insurance company.

The final regulations do not provide any inference as to whether some or all of a retrospective arrangement can qualify as an insurance contract, or as to whether or the extent to which amounts paid or payable to an insurance company with respect to a retrospective arrangement are for insurance coverage.

Premium stabilization reserves

Several comments asked for clarification of the treatment of premium stabilization reserves.[4] As noted below, the final regulations provide that retro credits are not unearned premiums for Federal income tax purposes. Thus, retro credits added to premium stabilization reserves are not unearned premiums for Federal income tax purposes. The final regulations also provide that amounts withdrawn from a premium stabilization reserve to pay premiums are included in gross premiums written for the taxable year in which these amounts are withdrawn from the stabilization reserve for that purpose.

Unearned premiums

The proposed regulations define unearned premiums as the portion of the gross premiums written that is attributable to future insurance coverage to be provided under an insurance or reinsurance contract. The final regulations generally retain the rules relating to unearned premiums. Consistent with the existing regulations under §1.801–4(a), the final regulations provide that an insurance company must exclude from unearned premiums amounts attributable to the net value of risks reinsured with, or retroceded to, another insurance company. The final regulations also provide that unearned premiums do not include a liability established by an insurance company on its annual statement to cover premium deficiencies.

The proposed regulations provide that an insurance company may consider the incidence or pattern of the insured risks in determining the portion of the gross premium written that is attributable to the unexpired portion of the insurance coverage. The final regulations clarify that, if the risk of loss under an insurance contract does not vary significantly over the effective period of the contract, the unearned premium attributable to the unexpired portion of the effective period of the contract is determined on a pro rata basis. However, if the risk of loss under an insurance contract varies significantly over the effective period of the contract, the insurance company may consider the pattern and incidence of the risk in determining the portion of gross premium which are attributable to the unexpired portion of the effective period of the contract, provided that the company maintains sufficient information to demonstrate that its method of computing unearned premiums accurately reflects the pattern and incidence of the risk for the insurance contract.

Effective date and transition rules

Under the proposed regulations, the new rules apply to the determination of premiums earned for insurance contracts issued or renewed during taxable years beginning after January 6, 2000. Several comments requested that the regulations permit an insurance company to adopt the new rules for determining premiums earned as a change in method of accounting deemed made with the Commissioners' consent, with audit protection for prior years. These comments also urged that the insurance company be given the option of either implementing the change in method of accounting on a cut-off basis or spreading the section 481(a) adjustments resulting from the change over a number of years consistent with the Commissioner's general administrative procedures when a taxpayer files a request to change a method of accounting under section 446(e).

In response to these comments, the final regulations permit taxpayers to change their method of accounting for determining premiums earned to comply with the final regulations under the automatic change in method of accounting provisions of Rev. Proc. 99–49, 1999–52 I.R.B. 725, subject to certain limitations. A taxpayer makes the automatic change in method of accounting on its Federal income tax return for the first taxable year beginning after December 31, 1999. The scope limitations in section 4.02 of Rev. Proc. 99–49 do not apply to a taxpayer's automatic change in method of accounting pursuant to this regulation. The timely duplicate filing requirement in section 6.02 of Rev. Proc. 99–49 also does not apply to this change. If the taxpayer's method of computing earned premiums was an issue under consideration (within the meaning of section 3.09 of Rev. Proc. 99–49) on January 5, 2000, however, then the audit protection rule in section 7.01 of Rev. Proc. 99–49 does not apply to the taxpayer's change in method of accounting.

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, and, because these regulations do not impose on small entities a collection of information requirement, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Gary Geisler, Office of the Assistant Chief Counsel (Financial Institutions and Products), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.832–4 is amended as follows:

1. Paragraph (a)(3) is revised.

2. Paragraphs (a)(4) and (a)(5) are redesignated as paragraphs (a)(13) and (a)(14).

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[4]In Rev. Rul. 97–5, 1997–1 C.B. 136, the Service revoked Rev. Rul. 70–480, 1970–2 C.B. 142, which had held that amounts held by a non-life insurance company in a premium stabilization reserve funded by retro credits are not unearned premiums under section 832(b)(4). Rev. Rul. 97–5 reasoned that the assumption in Rev. Rul. 70–480 that stabilization reserves are part of the insurance company's surplus was erroneous.

3. New paragraphs (a)(4) through (a)(12) are added.

The additions and revisions read as follows:

§1.832–4 Gross income.

(a) * * *

(3) *Premiums earned.* The determination of premiums earned on insurance contracts during the taxable year begins with the insurance company's gross premiums written on insurance contracts during the taxable year, reduced by return premiums and premiums paid for reinsurance. Subject to the exceptions in sections 832(b)(7), 832(b)(8), and 833(a)(3), this amount is increased by 80 percent of the unearned premiums on insurance contracts at the end of the preceding taxable year, and is decreased by 80 percent of the unearned premiums on insurance contracts at the end of the current taxable year.

(4) *Gross premiums written*—(i) *In general*. Gross premiums written are amounts payable for insurance coverage. The label placed on a payment in a contract does not determine whether an amount is a gross premium written. Gross premiums written do not include other items of income described in section 832(b)(1)(C) (for example, charges for providing loss adjustment or claims processing services under administrative services or cost-plus arrangements). Gross premiums written on an insurance contract include all amounts payable for the effective period of the insurance contract. To the extent that amounts paid or payable with respect to an arrangement are not gross premiums written, the insurance company may not treat amounts payable to customers under the applicable portion of such arrangements as losses incurred described in section 832(b)(5).

(ii) *Items included.* Gross premiums written include—

(A) Any additional premiums resulting from increases in risk exposure during the effective` period of an insurance contract;

(B) Amounts subtracted from a premium stabilization reserve to pay for insurance coverage; and

(C) Consideration in respect of assuming insurance liabilities under insurance contracts not issued by the taxpayer (such as a payment or transfer of property in an assumption reinsurance transaction).

(5) *Method of reporting gross premiums written*—(i) *In general*. Except as otherwise provided under this paragraph (a)(5), an insurance company reports 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. The effective date of the insurance contract is the date on which the insurance coverage provided by the contract commences. The effective period of an insurance contract is the period over which one or more rates for insurance coverage are guaranteed in the contract. If a new rate for insurance coverage is guaranteed after the effective date of an insurance contract, the making of such a guarantee generally is treated as the issuance of a new insurance contract with an effective period equal to the duration of the new guaranteed rate for insurance coverage.

(ii) *Special rule for additional premiums resulting from an increase in risk exposure*. An insurance company reports additional premiums that result from an increase in risk exposure during the effective period of an insurance contract in gross premiums written for the taxable year in which the change in risk exposure occurs. Unless the increase in risk exposure is of temporary duration (for example, an increase in risk exposure under a workers' compensation policy due to seasonal variations in the policyholder's payroll), the company reports additional premiums resulting from an increase in risk exposure based on the remainder of the effective period of the insurance contract.

(iii) *Exception for certain advance premiums*. If an insurance company receives a portion of the gross premium for an insurance contract prior to the first day of the taxable year that includes the effective date of the contract, the company may report the advance premium (rather than the full amount of the gross premium for the contract) in gross premiums written for the taxable year in which the advance premium is received. An insurance company may adopt this method of reporting advance premiums only if the company's deduction for premium acquisition expenses for the taxable year in which the company receives the advance premium does not exceed the limitation of paragraph (a)(5)(vii) of this section. A company that reports an advance premium in gross premiums written under this paragraph (a)(5)(iii) takes into account the remainder of the gross premium written and premium acquisition expenses for the contract in the taxable year that includes the effective date of the contract. A company that adopts this method of reporting advance premiums must use the method for all contracts with advance premiums.

(iv) *Exception for certain cancellable accident and health insurance contracts with installment premiums*. If an insurance company issues or proportionally reinsures a cancellable accident and health insurance contract (other than a contract with an effective period that exceeds 12 months) for which the gross premium is payable in installments over the effective period of the contract, the company may report the installment premiums (rather than the total gross premium for the contract) in gross premiums written for the earlier of the taxable year in which the installment premiums are due under the terms of the contract or the year in which the installment premiums are received. An insurance company may adopt this method of reporting installment premiums for a cancellable accident and health insurance contract only if the company's deduction for premium acquisition expenses for the first taxable year in which an installment premium is due or received under the contract does not exceed the limitation of paragraph (a)(5)(vii) of this section. A company that adopts this method of reporting installment premiums for a cancellable accident and health contract must use the method for all of its cancellable accident and health insurance contracts with installment premiums.

(v) *Exception for certain multi-year insurance contracts*. If an insurance company issues or proportionally reinsures an insurance contract, other than a contract described in paragraph (a)(5)(vi) of this section, with an effective period that exceeds 12 months, for which the gross premium is payable in installments over the effective period of the contract, the company may treat the insurance coverage provided under the multi-year contract as a series of separate insurance contracts.

The first contract in the series is treated as having been written for an effective period of twelve months. Each subsequent contract in the series is treated as having been written for an effective period equal to the lesser of 12 months or the remainder of the period for which the rates for insurance coverage are guaranteed in the multi-year insurance contract. An insurance company may adopt this method of reporting premiums on a multi-year contract only if the company's deduction for premium acquisition expenses for each year of the multi-year contract does not exceed the limitation of paragraph (a)(5)(vii) of this section. A company that adopts this method of reporting premiums for a multi-year contract must use the method for all multi-year contracts with installment premiums.

(vi) *Exception for insurance contracts described in section 832(b)(7).* If an insurance company issues or reinsures the risks related to a contract described in section 832(b)(7), the company may report gross premiums written for the contract in the manner required by sections 803 and 811(a) for life insurance companies. An insurance company may adopt this method of reporting premiums on contracts described in section 832(b)(7) only if the company also determines the deduction for premium acquisition costs for the contract in accordance with section 811(a), as adjusted by the amount required to be taken into account under section 848 in connection with the net premiums of the contract. A company that adopts this method of reporting premiums for a contract described in section 832(b)(7) must use the method for all of its contracts described in that section.

(vii) *Limitation on deduction of premium acquisition expenses*. An insurance company's deduction for premium acquisition expenses (for example, commissions, state premium taxes, overhead reimbursements to agents or brokers, and other similar amounts) related to an insurance contract is within the limitation of this paragraph (a)(5)(vii) if–

(A) The ratio obtained by dividing the sum of the company's deduction for premium acquisition expenses related to the insurance contract for the taxable year and previous taxable years by the total premium acquisition expenses attributable to the insurance contract; does not exceed

(B) The ratio obtained by dividing the sum of the amounts included in gross premiums written with regard to the insurance contract for the taxable year and previous taxable years by the total gross premium written for the insurance contract.

(viii) *Change in method of reporting gross premiums.* An insurance company that adopts a method of accounting for gross premiums written and premium acquisition expenses described in paragraph (a)(5)(iii), (iv), (v), or (vi) of this section must continue to use the method to report gross premiums written and premium acquisition expenses unless the company obtains the consent of the Commissioner to change to a different method under section 446(e) and §1.446–1(e).

(6) *Return premiums*—(i) *In general*. An insurance company's liability for return premiums includes amounts previously included in an insurance company's gross premiums written, which are refundable to a policyholder or ceding company, provided that the amounts are fixed by the insurance contract and do not depend on the experience of the insurance company or the discretion of its management.

(ii) *Items included*. Return premiums include amounts–

(A) Which were previously paid and become refundable due to policy cancellations or decreases in risk exposure during the effective period of an insurance contract;

(B) Which reflect the unearned portion of unpaid premiums for an insurance contract that is canceled or for which there is a decrease in risk exposure during its effective period; or

(C) Which are either previously paid and refundable or which reflect the unearned portion of unpaid premiums for an insurance contract, arising from the redetermination of a premium due to correction of posting or other similar errors.

(7) *Method of reporting return premiums*. An insurance company reports the liability for a return premium resulting from the cancellation of an insurance contract for the taxable year in which the contract is canceled. An insurance company reports the liability for a return premium attributable to a reduction in risk exposure under an insurance contract for the taxable year in which the reduction in risk exposure occurs.

(8) *Unearned premiums*—(i) *In general*. The unearned premium for a contract, other than a contract described in section 816(b)(1)(B), generally is the portion of the gross premium written that is attributable to future insurance coverage during the effective period of the insurance contract. However, unearned premiums held by an insurance company with regard to the net value of risks reinsured with other solvent companies (whether or not authorized to conduct business under state law) are subtracted from the company's unearned premiums. Unearned premiums also do not include any additional liability established by the insurance company on its annual statement to cover premium deficiencies. Unearned premiums do not include an insurance company's estimate of its liability for amounts to be paid or credited to a customer with regard to the expired portion of a retrospectively rated contract (retro credits). An insurance company's estimate of additional amounts payable by its customers with regard to the expired portion of a retrospectively rated contract (retro debits) cannot be subtracted from unearned premiums.

(ii) *Special rules for unearned premiums*. For purposes of computing "premiums earned on insurance contracts during the taxable year" under section 832(b)(4), the amount of unearned premiums includes—

(A) Life insurance reserves (as defined in section 816(b), but computed in accordance with section 807(d) and sections 811(c) and (d));

(B) In the case of a mutual flood or fire insurance company described in section 832(b)(1)(D) (with respect to contracts described in that section), the amount of unabsorbed premium deposits that the company would be obligated to return to its policyholders at the close of the taxable year if all its insurance contracts were terminated at that time;

(C) In the case of an interinsurer or reciprocal underwriter that reports unearned premiums on its annual statement net of premium acquisition expenses, the unearned premiums on the company's annual statement increased by the portion of premium acquisition expenses allocable to those unearned premiums; and

(D) In the case of a title insurance company, its discounted unearned premiums (computed in accordance with section 832(b)(8)).

(9) *Method of determining unearned premiums*. If the risk of loss under an insurance contract does not vary significantly over the effective period of the contract, the unearned premium attributable to the unexpired portion of the effective period of the contract is determined on a pro rata basis. If the risk of loss varies significantly over the effective period of the contract, the insurance company may consider the pattern and incidence of the risk in determining the portion of the gross premium that is attributable to the unexpired portion of the effective period of the contract. An insurance company that uses a method of computing unearned premiums other than the pro rata method must maintain sufficient information to demonstrate that its method of computing unearned premiums accurately reflects the pattern and incidence of the risk for the insurance contract.

(10) *Examples*. The provisions of paragraphs (a)(4) through (a)(9) of this section are illustrated by the following examples:

Example 1. (i) IC is a non-life insurance company which, pursuant to section 843, files its returns on a calendar year basis. IC writes a casualty insurance contract that provides insurance coverage for a one-year period beginning on July 1, 2000 and ending on June 30, 2001. IC charges a $500 premium for the insurance contract, which may be paid either in full by the effective date of the contract or in quarterly installments over the contract's one year term. The policyholder selects the installment payment option. As of December 31, 2000, IC collected $250 of installment premiums for the contract.

(ii) The effective period of the insurance contract begins on July 1, 2000 and ends on June 30, 2001. For the taxable year ending December 31, 2000, IC includes the $500 gross premium, based on the effective period of the contract, in gross premiums written under section 832(b)(4)(A). IC's unearned premium with respect to the contract was $250 as of December 31, 2000. Pursuant to section 832(b)(4)(B), to determine its premiums earned, IC deducts $200 ($250 x .8) for the insurance contract at the end of the taxable year.

Example 2. (i) The facts are the same as *Example 1*, except that the insurance contract has a stated term of 5 years. On each contract anniversary date, IC may adjust the rate charged for the insurance coverage for the succeeding 12 month period. The amount of the adjustment in the charge for insurance coverage is not substantially limited under the insurance contract.

(ii) Under paragraph (a)(5)(i) of this section, IC is required to report gross premiums written for the insurance contract based on the effective period for the contract. The effective period of the insurance contract is the period for which a rate for insurance coverage is guaranteed in the contract. Although the insurance contract issued by IC has a stated term of 5 years, a rate for insurance coverage is guaranteed only for a period of 12 months beginning with the contract's effective date and each anniversary date thereafter. Thus, for the taxable year ending December 31, 2000, IC includes the $500 gross premium for the 12 month period beginning with the contract's effective date in gross premiums written. IC's unearned premium with respect to the contract was $250 as of December 31, 2000. Pursuant to section 832(b)(4)(B), to determine its premiums earned, IC deducts $200 ($250 x .8) for the insurance contract at the end of the taxable year.

Example 3. (i) The facts are the same as *Example 1*, except that coverage under the insurance contract begins on January 1, 2001 and ends on December 31, 2001. On December 15, 2000, IC collects the first $125 premium installment on the insurance contract. For the taxable year ended December 31, 2000, IC deducts $20 of premium acquisition expenses related to the insurance contract. IC's total premium acquisition expenses, based on the insurance contract's $500 gross premium, are $80.

(ii) Under paragraph (a)(5)(iii) of this section, IC may elect to report only the $125 advance premium (rather than the contract's $500 gross premium) in gross premiums written for the taxable year ended December 31, 2000, provided that IC's deduction for the premium acquisition expenses related to the insurance contract does not exceed the limitation in paragraph (a)(5)(vii). IC's deduction for premium acquisition expenses is within this limitation only if the ratio of the insurance contract's premium acquisition expenses deducted for the taxable year and any previous taxable year to the insurance contract's total premium acquisition expenses does not exceed the ratio of the amounts included in gross premiums written for the taxable year and any previous taxable year for the contract to the total gross premium written for the contract.

(iii) For the taxable year ended December 31, 2000, IC deducts $20 of premium acquisition expenses related to the insurance contract. This deduction represents 25% of the total premium acquisition expenses for the insurance contract ($20/$80 = 25%). This ratio does not exceed the ratio of the $125 advance premium to the insurance contract's $500 gross premium ($125/$500 = 25%). Therefore, under paragraph (a)(5)(iii) of this section, IC may elect to report only the $125 advance premium (rather than the $500 gross premium) in gross premiums written for the taxable year ending December 31, 2000. IC reports the balance of the gross premium for the insurance contract ($375) and deducts the remaining premium acquisition expenses ($60) for the insurance contract in the taxable year ending December 31, 2001.

Example 4. (i) The facts are the same as *Example 3*, except that for the taxable year ending December 31, 2000, IC deducts $60 of premium acquisition expenses related to the insurance contract.

(ii) For the taxable year ended December 31, 2000, IC deducted 75% of total premium acquisition expenses for the insurance contract ($60/$80 = 75%). This ratio exceeds the ratio of the $125 advance premium to the $500 gross premium ($125/$500 = 25%). Because IC's deduction for premium acquisition expenses allocable to the contract exceeds the limitation in paragraph (a)(5)(vii) of this section, paragraph (a)(5)(i) of this section requires IC to report the $500 gross premium in gross premiums written for the taxable year ending December 31, 2000. IC's unearned premium with respect to the contract was $500 as of December 31, 2000. Pursuant to section 832(b)(4)(B), to determine its premiums earned, IC deducts $400 ($500 x .8) for the insurance contract at the end of the taxable year.

Example 5. (i) IC is a non-life insurance company which, pursuant to section 843, files its returns on a calendar year basis. On August 1, 2000, IC issues a one-year cancellable accident and health insurance policy to X, a corporation with 80 covered employees. The gross premium written for the insurance contract is $320,000. Premiums are payable in monthly installments. As of December 31, 2000, IC has collected $150,000 of installment premiums from X. For the taxable year ended December 31, 2000, IC has paid or incurred $21,000 of premium acquisition expenses related to the insurance contract. IC's total premium acquisition expenses for the insurance contract, based on the $320,000 gross premium, are $48,000.

(ii) Under paragraph (a)(5)(iv) of this section, IC may elect to report only the $150,000 of installment premiums (rather than the $320,000 estimated gross premium) in gross premiums written for the taxable year ended December 31, 2000, provided that its deduction for premium acquisition expenses allocable to the insurance contract does not exceed the limitation in paragraph (a)(5)(vii). For the taxable year ended December 31, 2000, IC deducts $21,000 of premium acquisition expenses related to the insurance contract, or 43.75% of total premium acquisition expenses for the insurance contract ($21,000/$48,000 = 43.75%). This ratio does not exceed the ratio of installment premiums to the gross premium for the contract ($150,000/$320,000 = 46.9%). Therefore, under paragraph (a)(5)(iv) of this section, IC may elect to report only $150,000 of installment premiums for the insurance contract (rather than $320,000 of gross premium) in gross premiums written for the taxable year ending December 31, 2000.

Example 6. (i) IC is a non-life insurance company which, pursuant to section 843, files its returns on a calendar year basis. On July 1, 2000, IC issues a one-year workers' compensation policy to X, an employer. The gross premium for the policy is determined by applying a monthly rate of $25 to each of X's employees. This rate is guaranteed for a period of 12 months, beginning with the effective date of the contract. On July 1, 2000, X has 1,050 employees. Based on the assumption that X's payroll would remain constant during the effective period of the contract, IC determines an estimated gross premium for the contract of $315,000 (1,050 x $25 x 12 = $315,000). The estimated gross premium is payable by X in equal monthly installments. At the end of each calendar quarter, the premiums payable under the contract are adjusted based on an audit of X's actual payroll during the preceding three months of coverage.

(ii) Due to an expansion of X's business in 2000, the actual number of employees covered under the contract during each month of the period between

July 1, 2000 and December 31, 2000 is 1,050 (July), 1,050 (August), 1,050 (September), 1,200 (October), 1,200 (November), and 1,200 (December). The increase in the number of employees during the year is not attributable to a temporary or seasonal variation in X's business activities and is expected to continue for the remainder of the effective period of the contract.

(iii) Under paragraph(a)(5)(i) of this section, IC is required to report gross premiums written for the insurance contract based the effective period of the contract. The effective period of X's contract is based on the 12 month period for which IC has guaranteed rates for insurance coverage. Under paragraph (a)(5)(ii), IC must also report the additional premiums resulting from the change in risk exposure under the contract for the taxable year in which the change in such exposure occurs. Unless the change in risk exposure is of temporary duration, the additional gross premiums are included in gross premiums written for the remainder of the effective period of the contract. Thus, for the taxable year ending December 31, 2000, IC reports gross premiums written of $348,750 with respect to the workers' compensation contract issued to X, consisting of the sum of the initial gross premium for the contract ($315,000) plus the additional gross premium attributable to the 150 employees added to X's payroll who will be covered during the last nine months of the contract's effective period (150 x $25 (monthly premium) x 9 = $33,750). IC's unearned premium with respect to the contract was $180,000 as of December 31, 2000, which consists of the sum of the remaining portion of the original gross premium ($315,000 x 6/12 = $157,500), plus the additional premiums resulting from the change in risk exposure ($33,750 x 6/9 = $22,500) that are allocable to the remaining six months of the contract's effective period. Pursuant to section 832(b)(4)(B), to determine its premiums earned, IC deducts $144,000 ($180,000 x .8) for the insurance contract at the end of the taxable year.

Example 7. (i) The facts are the same as *Example 6*, except that the increase in the number of X's employees for the period ending December 31, 2000 is attributable to a seasonal variation in X's business activity.

(ii) Under paragraph (a)(5)(ii) of this section, for the taxable year ending December 31, 2000, IC reports gross premiums written of $326,500, consisting of the sum of the initial gross premium for the contract ($315,000) plus the additional premium attributable to the temporary increase in risk exposure during the taxable year (150 x $25 x 3 = $11,250). The unearned premium that is allocable to the remaining six months of the effective period of the contract is $157,500. Pursuant to section 832(b)(4)(B), to determine its premiums earned, IC deducts $126,000 ($157,500 x .8) for the insurance contract at the end of the taxable year.

Example 8. (i) IC, a non-life insurance company, issues a noncancellable accident and health insurance contract (other than a qualified long-term care insurance contract, as defined in section 7702B(b)) to A, an individual, on July 1, 2000. The contract has an entry-age annual premium of $2,400, which is payable by A in equal monthly installments of $200 on the first day of each month of coverage. IC incurs agents' commissions, premium taxes, and other premium acquisition expenses equal to 10% of the gross premiums received for the contract. As of December 31, 2000, IC has collected $1,200 of installment premiums for the contract.

(ii) A noncancellable accident and health insurance contract is a contract described in section 832(b)(7). Thus, under paragraph (a)(5)(vi) of this section, IC may report gross premiums written in the manner required for life insurance companies under sections 803 and 811. Accordingly, for the taxable year ending December 31, 2000, IC may report gross premiums written of $1,200, based on the premiums actually received on the contract. Pursuant to section (a)(5)(vi) of this section, IC deducts a total of $28 of premium acquisition costs for the contract, based on the difference between the acquisition costs actually paid or incurred under section 811(a) ($1,200 x .10 = $120) and the amount required to taken into account under section 848 in connection with the net premiums for the contract ($1,200 x .077 = $92).

(iii) Under paragraph (a)(8)(ii)(A) of this section, IC includes the amount of life insurance reserves (as defined in section 816(b), but computed in accordance with section 807(d) and sections 811(c) and (d)) in unearned premiums under section 832(b)(4)(B). Section 807(d)(3)(A)(iii) requires IC to use a two-year preliminary term method to compute the amount of life insurance reserves for a noncancellable accident and health insurance contract (other than a qualified long-term care contract). Under this tax reserve method, no portion of the $1,200 gross premium received by IC for A's contract is allocable to future insurance coverage. Accordingly, for the taxable year ending December 31, 2000, no life insurance reserves are included in IC's unearned premiums under section 832(b)(4)(B) with respect to the contract.

Example 9. (i) IC, a non-life insurance company, issues an insurance contract with a twelve month effective period for $1,200 on December 1, 2000. Immediately thereafter, IC reinsures 90% of its liability under the insurance contract for $900 with IC-2, an unrelated and solvent insurance company. On December 31, 2000, IC-2 has an $825 unearned premium with respect to the reinsurance contract it issued to IC. In computing its earned premiums, pursuant to section 832(b)(4)(B), IC-2 deducts $660 of unearned premiums ($825 x .8) with respect to the reinsurance contract.

(ii) Under paragraph (a)(8)(i) of this section, unearned premiums held by an insurance company with regard to the net value of the risks reinsured in other solvent companies are deducted from the ceding company's unearned premiums taken into account for purposes of section 832(b)(4)(B). If IC had not reinsured 90% of its risks, IC's unearned premium for the insurance contract would have been $1,100 ($1,200 x 11/12) and IC would have deducted $880 ($1,100 x .8) of unearned premiums with respect to such contract. However, because IC reinsured 90% of its risks under the contract with IC-2, as of December 31, 2000, the net value of the risks retained by IC for the remaining 11 months of the effective period of the contract is $110 ($1,100 - $990). For the taxable year ending December 31, 2000, IC includes the $1,200 gross premium in its gross premiums written and deducts the $900 reinsurance premium paid to IC-2 under section 832(b)(4)(A). Pursuant to section 832(b)(4)(B), to determine its premiums earned, IC deducts $88 ($110 x .8) for the insurance contract at the end of the taxable year.

(11) *Change in method of accounting*—(i) *In general*. A change in the method of determining premiums earned to comply with the provisions of paragraphs (a)(3) through (a)(10) of this section is a change in method of accounting for which the consent of the Commissioner is required under section 446(e) and §1.446–1(e).

(ii) *Application*. For the first taxable year beginning after December 31, 1999, a taxpayer is granted consent of the Commissioner to change its method of determining premiums earned to comply with the provisions of paragraphs (a)(3) through (a)(10) of this section. A taxpayer changing its method of accounting in accordance with this section must follow the automatic change in accounting provisions of Rev. Proc. 99–49, 1999–52 I.R.B. 725 (see §601.601(d)(2) of this chapter), except that–

(A) The scope limitations in section 4.02 of Rev.

Proc. 99–49 shall not apply;

(B) The timely duplicate filing requirement in section 6.02(2) of Rev. Proc. 99–49 shall not apply; and

(C) If the method of accounting for determining premiums earned is an issue under consideration within the meaning of section 3.09 of Rev. Proc. 99–49 as of January 5, 2000, then section 7.01 of Rev. Proc. 99–49 shall not apply.

(12) *Effective date*. Paragraphs (a)(3) through (a)(11) of this section are applicable with respect to the determination of premiums earned for taxable years beginning after December 31, 1999.

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Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved December 23, 1999.

Jonathan Talisman,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on January 5, 2000, 8:45 a.m., and published in the issue of the Federal Register for January 6, 2000, 65 F.R. 701)

Section 1441.—Withholding of Tax on Nonresident Aliens

26 CFR 1.1441–10: Recharacterizing financing arrangements involving fast-pay stock.

See T.D. 8853 on page 377

Section 4251.—Imposition of Tax

26 CFR 49.4251–4: Prepaid telephone cards.

T.D. 8855

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 49 and 602

Communications Excise Tax; Prepaid Telephone Cards

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the application of the communications excise tax to prepaid telephone cards (PTCs). The regulations implement certain changes made by the Taxpayer Relief Act of 1997. They affect certain telecommunications carriers, resellers, and purchasers of PTCs.

DATES: *Effective Dates*: These regulations are effective January 7, 2000.

Applicability Dates: For the date of applicability, see §49.4251–4(f).

FOR FURTHER INFORMATION CONTACT: Bernard H. Weberman (202) 622-3130 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1628. Responses to this collection of information are required to obtain a tax benefit.

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

The estimated average burden per respondent is 0.25 hour. The estimated average annual burden per recordkeeper is 1.2 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224, and to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

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

Background

On December 17, 1998, a notice of proposed rulemaking (REG–118620–97, 1999–9 I.R.B. 46) was published in the **Federal Register** (63 FR 69585). Three written comments were received but no hearing was held because no requests to speak were received. The proposed regulations are adopted as revised by this Treasury decision.

The principal concerns of the commenters related to the rules for determining the face amount of an untariffed unit card transferred to a transferee reseller. The proposed regulations provide that the face amount can be determined by reference to actual retail sales by the carrier, by reference to the price at which the PTC is sold to the transferee reseller, or by reference to the minutes of domestic communications service provided by the PTC. One commenter requested additional explanation of the basis for these rules. Another suggested that in many situations, particularly in the case of high-denomination (for example, multi-hour) PTCs, none of the proposed methods for determining the face amount will accurately reflect the true retail value of the PTC. This commenter also suggested that if a carrier can substantiate the actual retail price of a PTC it should have the option of treating that price as the face amount.

The final regulations modify the rules relating to untariffed unit cards in three respects. First, they clarify that when the face amount is determined by reference to actual retail sales by the carrier, the retail sales taken into account are sales of PTCs that provide the same type and amount of communications service. The final regulations also modify the markup percentage used when the face amount is determined by reference to the price at which the carrier sells the PTC to the transferee reseller. The proposed regulations apply a markup of 65 percent. Under the final regulations, the markup is reduced to 35 percent to correspond more closely to markups in the retail sector generally. Lastly, the final regulations modify the rule for determining the face amount by reference to the minutes of domestic communications service provided by the PTC. The proposed regulations provide that the face amount may be determined by multiplying the number of minutes by a flat $0.30 per-minute rate. As noted in the comments, however, a high-denomination PTC generally provides lower cost service on a per-minute basis than an otherwise equivalent low- denomination PTC. Accordingly, the final regulations provide that the per-minute rate used to determine face amount is reduced from $0.30 per minute to $0.20 per minute as the amount of domestic communications service provided by a PTC increases from 40 to 240 minutes.

For sales to transferee resellers, the final regulations do not permit carriers that can substantiate the actual retail price of a PTC to use that price as the face amount. The IRS and Treasury Department believe that the modifications to the methods for determining face amount address concerns that the prescribed methods may overstate the face amount. Moreover, a system based on the actual retail sale price when the retail sale is made by a person other than the carrier could prove very difficult for the IRS to administer because of the difficulty of verifying the prices at which PTCs are sold by large numbers of small retailers that may have acquired the PTCs indirectly through one or more transferee resellers.

Commenters also suggested that state and local taxes should be excluded from the face amount even if they are not separately stated. In general, the comments propose an exclusion based on the average amount of state and local taxes imposed on the carrier's PTCs. These suggestions were not adopted. Section 4254(c) excludes from the section 4251 tax base only those state and local taxes that are imposed on the sale or furnishing of communications services and that are separately stated in the bill. A tax that is not separately stated (because, for example, it is imposed after the taxable sale of the PTC and its amount is not known at the time of the sale) does not qualify for this exclusion.

The regulations apply to PTCs transferred by carriers in calendar quarters beginning after January 7, 2000. Carriers and transferees may, however, rely on the regulations in determining the tax treatment of PTCs transferred in quarters beginning on or before that date.

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 on the fact that the time required to prepare or retain the notification is minimal and will not have a significant impact on those small entities that are required to provide notification. Furthermore, notification is provided only once to each seller. Accordingly, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Bernard H. Weberman, Office of Assistant Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 49 and 602 are amended as follows:

PART 49—FACILITIES AND SERVICES EXCISE TAXES

Paragraph 1. The authority citation for part 49 is revised to read as follows:

Authority: 26 U.S.C. 7805.

Section 49.4251–4 also issued under 26 U.S.C. 4251(d).

Par. 2. Section 49.4251–4 is added to read as follows:

§49.4251–4 Prepaid telephone cards.

(a) *In general*. In the case of communications services acquired by means of a prepaid telephone card (PTC), the face amount of the PTC is treated as an amount paid for communications services and that amount is treated as paid when the PTC is transferred by any carrier to any person that is not a carrier. This section provides rules for the application of the section 4251 tax to PTCs.

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

Carrier means a telecommunications carrier as defined in 47 U.S.C. 153.

Comparable PTC means a currently available dollar card or tariffed unit card (other than a PTC transferred in bulk or under special circumstances, such as for promotional purposes) that provides the same type and amount of communications services as the PTC to which it is being compared.

Dollar card means a PTC the value of which is designated by the carrier in dollars (even if also designated in units of service), provided that the designated value is not less than the amount for which the PTC is expected to be sold to a holder.

Holder means a person that purchases other than for resale.

Prepaid telephone card (PTC) means a card or similar arrangement that permits its holder to obtain a fixed amount of communications services by means of a code (such as a personal identification number (PIN)) or other access device provided by the carrier and to pay for those services in advance.

Tariff means a schedule of rates and regulations filed by a carrier with the Federal Communications Commission.

Tariffed unit card means a unit card that is transferred by a carrier—

(1) To a holder at a price that does not exceed the designated number of units on the PTC multiplied by the carrier's tariffed price per unit; or

(2) To a transferee reseller subject to a contractual or other arrangement under which the price at which the PTC is sold to a holder will not exceed the designated number of units on the PTC multiplied by the carrier's tariffed price per unit.

Transferee means the first person that is not a carrier to whom a PTC is transferred by a carrier.

Transferee reseller means a transferee that purchases a PTC for resale.

Unit card means a PTC other than a dollar card.

Untariffed unit card means a unit card other than a tariffed unit card.

(c) *Determination of face amount*—(1) *Dollar card*. The face amount of a dollar card is the designated dollar value.

(2) *Tariffed unit card*. The face amount of a tariffed unit card is the designated number of units on the PTC multiplied by the tariffed price per unit.

(3) *Untariffed unit card*—(i) *Transfer to holder*. The face amount of an untariffed unit card transferred by a carrier to a holder is the amount for which the carrier sells the PTC to the holder.

(ii) *Transfer to transferee reseller*—(A) *In general*. The face amount of an untariffed unit card transferred by a carrier to a transferee reseller is at the option of the carrier—

(*1*) The highest amount for which the carrier sells a PTC that provides the same type and amount of communications services to a holder that ordinarily would not be expected to buy more than one such PTC at a time (if the carrier makes such sales on a regular and arm's-length basis) or the face amount of a comparable PTC (if the carrier does not make such sales on a regular and arm's-length basis);

(*2*) 135 percent of the amount for which the carrier sells the PTC to the transferee reseller (including in that amount, in addition to any sum certain fixed at the time of the sale, any contingent amount per unit multiplied by the designated number of units on the PTC); or

(*3*) If the PTC is of a type that ordinarily is used entirely for domestic communications service, the maximum number of minutes of domestic communications service on the PTC multiplied by the applicable rate.

(B) *Applicable rate*. The applicable rate under paragraph (c)(3)(ii)(A)(*3*) of this section with respect to a PTC is $0.30 reduced (but not below $0.20) by $0.01 for each full 20 minutes by which the maximum number of minutes of domestic communications service on the PTC exceeds 40 minutes.

(C) *Sales not at arm's length*. In the case of a transfer of an untariffed unit card by a carrier to a transferee reseller otherwise than through an arm's-length transaction, the fair market retail value of the PTC shall be substituted for the amount determined in paragraph (c)(3)(ii)(A)(2) of this section.

(4) *Exclusion.* The amount of any state or local tax imposed on the furnishing or sale of communications services that is separately stated in the bill or on the face of the PTC and the amount of any section 4251 tax separately stated in the bill or on the face of the PTC are disregarded in determining, for purposes of this paragraph (c), the amount for which a PTC is sold.

(d) *Liability for tax*—(1) *In general.* Under section 4251(d), the section 4251(a) tax is imposed on the transfer of a PTC by a carrier to a transferee. The person liable for the tax is the transferee. Except as provided in paragraph (d)(2) of this section, the person responsible for collecting the tax is the carrier transferring the PTC to the transferee. If a holder purchases a PTC from a transferee reseller, the amount the holder pays for the PTC is not treated as an amount paid for communications services and thus tax is not imposed on that payment.

(2) *Effect of statement that purchaser is a carrier*—(i) *On transferor*. A carrier that transfers a PTC to a purchaser is not responsible for collecting the tax if, at the time of transfer, the transferor carrier has received written notification from the purchaser that the purchaser is a carrier, and the transferor has no reason to believe otherwise. The notification to be provided by the purchaser is a statement, signed under penalties of perjury by a person with authority to bind the purchaser, that the purchaser is a carrier (as defined in paragraph (b) of this section). The statement is not required to take any particular form.

(ii) *On purchaser*. If a purchaser that is not a carrier provides the notification described in paragraph (d)(2)(i) of this section to the carrier that transfers a PTC, the purchaser remains liable for the tax imposed on the transfer of the PTC.

(3) *Exemptions*. Any exemptions available under section 4253 apply to the transfer of a PTC from a carrier to a holder. Section 4253 does not apply to the transfer of a PTC from a carrier to a transferee reseller.

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

Example 1. Unit card; sold to individual. (i) On May 1, 2000, A, a carrier, sells a card it calls a prepaid telephone card at A's retail store to P, an individual, for P's use in making telephone calls. A provides P with a PIN. The value of the card is not denominated in dollars, but the face of the card is marked 30 minutes. The sales price is $9. A tariff has not been filed for the minutes on the card. The toll telephone service acquired by purchasing the card will be obtained by entering the PIN and the telephone number to be called.

(ii) Because P purchased from a carrier other than for resale, P is a holder. The card provides its holder, P, with a fixed amount of communications services (30 minutes of toll telephone service) to be obtained by means of a PIN, for which P pays in advance of obtaining service; therefore, the card is a PTC. Because the value of the PTC is not designated in dollars and a tariff has not been filed for the minutes on the PTC, the PTC is an untariffed unit card. Because it is transferred by the carrier to the holder, the face amount is the sales price ($9).

(iii) The card is a PTC; thus, under section 4251(d), the face amount is treated as an amount paid for communications services and that amount is treated as paid when the PTC is transferred from A to P. Accordingly, at the time of transfer, P is liable for the 3 percent tax imposed by section 4251(a). The amount of the tax is $0.27 (3% x the $9 face amount). Thus, the total paid by P is $9.27, the $9 sales price plus $0.27 tax. A is responsible for collecting the tax from P.

Example 2. Unit card; given to individual. (i) The facts are the same as in *Example 1*, except that instead of selling a card, A gives a 30 minute card to P.

(ii) Although the card provides P with a fixed amount of communications services (30 minutes of toll telephone service) to be obtained by means of a PIN, P does not pay for the service. Therefore, the card is not a PTC, even though it is called a prepaid telephone card by A.

(iii) Because the card is not a PTC, section 4251(d) does not apply. Furthermore, no tax is imposed by section 4251(a) because no amount is paid for the communications services.

Example 3. Unit card; adding value. (i) After using the card described in *Example 2*, P arranges with A by telephone to have 30 minutes of toll telephone service added to the card. The sales price is $9. P is told to continue using the PIN provided with the card.

(ii) Because P purchased from a carrier other than for resale, P is a holder. The arrangement provides its holder, P, with a fixed amount of communications services (30 minutes of toll telephone service) to be obtained by means of a PIN, for which P pays in advance of obtaining service; therefore, the arrangement is a PTC. Because the value of the PTC is not designated in dollars and a tariff has not been filed for the minutes on the PTC, the PTC is an untariffed unit card. Because it is transferred by the carrier to the holder, the face amount is the sales price ($9).

(iii) The arrangement is a PTC; thus, under section 4251(d), the face amount is treated as an amount paid for communications services and that amount is treated as paid when the PTC is transferred from A to P. Accordingly, at the time of transfer, P is liable for the 3 percent tax imposed by section 4251(a). The amount of the tax is $0.27 (3% x the $9 face amount). Thus, the total paid by P is $9.27, the $9 sales price plus $0.27 tax. A is responsible for collecting the tax from P.

Example 4. Dollar card; sold other than for resale. (i) On May 1, 2000, B, a carrier, sells 100,000 cards it calls prepaid telephone cards to Q, an auto dealer, for $50,000. Q will give away a card to each person that visits Q's dealership. B provides Q with a PIN for each card. The face of each card is marked $3. The toll telephone service acquired by purchasing the card will be obtained by entering the PIN and the telephone number to be called.

(ii) Because Q purchased from a carrier other than for resale, Q is a holder. Each card provides its holder, Q, with a fixed amount of communications services ($3 of toll telephone service) to be obtained by means of a PIN, for which Q pays in advance of obtaining service; therefore, each card is a PTC even though Q's visitors do not pay for the cards. The value of each PTC is designated in dollars; therefore, each PTC is a dollar card. Because the PTC is a dollar card, the face amount is the designated dollar value ($3).

(iii) The cards are PTCs; thus, under section 4251(d), the face amount is treated as an amount paid for communications services and that amount is treated as paid when the PTCs are transferred from B to Q. Accordingly, at the time of transfer, Q is liable for the 3 percent tax imposed by section 4251(a). The amount of the tax is $9,000 (3% x the $3 face amount x 100,000 PTCs). Thus, the total paid by Q is $59,000, the $50,000 sales price plus $9,000 tax. B is responsible for collecting the tax from Q.

Example 5. Tariffed unit card; sold to transferee reseller. (i) On May 1, 2000, C, a carrier, sells 1,000 cards it calls prepaid telephone cards to R, a convenience store owner, for $7,000. C provides R with a PIN for each card. The value of the cards is not denominated in dollars, but the face of each card is marked 30 minutes and a tariff of $0.33 per minute has been filed for the minutes on each card. R agrees that it will sell the cards to individuals for their own use and at a price that does not exceed $0.33 per minute. R actually sells the cards for $9 each (that is, at a price equivalent to $0.30 per minute). The toll telephone service acquired by purchasing the card will be obtained by entering the PIN and the telephone number to be called.

(ii) Because R purchased from a carrier for resale, R is a transferee reseller. Because R's customers will purchase other than for resale, they will be holders. Each card sold by R provides its holder, R's customer, with a fixed amount of communications services (30 minutes of toll telephone service) to be obtained by means of a PIN provided by the carrier, for which R's customer pays in advance of obtaining service; therefore, each card is a PTC. Because the value of each PTC is not designated in dollars and C sells the PTCs to R subject to an arrangement under which the price at which the PTCs are sold to holders will not exceed the designated number of minutes on the PTC multiplied by C's tariffed price per minute, each PTC is a tariffed unit card. Because the PTCs are tariffed unit cards, the face amount of each PTC is $9.90, the designated number of minutes on the PTC multiplied by the tariffed price per minute (30 x $0.33), even though the retail sale price of each card is $9.

(iii) The cards are PTCs; thus, under section 4251(d), the face amount is treated as an amount paid for communications services and that amount is treated as paid when the PTC is transferred from C to R. Accordingly, at the time of transfer, R is liable for the 3 percent tax imposed by section 4251(a). The amount of the tax is $297 (3% x the $9.90 face amount x 1,000 PTCs). Thus, the total paid by R is $7,297, the $7,000 sales price plus $297 tax. C is responsible for collecting the tax from R.

Example 6. Unit card; sold to transferee reseller. (i) On May 1, 2000, D, a carrier, sells 10,000 cards it calls prepaid telephone cards to S, a convenience store owner, for $60,000. D provides S with a PIN for each card. The value of the cards is not denominated in dollars, but the face of each card is marked 30 minutes. A tariff has not been filed for the minutes on each card. S will sell the cards to individuals for their own use for $9 each. D also sells a card that provides 30 minutes of the same type of communications service at its retail store for $9. The toll telephone service acquired by purchasing the card will be obtained by entering the PIN and the telephone number to be called.

(ii) Because S purchased from a carrier for resale, S is a transferee reseller. Because S's customers will purchase other than for resale, they will be holders. Each card sold by S provides its holder, S's customer, with a fixed amount of communications services (30 minutes of toll telephone service) to be obtained by means of a PIN provided by the carrier, for which S's customer pays in advance of obtaining service; therefore, each card is a PTC. Because the value of each PTC is not designated in dollars and a tariff has not been filed for the minutes on the PTC, each PTC is an untariffed unit card.

(iii) The PTCs are untariffed unit cards transferred by the carrier to a transferee reseller. Thus, the face amount is determined under paragraph (c)(3)(ii) of this section, which permits D to choose from three alternative methods. Under paragraph (c)(3)(ii)(A)(1) of this section, the face amount of each PTC would be $9, the highest amount for which D sells to holders purchasing a single PTC. Alternatively, under paragraph (c)(3)(ii)(A)(2) of this section, the face amount of each PTC would be $8.10, computed as follows: 135% x the $60,000 sales price â 10,000 PTCs. Finally, under paragraph (c)(3)(ii)(A)(3) of this section (assuming the PTCs are of a type that ordinarily is used entirely for domestic communications services), the face amount of each PTC would be $9 ($0.30 x 30 minutes).

(iv) The cards are PTCs; thus, under section 4251(d), the face amount is treated as an amount paid for communications services and that amount is treated as paid when the PTCs are transferred from D to S. Accordingly, at the time of transfer, S is liable for the 3 percent tax imposed by section 4251(a). Assuming that D chooses to determine the face amount as provided in paragraph (c)(3)(ii)(A)(2) of this section, the amount of the tax is $2,430 (3% x the $8.10 face amount x 10,000 PTCs). Thus, the total paid by S is $62,430, the $60,000 sales price plus $2,430 tax. D is responsible for collecting the tax from S.

Example 7. Transfer of card that is not a PTC. (i) On May 1, 2000, E, a carrier, provides a telephone card to T, an individual, for T's use in making telephone calls. E provides T with a PIN. The card provides access to an unlimited amount of communications services. E charges T $0.25 per minute of service, and bills T monthly for services used. The communications services acquired by using the card will be obtained by entering the PIN and the telephone number to be called.

(ii) Although the communications services will be obtained by means of a PIN, T does not receive a fixed amount of communications services. Also, T cannot pay in advance since the amount of T's payment obligation depends upon the number of minutes used. Therefore, the card is not a PTC.

(iii) Because the card is not a PTC, section 4251(d) does not apply. However, the 3 percent tax imposed by section 4251(a) applies to the amounts paid by T to E for the communications services. Accordingly, at the time an amount is paid for communications services, T is liable for tax. E is responsible for collecting the tax from T.

(f) *Effective date*. This section is applicable with respect to PTCs transferred by a carrier on or after the first day of the first calendar quarter beginning after January 7, 2000.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

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

Authority: 26 U.S.C. 7805.

Par. 4. In §602.101, paragraph (b) is amended by adding an entry in numerical order to the table to read as follows:

§602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
49.4251–4(d)(2)	1545-1628
* * * * *	

John M. Dalrymple,
Acting Deputy Commissioner of Internal Revenue.

Approved December 13, 1999.

Jonathan Talisman,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on January 6, 2000, 8:45 a.m., and published in the issue of the Federal Register for January 7, 2000, 65 F.R. 1056)

Section 7701.—Definitions

26 CFR 1.7701(l)–3: Recharacterizing financing arrangements involving fast-pay stock.

T.D. 8853

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

Recharacterizing Financing Arrangements Involving Fast-pay Stock

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that recharacterize, for tax purposes, financing arrangements involving fast-pay stock. The regulations are necessary to prevent taxpayers from using fast-pay stock to achieve inappropriate tax avoidance. The regulations affect corporations that issue fast-pay stock, holders of fast-pay stock, and other shareholders that may claim tax benefits purported to result from arrangements involving fast-pay stock.

DATES: *Effective Date*: February 27, 1997.

Applicability Dates: For dates of applicability, see sections 1.1441–10(e) and 1.7701(l)–3(g) of these regulations.

FOR FURTHER INFORMATION CONTACT: Jonathan Zelnik, (202) 622-3920 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545-1642. Responses to this collection of information are mandatory.

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

The estimated average annual burden hours per respondent/recordkeeper: 1 hour.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224, and to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

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

Background

On February 27, 1997, the IRS issued Notice 97–21, 1997–1 C.B. 407, which relates to financing arrangements involving fast-pay stock. Among other things, the notice informed the public that the IRS and Treasury Department expected to issue regulations recharacterizing these arrangements to prevent tax avoidance. No comments were received in response to Notice 97–21.

On January 6, 1999, the IRS published in the **Federal Register** a notice of proposed rulemaking (REG–104072–97, 1999–11 I.R.B. 12 [64 F.R. 805]) providing rules for the recharacterization of certain fast-pay arrangements under section 7701(l) of the Internal Revenue Code. Because no one requested to speak at the public hearing, the hearing was canceled. Four written comments responding to the notice of proposed rulemaking were received. The comments addressed neither (1) the accuracy of the estimate of the collection of information burden nor (2) the accuracy of the IRS's understanding that the total number of entities engaging in transactions affected by these regulations is not substantial and most are not small entities within the meaning of the Regulatory Flexibility Act (5 U.S.C. chapter 6). After considering the comments, the proposed regulations are adopted as final regulations with some changes.

The preamble to the proposed regulations (64 FR 805) provides a detailed discussion of fast-pay arrangements and the proposed regulations.

SUMMARY OF COMMENTS AND CHANGES

In General

Two commentators were generally favorable to the proposed regulations. One considered them a reasonable attempt to address abusive transactions. The other viewed them as consistent with section 7701(l), but preferred, as a matter of tax policy, a legislative solution. One of these commentators also recommended narrowing the scope of the proposed regulations, asserting they might penalize shareholders who do not benefit from the fast-pay arrangement. Significantly, neither of these commentators recommended that the final regulations adopt a different approach, such as the one taken in Notice 97–21.

A third commentator criticized the proposed regulations as inconsistent with section 7701(l). This commentator viewed them as addressing not a conduit financing issue, but a tax accounting issue, namely, that the amount of dividend income under tax principles can exceed the economic income from the stock. Additionally, this commentator believed that regulations under section 7701(l) cannot operate if there is no back-to-back structure or if the corporation subject to recharacterization holds bona fide assets such as third-party debt. Finally, the commentator questioned whether the grant of regulatory authority under section 7701(l) permits recharacterizing transactions subject to other, comprehensive statutory rules such as the rules governing the transactions of RICs and REITs.

The IRS and Treasury Department have concluded that section 7701(l) authorizes recharacterization of any multiple-party financing transaction, including a fast-pay arrangement. The IRS and Treasury Department have also concluded (as did the other two commentators) that recharacterizing a fast-pay arrangement as an arrangement directly between the fast-pay shareholders and the benefited shareholders is consistent with the legislative mandate of section 7701(l). Thus, the final regulations retain the approach of the proposed regulations while making some changes to address other comments.

Definition of Fast-pay Stock

Under the proposed regulations, stock is fast-pay stock if it is structured so that dividends (as defined in section 316) paid by the corporation with respect to the stock are economically (in whole or in part) a return of the holder's investment (as opposed to only a return on the holder's investment). To determine if it is fast-pay stock, stock is examined when issued, and, for stock that is not fast-pay stock when issued, when there is a significant modification in the terms of the stock or the related agreements or a significant change in the relevant facts and circumstances.

Two commentators expressed concern about the interaction of section 302 with the definition of fast-pay stock and the duty to retest stock. In particular, the commentators asked whether stock that is not fast-pay stock when issued can become fast-pay stock solely because a redemption of the stock is treated as a dividend under section 302. This conversion is possible because section 302 treats certain redemptions as distributions of property to which section 301 applies rather than as distributions in exchange for stock.

The commentators gave different reasons why stock should not become fast-pay stock solely because a redemption is treated as a dividend. One reason was that section 302 and the provisions referring to it (for example, section 1059(e)) already recharacterize certain redemptions of stock, which indicates Congress has determined the appropriate tax treatment of these transactions. Another reason was that applying the fast-pay regulations to arrangements involving redemptions may have a chilling effect on common, non-abusive transactions. Finally, it was suggested that any changes affecting the application of section 302 should be accomplished by issuing new regulations under that statute.

The IRS and Treasury Department agree it is inappropriate to treat as a fast-pay arrangement every arrangement in which a redemption of stock produces dividend income under section 302. The IRS and Treasury Department, however, conclude that eliminating all such arrangements from the scope of the regulations would render the regulations meaningless. Little difference exists between a fast-pay arrangement resulting from redemptions structured to be dividends and a fast-pay arrangement resulting from dividends structured to be a return of the holder's investment.

To balance the concerns of the commentators and the concerns of the IRS and Treasury Department, the final regulations add a new rule clarifying the effect of section 302 on the determination of whether stock is fast-pay stock. Under this rule, stock is not fast-pay stock solely because a redemption is treated as a dividend by section 302 unless there is a principal purpose of achieving the same economic and tax effect as a fast-pay arrangement. In this way, only those arrangements in which redemptions are designed to return a shareholder's economic investment as dividends are recharacterized. Because the problem of stock redemptions may be common to many different fast-pay arrangements, regardless of how they are structured, the rule addressing such problem is placed within the regulations under section 7701(l) rather than under a different section.

Characterization of the Financing Instruments

Under the proposed regulations, the fast-pay shareholders are treated as holding financing instruments issued by the benefited shareholders rather than as holding the fast-pay stock. The character of financing instruments (for example, stock or debt) is determined under general tax principles and depends on all the facts and circumstances.

All three commentators were concerned by the failure of the proposed regulations to classify the financing instruments as debt. If the financing instruments are classified as stock, the benefited shareholders are subject to substantially greater tax liabilities: they must include in income all dividends paid by the corporation that issues the fast-pay stock, but cannot deduct amounts deemed paid with respect to the financing instruments. According to the commentators, this result distorts the benefited shareholders' economic income. Therefore, the regulations should classify the financing instruments as debt in all cases.

After careful consideration of the comments, the IRS and Treasury Department have decided against characterizing the financing instruments in the final regulations. Although debt characterization may be appropriate in some cases, in other cases it will be more appropriate to characterize the financing instruments as equity or something else. Thus, the rule in the proposed regulations is retained. (As explained below, however, the final regulations permit taxpayers, for a limited period, to determine their taxable income attributable to a recharacterized fast-pay arrangement by treating the financing instruments as debt.)

Election to Limit Taxable Income Attributable to a Recharacterized Fast-pay Arrangement for Periods Before April 1, 2000

Because the regulations are effective February 27, 1997 (the date Notice 97–21 was issued to the public), the proposed regulations permit a shareholder of a recharacterized fast-pay arrangement to limit, for certain taxable years, its income from the arrangement. Specifically, a shareholder may limit its taxable income attributable to a recharacterized fast-pay arrangement to the taxable income that results if the fast-pay arrangement is recharacterized under Notice 97–21. This limit is available under the proposed regulations for taxable years ending after the effective date of the regulations and before the regulations are finalized. Any amount excluded under this limit must be included as an adjustment to taxable income in the shareholder's first taxable year that includes the date the regulations are finalized. Thus, the sole benefit of limiting taxable income under the proposed regulations is a timing benefit. The preamble to the proposed regulations found this appropriate on the assumption that over the life of a fast-pay arrangement a shareholder has the same amount of taxable income whether the fast-pay arrangement is recharacterized under Notice 97–21 or under the regulations.

One commentator criticized this assumption, and, therefore, the limit and later adjustment. In particular, the commentator pointed out that if the financing instruments are treated as equity under the regulations, a benefited shareholder would have had less taxable income over the life of the fast-pay arrangement under the recharacterization of Notice 97–21 (that is, a shareholder would have a permanent reduction to taxable income). Thus, the limit is without any substantive effect because any non-timing reduction in taxable income due to the limit is included in the year the regulations are finalized. To rectify this problem, the commentator asked that, if the final regulations do not classify the financing instruments as debt in all cases, they should at least classify the financing instruments as debt for the period starting after the effective date of the final regulations and ending before the final regulations are published.

To address these concerns, the final regulations adopt a different rule from the one in the proposed regulations. As with the proposed regulations, a shareholder may limit its taxable income to either the amount determined under Notice 97–21 or the amount determined under the regulations. For purposes of this limit, a shareholder may assume the financing instruments are debt under the final regulations. A shareholder may also make this assumption to determine the amount of any later adjustment to income because of the limit. Thus, the later adjustment will not include any permanent reduction to taxable income a shareholder realizes by limiting its taxable income to the amount determined under Notice 97–21.

The final regulations also adopt a longer period during which shareholders may limit their taxable income. Under the proposed regulation, a shareholder may limit its taxable income for taxable years ending after February 26, 1997, and before the date these regulations are published as final regulations in the Federal Register. The final regulations permit a shareholder to limit its taxable income for all periods before April 1, 2000. Thus, for all taxable years ending after February 26, 1997 and before April 1, 2000, and for that part of a shareholder's taxable year before April 1, 2000, a shareholder may limit its taxable income attributable to the fast-pay arrangement.

In permitting shareholders to determine their taxable income under the regulations by assuming that the financing instruments are debt for periods before April 1, 2000, the IRS and Treasury Department intend no implication regarding the proper characterization of the financing instruments under general tax principles. Rather, the rule regarding the financing instruments is intended solely for the purpose of giving shareholders the benefit of the recharacterization described in Notice 97–21 for periods before April 1, 2000.

Use of Derivatives to Avoid the Regulations

One commentator recommended adding an explicit rule to prevent parties from using derivative contracts to create a fast-pay arrangement that escapes either the regulations or the effect of the recharacterization rules. To illustrate this point, the commentator posited a simplified transaction in which a corporation issues fast-pay stock to one tax-exempt entity and benefited stock to another tax-exempt entity. The tax-exempt entity holding the benefited stock enters into a prepaid forward contract with a taxable person. Under the prepaid forward contract, the taxable person must buy the benefited stock in the future for an amount substantially below its expected value. According to the commentator, unless the taxable person is treated as owning the benefited stock, the parties have created a fast-pay arrangement in which the recharacterization of the regulations fails to prevent tax avoidance. Without making a recommendation, the commentator offered a number of rules to correct this situation. (The commentator did not discuss whether the benefited holder would be subject to the "debt-financing" rules in section 514).

The IRS and Treasury Department have concluded that there is no present need to modify the regulations to address this problem. First, the tax treatment of derivatives in general is outside of the scope of these regulations. Therefore, a rule specific to these regulations would only increase the complexity regarding the tax treatment of derivatives. Second, and more importantly, the IRS and Treasury Department have concluded that under existing law the party entitled to purchase the benefited stock under a prepaid forward contract such as the one described above is the owner of the benefited stock for federal income tax purposes. See Rev. Rul. 82–150, 1982–2 C.B. 110 (concluding that the holder of a deep-in-the-money option is the owner of the reference property). Finally, the regulations state they are to be interpreted in a manner consistent with preventing the avoidance of tax. Mechanically applying the regulations in a manner that does not prevent tax avoidance is clearly inconsistent with the purpose of the regulations and the Congressional mandate of section 7701(l).

Fast-pay Arrangement Defined

The proposed regulations define a fast-pay arrangement as any arrangement in which a corporation has outstanding for any part of its taxable year two or more classes of stock, at least one of which is fast-pay stock. Some taxpayers assert that the regulations can be avoided by creating a fast-pay arrangement in which a corporation issues what is nominally a single class of shares, notwithstanding that some of the shares are subject to a related agreement. These taxpayers apparently rely on the formal meaning of "class" under state corporate law and ignore the direction in the proposed regulations to determine whether stock is fast-pay stock based on all the facts and circumstances.

To remove any doubt that the regulations cover fast-pay arrangements no matter how contrived, the IRS and Treasury Department have simplified the definition of "fast-pay arrangement" in the final regulations. Under this definition, a fast-pay arrangement is any arrangement in which a corporation has fast-pay stock outstanding for any part of its taxable year. The regulations illustrate this point with an example.

Effective Date

These regulations apply to taxable years ending after February 26, 1997.

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 is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the understanding of the IRS and Treasury Department that the total number of fast-pay arrangements is fewer than 100, that the number of entities engaging in transactions affected by these regulations is not substantial and, of those entities, few or none are small entities within the meaning of the Regulatory Flexibility Act (5 U.S.C. chapter 6). 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 comments on its impact on small businesses.

Drafting Information

The principal authors of these regulations are Jonathan Zelnik and Marshall Feiring of the Office of the Assistant Chief Counsel (Financial Institutions & Products). However, other personnel from the IRS and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Section 1.7701(l)–3 also issued under 26 U.S.C. 7701(l). * * *

Par. 2. Section 1.1441–10, is added to read as follows:

§1.1441–10 Withholding agents with respect to fast-pay arrangements.

(a) In general. A corporation that issues fast-pay stock in a fast-pay arrangement described in §1.7701(l)–3(b)(1) is a withholding agent with respect to payments made on the fast-pay stock and payments deemed made under the recharacterization rules of §1.7701(l)–3. Except as provided in this paragraph (a) or in paragraph (b) of this section, the withholding tax rules under section 1441 and section 1442 apply with respect to a fast-pay arrangement described in §1.7701(l)–3(c)(1)(i) in accordance with the recharacterization rules provided in §1.7701(l)–3(c). In all cases, notwithstanding paragraph (b) of this section, if at any time the withholding agent knows or has reason to know that the Commissioner has exercised the discretion under either §1.7701(l)–3(c)(1)(ii) to apply the recharacterization rules of §1.7701(l)–3(c), or §1.7701(l)–3(d) to depart from the recharacterization rules of §1.7701(l)–3(c) for a taxpayer, the withholding agent must withhold on payments made (or deemed made) to that taxpayer in accordance with the characterization of the fast-pay arrangement imposed by the Commissioner under §1.7701(l)–3.

(b) *Exception.* If at any time the withholding agent knows or has reason to know that any taxpayer entered into a fast-pay arrangement with a principal purpose of applying the recharacterization rules of §1.7701(l)–3(c) to avoid tax under section 871(a) or section 881, then for each payment made or deemed made to such taxpayer under the arrangement, the withholding agent must withhold, under section 1441 or section 1442, the higher of—

(1) The amount of withholding that would apply to such payment determined under the form of the arrangement; or

(2) The amount of withholding that would apply to deemed payments determined under the recharacterization rules of §1.7701(l)–3(c).

(c) *Liability*. Any person required to deduct and withhold tax under this section is made liable for that tax by section 1461, and is also liable for applicable penalties and interest for failing to comply with section 1461.

(d) *Examples*. The following examples illustrate the rules of this section:

Example 1. REIT W issues shares of fast-pay stock to foreign individual A, a resident of Country C. United States source dividends paid to residents of C are subject to a 30 percent withholding tax. W issues all shares of benefited stock to foreign individuals who are residents of Country D. D's income tax convention with the United States reduces the United States withholding tax on dividends to 15 percent. Under §1.7701(l)–3(c), the dividends paid by W to A are deemed to be paid by W to the benefited shareholders. W has reason to know that A entered into the fast-pay arrangement with a principal purpose of using the recharacterization rules of §1.7701(l)–3(c) to reduce United States withholding tax. W must withhold at the 30 percent rate because the amount of withholding that applies to the payments determined under the form of the arrangement is higher than the amount of withholding that applies to the payments determined under §1.7701(l)–3(c).

Example 2. The facts are the same as in *Example 1* of this paragraph (d) except that W does not know, or have reason to know, that A entered into the arrangement with a principal purpose of using the recharacterization rules of §1.7701(l)–3(c) to reduce United States withholding tax. Further, the Commissioner has not exercised the discretion under §1.7701(l)–3(d) to depart from the recharacterization rules of §1.7701(l)–3(c). Accordingly, W must withhold tax at a 15 percent rate on the dividends deemed paid to the benefited shareholders.

(e) *Effective date*. This section applies to payments made (or deemed made) on or after January 6, 1999.

Par. 3. Section 1.7701(l)–0 is added to read as follows:

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This section lists captions that appear in §§1.7701(l)–1 and 1.7701(l)–3:

Par. 4. Section 1.7701(l)–3 is added to read as follows:

§1.7701(l)–3 Recharacterizing financing arrangements involving fast-pay stock.

(a) *Purpose and scope.* This section is intended to prevent the avoidance of tax by persons participating in fast-pay arrangements (as defined in paragraph (b)(1) of this section) and should be interpreted in a manner consistent with this purpose. This section applies to all fast-pay arrangements. Paragraph (c) of this section recharacterizes certain fast-pay arrangements to ensure the participants are taxed in a manner reflecting the economic substance of the arrangements. Paragraph (f) of this section imposes reporting requirements on certain participants.

(b) *Definitions*—(1) *Fast-pay arrangement*. A fast-pay arrangement is any arrangement in which a corporation has fast-pay stock outstanding for any part of its taxable year.

(2) *Fast-pay stock*—(i) *Defined*. Stock is fast-pay stock if it is structured so that dividends (as defined in section 316) paid by the corporation with respect to the stock are economically (in whole or in part) a return of the holder's investment (as opposed to only a return on the

holder's investment). Unless clearly demonstrated otherwise, stock is presumed to be fast-pay stock if—

(A) It is structured to have a dividend rate that is reasonably expected to decline (as opposed to a dividend rate that is reasonably expected to fluctuate or remain constant); or

(B) It is issued for an amount that exceeds (by more than a de minimis amount, as determined under the principles of §1.1273–1(d)) the amount at which the holder can be compelled to dispose of the stock.

(ii) *Determination.* The determination of whether stock is fast-pay stock is based on all the facts and circumstances, including any related agreements such as options or forward contracts. A related agreement includes any direct or indirect agreement or understanding, oral or written, between the holder of the stock and the issuing corporation, or between the holder of the stock and one or more other shareholders in the corporation. To determine if it is fast-pay stock, stock is examined when issued, and, for stock that is not fast-pay stock when issued, when there is a significant modification in the terms of the stock or the related agreements or a significant change in the relevant facts and circumstances. Stock is not fast-pay stock solely because a redemption is treated as a dividend as a result of section 302(d) unless there is a principal purpose of achieving the same economic and tax effect as a fast-pay arrangement.

(3) *Benefited stock.* With respect to any fast-pay stock, all other stock in the corporation (including other fast-pay stock having any significantly different characteristics) is benefited stock.

(c) *Recharacterization of certain fast-pay arrangements*— (1) *Scope.* This paragraph (c) applies to any fast-pay arrangement—

(i) In which the corporation that has outstanding fast-pay stock is a regulated investment company (RIC) (as defined in section 851) or a real estate investment trust (REIT) (as defined in section 856); or

(ii) If the Commissioner determines that a principal purpose for the structure of the fast-pay arrangement is the avoidance of any tax imposed by the Internal Revenue Code. Application of this paragraph (c)(1)(ii) is at the Commissioner's discretion, and a determination under this paragraph (c)(1)(ii) applies to all parties to the fast-pay arrangement, including transferees.

(2) *Recharacterization.* A fast-pay arrangement described in paragraph (c)(1) of this section is recharacterized as an arrangement directly between the benefited shareholders and the fast-pay shareholders. The inception and resulting relationships of the recharacterized arrangement are deemed to be as follows:

(i) *Relationship between benefited shareholders and fast-pay shareholders.* The benefited shareholders issue financial instruments (the financing instruments) directly to the fast-pay shareholders in exchange for cash equal to the fair market value of the fast-pay stock at the time of issuance (taking into account any related agreements). The financing instruments have the same terms (other than issuer) as the fast-pay stock. Thus, for example, the timing and amount of the payments made with respect to the financing instruments always match the timing and amount of the distributions made with respect to the fast-pay stock.

(ii) *Relationship between benefited shareholders and corporation.* The benefited shareholders contribute to the corporation the cash they receive for issuing the financing instruments. Distributions made with respect to the fast-pay stock are distributions made by the corporation with respect to the benefited shareholders' benefited stock.

(iii) *Relationship between fast-pay shareholders and corporation.* For purposes of determining the relationship between the fast-pay shareholders and the corporation, the fast-pay stock is ignored. The corporation is the paying agent of the benefited shareholders with respect to the financing instruments.

(3) *Other rules*—(i) *Character of the financing instruments.* The character of a financing instrument (for example, stock or debt) is determined under general tax principles and depends on all the facts and circumstances.

(ii) *Multiple types of benefited stock.* If any benefited stock has any significantly different characteristics from any other benefited stock, the recharacterization rules of this paragraph (c) apply among the different types of benefited stock as appropriate to match the economic substance of the fast-pay arrangement.

(iii) *Transactions affecting benefited stock*—(A) *Sale of benefited stock.* If one person sells benefited stock to another—

(*1*) In addition to any consideration actually paid and received for the benefited stock, the buyer is deemed to pay and the seller is deemed to receive the amount necessary to terminate the seller's position in the financing instruments at fair market value; and

(*2*) The buyer is deemed to issue financing instruments to the fast-pay shareholders in exchange for the amount necessary to terminate the seller's position in the financing instruments.

(B) *Transactions other than sales.* Except for transactions subject to paragraph (c)(3)(iii)(A) of this section, in the case of any transaction affecting benefited stock, the parties to the transaction must make appropriate adjustments to properly take into account the fast-pay arrangement as characterized under paragraph (c)(2) of this section.

(iv) *Adjustment to basis for amounts accrued or paid in taxable years ending before February 27, 1997.* In the case of a fast-pay arrangement involving amounts accrued or paid in taxable years ending before February 27, 1997, and recharacterized under this paragraph (c), a benefited shareholder must decrease its basis in any benefited stock (as determined under paragraph (c)(2)(ii) of this section) by the amount (if any) that—

(A) Its income attributable to the benefited stock (reduced by deductions attributable to the financing instruments) for taxable years ending before February 27, 1997, computed by recharacterizing the fast-pay arrangement under this paragraph (c) and by treating the financing instruments as debt; exceeds

(B) Its income attributable to such stock for taxable years ending before February 27, 1997, computed without applying the rules of this paragraph (c).

(d) *Prohibition against affirmative use of recharacterization by taxpayers.* A taxpayer may not use the rules of paragraph (c) of this section if a principal purpose for using such rules is the avoidance of any tax imposed by the Internal Revenue Code. Thus, with respect to such taxpayer, the Commissioner may depart from the rules of this section and recharacterize (for all purposes of the Internal Revenue

Code) the fast-pay arrangement in accordance with its form or its economic substance. For example, if a foreign person acquires fast-pay stock in a REIT and a principal purpose for acquiring such stock is to reduce United States withholding taxes by applying the rules of paragraph (c) of this section, the Commissioner may, for purposes of determining the foreign person's United States tax consequences (including withholding tax), depart from the rules of paragraph (c) of this section and treat the foreign person as holding fast-pay stock in the REIT.

(e) *Examples*. The following examples illustrate the rules of paragraph (c) of this section:

Example 1. Decline in dividend rate—(i) *Facts*. Corporation X issues 100 shares of A Stock and 100 shares of B Stock for $1,000 per share. By its terms, a share of B Stock is reasonably expected to pay a $110 dividend in years 1 through 10 and a $30 dividend each year thereafter. If X liquidates, the holder of a share of B Stock is entitled to a preference equal to the share's issue price. Otherwise, the B Stock cannot be redeemed at either X's or the shareholder's option.

(ii) *Analysis*. When issued, the B Stock has a dividend rate that is reasonably expected to decline from an annual rate of 11 percent of its issue price to an annual rate of 3 percent of its issue price. Since the B Stock is structured to have a declining dividend rate, the B Stock is fast-pay stock, and the A Stock is benefited stock.

Example 2. Issued at a premium—(i) *Facts*. The facts are the same as in *Example 1* of this paragraph (e) except that a share of B Stock is reasonably expected to pay an annual $110 dividend as long as it is outstanding, and Corporation X has the right to redeem the B Stock for $400 a share at the end of year 10.

(ii) *Analysis*. The B Stock is structured so that the issue price of the B Stock ($1,000) exceeds (by more than a de minimis amount) the price at which the holder can be compelled to dispose of the stock ($400). Thus, the B Stock is fast-pay stock, and the A Stock is benefited stock.

Example 3. Planned section 302(d) redemptions—(i) *Facts*. Corporation L, a subchapter C corporation, issues 220 shares of common stock for $1,000 per share. No other stock is authorized, but L can issue warrants entitling the holder to acquire L common stock for $3,000 per share until such time as L adopts a plan of liquidation. L can adopt a plan of liquidation if approved by 90 percent of its shareholders. Half of L's stock is purchased by Corporation M, and half by Organization N, which is tax exempt. At the time of purchase, M and N agree that for a period of ten years L will annually redeem (and N will tender) ten shares of stock in exchange for $12,100 and ten warrants. It is anticipated that, under sections 302 and 301, the annual payment to N will be a distribution of property that is a dividend.

(ii) *Analysis*. Considering all the facts and circumstances, including the agreement between M and N, L's redemption of N's stock is undertaken with a principal purpose of achieving the same economic and tax effect as a fast-pay arrangement. Thus, N's stock is fast-pay stock, M's stock is benefited stock, and the parties have entered into a fast-pay arrangement. Because L is neither a RIC nor a REIT, whether this fast-pay arrangement is recharacterized under paragraph (c) of this section depends on whether the Commissioner determines, under paragraph (c)(1)(ii) of this section, that a principal purpose for the structure of the fast-pay arrangement is the avoidance of any tax imposed by the Internal Revenue Code.

Example 4. Recharacterization illustrated—(i) *Facts*. On formation, REIT Y issues 100 shares of C Stock and 100 shares of D Stock for $1,000 per share. By its terms, a share of D Stock is reasonably expected to pay a $110 dividend in years 1 through 10 and a $30 dividend each year thereafter. In years 1 through 10, persons holding a majority of the D Stock must consent before Y may take any action that would result in Y liquidating or dissolving, merging or consolidating, losing its REIT status, or selling substantially all of its assets. Thereafter, Y may take these actions without consent so long as the D Stock shareholders receive $400 in exchange for their D Stock.

(ii) *Analysis*. When issued, the D Stock has a dividend rate that is reasonably expected to decline from an annual rate of 11 percent of its issue price to an annual rate of 3 percent of its issue price. In addition, the $1,000 issue price of a share of D Stock exceeds the price at which the shareholder can be compelled to dispose of the stock ($400). Thus, the D Stock is fast-pay stock, and the C Stock is benefited stock. Because Y is a REIT, the fast-pay arrangement is recharacterized under paragraph (c) of this section.

(iii) *Recharacterization*. The fast-pay arrangement is recharacterized as follows:

(A) Under paragraph (c)(2)(i) of this section, the C Stock shareholders are treated as issuing financing instruments to the D Stock shareholders in exchange for $100,000 ($1,000, the fair market value of each share of D Stock, multiplied by 100, the number of shares).

(B) Under paragraph (c)(2)(ii) of this section, the C Stock shareholders are treated as contributing $200,000 to Y (the $100,000 received for the financing instruments, plus the $100,000 actually paid for the C Stock) in exchange for the C Stock.

(C) Under paragraph (c)(2)(ii) of this section, each distribution with respect to the D Stock is treated as a distribution with respect to the C Stock.

(D) Under paragraph (c)(2)(iii) of this section, the C Stock shareholders are treated as making payments with respect to the financing instruments, and Y is treated as the paying agent of the financing instruments for the C Stock shareholders.

Example 5. Transfer of benefited stock illustrated— (i) *Facts*. The facts are the same as in *Example 4* of this paragraph (e). Near the end of year 5, a person holding one share of C Stock sells it for $1,300. The buyer is unrelated to REIT Y or to any of the D Stock shareholders. At the time of the sale, the amount needed to terminate the seller's position in the financing instruments at fair market value is $747.

(ii) *Benefited shareholder's treatment on sale*. Under paragraph (c)(3)(iii)(A) of this section, the seller's amount realized is $2,047 ($1,300, the amount actually received, plus $747, the amount necessary to terminate the seller's position in the financing instruments at fair market value). The seller's gain on the sale of the common stock is $47 ($2,047, the amount realized, minus $2,000, the seller's basis in the common stock). The seller has no income or deduction with respect to terminating its position in the financing instruments.

(iii) *Buyer's treatment on purchase*. Under paragraph (c)(3)(iii)(A) of this section, the buyer's basis in the share of D Stock is $2,047 ($1,300, the amount actually paid, plus $747, the amount needed to terminate the seller's position in the financing instruments at fair market value). Under paragraph (c)(3)(iii)(B) of this section, simultaneous with the sale, the buyer is treated as issuing financing instruments to the fast-pay shareholders in exchange for $747, the amount necessary to terminate the seller's position in the financing instruments at fair market value.

Example 6. Fast-pay arrangement involving amounts accrued or paid in a taxable year ending before February 27, 1997— (i) *Facts*. Y is a calendar year taxpayer. In June 1996, Y acquires shares of REIT T benefited stock for $15,000. In December 1996, Y receives dividends of $100. Under the recharacterization rules of paragraph (c)(2) of this section, Y's 1996 income attributable to the benefited stock is $1,200, Y's 1996 deduction attributable to the financing instruments is $500, and Y's basis in the benefited stock is $25,000.

(ii) *Analysis*. Under paragraph (c)(3)(iv) of this section, Y's basis in the benefited stock is reduced by $600. This is the amount by which Y's 1996 income from the fast-pay arrangement as recharacterized under this section ($1,200 of income attributable to the benefited stock less $500 of deductions attributable to the financing instruments), exceeds Y's 1996 income from the fast-pay arrangement as not recharacterized under this section ($100 of income attributable to the benefited stock). Thus, in 1997 when the fast-pay arrangement is recharacterized, Y's basis in the benefited stock is $24,400.

(f) *Reporting requirement*—(1) *Filing requirements*—(i) *In general*. A corporation that has fast-pay stock outstanding at any time during the taxable year must attach the statement described in paragraph (f)(2) of this section to its federal income tax return for such taxable year. This paragraph (f)(1)(i) does not apply to a corporation described in paragraphs (f)(1)(ii), (iii), or (iv) of this section.

(ii) *Controlled foreign corporation*. In the case of a controlled foreign corporation (CFC), as defined in section 957, that has fast-pay stock outstanding at any time during its taxable year (during which time it was a CFC), each controlling United States shareholder (within the meaning of §1.964-1(c)(5)) must attach the statement described in paragraph (f)(2) of this section to the shareholder's Form 5471 for the CFC's taxable year. The provisions of section 6038 and the regulations under section 6038 apply to any statement required by this paragraph (f)(1)(ii).

(iii) *Foreign personal holding company*. In the case of a foreign personal holding company (FPHC), as defined in section 552, that has fast-pay stock outstanding at any time during its taxable year (during which time it was a FPHC), each United States citizen or resident who is an officer, director, or 10-percent shareholder (within the meaning of section 6035(e)(1)) of such FPHC must attach the statement described in paragraph (f)(2) of this section to his or her Form 5471 for the FPHC's taxable year. The provisions of sections 6035 and 6679 and the regulations under sections 6035 and 6679 apply to any statement required by this paragraph (f)(1)(iii).

(iv) *Passive foreign investment company.* In the case of a passive foreign investment company (PFIC), as defined in section 1297, that has fast-pay stock outstanding at any time during its taxable year (during which time it was a PFIC), each shareholder that has elected (under section 1295) to treat the PFIC as a qualified electing fund and knows or has reason to know that the PFIC has outstanding fast-pay stock must attach the statement described in paragraph (f)(2) of this section to the shareholder's Form 8621 for the PFIC's taxable year. Each shareholder owning 10 percent or more of the shares of the PFIC (by vote or value) is presumed to know that the PFIC has issued fast-pay stock. The provisions of sections 1295(a)(2) and 1298(f) and the regulations under those sections (including §1.1295–1T(f)(2)) apply to any statement required by this paragraph (f)(1)(iv).

(2) *Statement*. The statement required under this paragraph (f) must say, "This fast-pay stock disclosure statement is required by §1.7701(l)–3(f) of the income tax regulations." The statement must also identify the corporation that has outstanding fast-pay stock and must contain the date on which the fast-pay stock was issued, the terms of the fast-pay stock, and (to the extent the filing person knows or has reason to know such information) the names and taxpayer identification numbers of the shareholders of any stock that is not traded on an established securities market (as described in §1.7704–1(b)).

(g) *Effective date*—(1) *In general*. Except as provided in paragraph (g)(4) of this section (relating to reporting requirements), this section applies to taxable years ending after February 26, 1997. Thus, all amounts accrued or paid during the first taxable year ending after February 26, 1997, are subject to this section.

(2) *Election to limit taxable income attributable to a recharacterized fast-pay arrangement for periods before April 1, 2000*—(i) *Limit*. For periods before April 1, 2000, provided the shareholder recharacterizes the fast-pay arrangement consistently for all such periods, a shareholder may limit its taxable income attributable to a fast-pay arrangement recharacterized under paragraph (c) of this section to the taxable income that results if the fast-pay arrangement is recharacterized under either—

(A) Notice 97–21, 1997–1 C.B. 407, see §601.601(d)(2) of this chapter; or

(B) Paragraph (c) of this section, computed by assuming the financing instruments are debt.

(ii) *Adjustment and statement*. A shareholder that limits its taxable income to the amount determined under paragraph (g)(2)(i)(A) of this section must include as an adjustment to taxable income the excess, if any, of the amount determined under paragraph (g)(2)(i)(B) of this section, over the amount determined under paragraph (g)(2)(i)(A) of this section. This adjustment to taxable income must be made in the shareholder's first taxable year that includes April 1, 2000. A shareholder to which this paragraph (g)(2)(ii) applies must include a statement in its books and records identifying each fast-pay arrangement for which an adjustment must be made and providing the amount of the adjustment for each such fast-pay arrangement.

(iii) *Examples*. The following examples illustrate the rules of this paragraph (g)(2). For purposes of these examples, assume that a shareholder may limit its taxable income under this paragraph (g)(2) for periods before January 1, 2000.

Example 1. Fast-pay arrangement recharacterized under Notice 97–21; REIT holds third-party debt—(i) *Facts*. (A) REIT Y is formed on January 1, 1997, at which time it issues 1,000 shares of fast-pay stock and 1,000 shares of benefited stock for $100 per share. Y and all of its shareholders are U.S. persons and have calendar taxable years. All shareholders of Y have elected to accrue market discount based on a constant interest rate, to include the market discount in income as it accrues, and to amortize bond premium.

(B) For years 1 through 5, the fast-pay stock has an annual dividend rate of $17 per share ($17,000 for all fast-pay stock); in later years, the fast-pay stock has an annual dividend rate of $1 per share ($1,000 for all fast-pay stock). At the end of year 5, and thereafter, a share of fast-pay stock can be acquired by Y in exchange for $50 ($50,000 for all fast-pay stock).

(C) On the day Y is formed, it acquires a five-year mortgage note (the note) issued by an unrelated third party for $200,000. The note provides for annual interest payments on December 31 of $18,000 (a coupon interest rate of 9.00 percent, compounded annually), and one payment of principal at the end of 5 years. The note can be prepaid, in whole or in part, at any time.

(ii) *Recharacterization under Notice 97–21*—(A) *In general*. One way to recharacterize the fast-pay arrangement under Notice 97–21 is to treat the fast-pay shareholders and the benefited shareholders as if they jointly purchased the note from the issuer with the understanding that over the five-year term of the note the benefited shareholders would use their share of the interest to buy (on a dollar-for-dollar basis) the fast-pay shareholders' portion of the note. The benefited shareholders' and the fast-pay shareholders' yearly taxable income under Notice 97–21 can then be calculated after determining their initial portions of the note and whether those initial portions are purchased at a discount or premium.

(B) *Determining initial portions of the debt instrument*. The fast-pay shareholders' and the benefited shareholders' initial portions of the note can be determined by comparing the present values of their expected cash flows. As a group, the fast-pay shareholders expect to receive cash flows of $135,000 (five annual payments of $17,000, plus a final payment of $50,000). As a group, the benefited shareholders expect to receive cash flows of $155,000 (five annual payments of $1,000, plus a final payment of $150,000). Using a discount rate equal to the yield to maturity (as determined under §1.1272–1(b)(1)(i)) of the mortgage note (9.00 percent, compounded annually), the present value of the fast-pay shareholders' cash flows is $98,620, and the present value of the benefited shareholders' cash flows is $101,380. Thus, the fast-pay shareholders initially acquire 49 percent of the note at a $1,380 premium (that is, they paid $100,000 for $98,620 of principal in the note). The benefited shareholders initially acquire 51 percent of the note at a $1,380 discount (that is, they paid $100,000 for $101,380 of principal in the note). Under section 171, the fast-pay shareholders' premium is amortizable based on their yield in their initial portion of the note (8.574 percent, compounded annually). The benefited shareholders' discount accrues based on the yield in their initial portion of the note (9.353 percent, compounded annually).

(C) *Taxable income under Notice 97–21*—(1) *Fast-pay shareholders*. Under Notice 97–21, the fast-pay shareholders compute their taxable income attributable to the fast-pay arrangement for periods before January 1, 2000, by subtracting the amortizable premium from the accrued interest on the fast-pay shareholders' portion of the note. For purposes of paragraph (g)(2)(i)(A) of this section, the fast-pay shareholders' taxable income as a group is as follows:

Taxable Period	Interest Income	Amortizable Premium	Taxable Income
1/1/97 - 12/31/97	$ 8,876	($302)	$ 8,574
1/1/98 - 12/31/98	$ 8,145	($293)	$ 7,852
1/1/99 - 12/31/99	$ 7,348	($281)	$ 7,067
	$24,369	($876)	$23,493

(*2*) *Benefited shareholders*. Under Notice 97–21, the benefited shareholders compute their taxable income attributable to the fast-pay arrangement for periods before January 1, 2000, by adding the accrued discount to the accrued interest on the benefited shareholders' portion of the note. For purposes of paragraph (g)(2)(i)(A) of this section, the benefited shareholders' taxable income as a group is as follows:

Taxable Period	Interest Income	Accrued Discount	Taxable Income
1/1/97 - 12/31/97	$ 9,124	$229	$ 9,353
1/1/98 - 12/31/98	$ 9,855	$251	$10,106
1/1/99 - 12/31/99	$10,652	$274	$10,926
	$29,631	$754	$30,385

(iii) *Taxable income under the recharacterization of this section*—(A) *Fast-pay shareholders*. Under paragraphs (c) and (g)(2)(i)(B) of this section, the fast-pay shareholders' taxable income attributable to the fast-pay arrangement for periods before January 1, 2000, is the interest deemed paid on the financing instruments. For purposes of paragraph (g)(2)(i)(B) of this section, the fast-pay shareholders' taxable income as a group is as follows:

Taxable Period	Taxable Income
1/1/97 - 12/31/97	$ 8,574
1/1/98 - 12/31/98	$ 7,852
1/1/99 - 12/31/99	$ 7,067
	$23,493

(B) *Benefited shareholders*. Under paragraphs (c) and (g)(2)(i)(B) of this section, the benefited shareholders compute their taxable income attributable to the fast-pay arrangement for periods before January 1, 2000, by subtracting the interest deemed paid on the financing instruments from the dividends actually and deemed paid on the benefited stock. For purposes of paragraph (g)(2)(i)(B) of this section, the benefited shareholders' taxable income as a group is as follows:

Taxable Period	Dividends Paid On Benefited Stock	Interest Paid On Financing Instruments	Taxable Income
1/1/97 - 12/31/97	$18,000	($ 8,574)	$ 9,426
1/1/98 - 12/31/98	$18,000	($ 7,852)	$10,148
1/1/99 - 12/31/99	$18,000	($ 7,067)	$10,933
	$54,000	($23,493)	$30,507

(iv) *Limit on taxable income under paragraph (g)(2)(i) of this section*—(A) *Fast-pay shareholders*. For periods before January 1, 2000, the fast-pay shareholders have the same taxable income under the recharacterization of Notice 97–21 and paragraph (g)(2)(i)(A) of this section ($23,493) as they have under the recharacterization of paragraphs (c) and (g)(2)(i)(B) of this section ($23,493). Thus, under paragraph (g)(2)(i) of this section, the fast-pay shareholders may limit their taxable income attributable to the fast-pay arrangement for periods before January 1, 2000, to $23,493 (as a group).

(B) *Benefited shareholders*. For periods before January 1, 2000, the benefited shareholders have taxable income attributable to the fast-pay arrangement of $30,385 under the recharacterization of Notice 97–21 and paragraph (g)(2)(i)(A) of this section, and taxable income of $30,507 under the recharacterization of paragraphs (c) and (g)(2)(i)(B) of this section. Thus, under paragraph (g)(2)(i) of this section, the benefited shareholders may limit their taxable income attributable to the fast-pay arrangement for periods before January 1, 2000, to either $30,385 (as a group) or $30,507 (as a group).

(v) *Adjustment to taxable income under paragraph (g)(2)(ii) of this section*. Under paragraph (g)(2)(ii) of this section, any benefited shareholder that limited its taxable income to the amount determined under paragraph (g)(2)(i)(A) of this section must include as an adjustment to taxable income the excess, if any, of the amount determined under paragraph (g)(2)(i)(B) of this section, over the amount determined under paragraph (g)(2)(i)(A) of this section. If all benefited shareholders limited their taxable income to the amount determined under paragraph (g)(2)(i)(A) of this section, then as a group their adjustment to income is $122 ($30,507, minus $30,385). Each shareholder must include its adjustment in income for the taxable year that includes January 1, 2000.

Example 2. REIT holds debt issued by a benefited shareholder—(i) *Facts*. The facts are the same as in *Example 1* of this paragraph (g)(2) except that corporation Z holds 800 shares (80 percent) of the benefited stock, and Z, instead of a third party, issues the mortgage note acquired by Y.

(ii) *Recharacterization under Notice 97–21*. Because Y holds a debt instrument issued by Z, the fast-pay arrangement is recharacterized under Notice 97–21 as an arrangement in which Z issued one or more instruments directly to the fast-pay shareholders and the other benefited shareholders.

(A) *Fast-pay shareholders*. Consistent with this recharacterization, Z is treated as issuing a debt instrument to the fast-pay shareholders for $100,000. The debt instrument provides for five annual payments of $17,000 and an additional payment of $50,000 in year five. Thus, the debt instrument's yield to maturity is 8.574 percent per annum, compounded annually.

(B) *Benefited shareholders*. Z is also treated as issuing a debt instrument to the other benefited shareholders for $20,000 (200 shares multiplied by $100, or 20 percent of the $100,000 paid to Y by the benefited shareholders as a group). This debt instrument provides for five annual payments of $200 and an additional payment of $30,000 in year five. The debt instrument's yield to maturity is 9.304 percent per annum, compounded annually.

(C) *Issuer's interest expense under Notice 97–21*. Under Notice 97-21, Z's interest expense attributable to the fast-pay arrangement for periods before January 1, 2000, equals the interest accrued on the debt instrument held by the fast-pay shareholders, plus the interest accrued on the debt instrument held by the benefited shareholders other than Z. For purposes of paragraph (g)(2)(i)(A) of this section, Z's interest expense is as follows:

Taxable Period	*Accrued Interest Fast-pay Shareholders*	*Accrued Interest Other Benefited Shareholders*	*Total Interest Expense*
1/1/97 - 12/31/97	($ 8,574)	($1,861)	($10,435)
1/1/98 - 12/31/98	($ 7,852)	($2,015)	($ 9,867)
1/1/99 - 12/31/99	($ 7,067)	($2,184)	($ 9,251)
	($23,493)	($6,060)	($29,553)

(iii) *Recharacterization under this section*. Under paragraphs (c) and (g)(2)(i)(B) of this section, Z's taxable income attributable to the fast-pay arrangement for periods before January 1, 2000, equals Z's share of the dividends actually and deemed paid on the benefited stock (80 percent of the outstanding benefited stock), reduced by the sum of the interest accrued on the note held by Y and the interest accrued on the financing instruments deemed to have been issued by Z. For purposes of paragraph (g)(2)(i)(B) of this section, Z's taxable income is as follows:

Taxable Period	*Dividends Benefited Stock*	*Accrued Interest On Debt Held By Y*	*Accrued Interest Financing Instruments*	*Taxable Expense*
1/1/97 - 12/31/97	$14,400	($18,000)	($ 6,859)	($10,459)
1/1/98 - 12/31/98	$14,400	($18,000)	($ 6,281)	($ 9,881)
1/1/99 - 12/31/99	$14,400	($18,000)	($ 5,654)	($ 9,254)
	$43,200	($54,000)	($18,794)	($29,594)

(iv) *Limit on taxable income under this paragraph (g)(2)*. For periods before January 1, 2000, Z has a taxable loss attributable to the fast-pay arrangement of $29,553 under the recharacterization of Notice 97-21 and paragraph (g)(2)(i)(A) of this section, and a taxable loss of $29,594 under the recharacterization of paragraphs (c) and (g)(2)(i)(B) of this section. Thus, under paragraph (g)(2)(i) of this section, Z may report a taxable loss attributable to the fast-pay arrangement for periods before January 1, 2000, of either $29,553 or $29,594. Under paragraph (g)(2)(ii), Z has no adjustment to its taxable income for its taxable year that includes January 1, 2000.

(3) *Rule to comply with this section*. To comply with this section for each taxable year in which it failed to do so, a taxpayer should file an amended return. For taxable years ending before January 10, 2000, a taxpayer that has complied with Notice 97–21, 1997–1 C.B. 407 (see §601.601(d)(2) of this chapter), for all such taxable years is considered to have complied with this section and limited its taxable income under paragraph (g)(2)(i)(A) of this section.

(4) *Reporting requirements*. The reporting requirements of paragraph (f) of this section apply to taxable years (of the person required to file the statement) ending after January 10, 2000.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

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

Authority: 26 U.S.C. 7805.

Par. 6. Section 602.101(b) is amended by adding an entry in numerical order to the table to read as follows:

§602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
49.4251–4(d)(2)	1545-1628
* * * * *	

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved January 7, 2000.

Jonathan Talisman,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on January 7, 2000, 8:45 a.m., and published in the issue of the Federal Register for January 10, 2000, 65 F.R. 1310)

Part III. Administrative, Procedural, and Miscellaneous

Application Procedures for Qualified Intermediary Status Under Section 1441; Final Qualified Intermediary Withholding Agreement

Rev. Proc. 2000–12

SECTION 1. PURPOSE AND SCOPE

.01 *Purpose*. This revenue procedure provides guidance for entering into a qualified intermediary (QI) withholding agreement with the Internal Revenue Service (IRS) under §1.1441–1(e)(5) of the income tax regulations.[1] Section 3 of this revenue procedure provides the application procedures for becoming a QI and Section 4 provides the final qualified intermediary withholding agreement ("QI withholding agreement"). The objective of the QI withholding agreement is to simplify withholding and reporting obligations for payments of income (including interest, dividends, royalties, and gross proceeds) made to an account holder through one or more foreign intermediaries.

.02 *Scope*. This revenue procedure applies to persons described in §1.1441–1(e)(5)(ii)(A) and (B)–foreign financial institutions, foreign clearing organizations, and foreign branches of U.S. financial institutions and U.S. clearing organizations. The principles of this agreement may, however, be used to conclude QI withholding agreements with foreign corporations described in §1.1441–1(e)(5)(ii)(C) seeking to become a QI to present claims of benefits under an income tax treaty on behalf of shareholders and to other persons that the IRS may accept to be qualified intermediaries as authorized under §1.1441–1(e)(5)(ii)(D). This revenue procedure does not apply to a foreign partnership seeking to qualify as a withholding foreign partnership. See §1.1441–5(c)(2)(ii). The IRS and Treasury will, however, consider applying the principles of the QI withholding agreement provided in this revenue procedure to a foreign partnership acting on behalf of its partners in appropriate circumstances. A person that is not within the scope of this revenue procedure may seek QI status by contacting the Office of the Assistant Commissioner (International) at the address or telephone number in Section 3.01 of this revenue procedure.

SECTION 2. BACKGROUND

.01 *Withholding and reporting on payments to foreign persons.* Under sections 1441 and 1442 of the Internal Revenue Code (Code), a person that makes a payment of U.S. source interest, dividends, royalties, and certain other types of income to a foreign person must generally deduct and withhold 30 percent from the payment. A lower rate of withholding may apply under the Code (e.g., section 1443), the regulations, or an income tax treaty. Generally, a payor of these types of income must also report the payments on Forms 1042–S. See §1.1461–1(c).

Under sections 6041, 6042, 6045, 6049, and 6050N of the Code (the Form 1099 reporting provisions), payors of interest, dividends, royalties, gross proceeds from the sales of securities, and other fixed or determinable income must report payments on Form 1099 unless an exception applies. If a payment is reportable on Form 1099, a payor must generally obtain a Form W-9 from the payee. If the payor does not receive the Form W-9, it must generally backup withhold at a 31 percent rate under section 3406 of the Code and report the payment on Form 1099. An exception to the Form 1099 reporting provisions applies if the payee is a foreign person. A payor can treat a person as foreign if the payor can reliably associate the payment with documentation that establishes that the person is the beneficial owner of the income or a foreign payee. See §§1.6041–4(a), 1.6042–3(b)(1)(iii); 1.6045–1(g)(1)(i); 1.6049–5(b)(12); and 1.6050N–1(c)(1)(i). Moreover, a payor does not have to backup withhold on payments to foreign beneficial owners or foreign payees because backup withholding applies only to amounts that the payor must report on Form 1099.

.02 *Responsibilities of intermediaries that enter into the QI withholding agreement*. When the IRS enters into a QI withholding agreement with a foreign person, that foreign person becomes a QI. A QI is a withholding agent under chapter 3 of the Code and a payor under chapter 61 and section 3406 of the Code for amounts that it pays to its account holders. Except as otherwise provided in the Agreement, a QI's obligations with respect to amounts it pays to account holders are governed by chapter 3, chapter 61, and section 3406 of the Code and the regulations thereunder. A QI shall act in its capacity as a QI pursuant to the Agreement only for those accounts the QI has with a withholding agent that the QI has designated as accounts for which it acts as a QI. A QI is not required to act as a QI for all accounts that it has with a withholding agent. However, if QI designates an account as one for which it will act as a QI, it must act as a QI for all payments made to that account.

SECTION 3. APPLICATION FOR QI STATUS

.01 *Where to Apply*. To apply for QI status, an eligible person must submit the information required by this Section 3 to:

Assistant Commissioner (International)
Foreign Payments Division
OP:IN:I:FP
950 L'Enfant Plaza South, SW
Washington, DC 20024
Telephone: (202) 874-1800
Fax: (202) 874-1797

.02 *Contents of the Application*. A prospective QI must submit an application to become a QI. The application must establish to the satisfaction of the IRS that the applicant has adequate resources and procedures to comply with the terms of the QI withholding agreement. An application must include the information specified in this section 3.02, and any additional information and documentation requested by the IRS:

(1) A statement that the applicant is an eligible person and that it requests to enter into a QI withholding agreement with the IRS.

(2) The applicant's name, address, and employer identification number (EIN), if any.

(3) The country in which the applicant was created or organized and a description of the applicant's business.

[1] All citations to income tax regulations in this revenue procedure are to the regulations as amended by T.D. 8734 (62 FR 53387), T.D. 8804 (63 FR 72183), and T.D. 8856 (64 FR 73408).

(4) A list of the position titles of those persons who will be the responsible parties for performance under the Agreement and the names, addresses, and telephone numbers of those persons as of the date the application is submitted.

(5) An explanation and sample of the account opening agreements and other documents used to open and maintain the accounts at each location covered by the Agreement.

(6) A list describing the type of account holders (e.g., U.S., foreign, treaty benefit claimant, or intermediary), the approximate number of account holders within each type, and the estimated value of U.S. investments that the QI agreement will cover.

(7) A general description of U.S. assets by type (e.g., U.S. securities, U.S. real estate), including assets held by U.S. custodians, and their approximate aggregate value by type. The applicant should provide separate information for assets beneficially owned by the applicant and for assets it holds for others.

(8) A completed Form SS-4 (Application for Employer Identification Number) to apply for a QI Employer Identification Number (QI-EIN) to be used solely for QI reporting and filing purposes. An applicant must apply for a QI-EIN even if it already has another EIN. Each legal entity governed by the QI withholding agreement must complete a Form SS-4.

(9) Completed appendices and attachments that appear at the end of the QI agreement set forth in section 4.

The IRS will not enter into a QI withholding agreement that provides for the use of documentary evidence obtained under a country's know-your-customer rules if it has not received the "know-your-customer" practices and procedures for opening accounts and responses to the 18 specific items presented below. If the information has already been provided to the IRS, it is not necessary for a particular prospective QI to submit the information. The IRS may publish lists of countries for which it has received know-your-customer information and for which the know-your-customer rules are acceptable. A prospective QI applicant may also contact the IRS at the address or telephone number provided in section 3.01 to obtain information. The 18 items are as follows:

1. An English translation of the laws and regulations ("know-your-customer" rules) governing the requirements of a QI to obtain documentation confirming the identity of QI's account holders. The translation must include the name of the law, and the appropriate citations to the law and regulations.
2. The name of the organization (whether a governmental entity or private association) responsible for enforcing the know-your-customer rules. Specify how those rules are enforced (e.g., through audit) and the frequency of compliance checks.
3. The penalties that apply for failure to obtain, or evaluate, documentation under the know-your-customer rules.
4. The definition of customer or account holder that is used under the know-your- customer rules. Specify whether the definition encompasses direct and indirect beneficiaries of an account if the activity in the account involves the receipt or disbursal of funds. Specify whether the definition of customer or account holder includes a trust beneficiary, a company whose assets are managed by an asset manager, a controlling shareholder of a closely held corporation or the grantor of a trust.
5. A statement regarding whether the documentation required under the know-your- customer rules requires a financial institution to determine if its account holder is acting as an intermediary for another person.
6. A statement regarding whether the documentation required under the know-your- customer rules requires a financial institution to identify the account holder as a beneficial owner of income credited to an account.
7. A list of the specific documentation required to be used under the know-your- customer rules, or if those rules do not require use of specific documentation, the documentation that is generally accepted by the authorities responsible for enforcing those rules.
8. A statement regarding whether the know-your-customer rules require that an account holder provide a permanent residence address.
9. A summary of the rules that apply if an account is not opened in person (e.g., correspondence, telephone, Internet).
10. Whether an account holder's identity may be established, in whole or in part, by introductions or referrals.
11. The circumstances under which new documentation must be obtained, or existing documentation verified, under the know-your-customer rules.
12. A list of all the exceptions, if any, to the documentation requirements under the know-your-customer rules.
13. A statement regarding whether the know-your-customer rules do not require documentation from an account holder if a payment to or from that account holder is cleared by another financial institution.[2]
14. A statement regarding how long the documentation remains valid under the know- your-customer rules.
15. A statement regarding how long the documentation obtained under the know-your- customer rules must be retained and the manner for maintaining that documentation.
16. Specify whether the rules require the maintenance of wire transfer records, the form of the wire transfer records and how long those records must be maintained. State whether the wire transfer records require information as to both the original source of the funds and the final destination of the funds.
17. A list of any payments or types of accounts that are not subject to the know-your- customer rules.
18. Specify whether there are special rules that apply for purposes of private banking activities.

SECTION 4. QUALIFIED INTERMEDIARY WITHHOLDING AGREEMENT

The text of the QI agreement is set forth below. Upon receipt and review of an application to become a qualified intermediary, the IRS will complete the QI agreement (e.g., insertion of the QI's name, etc.). A prospective QI should ensure that it has provided to the IRS all of the information that is required to complete the agreement. It may be necessary for the IRS to contact the potential qualified intermediary, or its authorized repre-

[2] Generally, the IRS will not permit a QI to establish the identity of an account holder without obtaining documentation directly from the account holder.

sentative, to obtain additional information. Once the IRS has obtained all the information required to complete the agreement, the IRS will send two unsigned copies of the QI withholding agreement to the prospective QI for signature. Both copies of the agreement should be signed by a person with the authority to sign the agreement and returned to the IRS at the address specified in section 3.01. The IRS will sign the QI agreement and return one of the originals to the qualified intermediary.

The IRS will consider changes to the text of the QI agreement as set forth below only in rare and unusual circumstances. The IRS will not accept, however, any changes that it determines would provide a potential QI with a competitive advantage over other similarly situated QIs.

COUNTRY-BY-COUNTRY REPORTING

The IRS and Treasury have decided that a QI that has executed a QI withholding agreement prior to January 1, 2001, will not be required to provide a country-by-country break down of reporting pools on Form 1042-S. See section 8.03 of the QI withholding agreement for a definition of reporting pool. It was decided that requiring such information at this time would impede implementation of the QI system since it is recognized that financial institutions will be required to commit substantial information technology resources to address technology issues that have been delayed by the year 2000 problem. The IRS and Treasury, however, are continuing to study whether to require country code information for reporting pools in the future. Therefore, the IRS and Treasury may require a potential QI that enters into an agreement after December 31, 2000, or a QI that enters into an agreement after the expiration of an agreement's initial term, to provide a country-by-country break down of reporting pools.

SECTION 6. QUALIFIED INTERMEDIARY WITHHOLDING CERTIFICATE AND DISCLOSURE OF ACCOUNT HOLDERS TO WITHHOLDING AGENT

SECTION 7. TAX RETURN OBLIGATIONS

SECTION 8. INFORMATION REPORTING OBLIGATIONS

SECTION 9. ADJUSTMENTS FOR OVER- AND UNDER-WITHHOLDING; REFUNDS

SECTION 10. EXTERNAL AUDIT PROCEDURES

SECTION 11. EXPIRATION, TERMINATION AND DEFAULT

SECTION 12. MISCELLANEOUS PROVISIONS

THIS AGREEMENT is made in duplicate under and in pursuance of section 1441 of the Internal Revenue Code of 1986, as amended, (the "Code") and Treasury Regulation §1.1441–1(e)(5) by and between ______________, any affiliated entities of ____________ designated in Appendix A of this Agreement that are signatories to this Agreement (individually and collectively referred to as "QI"), and the INTERNAL REVENUE SERVICE (the "IRS"):

WHEREAS, QI has submitted an application in accordance with Revenue Procedure 2000–12 to be a qualified intermediary for purposes of Treas. Reg. §1.1441–1(e)(5);

WHEREAS, QI and the IRS desire to enter into an agreement to establish QI's rights and obligations regarding documentation, withholding, information reporting, tax return filing, deposits, and refund procedures under sections 1441, 1442, 1443, 1461, 3406, 6041, 6042, 6045, 6049, 6050N, 6302, 6402, and 6414 of the Code with respect to certain types of payments;

NOW, THEREFORE, in consideration of the following terms, representations, and conditions, the parties agree as follows:

SECTION 1. PURPOSE AND SCOPE

Sec. 1.01. General Obligations. QI is a withholding agent under chapter 3 of the Code and a payor under chapter 61 and section 3406 of the Code for amounts that it pays to its account holders. Except as otherwise provided in this Agreement, QI's obligations with respect to amounts it pays to account holders are governed by chapter 3, chapter 61, and section 3406 of the Code and the regulations thereunder. QI shall act in its capacity as a qualified intermediary pursuant to this Agreement only for those accounts QI has with a withholding agent that QI has designated as accounts for which it acts as a qualified intermediary. QI is not required to act as a qualified intermediary for all accounts that it has with a withholding agent. However, if QI designates an account as one for which it will act as a qualified intermediary, it must act as a qualified intermediary for all payments made to that account.

Sec. 1.02. Parties to the Agreement. This Agreement applies to:

(A) All offices of QI located in the countries described in Appendix A of this Agreement; and

(B) The Internal Revenue Service.

Notwithstanding section 1.02(A) of this Agreement, an office of QI shall be subject to the provisions of this Agreement only to the extent it receives a payment from a withholding agent with respect to an account that QI has designated as an account for which it is acting as a qualified intermediary. See section 6.02 of this Agreement for the procedure to designate an account. QI may add any countries not initially included in Appendix A without prior IRS approval if the country is one for which the IRS will enter a model qualified intermediary agreement and QI provides the IRS an amended Appendix A at the address described in section 12.06 of this Agreement. Offices in the additional countries may begin to operate under this Agreement immediately after QI satisfies the notification requirement of this section 1.02. Appendix A, as amended, shall become part of this Agreement.

SECTION 2. DEFINITIONS

For purposes of this Agreement, the terms listed below are defined as follows:

Sec. 2.01. Account Holder. An "account holder" means any person that is a direct account holder or an indirect account holder and for which QI acts as a qualified intermediary. A direct account holder is any person who has an account directly with QI (including an intermediary or flow-through entity). An indirect account holder is any person who receives amounts from a QI but who does not have a direct account relationship with QI. For example, a person that has an account with a foreign intermediary or an interest in a flow-through entity which, in turn, is a direct account holder of QI is an indirect account holder. In addition, the person that is the sole owner of an entity that is disregarded under Treas. Reg. §301.7701–2(c)(2) as an entity separate from its owner is an indirect account holder. A person is an indirect account holder even if there are multiple tiers of intermediaries or flow-through entities between the person and the QI.

Sec. 2.02. Agreement. "Agreement" means this Agreement, all appendices and attachments to this Agreement, and QI's application to become a qualified intermediary. All such appendices, attachments, and QI's application are incorporated into this Agreement by reference.

Sec. 2.03. Amounts Subject to NRA Withholding. An "amount subject to NRA withholding" is an amount described in Treas. Reg. §1.1441–2(a). An amount subject to NRA withholding shall not include interest paid as part of the purchase price of an obligation sold between interest payment dates or original issue discount paid as part of the purchase price of an obligation sold in a transaction other than the redemption of such obligation, unless the sale is part of a plan the principal purpose of which is to avoid tax and QI has actual knowledge or reason to know of such plan.

Sec. 2.04. Assumption of Withholding Responsibility. A QI that assumes primary NRA withholding responsibility, or assumes primary Form 1099 reporting and backup withholding responsibility, assumes the primary responsibility for deducting, withholding, and depositing the appropriate amount from a payment. Generally, a qualified intermediary's assumption of primary NRA withholding responsibility or the assumption of primary backup withholding responsibility relieves the person who makes a payment to the qualified intermediary from the responsibility to withhold. Under section 3.05 of this Agreement, QI generally has primary Form 1099 reporting and backup withholding responsibility with respect to certain payments even though it does not assume such responsibility for payments not described in that section.

Sec. 2.05. Backup Withholding. "Backup withholding" means the withholding required under section 3406 of the Code.

Sec. 2.06. Beneficial Owner. A "beneficial owner" has the meaning given to that term in Treas. Reg. §1.1441–1(c)(6).

Sec. 2.07. Broker Proceeds. "Broker proceeds" means the gross proceeds from a sale of an asset to the extent that the gross proceeds would be subject to Form 1099 reporting if paid to a U.S. non-exempt recipient. For purposes of this Agreement, broker proceeds also include any proceeds paid by QI from the sale of assets pursuant to the provisions of section 6.04 of this Agreement that are owned by a U.S. non-exempt recipient and that produce, or could produce, reportable payments regardless of whether the sale is effected at an office inside or outside the United States and regardless of whether or not the sale is effected by QI or another person on instructions from QI. Thus, the exception in Treas. Reg. §1.6045–1(a), which excludes from Form 1099 reporting certain sales effected at an office outside the United States, shall not apply in the case of U.S. non-exempt recipients whose identity is prohibited by law from disclosure. In addition, the exception from backup withholding on certain payments contained in Treas. Reg. §31.3406(g)–1(e) shall not apply to such broker proceeds.

Sec. 2.08. Chapter 3 of the Code. Any reference to "chapter 3 of the Code" means sections 1441, 1442, 1443, 1461, 1463, and 1464 of the Code.

Sec. 2.09. Chapter 61 of the Code. Any reference to "chapter 61 of the Code" means sections 6041, 6042, 6045, 6049, and 6050N of the Code.

Sec. 2.10. Deposit Interest. "Deposit interest" means interest described in section 871(i)(2)(A) of the Code.

Sec. 2.11. Designated Broker Proceeds. "Designated broker proceeds" means–

(A) Any broker proceeds from the sale of assets that produce, or could produce, reportable amounts if the sale is effected at an office inside the United States, as defined in Treas. Reg. §1.6045–1(g)(3), (unless an exception to reporting applies under chapter 61 of the Code); and

(B) Any broker proceeds from the sale of an asset that produces, or could produce, reportable amounts that are beneficially owned by a U.S. non-exempt recipient whose identity and account information is prohibited from disclosure as described in section 6.04 of this Agreement. For this purpose, it is irrelevant whether the sale is effected by QI or another person upon instructions from QI. It is also irrelevant whether the sale is effected at an office inside or outside the United States. Thus, the exception in Treas. Reg. §1.6045–1(a) (which excepts sales effected at an office outside the United States by a non-U.S. payor) and the exception in Treas. Reg. 31.3406(g)–1(e) (which excepts certain payments made outside the United States from backup withholding) do not apply in the case of an account holder whose identity is prohibited by law from disclosure.

Sec. 2.12. Documentary Evidence. "Documentary evidence" means any documentation obtained under the appropriate know-your-customer rules (as described in the Attachments to this Agreement), any documentary evidence described in Treas. Reg. §1.1441–6 sufficient to establish entitlement to a reduced rate of withholding under an income tax treaty, or any documentary evidence described in Treas. Reg. §1.6049–5(c) sufficient to establish an account holder's status as a foreign person for purposes of chapter 61 of the Code. Documentary evidence does not include a Form W-8 or Form W-9 (or an acceptable substitute Form W-8 or Form W-9).

Sec. 2.13. Documentation. "Documentation" means any valid Form W-8, Form W-9 (or acceptable substitute Form W-8 or Form W-9) or documentary evidence as defined in section 2.12 of this Agreement, including all statements or other information required to be associated with the form or documentary evidence.

Sec. 2.14. Documented Account Holder. A "documented account holder" is an account holder for whom QI holds valid documentation.

Sec. 2.15. Exempt Recipient. For purposes of Form 1099 reporting and backup withholding, an "exempt recipient" means a person described in Treas. Reg. §1.6049– 4(c)(1)(ii) (for interest, dividends, and royalties), a person described in Treas. Reg. §5f.6045–1(c)(3)(i)(B) and §1.6045–2(b)(2)(i) (for broker proceeds), and a person described in Treas. Reg. §1.6041–3(q) (for rents, amounts paid on notional principal contracts, and other fixed or determinable income). Exempt recipients are not exempt from NRA withholding.

Sec. 2.16. External Auditor. An "external auditor" is any approved auditor listed in Appendix B of this Agreement that QI (or any private arrangement intermediary of QI) engages to perform the audits required by section 10 of this Agreement.

Sec. 2.17. Flow -Through Entity. A flow-through entity is a foreign partnership described in Treas. Reg. §301.7701–2 or 3 (other than a withholding foreign partnership), a foreign trust that is described in section 651(a) of the Code, or a foreign trust all or a portion of which is treated as owned by the grantor or other person under sections 671 through 679 of the Code. For an item of income for which a treaty benefit is claimed, an entity is also a flow-through entity to the extent it is treated as fiscally transparent under section 894 and the regulations thereunder.

Sec. 2.18. Foreign Person. A "foreign person" is any person that is not a "United States person" and includes a "nonresident alien individual," a "foreign corporation," a "foreign partnership," a "foreign trust," and a "foreign estate," as those terms are defined in section 7701 of the Code. For purposes of chapter 3 of the Code, the term foreign person also means, with respect to a payment by a withholding agent (including a qualified intermediary), a foreign branch of a U.S. person that provides a valid Form W-8IMY on which it represents that it is a qualified intermediary. A foreign branch of a U.S. person that is a qualified intermediary is, however, a U.S. payor for purposes of chapter 61 and section 3406 of the Code.

Sec. 2.19. Form W-8. "Form W-8" means IRS Form W-8BEN, Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding; IRS Form W-8ECI, Certificate of Foreign Person's Claim for Exemption From Withholding on Income Effectively Connected With the Conduct of a Trade or Business in the United States; IRS Form W-8EXP, Certificate of Foreign Governments and Other Foreign Organizations for United States Tax Withholding; and IRS Form W-8IMY, Certificate of Foreign Intermediary, Foreign Partnership, and Certain U.S. Branches for United States Tax Withholding, as appropriate. It also includes any acceptable substitute form.

Sec. 2.20. Form W-9. "Form W-9" means IRS Form W-9, Request for Taxpayer Identification Number and Certification, or any acceptable substitute.

Sec. 2.21. Form 945. "Form 945" means IRS Form 945, Annual Return of Withheld Federal Income Tax.

Sec. 2.22. Form 1042. "Form 1042" means an IRS Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons.

Sec. 2.23. Form 1042-S. "Form 1042-S" means an IRS Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding.

Sec. 2.24. Form 1096. "Form 1096" means IRS Form 1096, Annual Summary and Transmittal of U.S. Information Returns.

Sec. 2.25. Form 1099. "Form 1099" means IRS Form 1099-B, Proceeds From Broker and Barter Exchange Transactions; IRS Form 1099-DIV, Dividends and Distributions; IRS Form 1099-INT, Interest Income; IRS Form 1099-MISC, Miscellaneous Income; IRS Form 1099-OID, Original Issue Discount, and any other form in the IRS Form 1099 series appropriate to the type of payment required to be reported.

Sec. 2.26. Form 1099 Reporting. "Form 1099 reporting" means the reporting required on Form 1099.

Sec. 2.27. Intermediary. An "intermediary" means any person that acts on behalf of another person such as a custodian, broker, nominee, or other agent.

Sec. 2.28. Know-Your-Customer Rules. The phrase "know-your customer rules" refers to the applicable laws, regulations, rules, and administrative practices and procedures, identified in the Attachments to this Agreement, governing the requirements of QI to obtain documentation confirming the identity of QI's account holders.

Sec. 2.29. Marketable Securities. For purposes of this Agreement, the term "marketable securities" means those securities described in Treas. Reg. §1.1441–6 for which a TIN is not required to obtain treaty benefits.

Sec. 2.30. Non-Exempt Recipient. A "non-exempt recipient" means a person that is not an exempt recipient under the definition in section 2.15 of this Agreement.

Sec. 2.31. Nonqualified Intermediary. A "nonqualified intermediary" is any intermediary that is not a qualified intermediary. A nonqualified intermediary includes any custodian, nominee, or other agent as well as any financial institution intermediary unless such person enters an agreement to be a qualified intermediary and acts in such capacity.

Sec. 2.32. NRA Withholding. "Nonresident alien (NRA) withholding" is any withholding required under chapter 3 of the Code, whether the payment subject to withholding is made to an individual or to an entity.

Sec. 2.33. Overwithholding. The term "overwithholding" means the excess of the amount actually withheld under chapter 3 or section 3406 of the Code over the amount required to be withheld.

Sec. 2.34. Paid Outside the United States. An amount is "paid outside the United States" if it is paid outside the United States within the meaning of Treas. Reg. §1.6049–5(e).

Sec. 2.35. Payment. A "payment" is considered made to a person if that person realizes income whether or not such income results from an actual transfer of cash or other property. See Treas. Reg. §1.1441–2(e). For example, a payment includes crediting an amount to an account.

Sec. 2.36. Payor. A "payor" is defined in Treas. Reg. §31.3406(a)–2 and §1.6049–4(a)(2) and generally means any person required to make an information return under chapter 61 of the Code. The term includes any person that makes a payment, directly or indirectly, to QI and to whom QI provides information, pursuant to this Agreement, so that such person can report a payment on Form 1099 and, if appropriate, backup withhold. See sections 3.05 and 6 of this Agreement. Also see section 2.50 of this Agreement for the definition of U.S. payor and non-U.S. payor.

Sec. 2.37. Presume/Presumption. The terms "presume" or "presumption" refer to the presumption rules set forth in section 5.13(C) of this Agreement.

Sec. 2.38. Private Arrangement Intermediary. A "private arrangement intermediary" or "PAI" is an intermediary described in section 4 of this Agreement.

Sec. 2.39. Qualified Intermediary. A "qualified intermediary" is a person, described in Treas. Reg. §1.1441–1(e)(5)(ii), that enters into a withholding agreement with the IRS to be treated as a qualified intermediary and acts in its capacity as a qualified intermediary.

Sec. 2.40. Qualified Intermediary (or QI) EIN. A "qualified intermediary EIN" or "QI-EIN" means the employer identification number assigned by the IRS to a qualified intermediary. QI's QI-EIN is only to be used when QI is acting as a qualified intermediary. For example, QI must give a withholding agent its non-QI EIN, if any, rather than its QI-EIN if it is receiving income as a beneficial owner and a taxpayer identification number is required. QI must also use its non-QI EIN, if any, when acting as a nonqualified intermediary. Each signatory to this agreement must have its own QI-EIN.

Sec. 2.41. Reduced Rate of Withholding. A "reduced rate of withholding" means a rate of withholding under chapter 3 of the Code that is less than 30 percent, including an exemption from withholding, or not withholding 31 percent under section 3406 of the Code.

Sec. 2.42. Reliably Associating a Payment With Documentation. See section 5.13(B) of this Agreement to determine whether QI can reliably associate a payment with documentation.

Sec. 2.43. Reportable Amount. A "reportable amount" means an amount subject to NRA withholding (as defined in section 2.03 of this Agreement); U.S. source deposit interest (as defined in section 2.10 of this Agreement); and U.S. source interest or original issue discount paid on the redemption of short-term obligations (as defined in section 2.46 of this Agreement). The term does not include payments on deposits with banks and other financial institutions that remain on deposit for two weeks or less. It also does not include amounts of original issue discount arising from a sale and repurchase transaction completed within a period of two weeks or less, or amounts described in Treas. Reg. §1.6049–5(b)(7), (10), or (11) (relating to certain foreign targeted registered obligations and certain obligations issued in bearer form).

Sec. 2.44. Reportable Payment. For purposes of this Agreement, a reportable payment means amounts described in section 2.44(A) of this Agreement, in the case of a U.S. payor, and amounts described in section 2.44(B) of this Agreement, in the case of a non-U.S. payor.

(A) U.S. Payor. If QI is a U.S. payor, a reportable payment means any reportable payment as defined in section 3406(b) of the Code, including any broker proceeds from the sale of assets beneficially owned by a U.S. non-exempt recipient account holder that produce, or could produce, reportable payments if the identity and account information of that account holder is prohibited by law, including by contract, from disclosure as described in section 6.04 of this Agreement. For this purpose, it is irrelevant whether the sale is effected by QI or QI instructs another person to effect the sale. It is also irrelevant whether the sale is effected at an office inside or outside the United States. Thus, the exception in Treas. Reg. §1.6045–1(a) (which excepts sales effected at an office outside the United States by a non-U.S. payor) and the exception in Treas. Reg. 31.3406(g)–1(e) (which excepts certain payments made outside the United States from backup withholding) do not apply in the case of an account holder whose identity is prohibited by law from disclosure.

(B) Non-U.S. Payor. If QI is a non-U.S. payor a reportable payment means–

(1) Any reportable amount (unless an exception to reporting applies under chapter 61 of the Code);

(2) Any broker proceeds from the sale of assets that produce, or could produce, reportable amounts if the sale is effected at an office inside the United States, as defined in Treas. Reg. §1.6045–1(g)(3), (unless an exception to reporting applies under chapter 61 of the Code);

(3) Any broker proceeds from the sale of an asset that produces, or could produce, reportable amounts that are beneficially owned by a U.S. non-exempt recipient whose identity and account information is prohibited by law, including by contract, from disclosure as described in section 6.04 of this Agreement. For this purpose, it is irrelevant whether the sale is effected by QI or another person upon instructions from QI. It is also irrelevant whether the sale is effected at an office inside or outside the United States. Thus, the exception in Treas. Reg. §1.6045–1(a) (which excepts sales effected at an office outside the United States by a non-U.S. payor) and the exception in Treas. Reg. 31.3406(g)–1(e) (which excepts certain payments made outside the United States from backup withholding) do not apply in the case of an account holder whose identity is prohibited by law from disclosure; and

(4) Any foreign source interest, dividends, rents, royalties, or other fixed and determinable income if such income is paid in the United States or to an account maintained in the United States or any other amount presumed paid to a U.S. non-exempt recipient under section 5.13(C)(4) of this Agreement (unless an exception to reporting applies under chapter 61 of the Code).

Sec. 2.45. Reporting Pool. A reporting pool is defined in section 8.03 of this Agreement.

Sec. 2.46. Short-Term Obligation. A "short-term obligation" is any obligation described in section 871(g)(1)(B)(i) of the Code.

Sec. 2.47. TIN. A "TIN" is a U.S. taxpayer identification number.

Sec. 2.48. Underwithholding. "Underwithholding" means the excess of the amount required to be withheld under chapter 3 or section 3406 of the Code over the amount actually withheld.

Sec. 2.49. Undocumented Account Holder. An "undocumented account holder" is an account holder for whom QI does not hold valid documentation.

Sec. 2.50. U.S. Payor/Non-U.S. Payor. The terms "U.S. payor" and "non-U.S. payor" have the same meaning as in Treas. Reg. §1.6049–5(c).

Sec. 2.51. U.S. Person. A "United States (or U.S.) person" is a person described in section 7701(a)(30) of the Code, the U.S. government (including an agency or instrumentality thereof), a State of the United States (including an agency or instrumentality thereof), or the District of Columbia (including an agency or instrumentality thereof).

Sec. 2.52. Withholding Agent. A "withholding agent" has the same meaning as set forth in Treas. Reg. §1.1441–7(a) and includes a payor (as defined in section 2.36 of this Agreement). As used in this Agreement, the term generally refers to the person making a payment to a qualified intermediary.

Sec. 2.53. Withholding Rate Pool. The term "withholding rate pool" is defined in section 6.03 of this Agreement.

Sec. 2.54. Withholding Statement. The term "withholding statement" is defined in section 6.02 of this Agreement.

Sec. 2.55. Other Terms. Any term not defined in this section has the same meaning that it has under the Code, the income tax regulations under the Code, or any applicable income tax treaty.

SECTION 3. WITHHOLDING RESPONSIBILITY

Sec. 3.01. NRA Withholding Responsibility. QI is subject to the withholding and reporting provisions applicable to withholding agents under chapter 3 of the Code. Under chapter 3, a withholding agent must withhold 30 percent of any payment of an amount subject to NRA withholding made to an account holder that is a foreign person unless the withholding agent can reliably associate the payment with documentation upon which it can rely to treat the payment as made to a payee that is a U.S. person or as made to a beneficial owner that is a foreign person entitled to a reduced rate of withholding. See section 5 of this Agreement regarding documentation requirements.

Sec. 3.02. Primary NRA Withholding Responsibility Not Assumed. Notwithstanding sections 1.01 and 3.01 of this Agreement, QI shall not be required to withhold under chapter 3 of the Code if it does not accept primary NRA withholding responsibility under section 3.03 of this Agreement and it has provided a valid withholding certificate and correct withholding statements to a withholding agent from which it receives an amount subject to NRA withholding in accordance with section 6 of this Agreement. Notwithstanding its election not to assume primary NRA withholding responsibility, QI shall, however, withhold the difference between the amount of NRA withholding required under chapter 3 of the Code and the amount actually withheld by another withholding agent if QI–

(A) Actually knows that the appropriate amount has not been withheld by another withholding agent; or

(B) Made an error which results in the withholding agent's failure to withhold the correct amount due (e.g., QI fails to provide an accurate withholding statement with respect to the payment) and QI has not corrected the underwithholding under the reimbursement and setoff procedures of section 9.05 of this Agreement.

QI is not required to withhold under chapter 3 of the Code on an amount subject to NRA withholding that it pays to another qualified intermediary that has assumed primary NRA withholding responsibility with respect to the payment or to a withholding foreign partnership. See section 8 of this Agreement regarding QI's responsibility to report amounts subject to withholding on Form 1042–S.

Sec. 3.03. Assumption of Primary NRA Withholding Responsibility. QI, upon notification to a withholding agent, may assume primary NRA withholding responsibility for an amount subject to NRA withholding by providing a valid withholding certificate described in section 6 of this Agreement to a withholding agent that makes a payment of an amount subject to NRA withholding and by designating on the withholding statement associated with such certificate the account for which QI assumes primary NRA withholding responsibility. QI may assume primary NRA withholding responsibility without informing the IRS. QI is not required to assume primary NRA withholding responsibility for all accounts it has with the withholding agent. However, if QI assumes primary NRA withholding responsibility for any account, it must assume that responsibility for all payments of amounts subject to NRA withholding made by the withholding agent to that account. To the extent that QI assumes primary NRA withholding responsibility, QI shall withhold from amounts subject to NRA withholding the amount required to be withheld under chapter 3 of the Code. QI is not required, however, to withhold on amounts it pays to another qualified intermediary that has certified to QI on Form W-8IMY that it has assumed primary withholding responsibility with respect to the payment or to a withholding foreign partnership. See section 8 of this Agreement regarding QI's responsibility to report amounts subject to withholding on Form 1042-S.

Sec. 3.04. Backup Withholding Responsibility. QI is a payor under section 3406 of the Code with respect to reportable payments. Under section 3406, a payor is required to deduct and withhold 31 percent from the payment of a reportable payment to a U.S. non-exempt recipient if the U.S. non-exempt recipient has not provided its TIN in the manner required under that section; the IRS notifies the payor that the TIN furnished by the payee is incorrect; there has been a notified payee under-reporting described in section 3406(c); or there has been a payee certification failure described in section 3406(d). QI represents that there are no legal restrictions that prohibit it from complying with the Form 1099 reporting requirements of this Agreement or imposing backup withholding and depositing the amounts withheld in accordance with section 3.08 of this Agreement.

Sec. 3.05. Primary Form 1099 Reporting and Backup Withholding Responsibility For Reportable Payments Other Than Reportable Amounts. Under section 6.01 of this Agreement, QI is only required to provide a withholding agent with information regarding reportable amounts. Therefore, QI is primarily responsible for reporting on Form 1099 and, if required, backup withholding on the payments described in section 3.05(A) and (B) of this Agreement whether or not QI assumes primary Form 1099 reporting and backup withholding responsibility with respect to reportable amounts under section 3.07 of this Agreement. No provision of this Agreement which requires QI to provide another withholding agent with information regarding reportable amounts shall be construed as relieving QI of its Form 1099 reporting and backup withholding obligations with respect to reportable payments that are not reportable amounts.

(A) U.S. Payor. Except as provided in section 3.05(C) of this Agreement, if QI is a U.S. payor, QI has primary Form 1099 reporting and backup withholding responsibility for reportable payments as defined in section 3406(b) of the Code other than reportable amounts. For example, if QI is a U.S. payor, it has primary Form 1099 reporting and backup withholding responsibility for payments of foreign source income as well as all broker proceeds paid to account holders that are, or are presumed to be, U.S. non-exempt recipients, unless an exception to reporting or backup withholding applies. QI also has primary Form 1099 reporting and backup withholding responsibility for broker proceeds from the sale of assets beneficially owned by a U.S. non-exempt recipient account holder that produce or could produce, reportable payments if the identity and account information of that account holder is prohibited by law from disclosure as described in section 6.04 of this Agreement. See section 2.44(A) of this Agreement for the instances in which certain reporting and withholding exceptions do not apply.

(B) Non-U.S. Payor. Except as provided in section 3.05(C) of this Agreement, if QI is a non-U.S. payor, QI has primary Form 1099 reporting and backup withholding responsibility for broker proceeds described in section 2.44(B)(2) and (3) of this Agreement and foreign source income paid in the United States or to an account maintained in the United States as described in section 2.44(B)(4) of this Agreement, if such payments are made, or presumed made under section 5.13(C)(4) of this Agreement, to U.S. non-exempt recipients.

(C) Designated Broker Proceeds Procedure. Whether QI is a U.S. payor or non-U.S. payor, QI may request another payor to report on Form 1099 and, if required, backup withhold on designated broker proceeds (as defined in section 2.11 of this Agreement), provided the other payor actually receives the broker proceeds. QI will not be primarily responsible for Form 1099 reporting and for backup withholding if the other payor agrees to do the reporting and backup withholding and QI provides all of the information necessary for the other payor to properly report, and backup withhold on the designated broker proceeds. QI, however, remains primarily responsible for Form 1099 reporting and backup withholding if the other payor does not agree to report and backup withhold, or QI knows that the other payor failed to do so.

Sec. 3.06. Primary Form 1099 Reporting and Backup Withholding Responsibility For Reportable Amounts Not Assumed. Notwithstanding sections 1.01 and 3.04 of this Agreement, QI shall not be required to backup withhold on a reportable amount if QI does not assume primary Form 1099 reporting and backup withholding responsibility and it provides a payor from which it receives a reportable amount the Forms W-9 of its U.S. non- exempt recipient account holders (or, if a U.S. non-exempt recipient fails to provide a Form W-9, information regarding the account holder's name, address, and TIN, if a TIN is available) together with the withholding rate pools (as defined in section 6.03 of this Agreement) attributable to U.S. non-exempt recipient account holders. Notwithstanding its election not to assume primary Form 1099 reporting and backup withholding responsibility, QI shall backup withhold and report a reportable amount if–

(A) QI actually knows a reportable amount is subject to backup withholding and another payor failed to apply backup or NRA withholding;

(B) Another payor has not applied backup or NRA withholding to a reportable amount because of an error made by QI (e.g., QI failed to provide the other payor with information regarding the name, address, TIN, if available, and withholding rate pool for a U.S. non-exempt recipient account holder subject to backup withholding);

(C) QI pays a reportable amount to a U.S. non-exempt recipient whose identity and other account information are prohibited by law from disclosure (see section 6.04 of this Agreement) and another payor of the reportable amount has not backup withheld.

QI is not required to backup withhold, however, on a reportable amount it makes to a withholding foreign partnership or to another qualified intermediary if the other qualified intermediary has assumed primary Form 1099 reporting and backup withholding responsibility with respect to the payment. See section 3.05 of this Agreement for backup withholding responsibility for reportable payments other than reportable amounts. See section 8.04 of this Agreement regarding QI's responsibility to report reportable payments on Form 1099.

[NOTE: A qualified intermediary that is not a U.S. payor must obtain IRS approval to assume primary Form 1099 reporting and backup withholding responsibility with respect to reportable amounts. The IRS will evidence its approval of a non-U.S. payor's assumption of primary Form 1099 reporting and backup withholding responsibility by the signature of the Commissioner, or his delegate, in the margin of section 3.07 of this Agreement.]

Sec. 3.07. Assumption of Primary Form 1099 Reporting and Backup Withholding Responsibility. QI may assume primary Form 1099 reporting responsibility under chapter 61 of the Code and primary backup withholding responsibility under section 3406 of the Code with respect to reportable amounts. See sections 3.05 and 8.04 of this Agreement for QI's obligations regarding reportable payments other than reportable amounts. A qualified intermediary that assumes such responsibility is subject to all of the obligations imposed by chapter 61 and section 3406 of the Code and shall be subject to any applicable penalties for failure to meet those obligations. The exception from backup withholding under Treas. Reg. §31.3406(g)–1(e) shall not apply, however, to payments of deposit interest, or interest or original issue discount on redemptions of short-term obligations, to the extent QI must presume that an account holder is a U.S. non-exempt recipient under section 5.13(C)(2) of this Agreement. QI shall inform a withholding agent from which it receives a reportable amount that it has assumed primary Form 1099 reporting and backup withholding responsibility by providing the withholding agent with a valid withholding certificate described in section 6 of this Agreement and by designating on the withholding statement associated with such certificate the account for which QI assumes primary Form 1099 reporting and backup withholding responsibility. QI may assume primary Form 1099 reporting and backup withholding responsibility without informing the IRS, unless QI is a non-U.S. payor. QI is not required to assume primary Form 1099 reporting and backup withholding responsibility for all accounts it has with a withholding agent. However, if QI assumes primary Form 1099 reporting and backup withholding responsibility for any account, it must assume that responsibility for all reportable amounts made by a payor to that account. QI shall not be required to backup withhold on a reportable amount it makes to another qualified intermediary that has assumed primary Form 1099 reporting and backup withholding responsibility with respect to the reportable amount. See section 8 of this Agreement regarding QI's responsibility to report reportable payments on Form 1099.

Sec. 3.08. Deposit Requirements. If QI is a U.S. payor or a non-U.S. payor that assumes primary NRA withholding responsibility or primary Form 1099 and backup withholding responsibility, it must deposit amounts withheld under chapter 3 or section 3406 of the Code with a Federal Reserve bank or authorized financial institution at the time and in the manner provided under section 6302 of the Code (see Treas. Reg. §1.6302–2(a) or §31.6302–1(h)). If QI is a non-U.S. payor that does not assume primary NRA withholding responsibility or primary Form 1099 and backup withholding responsibility, QI must deposit amounts withheld by the 15th day following the month in which the NRA or backup withholding occurred.

SECTION 4. PRIVATE ARRANGEMENT INTERMEDIARIES

Sec. 4.01. In General. QI may enter into a private arrangement with another intermediary under which the other intermediary agrees to perform all of the obligations of QI under this Agreement, except as provided in section 4.02 of this Agreement. Such agreement shall be between the QI and all the offices of the other intermediary located in a specified country. The specified country must be one for which this Agreement is available. Such an intermediary is referred to in this Agreement as a private arrangement intermediary ("PAI"). By entering into a PAI agreement, QI is not assigning its liability for the performance of any of its obligations under this Agreement. Therefore, QI shall remain liable for any tax, penalties, interest, and any other sanction that may result from the failure of the PAI to meet any of the obligations imposed by its agreement with QI. QI agrees not to assert any defenses against the IRS for the failures of the PAI or any defenses that the PAI may assert against QI. For purposes of this Agreement, the PAI's actual knowledge or reason to know of facts relevant to withholding or reporting shall be imputed to QI. QI's liability for the failures of the PAI shall apply even though the PAI is itself a withholding agent under chapter 3 of the Code and a payor under chapter 61 and section 3406 and is itself separately liable for its failure to meet its obligations under the Internal Revenue Code. Notwithstanding the foregoing, QI shall not be liable for tax, interest, or penalties for failure to withhold and report under chapters 3, 61, and section 3406 of the Code unless the underwithholding or the failure to report amounts correctly on Forms 945, 1042, 1042-S or 1099 are due to QI's or its PAI's failure to properly perform its obligations under this Agreement. The PAI is not required to enter into an agreement with the IRS. The IRS may, however, in its sole discretion, refuse to permit an intermediary to operate as a PAI by providing notice to QI at the address provided in section 12.06 of this Agreement. QI may, however, appeal the IRS's determination by following the notice and cure provisions in section 11.05 of this Agreement. For purposes of this Agreement, an intermediary shall be considered a PAI only if the following conditions are met:

(A) The PAI is, pursuant to a written agreement between QI and the PAI, subject to all the obligations of QI under this Agreement, except to the extent modified by section 4.02 of this Agreement;

(B) QI files a notice with the Commissioner, or his delegate, at the address set forth in section 12.06 of this Agreement, before the first payment for which the intermediary acts as a PAI giving the name, address, taxpayer identification number of the intermediary, if any, and the name of the country or countries in which the offices of the intermediary that are subject to the PAI agreement are located;

(C) The PAI is subject to the identical external audit procedures that apply to QI under this Agreement and the PAI uses an external auditor designated in Appendix B of this Agreement, or another auditor approved by the IRS for that PAI; and

(D) The PAI furnishes QI with a Form W-8IMY described in section 6 of this Agreement as modified by this section 4.01(D). The PAI is required to provide QI with the Forms W-9 (or, in absence of the form, the name, address and TIN, if available) of the PAI's U.S. non-exempt recipient account holders and the withholding rate pool information for those account holders as required by section 6.03 of this Agreement. In addition, the PAI is required to disclose to QI the account holders of a nonqualified intermediary, or interest holders in a flow-through entity, which has an account with the PAI and all of the information relating to those account holders that is required for the QI, or another withholding agent, to report the payments made to those account holders as required by sections 8.02(B) and 8.04 of this Agreement. The PAI is not required to disclose to QI, or another withholding agent, its direct account holders that are foreign persons.

Sec. 4.02. Modification of Obligations for PAI Agreements. The agreement between QI and a PAI must provide that QI shall include all reportable payments made by the PAI in QI's Forms 945 and 1099 and all payments of amounts subject to NRA withholding made by the PAI in QI's Forms 1042 and 1042-S as if QI had made the payments directly to the PAI's account holders. Therefore, QI shall report payments made to a PAI's direct foreign account holders (other than intermediaries, custodians, nominees, agents or flow-through entities) using the reporting pools as described in section 8.03 of this Agreement and shall report payments made to indirect foreign account holders of the PAI by reporting the payments as made to specific recipients under the rules of section 8.02 of this Agreement. QI shall also file Forms 1099 and, if required, backup withhold on reportable payments made to U.S. non-exempt recipient direct or indirect account holders of a PAI in accordance with the terms of this Agreement. QI shall require a PAI to provide QI with all the information necessary for QI to meet its obligations under this Agreement. No provisions shall be contained in the agreement between QI and a PAI that preclude, and no provisions of this Agreement shall be construed to preclude, the PAI's joint and several liability for tax, penalties, and interest under chapters 3, 61, and section 3406 of the Code to the extent that underwithholding, penalties, and interest have not been collected from QI and the underwithholding or failure to report amounts correctly on Forms 945, 1042, 1042-S or 1099 are due to a PAI's failure to properly perform its obligations under its agreement with QI. QI's agreement with a PAI must require the PAI to disclose information regarding

U.S. non-exempt recipients to the same extent that QI is required to disclose such information to the IRS or another payor under this Agreement. Nothing in the agreement between QI and a PAI shall permit the PAI to assume primary NRA withholding responsibility or primary Form 1099 reporting and backup withholding responsibility.

Sec. 4.03. Termination of Arrangement. QI shall cease to treat an intermediary as a PAI within 90 days from the day QI knows that the PAI is in default of its agreement with QI unless the PAI has cured the event of default prior to the expiration of such 90 day period. QI must provide the IRS with notice of any PAI agreement that has been terminated within 30 days of the termination.

SECTION 5. DOCUMENTATION REQUIREMENTS

Sec. 5.01. Documentation Requirements. QI shall apply the presumption rules to any account holder that receives a reportable amount or reportable payment unless QI can reliably associate the payment with valid documentation from the account holder. QI agrees to use its best efforts to obtain documentation from account holders. If QI is obtaining documentary evidence, QI also agrees to adhere to the know-your-customer rules that apply to QI with respect to the account holder from whom the documentary evidence is obtained. As set forth in section 11.04(F) of this Agreement, failure to obtain documentation from a significant number of direct account holders constitutes an event of default. QI agrees to review and maintain documentation in accordance with this section 5 and, in the case of documentary evidence obtained from direct account holders, in accordance with the know-your-customer rules set forth in the Attachments to this Agreement. QI also agrees to make documentation (together with any associated withholding statements and other documents or information) available upon request for inspection by QI's external auditor. QI represents that none of the laws to which it is subject prohibits disclosure of the identity of any account holder (including account holders subject to the provisions of section 6.04 of this Agreement) or account information to QI's external auditor. QI may rely on the documentation it obtains under this section 5 as the basis for the information it provides another withholding agent under section 6 of this Agreement, as well as to determine its own withholding and reporting obligations.

Sec. 5.02. Documentation For Foreign Account Holders. Except as otherwise provided in section 5 of this Agreement, QI may treat an account holder (including an account holder that is a collective investment vehicle) as a foreign beneficial owner of an amount if the account holder provides a valid Form W-8 (other than Form W-8IMY) or valid documentary evidence, as described in section 2.12 of this Agreement, that supports the account holder's status as a foreign person. QI may treat a documented foreign beneficial owner account holder as entitled to a reduced rate of NRA withholding if all the requirements to a reduced rate are met and the documentation provided by the account holder supports entitlement to a reduced rate. QI may not, however, reduce the rate of NRA withholding or backup withholding required under the presumption rules of section 5.13(C) of this Agreement if QI knows that the account holder (including a collective investment vehicle) is not the beneficial owner of a reportable amount or reportable payment. In addition, QI may not treat an account holder that provides documentation indicating that it is a bank, broker, intermediary, or agent (such as an attorney) as a beneficial owner unless QI receives a statement, in writing and signed by a person with authority to sign such a statement, stating that such account holder is the beneficial owner of the income. Further, QI may not reduce the rate of withholding that applies under the presumption rules of section 5.13(C) of this Agreement on the basis of a collective or global certification that is made by any person (such as an intermediary or flow-through entity) on behalf of others unless the certification is a valid Form W-8IMY, and then, only to the extent that QI can reliably associate the payment with valid documentation that establishes the account holder's entitlement to a reduced rate of withholding. See section 5.13(B) of this Agreement for rules regarding reliable association with documentation.

Sec. 5.03. In General. QI may not reduce the rate of withholding based on a beneficial owner's claim of treaty benefits unless QI obtains the documentation required by section 5.03(A) of this Agreement. In addition, QI agrees to establish procedures to inform account holders of the terms of limitation on benefits provisions of a treaty (whether or not those provisions are contained in a separate article entitled Limitation on Benefits) under which the account holder is claiming benefits.

(A) Treaty Documentation. The documentation required by this section 5.03(A) is as follows:

(1) The account holder has provided a properly completed Form W-8BEN with part II of the form completed, including the appropriate limitation on benefits and section 894 certifications. A TIN shall not be required, however, if the beneficial owner is a direct account holder. An indirect account holder is required to have a TIN to claim treaty benefits unless it is claiming treaty benefits on income from a marketable security;

(2) The account holder has provided documentary evidence that has been obtained pursuant to the know-your-customer rules that apply to the account holder and the account holder has made the treaty statement required by section 5.03(B) of this Agreement, if applicable; or

(3) The account holder provides the type of documentary evidence required under Treas. Reg. §1.1441-6 to establish entitlement to a reduced rate of withholding under a treaty and the account holder has made the treaty statement required by section 5.03(B) of this Agreement, if applicable.

(B) Treaty Statement. The treaty statement required by this section 5.03(B) is as follows:

> [Name of account holder] meets all provisions of the treaty that are necessary to claim a reduced rate of withholding, including any limitation on benefits provisions, and derives the income within the meaning of section 894 of the Code, and the regulations thereunder, as the beneficial owner.

QI shall not be required to obtain a treaty statement required by this section 5.03(B) from an individual who is a resident of an applicable treaty country or from the government, or its political subdivisions, of a treaty country.

(C) Transition Rule for Treaty Certification. QI may reduce the rate of withholding on a payment made to a beneficial owner account holder that is otherwise entitled to a reduced rate of withholding under an income tax treaty without obtaining the treaty statement required in sections 5.03(B) of this Agreement provided that the account to which the payment is made was established before January 1, 2001, and the payment to which a reduced rate of withholding under the income tax treaty is applied is received on or before December 31, 2002.

Sec. 5.04. Documentation for International Organizations. QI may not treat an account holder as an international organization entitled to an exemption from withholding under section 892 of the Code unless the name provided on the documentation (including a Form W-8EXP) is the name of an entity designated as an international organization by executive order pursuant to 22 United States Code 288 through 288(f) and the documentation is valid under section 5.10 of this Agreement. If an international organization is not claiming benefits under section 892 of the Code but under another Code exception, the provisions of sections 5.02 of this Agreement apply rather than the provisions of this section 5.04.

Sec. 5.05. Documentation for Foreign Governments and Foreign Central Banks of Issue.

(A) Documentation From a Foreign Government or Foreign Central Bank of Issue Claiming an Exemption From Withholding Under Section 892 or Section 895. QI may not treat an account holder as a foreign government or foreign central bank of issue exempt from withholding under section 892 or 895 of the Code unless–

(1) QI receives from the account holder a Form W-8EXP or documentary evidence establishing that the account holder is a foreign government or foreign central bank of issue;

(2) The income paid to the account holder is the type of income that qualifies for an exemption from withholding under section 892 or 895; and

(3) QI does not know, or have reason to know, that the account holder is a controlled commercial entity, that the income owned by the foreign government or foreign central bank of issue is being received from a controlled commercial entity, or that the income is from the disposition of an interest in a controlled commercial entity.

(B) Treaty Exemption. QI may treat an account holder as a foreign government or foreign central bank of issue entitled to a reduced rate of withholding under an income tax treaty if it has valid documentation that, under section 5.03 of this Agreement, is sufficient to obtain a reduced rate of withholding under a treaty.

(C) Other Code Exception. If a foreign government or foreign central bank of issue is not claiming benefits under section 892 of the Code but under another Code exception (e.g., the portfolio interest exception under sections 871(h) or 881(c) of the Code), the provisions of sections 5.02 of this Agreement apply rather than the provisions of this section 5.05.

Sec. 5.06. Documentation for Foreign Tax-Exempt Organizations.

(A) Reduced Rate of Withholding Under Section 501. QI may not treat an account holder as a foreign organization described under section 501(c) of the Code, and therefore exempt from withholding (or, if the account holder is a foreign private foundation, subject to withholding at a 4-percent rate under section 1443(b) of the Code) unless QI obtains a valid Form W-8EXP on which Part III of the form is completed.

(B) Reduced Rate of Withholding Under Treaty. QI may not treat an account holder as a foreign organization that is tax-exempt on an item of income pursuant to a treaty unless QI obtains valid documentation as described under section 5.03 of this Agreement that is sufficient for obtaining a reduced rate of withholding under a treaty and the documentation establishes that the account holder is an organization exempt from tax under the treaty on that item of income.

(C) Other Exceptions. If a tax-exempt entity is not claiming a reduced rate of withholding because it is an organization described under section 501(c) of the Code or under a treaty article that applies to exempt certain organizations from tax, but is claiming a reduced rate of withholding under another Code or treaty exception, the provisions of section 5.02 of this Agreement shall apply rather than the provisions of this section 5.06.

Sec. 5.07. Documentation From Intermediaries or Flow-Through Entities. QI shall apply the presumption rules of section 5.13 of this Agreement to a reportable amount or reportable payment made to a nonqualified intermediary or flow-through entity except to the extent QI follows the documentation procedures set forth below.

(A) Nonqualified Intermediaries and Flow-Through Entities. QI shall not apply the presumption rules on a payment made to a nonqualified intermediary or flow-through entity to the extent–

(1) QI receives a valid Form W-8IMY provided by the nonqualified intermediary or the flow- through entity; and

(2) QI can reliably associate the payment, within the meaning of section 5.13(B) of this Agreement, with valid documentation described in this section 5 provided by account holders that are not themselves nonqualified intermediaries or flow through entities.

(B) Qualified Intermediaries and Withholding Foreign Partnerships. QI shall not apply the presumption rules to a payment made to a qualified intermediary or withholding foreign partnership to the extent QI can reliably associate the payment with a valid Form W-8IMY provided by the qualified intermediary or withholding foreign partnership and, for those payments for which a qualified intermediary has not assumed primary NRA withholding responsibility or primary Form 1099 reporting and backup withholding responsibility, QI can reliably associate the payment with a withholding rate pool, as described in section 6.03 of this Agreement.

(C) Private Arrangement Intermediaries. QI shall not apply the presumption rules of section 5.13 of this Agreement if QI has an agreement with a PAI, QI obtains from the PAI a Form W-8IMY completed as if the PAI were a qualified intermediary (with the exception that the PAI must not provide a QI-EIN on the Form W-8IMY) and QI can reliably associate the payment with reporting pools as described under section 8 of this Agreement, or with withholding rate pool information relating to U.S. non-exempt recipients and indirect foreign account holders.

Sec. 5.08. Documentation For U.S. Exempt Recipients. QI shall not treat an account holder as a U.S. exempt recipient unless QI obtains from the account holder–

(A) A valid Form W-9 on which the account holder writes "Exempt" in Part II of the Form;

(B) Documentary evidence that is sufficient to establish both the account holder's U.S. and exempt recipient status; or

(C) Documentary evidence that is sufficient to establish the account holder's status as a U.S. person and QI can treat the person as an exempt recipient under the rules of Treas. Reg. §§1.6041–3(q), 5f.6045–1(c)(3)(i)(B), 1.6045–2(b)(2)(i), or 1.6049–4(c)(1)(ii), as appropriate, without obtaining documentation.

Sec. 5.09. Documentation for U.S. Non-Exempt Recipients. QI shall not treat an account holder as a U.S. non-exempt recipient unless QI obtains a valid Form W-9 from the account holder, QI knows an account holder is a U.S. non-exempt recipient, or QI must presume a person is a U.S. non-exempt recipient under sections 5.13(C)(2) or (4) of this Agreement. See section 6.04 of this Agreement for rules that apply if the identity of a U.S. non-exempt recipient is prohibited by law from being disclosed.

Sec. 5.10. Documentation Validity.

(A) In General. QI may not rely on documentation if QI has actual knowledge, or reason to know as described in section 5.10(B) and (C) of this Agreement, that the information or statements contained in the documentation are unreliable or incorrect. Once QI knows, or has reason to know, that documentation provided by an account holder is unreliable or incorrect, it can no longer reliably associate a payment with valid documentation and, therefore, shall treat the account holder as an undocumented account holder and shall apply the presumption rules of section 5.13 of this Agreement until it obtains valid documentation. In addition, if QI discovers that information contained in documentation is unreliable or incorrect, QI agrees that it will promptly provide a withholding agent with corrected information (e.g., corrected withholding rate pools, corrected Forms W-9, or correct TINs), if necessary for the withholding agent to perform its obligations, within 30 days after QI discovers that the documentation upon which it has relied is unreliable or incorrect. If QI receives notification from the IRS that documentation provided by an account holder is unreliable or incorrect (e.g., that the TIN provided by an account holder is incorrect) QI shall follow the procedures set forth in Treas. Reg. §31.3406(d)–5.

(B) Reason to Know–Direct Account Holders. QI shall be considered to have reason to know that documentation provided by a direct account holder is unreliable or incorrect only if one or more of the circumstances described in this section 5.10(B) apply. If an account holder has provided documentation that is not reliable under the rules of this section 5.10(B), QI may require new documentation. Alternatively, QI may rely on the documentation originally provided if the rules of this section 5.10(B) permit such reliance based on additional statements and documentation.

(1) General Rules.

(i) To the extent QI has primary Form 1099 and backup withholding responsibility, QI shall not rely on a Form W-9 if it is not permitted to do so under the rules of Treas. Reg. §31.3406(h)–3(e).

(ii) QI shall not treat documentary evidence provided by an account holder as valid if the documentary evidence does not reasonably establish the identity of the person presenting the documentary evidence. For example, documentary evidence is not valid if it is provided in person by an account holder that is a natural person and the photograph on the documentary evidence, if any, does not match the appearance of the person presenting the document.

(iii) QI may not rely on documentation to reduce the withholding rate that would otherwise apply under the presumption rules if the account holder's documentation is incomplete, contains information that is inconsistent with the account holder's claim, QI has other account information that is inconsistent with the account holder's claim, or the documentation lacks information necessary to establish entitlement to a reduced rate of withholding. For example, if an account holder provides documentary evidence to claim treaty benefits and the documentary evidence establishes the account holder's status as a foreign person and a resident of a treaty country, but fails to provide the treaty statement in section 5.03 of this Agreement, if required, the documentary evidence does not establish the account holder's entitlement to a reduced rate of withholding. However, for purposes of establishing an account holder's status as a foreign person or residency under an income tax treaty, documentation shall be considered inconsistent only if it is not reliable under the rules of section 5.10(B)(2) and (3) of this Agreement.

(2) Rules Regarding Establishment of Foreign Status.

(i) QI shall not treat documentary evidence provided by an account holder after December 31, 2000, as valid for purposes of establishing the account holder's foreign status if the only mailing or residence address that is available to QI is an address at a financial institution (unless the financial institution is a beneficial owner), an in-care-of address, or a P.O. Box. In this case, QI must obtain additional documentation that is sufficient to establish the account holder's identity as a foreign person. QI shall not treat documentary evidence provided by an account holder before January 1, 2001, as valid for purposes of establishing an account holder's status as a foreign person if it has actual knowledge that a person is a U.S. person or if it has a mailing or residence address for the account holder in the United States. If QI has an address for the account holder in the United States, QI may treat the account holder as a foreign person if it can so treat the account holder under the rules of section 5.10(B)(2)(ii) of this Agreement.

(ii) QI shall not treat documentation as valid for purposes of establishing an account holder's status as a foreign person if QI has a mailing or residence address (whether or not on the documentation) for the account holder in the United States or if the account holder notifies QI of a new address in the United States.

If the account holder is a natural person, QI may nevertheless treat the account holder as a foreign person if QI–

(a) Has in its possession or obtains additional documentary evidence (which does not contain a U.S. address) supporting the claim of foreign status and a reasonable explanation in writing supporting the account holder's foreign status;

(b) Has in its possession or obtains a valid Form W-8, if the initial documentation provided was not a Form W-8, and the Form W-8 contains a permanent residence address outside the United States and a mailing address outside the United States (or if a mailing address is inside the United States the account holder provides a reasonable explanation in writing supporting the account holder's foreign status); or

(c) Is required to report annually a payment to the account holder on a tax information statement in the country in which

QI, or a branch of QI, is located; QI is required to file a copy of that statement with the tax authority of that country; and that country has an income tax treaty in effect with the United States.

If the documentation is provided by an entity (other than a flow-through entity), QI may nevertheless treat the account holder as a foreign person if QI–

(d) Has in its possession, or obtains, documentation that substantiates that the entity is actually organized or created under the laws of a foreign country;

(e) Obtains a valid Form W-8, if the initial documentation provided was not a Form W-8, and the Form W-8 contains a permanent residence outside the United States and a mailing address outside the United States (or if a mailing address is inside the United States the account holder provides additional documentary evidence sufficient to establish the account holder's foreign status); or

(f) Is required to report annually a payment to the account holder on a tax information statement in the country in which QI, or a branch of QI, is located; QI is required to file a copy of that statement with the tax authority of that country; and that country has an income tax treaty in effect with the United States.

(iii) QI shall not treat documentation as valid for purposes of establishing an account holder's status as a foreign person if the account holder has standing instructions directing QI to pay amounts from its account to an address or an account maintained in the United States. QI may treat documentation as valid for establishing foreign status even though the account holder has such standing instructions if the account holder provides a reasonable explanation in writing that supports its foreign status.

(3) Rules for Establishing Residency Under An Income Tax Treaty.

(i) QI shall not treat an account holder as a resident under an income tax treaty if the permanent residence address on a Form W-8 is not in the applicable treaty country. QI may, however, rely on the Form W-8 if the account holder provides a reasonable explanation for the permanent residence address outside the treaty (e.g., the address is the address of a branch located outside the treaty country in which the entity is a resident) or QI has in its possession, or obtains, documentary evidence that establishes residency in a treaty country.

(ii) QI shall not treat an account holder as a resident under an income tax treaty if the permanent residence address on a Form W-8 is in the applicable treaty country but QI has a mailing or residence address for the account holder (whether or not contained on the Form W-8) outside the applicable treaty country. A mailing address that is a P.O. Box, in-care-of address, or address at a financial institution (if the financial institution is not a beneficial owner) shall not preclude QI from treating the account holder as a resident of an applicable treaty country if such address is in the applicable treaty country. If QI has a mailing or residence address for the account holder outside the applicable treaty country, QI may nevertheless rely on the form if–

(a) QI has in its possession, or obtains, additional documentation supporting the account holder's claim of residence in the applicable treaty country (and the additional documentation does not contain an address outside the treaty country);

(b) QI has in its possession, or obtains, documentation that establishes that the account holder is an entity organized in a treaty country (or an entity managed and controlled in a treaty country, if the applicable treaty so requires);

(c) QI knows that the address outside the applicable treaty country (other than a P.O. Box, or in-care-of address) is a branch of a bank or insurance company; or

(d) QI obtains a written statement from the account holder that reasonably establishes entitlement to treaty benefits.

(iii) QI shall not treat documentary evidence as valid for purposes of establishing residency in a treaty country if QI has a mailing or residence address for the account holder (whether or not on the documentary evidence) that is outside the applicable treaty country, or the only address that QI has (whether in or outside of the applicable treaty country) is a P.O. Box, an in-care-of address, or the address of a financial institution (if the financial institution is not the beneficial owner). QI may nevertheless rely on the documentary evidence if–

(a) QI has in its possession, or obtains, additional documentary evidence supporting the account holder's claim of residence in the applicable treaty country (and the documentary evidence does not contain an address outside the applicable treaty country, a P.O. Box, an in-care-of address, or the address of a financial institution);

(b) QI has in its possession, or obtains, documentary evidence that establishes that the account holder is an entity organized in a treaty country (or an entity managed and controlled in a treaty country, if the applicable treaty so requires); or

(c) QI obtains a valid Form W-8 that contains a permanent residence address and a mailing address in the applicable treaty country.

(iv) QI shall not treat documentation as valid for purposes of establishing an account holder's residence in an applicable treaty country if the account holder has standing instructions for QI to pay amounts from its account to an address or an account outside the treaty country unless the account holder provides a reasonable explanation, in writing, establishing the account holder's residence in the applicable treaty country.

(C) Reason to know–Indirect Account Holders. QI shall be considered to have reason to know that relevant information or statements contained in documentation provided by an indirect account holder are unreliable or incorrect if a reasonably prudent person in the position of a qualified intermediary would question the claims made. QI shall have reason to know that indirect account holder documentary evidence provided by a nonqualified intermediary or a flow-through entity is unreliable or incorrect if a nonqualified intermediary or flow-through entity does not provide QI with the names of the indirect account holders, their addresses, allocation information allocating payments to each indirect account holder, and sufficient information for QI to report payments on Forms 1042-S and Forms 1099. In addition, QI shall have reason to believe that an indirect account holder is not entitled to a reduced rate of withholding under an income tax treaty if the nonqualified intermediary or flow-through entity has not provided sufficient information so that QI can verify that the indirect account holder has provided a TIN, if required, and made the necessary statements regarding limitations on benefits provisions and deriving the income under section 894 of the Code and the regulations thereunder.

Sec. 5.11. Documentation Validity Period.

(A) Documentation Other than Form W-9. QI may rely on valid documentary evidence obtained from account holders in accordance with applicable know-your-customer rules as long as the documentary evidence remains valid under those rules or until QI knows, or has reason to know, that the information contained in the documentary evidence is incorrect. QI may rely on the representations described in section 5.03 of this Agreement obtained in connection with such documentation for the same period of time as the documentation. QI may rely on a Form W-8 until its validity expires under Treas. Reg. §1.1441–1(e)(4)(ii) and may rely on documentary evidence (other than documentary evidence obtained pursuant to applicable know-your-customer rules) until its validity expires under Treas. Reg. §1.6049–5(c)(2).

(B) Form W-9. QI may rely on a valid Form W-9 as long as it has not been informed by the IRS or another withholding agent that the form is unreliable. If QI has primary Form 1099 reporting and backup withholding responsibility, it may rely on a Form W-9 unless one of the conditions of Treas. Reg. §31.3406(h)–3(e)(2)(i) through (v) apply.

Sec. 5.12. Maintenance and Retention of Documentation.

(A) Maintaining Documentation. QI shall maintain documentation by retaining the original documentation, a certified copy, a photocopy, a microfiche, or by electronic storage or similar means of record retention. For accounts opened prior to January 1, 2001, if QI was not required under its know-your-customer rules to maintain originals or copies of documentation, QI may rely on its account information if it has complied with all other aspects of its know-your-customer rules regarding establishment of an account holder's identity, it has a record that the documentation required under the know-your-customer rules was actually examined by an employee of QI in accordance with the know-your-customer rules, and it has no information in its possession that would require QI to treat the documentation as invalid under the rules of section 5.10(B) of this Agreement.

(B) Retention Period. QI shall retain an account holder's documentation obtained under this section 5 for as long as documentation is required to be retained under know-your-customer rules identified in the relevant Attachment(s) to this Agreement, whether or not the documentation was obtained pursuant to those rules.

Sec. 5.13. Application of Presumption Rules.

(A) In General. QI shall apply the presumption rules of section 5.13(C) of this Agreement if QI cannot reliably associate a payment with valid documentation from an account holder other than a nonqualified intermediary or a flow-through entity. The presumption rules cannot be used to grant a reduced rate of withholding. For example, the portfolio interest exception of sections 871(h) and 881(c) of the Code shall not apply to a person that is presumed to be foreign. Further, QI must apply the presumption rules when required and may not rely on its actual knowledge regarding an account holder's status as a U.S. or foreign person. For example, if the account holder is presumed to be a U.S. non-exempt recipient, QI must treat the account holder as subject to 31% backup withholding on a reportable payment even though QI actually knows that the account holder is a foreign person. Notwithstanding the preceding sentence, QI must rely on its actual knowledge regarding an account holder rather than what is presumed under section 5.13(C) of this Agreement if, based on such knowledge, it should withhold an amount greater than the withholding rate under the presumption rules or it should report on Form 1042-S or Form 1099 an amount that would otherwise not be reported. Thus, if an account holder is presumed to be a foreign person with respect to an amount subject to withholding, QI must treat the account holder as subject to 30 percent withholding and report the payment on Form 1042-S unless QI has actual knowledge that the account holder is a U.S. non-exempt recipient, in which case it must withhold 31 percent from the gross amount of the payment and report the payment on Form 1099. Failure to follow the presumption rules may result in liability for underwithholding, penalties, and interest.

(B) Reliably Associating a Payment With Documentation. A payment can be reliably associated with documentation if it is considered reliably associated with documentation under the rules of Treas. Reg. §1.1441–1(b)(2)(vii). Generally, QI can reliably associate a payment with documentation if, for that payment, it holds valid documentation, as described in section 5 of the Agreement, from an account holder other than a nonqualified intermediary or flow-through entity; it can reliably determine how much of the payment relates to the valid documentation provided by such an account holder; and it has no actual knowledge or reason to know that any of the information or statements in the documentation are incorrect. Sections 5.13(B)(1)–(5) of this Agreement describe whether a payment is reliably associated with documentation if the payment is made to an intermediary or flow-through entity.

(1) Reliably Associating a Payment With Documentation Provided by a Nonqualified Intermediary or a Flow-Through Entity. Generally, QI can reliably associate a payment with documentation provided by a nonqualified intermediary or a flow-through entity only to the extent it can reliably associate the payment with a valid Form W-8IMY; it can determine the portion of the payment that relates to valid documentation, associated with the Form W-8IMY, from an account holder other than a nonqualified intermediary or flow-through entity; and the nonqualified intermediary or flow-through entity provides sufficient information for QI to report the payments on Form 1042-S or Form 1099, if reporting is required. Notwithstanding the preceding sentence, to the extent a payment is not subject to reporting on Form 1042-S or Form 1099, QI can reliably associate the payment with valid documentation provided it can determine the portion of the payment allocable to a group of documented account holders (other than nonqualified intermediaries or flow-through entities) for whom withholding and reporting is not required. For example, a QI can treat a payment of deposit interest allocable to a group of documented foreign account holders and documented U.S. exempt recipients as reliably associated with valid documentation. If the documentation attached to a nonqualified intermediary or flow-through entity's Form W-8IMY is documentation from another nonqualified intermediary or flow-through entity, then the qualified intermediary must apply the rules of this paragraph to that other nonqualified intermediary or flow-through entity.

(2) Reliably Associating a Payment With a Withholding Certificate Provided By a Qualified Intermediary. Generally, QI can reliably associate a payment with documentation provided by another qualified intermediary that does not assume either primary NRA withholding responsibility or primary Form 1099 reporting and backup withholding responsibility to the extent the other qualified intermediary provides a valid Form W-8IMY and a withholding statement that allocates the payment among withholding rate pools for foreign account holders and withholding rate pools attributable to each U.S. non-exempt recipient account holder for which the other qualified intermediary has provided a valid Form W-9. The presumption rules shall not apply, however, even if a payment cannot be allocated to each U.S. non-exempt recipient account holder to the extent the alternative procedures of section 6.03(B) of this Agreement apply.

(3) Reliably Associating a Payment with Documentation Provided by a Qualified Intermediary That Assumes Primary NRA Withholding Responsibility. Generally, QI can reliably associate a payment with valid documentation provided by another qualified intermediary that assumes primary NRA withholding responsibility, but not primary Form 1099 reporting and backup withholding responsibility, to the extent it can associate the payment with a valid Form W-8IMY and the withholding statement associated with the Form W-8IMY allocates the payment between a single withholding rate pool attributable to all foreign persons for which the qualified intermediary assumes primary NRA withholding responsibility and to withholding rate pools attributable to each U.S. non-exempt recipient account holder for which the other qualified intermediary has provided a valid Form W-9. The presumption rules shall not apply, however, even if a payment cannot be allocated to each U.S. non-exempt recipient account holder to the extent the alternative procedures of section 6.03(B) of this Agreement apply.

(4) Reliably Associating a Payment With Documentation Provided by a Qualified Intermediary that Assumes Primary Form 1099 Reporting and Backup Withholding Responsibility. Generally, QI can reliably associate a payment with valid documentation provided by another qualified intermediary that assumes primary Form 1099 reporting and backup withholding responsibility, but not primary NRA withholding responsibility, to the extent it can associate the payment with a valid Form W-8IMY and a withholding statement that allocates the payment among withholding rate pools for foreign account holders.

(5) Reliably Associating a Payment With Documentation Provided by a Qualified Intermediary that Assumes Both Primary NRA Withholding Responsibility and Primary Form 1099 Reporting and Backup Withholding Responsibility. Generally, QI can reliably associate a payment with valid documentation provided by another qualified intermediary that assumes both primary NRA withholding responsibility and primary Form 1099 reporting and backup withholding responsibility if QI can associate the payment with a valid Form W-8IMY and a withholding statement that designates the accounts for which the other qualified intermediary is acting as a qualified intermediary and is assuming primary NRA withholding and primary Form 1099 reporting and backup withholding responsibility.

(C) Presumption Rules. The presumption rules are as follows:

(1) Payments Made Outside the United States to an Offshore Account of Amounts Subject to NRA Withholding. An amount that is subject to NRA withholding that is paid outside the United States to an account that is maintained outside the United States is presumed made to an undocumented foreign account holder. Therefore, QI must treat the amount as subject to withholding at a rate of 30 percent on the gross amount paid and report the payment to an unknown account holder on Form 1042-S.

(2) Payments of Deposit Interest and OID on Short-Term Obligations. An amount of U.S. source deposit interest (other than an amount that is part of the purchase price of a certificate of deposit sold in a transaction other than a redemption) or an amount of U.S. source interest or original issue discount on the redemption of a short-term obligation that is paid outside the United States to an offshore account is presumed made to an undocumented U.S. non-exempt recipient account holder. QI must backup withhold at 31 percent and report such amounts on Form 1099 unless it has provided sufficient information for another payor from which it receives such amounts to backup withhold and report the payments and QI does not know that the other payor has failed to backup withhold or report.

(3) Foreign Source Income, Broker Proceeds, and Certain Other Amounts. QI shall presume that the following payments are made to an exempt recipient provided that such amounts are paid outside the United States to an account maintained outside the United States:

(i) Foreign source income;

(ii) Broker proceeds;

(iii) Original issue discount paid in a sale other than a redemption;

(iv) Interest paid as part of the purchase price of an obligation when the instrument is sold between interest payment dates;

(v) Amounts held on deposit with banks or other financial institutions for two weeks or less;

(vi) Amounts of original issue discount arising from a sale and repurchase transaction that is completed within two weeks or less; or

(vii) Amounts described in Treas. Reg. §§1.6049-5(b)(7), (10), and (11).

Such amounts are not subject to withholding or reporting.

(4) Other Payments. Any payment not covered in sections 5.13(C)(1), (2) or (3) of this Agreement shall be presumed made to a U.S. non-exempt recipient and therefore shall be subject to Form 1099 reporting and to backup withholding. Backup withholding shall not be required, however, if the exception provided in Treas. Reg. §31.3406(g)–1(e) applies. For example, any reportable payment paid inside the United States or paid to a U.S. account is presumed made to a U.S. non-exempt recipient and shall be subject to backup withholding and reporting on Form 1099 as paid to an unknown owner.

SECTION 6. QUALIFIED INTERMEDIARY WITHHOLDING CERTIFICATE AND DISCLOSURE OF ACCOUNT HOLDERS TO WITHHOLDING AGENT

Sec. 6.01. Qualified Intermediary Withholding Certificate. QI agrees to furnish a qualified intermediary withholding certificate to each withholding agent from which it receives a reportable amount as a qualified intermediary. The qualified intermediary withholding certificate is a Form W-8IMY (or acceptable substitute form) that certifies that QI is acting as a qualified intermediary, contains QI's QI-EIN, and provides all other information required by the form. QI also agrees to furnish each withholding agent to whom it provides a Form W-8IMY the withholding statement described in section 6.02 of this Agreement. QI is not required to disclose, as part of its Form W-8IMY or its withholding statement, any information regarding the identity of an account holder that is a foreign person or a U.S. exempt recipient. However, to the extent it does not assume primary Form 1099 reporting and backup withholding responsibility, QI must provide to a withholding agent the Forms W-9 obtained from each U.S. non-exempt recipient account holder on whose behalf QI receives a reportable amount. If a U.S. non-exempt recipient that must be disclosed has not provided a Form W-9, QI must, to the extent it has not assumed primary Form 1099 reporting and backup withholding, disclose the name, address, and TIN (if available) to the withholding agent. QI is not required, however, to disclose the identity of a U.S. non-exempt recipient if QI is prohibited by law from making the disclosure and QI follows the procedures of section 6.04 of this Agreement.

Sec. 6.02. Withholding Statement.

(A) In General. QI agrees to provide to each withholding agent from which QI receives reportable amounts as a qualified intermediary a written statement (the "withholding statement") described in this section 6.02. The statement forms an integral part of the Form W-8IMY. The withholding statement may be provided in any manner, and in any form, to which QI and the withholding agent mutually agree. For example, QI and the withholding agent may agree to establish a procedure to furnish withholding statement information electronically. The procedure must contain sufficient safeguards to ensure that the information received by the withholding agent is the information sent by QI and must also document all occasions of user access that result in the submission or modification of withholding statement information. In addition, the QI and the withholding agent must be capable of providing a hard copy of all withholding statements provided by the QI. The withholding statement shall be updated as often as necessary for the withholding agent to meet its reporting and withholding obligations under this Agreement.

(B) Content of Withholding Statement. The withholding statement must contain sufficient information for a withholding agent to apply the correct rate of withholding on payments from the accounts identified on the statement and to properly report such payments on Forms 1042-S and Forms 1099, as applicable. The withholding statement must–

(1) Designate those accounts for which QI acts as a qualified intermediary;

(2) Designate those accounts for which QI assumes primary NRA withholding responsibility and/or primary Form 1099 reporting and backup withholding responsibility; and

(3) Provide information regarding withholding rate pools, as described in section 6.03 of this Agreement, if necessary.

Sec. 6.03. Withholding Rate Pools.

(A) In General. QI shall provide as part of its withholding statement withholding rate pool information in a manner sufficient for the withholding agent to meet its NRA and backup withholding responsibilities and its Form 1042-S and Form 1099 reporting responsibilities. Withholding rate pool information is not required to the extent QI has assumed both primary NRA withholding responsibility and primary Form 1099 reporting and backup withholding responsibility and all the information required for the withholding agent to report payments on Form 1042-S (e.g., the type of income) are within the knowledge of the withholding agent. A withholding rate pool is a payment of a single type of income (e.g., interest, dividends) determined in accordance with the categories of income reported on Form 1042-S or Form 1099, as applicable, that is subject to a single rate of withholding (e.g., 0%, 10%, 15%, or 30%). To the extent QI does not assume primary Form 1099 and backup withholding responsibility, QI's withholding statement must establish a separate withholding rate pool for each U.S. non-exempt recipient account holder that QI has disclosed to the withholding agent unless QI uses the alternative procedures in section 6.03(B) of this Agreement. QI shall determine withholding rate pools based on valid documentation obtained under section 5 of this Agreement, or if a payment cannot be reliably associated with valid documentation, on the presumption rules of section 5.13(C) of this Agreement. If QI has an account holder that is another intermediary (whether a qualified intermediary, a non-qualified intermediary, or a private arrangement intermediary) or a flow-through entity, QI may combine the account holder information provided by the intermediary or flow-through entity with QI's direct account holder information to determine QI's withholding rate pools.

(B) Alternative Procedure for U.S. Non-Exempt Recipients. QI may, by mutual agreement with the withholding agent, establish a single withholding rate pool (not subject to backup withholding) for all U.S. non-exempt recipient account holders for whom QI has provided Forms W-9 prior to the withholding agent paying any reportable amounts or, if applicable, designated broker proceeds. Alternatively, QI may include such U.S. non-exempt recipients in a zero rate withholding pool that includes U.S. exempt recipients and foreign persons exempt from NRA withholding provided that all the conditions of this paragraph 6.03(B) are met. QI may establish a separate withholding rate pool (subject to 31% withholding) for all U.S. non-exempt recipient account holders for whom QI has not provided Forms W-9 prior to the withholding agent paying any reportable amounts or, if applicable, designated broker proceeds. If QI chooses the alternative procedure of this section 6.03(B), QI must provide sufficient information to the withholding agent no later than January 15 of the year following the year in which the reportable amounts and designated broker proceeds, if applicable, are paid that allocates such payments to each U.S. non-exempt recipient account holder. Failure to provide such information will result in the application of penalties to the QI under sections 6721 and 6722 of the Code and shall constitute an event of default under section 11.04 of this Agreement.

Sec. 6.04. Legal Prohibitions Against Disclosure of U.S. Non-Exempt Recipients.

(A) Accounts Established Prior to January 1, 2001. If QI knows an account holder is a U.S. non-exempt recipient and the account holder's account was established with QI prior to January 1, 2001 (a pre-2001 account), QI agrees to the following procedures:

(1) If QI is prohibited by law, including by contract, from disclosing to a withholding agent or to the IRS on Form 1099 the account holder's name, address, and TIN, for reportable payments paid to the account holder, then QI must–

(i) Request from the account holder the authority to make such a disclosure;

(ii) Request from the account holder the authority to sell any assets that generate, or could generate, reportable payments; or

(iii) Request that the account holder disclose himself by mandating QI to provide a Form W-9 completed by the account holder.

(2) QI must make the requests described in section 6.04(A)(1) at least two times during each calendar year and in a manner consistent with QI's normal communications with the account holder (e.g., by mail, telephone, etc.). If QI is not authorized to initiate communications with the account holder (e.g., QI can only communicate with the account holder in person), QI must make the request at the time and in the manner that QI is authorized to communicate with the account holder.

(3) Until QI receives a waiver of all prohibitions against disclosure or authorization to sell all assets that generate, or could generate, reportable payments, or a mandate from the account holder to provide a Form W-9, QI shall backup withhold on all reportable payments paid to the account holder and report those payments on Form 1099 or, in the case of reportable amounts and designated proceeds, provide another withholding agent with all the information required for that withholding agent to backup withhold and report the payments on Form 1099. If the account holder disposes of any assets that generate, or could generate, reportable payments prior to providing QI with a waiver of all prohibitions against disclosure or authorization to sell all such assets, QI shall apply backup withholding and Form 1099 reporting in accordance with sections 3 and 8 of this Agreement.

(4) If QI has not assumed primary Form 1099 reporting and backup withholding responsibility but is authorized, or is mandated, to disclose the account holder's name, address, TIN and reportable amounts (and, designated broker proceeds if section 3.05(C) of this Agreement applies) to a withholding agent, QI must provide the account holder's Form W-9 (or, if a Form W-9 was not obtained, the account holder's name, address, and TIN, if available) to the withholding agent together with appropriate withholding rate pool information within 30 days of the date QI receives such authorization.

(5) If QI is authorized to dispose of the account holder's assets that generate, or could generate, reportable payments, QI must sell or exchange all such assets within 60 days of receiving authorization. In addition, if QI later discovers that an account contains such assets, QI must sell such assets within 60 days of the discovery. See sections 3 and 8 of this Agreement for backup withholding and Form 1099 reporting responsibilities.

(6) If QI is not authorized to disclose the account holder's identity or to sell or exchange all of the account holder's assets that generate or could generate reportable payments, but QI is not prohibited by law, including by contract, from disposing of the account holder's assets even though it has not obtained specific authorization, QI must sell or exchange all such assets on or before December 31, 2002, and apply backup withholding and Form 1099 reporting in accordance with sections 3 and 8 of this Agreement.

(B) Account Holder Discovered to be U.S. Non-Exempt Recipient. If QI's records indicate that the account holder of a pre-2001 account is a foreign person and the QI discovers that the account holder is a U.S. non-exempt recipient, QI shall follow the procedures of section 6.04(A) of this Agreement, except that if QI may legally sell or exchange the account holder's assets that generate, or could generate, reportable payments without authorization, QI must sell or exchange all such assets on or before the date that is 365 days after QI learns that the account holder is a U.S. non-exempt recipient, or, if later, December 31, 2002.

(C) Accounts Opened on or After January 1, 2001. QI agrees to the following procedures for accounts opened by U.S. non-exempt recipients on or after January 1, 2001 (post-2000 accounts):

(1) If QI is prohibited by law, including by contract, from disclosing to a withholding agent or to the IRS on Form 1099 the account holder's name, address, and TIN, for reportable payments paid to the account holder, then QI must–

(i) Request from the account holder the authority to make such a disclosure;

(ii) Request from the account holder, prior to opening the account, the authority to exclude from the account holder's account any assets that generate, or could generate, reportable payments; or

(iii) Request that the account holder disclose himself by mandating QI to transfer a Form W-9 completed by the account holder.

(2) If QI is authorized to disclose the account holder's name, address, TIN (if available) and reportable amounts (and designated broker proceeds, if section 3.05(C) of this Agreement applies), QI must obtain a valid Form W-9 from the account holder and, to the extent QI does not have primary Form 1099 and backup withholding responsibility, provide the Form W-9 to the appropriate withholding agent promptly after obtaining the Form W-9. If a Form W-9 is not obtained, then QI must provide the account holder's name, address, and TIN, if any, to the withholding agents from whom QI receives reportable amounts (and, if applicable, designated broker proceeds) on behalf of the account holder together with appropriate withholding rate pool information relating to the account holder. To the extent QI has assumed primary Form 1099 reporting and backup withholding, it must backup withhold on all reportable payments until it receives a valid Form W-9.

(3) If QI is not authorized to disclose an account holder's name and other required information but is authorized to exclude from the account holder's account any assets that generate, or could generate, reportable payments, QI must follow procedures designed to ensure that it will not hold any assets that generate, or could generate, reportable payments in the account holder's account.

(4) If QI is authorized to exclude from the account holder's account any assets that generate, or could generate, reportable payments and QI discovers that the account contains such assets, QI must sell such assets within 60 days of discovering such assets and apply backup withholding and Form 1099 reporting in accordance with sections 3 and 8 of this Agreement.

(5) QI agrees that if any account holder in a post-2000 account is discovered, after the opening of the account, to be a U.S. non-exempt recipient then QI will–

(i) Immediately correct the withholding statement information provided to the withholding agent, if necessary, and

(ii) Either obtain a Form W-9 within 60 days of discovering that the account holder is a U.S. non-exempt recipient, and, if QI has not assumed primary Form 1099 reporting and backup withholding responsibility, provide the Form W-9 to the appropriate withholding agents together with appropriate withholding pool information promptly after obtaining the Form W-9 or, if QI is not authorized to disclose account holder information, sell all of the account holder's assets that generate or could generate reportable payments within 60 calendar days from the day that QI discovers the account holder is a U.S. non-exempt recipient. QI must backup withhold, or instruct a withholding agent to backup withhold on any reportable payments made after the time QI discovers the account holder's U.S. non-exempt recipient status and before obtaining a valid Form W-9 from the account holder.

SECTION 7. TAX RETURN OBLIGATIONS

Sec. 7.01. Form 1042 Filing Requirement.

(A) In general. QI shall file a return on Form 1042, whether or not QI withheld any amounts under chapter 3 of the Code, on or before March 15 of the year following any calendar year in which QI acts as a qualified intermediary. A separate Form 1042 must be filed by each legal entity that is a qualified intermediary covered by this Agreement. Form 1042 shall be filed at the address indicated on the form or at any other address at which the IRS notifies QI under the provisions of section 12.06 of this Agreement. In addition to the information specifically requested on Form 1042 and the accompanying instructions, QI shall attach to the form the following information:

(1) A statement setting forth the amounts of any overwithholding or underwithholding adjustments made under Treas. Reg. §1.1461-2 and sections 9.02 and 9.05 of this Agreement, and an explanation of the circumstances that resulted in the over- or under- withholding.

(2) A statement that sets forth the aggregate amounts of reportable payments paid to U.S. non-exempt recipient account holders, and the number of such account holders, whose identity is prohibited by foreign law, including by contract, from disclosure. QI must separately report each type of reportable payment (determined by reference to the types of income reported on Forms 1099) and the number of undisclosed account holders receiving such payments. See section 6.04 of this Agreement.

(B) Extensions For Filing Returns. QI may request an extension of the time for filing Form 1042, or any of the information required to be attached to the form, by submitting Form 2758, Application for Extension of Time to File Certain Excise, Income, Information, and Other Returns on or before the due date of the return. The application must be in writing, properly signed by a duly authorized agent of QI, and shall clearly set forth the following:

(1) The calendar year for which the extension is requested; and

(2) A full explanation of the reasons for requesting the extension to assist the IRS in determining the period of extension, if any, that will be granted.

Sec. 7.02. Form 945 Filing Requirement. QI shall file a return on Form 945 on or before January 31 following the calendar year in which QI backup withheld any amount under section 3406 of the Code. Separate Forms 945 must be filed by each legal entity that is a qualified intermediary covered by this Agreement. The form must be filed at the address specified in the instructions for Form 945 or at any other address at which the IRS notifies QI under the provisions of section 12.06 of this Agreement.

Sec. 7.03. Retention of Returns. QI shall retain Forms 945 and 1042 for the applicable statute of limitations on assessments and collection under section 6501 of the Code.

SECTION 8. INFORMATION REPORTING OBLIGATIONS

Sec. 8.01. Form 1042-S Reporting. Except as otherwise provided in section 8.02 of this Agreement, QI is not required to file Forms 1042-S for amounts paid to each separate account holder for whom such reporting would otherwise be required. Instead, QI shall file a Form 1042-S reporting the pools of income ("reporting pools") as determined in section 8.03 of this Agreement. QI must file its Forms 1042-S in the manner required by the regulations under chapter 3 of the Code and the instructions to the form, including any requirement to file the forms magnetically or electronically. Separate Forms 1042-S must be filed by each legal entity that is a qualified intermediary covered by this Agreement. Each qualified intermediary covered by this Agreement may, however, allow its individual branches to file Forms 1042-S provided that all Forms 1042-S contain the QI-EIN of the legal entity of which the branch forms a part. Any Form 1042-S required by this section 8 shall be filed on or before March 15 following the calendar year in which the payment reported on the form was made. QI may request an extension of time to file Forms 1042-S by submitting Form 8809, Request for Extension of Time to File Information Returns, by the due date of Forms 1042-S in the manner required by Form 8809.

Sec. 8.02. Recipient Specific Reporting. QI (whether or not it assumes primary NRA withholding responsibility) is required to file separate Forms 1042-S for amounts paid to each separate account holder as described in this section 8.02. QI must file separate Forms 1042-S by income code, exemption code, recipient code, and withholding rate.

(A) QI must file separate Forms 1042-S for each qualified intermediary or withholding foreign partnership account holder that receives an amount subject to NRA withholding from QI (or from a PAI of QI), whether such account holder is a direct or indirect account holder.

(B) QI must file separate Forms 1042-S for each foreign account holder of a nonqualified intermediary or foreign interest holder of a flow-through entity receiving an amount subject to NRA withholding (whether the nonqualified intermediary or flow-through entity is a direct or indirect account holder) to the extent QI can reliably associate such amounts with valid documentation from an account holder that is not itself a nonqualified intermediary or flow-through entity. In addition, QI must file separate Forms 1042-S for each foreign account holder of a nonqualified intermediary or foreign interest holder of a flow-through entity that is an account holder of a PAI of QI (whether the nonqualified intermediary or flow-through entity is a direct or indirect account holder of the PAI) to the extent QI can reliably associate the amounts subject to NRA withholding with valid documentation from an account holder that is not itself a nonqualified intermediary or flow-through entity.

(C) QI must file separate Forms 1042-S made out to an unknown recipient for amounts subject to withholding paid to a nonqualified intermediary or flow-through entity (whether the nonqualified intermediary or flow-through entity is a direct or indirect account holder), to the extent that QI cannot reliably associate such amounts with valid documentation from the account holders of the nonqualified intermediary or the interest holders of the flow-through entity. In addition, QI must file separate Forms 1042-S made out to an unknown recipient for amounts subject to withholding paid to a nonqualified intermediary or flow-through entity that is a direct or indirect account holder of a PAI of QI to the extent that QI cannot reliably associate such amounts with valid documentation from the account holders of such nonqualified intermediary or the interest holders of the flow-through entity.

Sec. 8.03. Reporting Pools for Form 1042-S Reporting. Except for amounts required to be reported under section 8.02 of this Agreement, QI shall report all amounts subject to NRA withholding by reporting pools on a Form 1042-S if those amounts are paid to direct account holders of QI or to direct account holders of a PAI of QI that are (or are presumed to be) foreign persons. A separate Form 1042-S shall be filed for each type of reporting pool. A reporting pool consists of income that falls within a particular withholding rate and within a particular income code, exemption code, and recipient code as determined on Form 1042-S. QI may use a single recipient code for all reporting pools except for amounts paid to foreign tax-exempt recipients, for which a separate recipient code must be used. For this purpose, a foreign tax-exempt recipient includes any organization that is not subject to NRA withholding and is not liable to tax in its country of residence because it is a charitable organization, a pension fund, or a foreign government.

Sec. 8.04. Form 1099 Reporting Responsibility. QI shall file Forms 1099 and, unless filing magnetically, Form 1096, for reportable payments made to the persons specified in this section 8.04. Forms 1099 shall be filed on or before the date prescribed for the particular Form 1099 under chapter 61 of the Code and in the manner required by regulations under chapter 61 of the Code and the instructions to the forms, including any requirement to file the forms magnetically or electronically. Extensions of the time to file Forms 1099 may be requested by submitting Form 8809, Request for Extension of Time to File Information Returns, in the manner required by the form. If QI is required to file Forms 1099, it must file the appropriate form for the type of income paid (e.g., Form 1099-DIV for dividends, Form 1099-INT for interest, Form 1099-B for broker proceeds). QI must file Forms 1099 in the situations listed in sections 8.04(A) through (E) of this Agreement regardless of whether it assumes primary Form 1099 reporting and backup withholding responsibility unless otherwise provided in those sections.

(A) QI must file a Form 1099 made out to an unknown owner for the aggregate amount of a particular type of reportable amount paid to account holders that are U.S. non-exempt recipients (whether direct or indirect account holders) whose identity and account information are prohibited by law, including by contract, from being disclosed. However, QI is not required to file a Form 1099 for, or backup withhold on, a reportable amount to the extent QI has provided sufficient information to another payor for that payor to report the reportable amount as paid to an unknown owner and to backup withhold on the reportable amount and QI does not know that the other payor has failed to report or backup withhold.

(B) QI must file a Form 1099 made out to an unknown owner on the aggregate amount of a reportable payment that is not a reportable amount paid to a U.S. non-exempt recipient (whether a direct or indirect account holder) whose identity and account information are prohibited by law, including by contract, from disclosure. Notwithstanding the previous sentence, QI is not required to report on Form 1099 and backup withhold on designated broker proceeds to the extent the designated broker proceeds provisions of section 3.05 of this Agreement apply and QI does not know that the other payor has failed to report or backup withhold.

(C) QI must file a Form 1099 for a reportable amount paid to each U.S. non-exempt recipient account holder (whether a direct or indirect account holder) whose identity and account information are not prohibited by foreign law, including by contract, from disclosure and for whom QI has not provided a Form W-9 to a withholding agent or has not provided the account holder's name, address, TIN (if available) and withholding rate pool information to a withholding agent.

(D) QI must file a Form 1099 for a reportable payment (other than a reportable amount) paid to each U.S. non-exempt recipient (whether a direct or indirect account holder), or to any account holder that is presumed to be a U.S. non-exempt recipient, whose identity and account information are not prohibited by foreign law, including by contract, from disclosure. Notwithstanding the previous sentence, QI is not required to report on Form 1099 or backup withhold on designated broker proceeds paid to a U.S. non-exempt recipient if the procedures of section 3.05 of this Agreement apply and QI does not know that the other payor has failed to report or backup withhold.

(E) QI must file a Form 1099 for account holders (whether direct or indirect) that are, or are presumed to be, U.S. non-exempt recipients that receive reportable amounts for which QI has assumed primary Form 1099 reporting and backup withholding responsibility.

(F) QI must file a Form 1099 for an account holder (whether direct or indirect) that is a U.S. person (whether exempt or non-exempt) if QI has made a reportable payment to which it applied backup withholding and QI has not reported the amount under section 8.04(A)-(E) of this Agreement.

SECTION 9. ADJUSTMENTS FOR OVER- AND UNDER-WITHHOLDING; REFUNDS

Sec. 9.01. Adjustments for NRA Overwithholding by Withholding Agent. QI may request a withholding agent to make an adjustment for amounts paid to QI on which the withholding agent has overwithheld under chapter 3 of the Code by applying either the reimbursement procedure described in section 9.01(A) of this Agreement or the set-off procedure described in section 9.01(B) of this Agreement within the time period prescribed for those procedures. Nothing in this section shall be interpreted to require a withholding agent to apply the reimbursement or set off procedures under sections 9.01(A) or (B) of this Agreement.

(A) Reimbursement Procedure. QI may request a withholding agent to repay QI for any amount overwithheld under chapter 3 of the Code and for the withholding agent to reimburse itself under the reimbursement procedures of Treas. Reg. §1.1461-2(a)(2)(i) by making the request to the withholding agent prior to the due date for filing the Form 1042 and Form 1042-S (without regard to extensions) for the calendar year of overwithholding.

(B) Set-off Procedure. QI may request a withholding agent to repay QI by applying the amount overwithheld against any amount which otherwise would be required to be withheld under chapter 3 of the Code from income paid by the withholding agent to QI. QI must make the request before the earlier of the due date (without regard to extensions) for the withholding agent to file Form 1042-S for the calendar year of overwithholding or the date that the Form 1042-S is actually filed with the IRS.

Sec. 9.02. Adjustments for NRA Overwithholding by QI. QI may make an adjustment for amounts paid to its account holders that it has overwithheld under chapter 3 of the Code by applying either the reimbursement or set-off procedures described in this section within the time period prescribed for those procedures.

(A) Reimbursement Procedure. QI may repay its account holders for an amount overwithheld and reimburse itself by reducing, by the amount of tax actually repaid to the account holders, the amount of any subsequent deposit of tax required to be made by QI under section 3.08 of this Agreement. For purposes of this section 9.02(A), an amount that is overwithheld shall be applied in order of time to each of the QI's subsequent deposit periods in the same calendar year to the extent that the withholding taxes required to be deposited for a subsequent deposit period exceed the amount actually deposited. An amount overwithheld in a calendar year may be applied to deposit periods in the calendar year following the calendar year of overwithholding only if:

(1) QI states on a Form 1042-S (issued, if applicable, to the account holders of the income or otherwise to a reporting pool), filed by March 15 of the calendar year following the calendar year of overwithholding, the amount of tax withheld and the amount of any actual repayments; and

(2) QI states on a Form 1042, filed by March 15 of the calendar year following the calendar year of overwithholding, that the filing of the Form 1042 constitutes a claim for credit in accordance with Treas. Reg. §1.6414–1.

(B) Set-Off Procedure. QI may repay its account holders by applying the amount overwithheld against any amount which otherwise would be required under chapter 3 of the Code to be withheld from a payment made by QI to the account holders before the earlier of March 15 of the calendar year following the calendar year of overwithholding or the date that the Form 1042-S is actually filed with the IRS. For purposes of making a return on Form 1042 or 1042-S for the calendar year of overwithholding, and for purposes of making a deposit of the amount withheld, the reduced amount shall be considered the amount required to be withheld from such income under chapter 3 of the Code.

Sec. 9.03. Repayment of Backup Withholding. If QI erroneously withholds, as defined under Treas. Reg. §31.6413(a)–3, an amount under section 3406 of the Code from an account holder, QI may refund the amount erroneously withheld as provided in Treas. Reg. §31.6413(a)–3.

Sec. 9.04. Collective Credit or Refund Procedures for NRA Overwithholding. If there has been overwithholding under chapter 3 of the Code on amounts subject to NRA withholding paid to QI's account holders during a calendar year and the amount has not been recovered under the reimbursement or set-off procedures under sections 9.01 or 9.02 of this Agreement, QI may request a credit or refund of the total amount overwithheld by following the procedures of this section 9.04. QI shall not include in its collective refund claim payments made to an indirect account holder or to a direct account holder that is a nonqualified intermediary or flow-through entity. QI shall follow the procedures set forth under sections 6402 and 6414 of the Code, and the regulations thereunder, to claim the credit or refund. No credit or refund will be allowed after the expiration of the statutory period of limitation for refunds under section 6511 of the Code. QI may use the collective refund procedures under this section 9.04 only if the following conditions are met:

(A) QI must not have issued Forms 1042-S to the account holders that received the payment that was subject to overwithholding;

(B) QI must submit together with its amended return on which it claims a credit or refund a statement of the reason for the overwithholding;

(C) QI must submit together with its amended return on which it claims a credit or refund a statement that it has repaid the amount of overwithholding to the appropriate account holders prior to filing the claim for credit or refund; and

(D) QI must retain a record showing that it repaid the account holders the amount of the overwithholding.

Sec. 9.05. Adjustments for NRA Underwithholding. If QI knows that an amount should have been withheld under chapter 3 of the Code from a previous payment to an account holder but was not withheld, QI may either withhold from future payments made to the same account holder or satisfy the tax from property that it holds in custody for the account holder or property over which it has control. The additional withholding or satisfaction of the tax owed may only be made before the due date of the Form 1042 (not including extensions) for the calendar year in which the underwithholding occurred. QI's responsibilities will be met if it informs a withholding agent from which it received the payment of the underwithholding and the withholding agent satisfies the underwithholding.

Sec. 9.06. NRA Underwithholding After Form 1042 Filed. If, after a Form 1042 has been filed for a calendar year, QI, QI's external auditor, or the IRS determines that, due to QI's failure to carry out its obligations under this Agreement, QI has underwithheld tax for such year, QI shall file an amended Form 1042 to report and pay the underwithheld tax. QI shall pay the underwithheld tax, the interest due on the underwithheld tax, and any applicable penalties, at the time of filing the amended Form 1042. If QI fails to file an amended return, the IRS shall make such return under section 6020 of the Code. See section 10.04 of this Agreement for procedures that apply if underwithholding is discovered as part of a statistical sampling of accounts.

Sec. 9.07. Special Rule Regarding Failure to Deposit Penalties. Solely for purposes of applying section 6656 of the Code (failure to make deposit of taxes), neither QI nor its withholding agent will be considered to have made an underpayment of a deposit of NRA withholding taxes if the conditions of this paragraph are met. The conditions of this paragraph are that–

(A) The withholding agent or QI makes its deposits within the time (deposit period) required by section 6302 of the Code, or if applicable, section 3.08 of this Agreement;

(B) The deposit is not less than 90 percent of the aggregate amount of the tax required to be withheld under chapter 3 of the Code during the deposit period applicable to the withholding agent or QI; and

(C) QI and the withholding agent determine the difference between the total amount required to be deposited and the amount actually deposited as of the end of the 3rd, 6th, 9th, and 12th months of the calendar year and the difference is deposited no later than the 15th day of the second following month (i.e., May 15, August 15, November 15 and February 15, respectively). In determining whether there has been an underpayment, reimbursements and set-offs shall be taken into account.

SECTION 10. EXTERNAL AUDIT PROCEDURES

Sec. 10.01. In General. Unless QI requests an IRS audit in lieu of an external audit, the IRS agrees not to conduct an on-site audit of QI, or any PAI with which QI has an agreement, with respect to withholding and reporting obligations covered by this Agreement provided that an external auditor designated in Appendix B of this Agreement conducts an audit of QI, and any PAI, in accordance with this section 10. QI shall permit the external auditor to have access to all relevant records of QI for purposes of performing the external audit, including information regarding specific account holders. QI shall permit the IRS to communicate directly with the external auditor and to review the audit procedures followed by the external auditor. QI represents that there are no legal prohibitions that prevent the external auditor from examining any information relevant to the external audit to be performed under this section 10 and that there are no legal prohibitions that prevent the IRS from communicating directly with the auditor. QI shall permit the IRS to examine the external auditor's work papers and reports. However, the external auditor is not required to divulge the identity of QI's account holders to the IRS.

Sec. 10.02. Designation of External Auditor. QI's external auditor must be one of the auditors listed in Appendix B of this Agreement, unless QI and the IRS agree, prior to the audit, to substitute another auditor. QI shall not propose an external auditor unless it has a reasonable belief that the auditor is subject to laws, regulations, or rules that impose sanctions for failure to exercise its independence and to perform the audit competently. The IRS has the right to reject a proposed external auditor, or to revoke its acceptance of an external auditor, if the IRS, in its sole discretion, reasonably believes that the auditor is not independent or cannot perform an effective audit under this Agreement.

Sec. 10.03. Timing and Scope of External Audits. QI shall have the external auditor conduct an audit of the second full calendar year and the fifth full calendar year that this Agreement is in effect, subject to section 10.06 of this Agreement. The external auditor shall verify whether QI is in compliance with this Agreement by conducting an audit that meets the requirements of this section 10.03. The external auditor shall verify whether QI is in compliance with its QI agreement by providing a report to the IRS. The report must be received by the IRS, at the address set forth in section 12.06 of this Agreement, no later than June 30 of the year following the year being audited. The IRS may, however, upon request by the external auditor, extend the due date of the audit report upon good cause. The report must disclose that the external auditor has, at a minimum, performed the following checks listed in this paragraph 10.03, and set forth how each of those checks was performed and the results of the checks. QI's (or a PAI's) external auditor is encouraged to contact the IRS at the address set forth in section 12.06 of this Agreement and submit an audit plan (which includes, if relevant, the extent to which the external auditor proposes to rely on QI's internal audit procedures) prior to performing the audit so that the audit may be conducted in the most efficient and least costly manner possible.

(A) Documentation. The external auditor must–

(1) Verify that QI has training materials, manuals, and directives that instruct the appropriate QI employees how to request, collect, review, and maintain documentation in accordance with this Agreement;

(2) Review QI's account opening procedures and interview QI's employees, to determine if appropriate documentation is requested from account holders and, if obtained, that it is reviewed and maintained in accordance with this Agreement;

(3) Verify that QI follows procedures designed to inform account holders that claim a reduced rate of withholding under an income tax treaty about any applicable limitation on benefits procedures;

(4) Review QI's accounts, using a valid sample of accounts for which treaty benefits are claimed, to ensure that QI is obtaining the treaty statements required by section 5.03(B);

(5) Review information, using a valid sample, contained in account holder files to determine if the documentation validity standards of section 5.10 of this Agreement are being met. For example, the external auditor must verify that changes in account holder information (e.g., a change of address to a U.S. address or change of account holder status from foreign to U.S.) are being conveyed to QI's withholding agent, or, if QI assumes primary NRA withholding responsibility or primary Form 1099 reporting and backup withholding responsibility, that QI is applying the appropriate withholding rate;

(6) Review accounts, using a valid sample of U.S. non-exempt recipient account holders, to determine if QI is obtaining Forms

W-9 from those customers whose identity is not prohibited by law from disclosure, and that QI is transmitting those forms to a withholding agent to the extent QI does not assume primary Form 1099 reporting and backup withholding responsibility with respect to reportable amounts and, if applicable, designated broker proceeds;

(7) Review accounts, using a valid sample of U.S. non-exempt recipient account holders whose identity and account information is prohibited by law, including by contract, from disclosure, to verify that–

(i) Such accounts exist in only rare and unusual circumstances (and detailing in the audit report the nature of such circumstances); and

(ii) The procedures of section 6.04 have been, and are being, followed.

(8) Review QI's agreements with its PAIs to ensure that the obligations imposed on the PAIs are identical to the obligations imposed on QI under this Agreement, except as otherwise provided in section 4.02.

(9) State in its external audit report if the auditor is aware that QI is in material violation or is under investigation for violation of any of the know-your-customer rules, practices, or procedures applicable to the offices audited.

(10) State in its external audit report if the auditor is aware that QI removes U.S. non- exempt recipients from accounts covered by this Agreement for the purpose of circumventing the Form 1099 reporting and backup withholding provisions of this Agreement.

(B) Withholding Rate Pools. The external auditor must–

(1) Verify that QI has training materials, manuals, and directives that instruct the appropriate QI employees how to determine withholding rate pools based on documentation and the presumption rules;

(2) Interview employees responsible for determining withholding rate pools to ascertain if they are adequately trained to determine those pools and that they follow adequate procedures for determining those pools;

(3) Review QI's procedures for preparing the withholding statements associated with QI's Forms W-8IMY and verify that the withholding statements provided to withholding agents convey complete and correct information on a timely basis;

(4) Perform test checks, using a valid sample of account holders assigned to each withholding rate pool, and cross check that assignment against the documentation provided by, or presumption rules that apply to, the account holder, the type of income earned, and the withholding rate applied;

(5) Perform test checks, using a valid sample of accounts of U.S. non-exempt recipients, to verify that appropriate withholding rate pools are established for U.S. non-exempt recipients; and

(6) Verify, if QI is using the alternative procedure for U.S. non-exempt recipients contained in section 6.03(B) of this Agreement, that QI is providing sufficient and timely information to withholding agents that allocates reportable payments to U.S. non-exempt recipients.

(C) Withholding Responsibilities. The external auditor must–

(1) To the extent QI has assumed primary NRA withholding responsibility, perform test checks, using a valid sample of foreign account holders, to verify that QI is withholding the proper amounts;

(2) To the extent QI has not assumed primary NRA withholding responsibility, verify that QI has fulfilled its responsibilities under section 3.02 of this Agreement;

(3) To the extent QI has assumed primary Form 1099 reporting and backup withholding responsibility, perform test checks using a valid sample of U.S. non-exempt recipient account holders to verify that QI backup withheld when required;

(4) To the extent QI has not assumed primary Form 1099 reporting and backup withholding responsibility, perform test checks using a valid sample of U.S. non-exempt account holders to verify that QI has fulfilled its backup withholding responsibilities under sections 3.04, 3.05 and 3.06 of this Agreement;

(5) Review the accounts of U.S. non-exempt recipient account holders whose identity is prohibited by law, including by contract, from disclosure and verify that QI or another payor is backup withholding on reportable payments made to such account holders;

(6) Review a valid sample of accounts of U.S. non-exempt recipient account holders and determine if assets that generate or could generate reportable payments are held in an account of any U.S. non-exempt recipient account holders whose identity is prohibited by law, including by contract, from disclosure, and ascertain the reason why such assets have not been disposed of or the account holder disclosed; and

(7) Verify that amounts withheld were timely deposited in accordance with section 3.08 of this Agreement.

(D) Return Filing and Information Reporting. The external auditor must–

(1) Obtain copies of original and amended Forms 1042 and Forms 945, and any schedules, statements, or attachments required to be filed with those forms, and determine whether the amounts of income, taxes, and other information reported on those forms are accurate by–

(i) Reviewing work papers;

(ii) Reviewing Forms W-8IMY, together with the associated withholding statements, that QI has provided to withholding agents;

(iii) Reviewing copies of Forms 1042-S that withholding agents have provided QI;

(iv) Reviewing account statements from withholding agents;

(v) Reviewing correspondence between QI and withholding agents; and

(vi) Interviewing personnel responsible for preparing the Forms 1042 and 945 and the work papers used to prepare those forms.

(2) Obtain copies of original and corrected Forms 1042-S and Forms 1099 together with the work papers used to prepare those forms and determine whether the amounts reported on those forms are accurate by–

(i) Reviewing the Forms 1042-S received from withholding agents;

(ii) Reviewing the Forms W-8IMY, and the associated withholding statements, that QI has provided withholding agents;

(iii) Reviewing a valid sample of account statements issued by QI to account holders; and

(iv) Interviewing QI's personnel responsible for preparing the Forms 1042-S and, if applicable, Forms 1099, and the work papers used to prepare those forms.

(3) Thoroughly review the statements attached to amended Forms 1042 filed to claim a refund, ascertain their veracity, and determine the causes of any overwithholding reported and ensure QI did not issue Forms 1042-S to persons whom it included as part of its collective credit or refund.

(4) Determine, in the case of collective credits or refunds, that QI repaid the appropriate account holders prior to requesting a collective refund or credit.

(E) Change in Circumstances. The external auditor must verify that in the course of the audit it has not discovered any significant change in circumstances, as described in section 11.03(A), (D), or (E) of this Agreement.

Sec. 10.04. Use of Statistical Sampling. If the external auditor is required to make a determination based on a valid sample of accounts, it shall use a statistical sampling whenever an examination of all of accounts within a particular class of accounts would be prohibitive in terms of time and expense. If it is reasonable to examine all accounts in connection with a particular issue, statistical sampling techniques shall not be used. If statistical sampling techniques are required, the external auditor must determine a sample size that provides a 95 percent confidence level. If statistical sampling has been used and the auditor determines that underwithholding has occurred with respect to the sampled accounts, the IRS will determine the total amount of underwithheld tax by projecting the underwithholding over the entire population of similar accounts. For this purpose, QI agrees to provide the IRS with the information (e.g., number of accounts and amounts) required to project the underwithholding. QI shall either report and pay, in accordance with section 9.06 of this Agreement, the underwithheld tax determined under the IRS projection or propose another amount of underwithholding based on a more accurate population, a more accurate projection technique, or an examination of all similar accounts. If the IRS does not agree with the amount proposed by QI, the IRS shall assess a tax by making a return under section 6020 of the Code.

Sec. 10.05. External Auditor's Report. Upon completion of the audit of QI and any PAI, the external auditor shall issue a report, or reports, of audit findings directly to the IRS by sending the original report to the IRS at the address set forth in section 12.06 of this Agreement by June 30 following the calendar year being audited, or if that date falls on a Saturday or Sunday, the next U.S. business day. The report must be in writing, in English, and currency amounts must be stated in U.S. dollars. The report must fully describe the scope of the audit, the methodologies (including sampling techniques) used to determine whether QI is in compliance with the provisions of this Agreement, and the result of each such determination. The report must also specifically address each of the items in section 10.03 of this Agreement.

Sec. 10.06. Expanding Scope and Timing of External Audit. Upon review of the external auditor's report, the IRS may request, and QI must permit, the external auditor to perform additional audit procedures, or to expand the external audit to cover some or all of the calendar years for which the period of limitations for assessment of taxes has not expired. In addition, the IRS may request, and QI agrees to permit, the external auditor to perform an audit for one or more calendar years not scheduled for audit under section 10.03 of this Agreement.

SECTION 11. EXPIRATION, TERMINATION AND DEFAULT

Sec. 11.01. Term of Agreement. This Agreement shall be in effect on _________ and shall expire on December 31 of the fifth full calendar year after the year in which this Agreement first takes effect. This Agreement may be renewed as provided in section 11.06 of this Agreement.

Sec. 11.02. Termination of Agreement. This Agreement may be terminated by either the IRS or QI prior to the end of its term by delivery of a notice of termination to the other party in accordance with section 12.06 of this Agreement. The IRS, however, shall not terminate the Agreement unless there has been a significant change in circumstances, as defined in section 11.03 of this Agreement, or an event of default has occurred, as defined in section 11.04 of this Agreement, and the IRS determines, in its sole discretion, that the significant change in circumstances or the event of default warrants termination of this Agreement. In addition, the IRS shall not terminate this Agreement in the event of default if QI can establish to the satisfaction of the IRS that all events of default for which it has received notice have been cured within the time period agreed upon. The IRS shall notify QI, in accordance with section 11.05 of this Agreement, that an event of default has occurred and that the IRS intends to terminate the Agreement unless QI cures the default. A notice of termination sent by either party shall take effect on the date specified in the notice.

Sec. 11.03. Significant Change in Circumstances. For purposes of this Agreement, a significant change in circumstances includes, but is not limited to–

(A) An acquisition of all, or substantially all, of QI's assets in any transaction in which QI is not the surviving legal entity;

(B) A change in U.S. federal law or policy, or applicable foreign law or policy, that affects the validity of any provision of this Agreement, materially affects the procedures contained in this Agreement, or affects QI's ability to perform its obligations under this Agreement;

(C) A ruling of any court that affects the validity of any provision of this Agreement;

(D) A material change in the know-your-customer rules and procedures set forth in any Attachment to this Agreement; or

(E) A significant change in QI's business practices that affects QI's ability to meet its obligations under this Agreement.

Sec. 11.04. Events of Default. For purposes of this Agreement, an event of default occurs if QI fails to perform any material duty or obligation required under this Agreement, and includes, but is not limited to, the occurrence of any of the following:

(A) QI fails to implement adequate procedures, accounting systems, and internal controls to ensure compliance with this Agreement;

(B) QI underwithholds an amount that QI is required to withhold under chapter 3 of the Code and fails to correct the underwithholding or to file an amended Form 1042 reporting, and paying, the appropriate tax;

(C) QI underwithholds an amount that QI is required to backup withhold under section 3406 of the Code;

(D) QI makes a misrepresentation on Forms W-8IMY or the associated withholding statement that results in underwithholding by a withholding agent;

(E) QI makes excessive refund claims;

(F) Documentation described in section 5 of this Agreement is lacking, incorrect, or unreliable for a significant number of direct account holders;

(G) QI fails to timely file Forms 945, 1042, 1042-S, or 1099 or files forms that are materially incorrect or fraudulent or fails to provide information necessary for a withholding agent or payor to file Forms 1099 with respect to disclosed U.S. persons;

(H) QI fails to have an external audit performed when required, QI's external auditor fails to provide its report directly to the IRS on a timely basis, QI fails to cooperate with the external auditor, or QI or its external auditor fails to cooperate with the IRS;

(I) QI fails to disclose to a withholding agent, or to the IRS, U.S. nonexempt recipient account holders to the extent the disclosure is not prohibited by foreign law, including by contract;

(J) QI fails to inform the IRS of any change in the know-your-customer rules described in any Attachment to this Agreement within 90 days of the change becoming effective;

(K) QI fails to inform the IRS within 90 days of any significant change in its business practices to the extent that change affects QI's obligations under this Agreement;

(L) QI fails to inform the IRS of any private arrangement, as described in section 4 of this Agreement;

(M) QI fails to cure a default identified by the IRS or by an external auditor;

(N) QI makes any fraudulent statement or a misrepresentation of material fact with regard to this Agreement to the IRS, a withholding agent, or QI's external auditor;

(O) The IRS determines that QI's external auditor is not sufficiently independent to adequately perform its audit function or the external auditor fails to provide an audit report that complies with section 10 of this Agreement;

(P) An intermediary with which QI has a PAI agreement is in default with that agreement and QI fails to meet its obligation to terminate that agreement within the time period specified in section 4.03 of this Agreement;

(Q) QI has not complied with the procedures of section 6.04 of this Agreement or has any undisclosed U.S. non-exempt recipients (except in rare and unusual circumstances) whose accounts contain assets that generate, or could generate, reportable payments;

(R) QI is prohibited by any law from disclosing the identity of an account holder or account information to QI's external auditor;

(S) QI, to the extent it has primary Form 1099 reporting and backup withholding responsibility, fails to comply with the requirements of chapter 61 and section 3406 of the Code;

(T) QI, to the extent that it elects the alternative withholding rate pool procedures of section 6.03(B) of this Agreement (regarding U.S. non-exempt recipient account holders) fails to provide allocation information by January 15th as required by that section;

(U) QI fails to make deposits in the time and manner required by section 3.08 of this Agreement or fails to make adequate deposits, taking into account the procedures of 9.07 of this Agreement;

(V) QI fails to permit the external auditor to perform additional audit procedures, or to expand the external audit to cover some or all of the calendar years for which the period of limitations for assessment of taxes has not expired under the provisions of section 10.06 of this Agreement; or

(W) QI removes U.S. non-exempt recipients from accounts covered by this Agreement for the purpose of circumventing the Form 1099 reporting and backup withholding provisions of this Agreement.

Sec. 11.05. Notice and Cure. Upon the occurrence of an event of default, the IRS may deliver to QI a notice of default specifying the event of default that has occurred. QI shall respond to the notice of default within 60 days (60-day response) from the date of the notice of default. The 60-day response shall contain an offer to cure the event of default and the time period in which the cure will be accomplished or shall state the reasons why QI does not agree that an event of default has occurred. If QI does not provide a 60-day response, the IRS may deliver a notice of termination as provided in section 11.02 of this Agreement. If QI provides a 60-day response, the IRS shall either accept or reject QI's statement that no default has occurred or accept or reject QI's proposal to cure an event of default. If the IRS rejects QI's contention that no default has occurred or rejects QI's proposal to cure a default, the IRS will offer a counter-proposal to cure the event of default. Within 30 days of receiving the IRS's counter-proposal, QI shall notify the IRS (30-day response) whether it continues to maintain that no default has occurred or whether it rejects the IRS's counter-proposal to cure an event of default. If QI's 30-day response states that no default has occurred or it rejects the IRS's counter-proposal to cure, the parties shall seek to resolve their disagreement within 30 days of the IRS's receipt of QI's 30-day response. If a satisfactory resolution has not been achieved at the end of this latter 30-day period, or if QI fails to provide a 30-day response, the IRS may terminate this Agreement by providing a notice of termination in accordance with section 11.02 of this Agreement. If QI receives a notice of termination from the IRS, it may appeal the determination within 30 days of the date of the notice of termination by sending a written notice to the address specified in section 12.06 of this Agreement. If QI appeals the notice of termination, this Agreement shall not terminate until the appeal has been decided. If an event of default is discovered in the course of an external audit, the QI may cure the default, without following the procedures of this section 11.05, if the external auditor's report describes the default and the actions that QI took to cure the default and the IRS determines that the cure procedures followed by QI were sufficient. If the IRS determines that QI's actions to cure the default were not sufficient, the IRS shall issue a notice of default and the procedures described in this section 11.05 shall be followed.

Sec. 11.06. Renewal. If QI intends to renew this Agreement, it shall submit an application for renewal to the IRS no earlier than one year and no later than six months prior to the expiration of this Agreement. Any such application for renewal must contain an update of the information provided by QI to the IRS in connection with the application to enter into this Agreement, and any other information the IRS may request in connection with the renewal process. This Agreement shall be renewed only upon the signatures of both QI and the IRS. Either the IRS or QI may seek to negotiate a new qualified intermediary agreement rather than renew this Agreement.

SECTION 12. MISCELLANEOUS PROVISIONS

Sec. 12.01. QI's application to become a qualified intermediary and all the Appendices and Attachments to this Agreement are hereby incorporated into and made an integral part of this Agreement. This Agreement, QI's application, and the Appendices and Attachments to this Agreement constitute the complete agreement between the parties.

Sec. 12.02. This Agreement may be amended by the IRS if the IRS determines that such amendment is needed for the sound administration of the internal revenue laws or internal revenue regulations. The agreement may also be modified by either QI or the IRS upon mutual agreement. Such amendments or modifications shall be in writing.

Sec. 12.03. Any waiver of a provision of this Agreement is a waiver solely of that provision. The waiver does not obligate the IRS to waive other provisions of this Agreement or the same provision at a later date.

Sec. 12.04. This Agreement shall be governed by the laws of the United States. Any legal action brought under this Agreement shall be brought only in a United States court with jurisdiction to hear and resolve matters under the internal revenue laws of the United States. For this purpose, QI agrees to submit to the jurisdiction of such United States court.

Sec. 12.05. QI's rights and responsibilities under this Agreement cannot be assigned to another person.

Sec. 12.06. Notices provided under this Agreement shall be mailed registered, first class airmail. Notice shall be directed as follows:

To the IRS
Assistant Commissioner (International)
Foreign Payments Division
OP:IN:I:FP
950 L'Enfant Plaza South, SW
Washington, DC 20024

All notices sent to the IRS must include the QI's QI-EIN.

To QI:

____

____

____

____

Sec. 12.07. QI, acting in its capacity as a qualified intermediary or in any other capacity, does not act as an agent of the IRS, nor does it have the authority to hold itself out as an agent of the IRS.

IN WITNESS WHEREOF, the above parties have subscribed their names to these presents, in duplicate.

Signed this day of ,

____
(name and title of person signing for QI)

____
(name and title of person signing for IRS)

Appendix A

[Name of QI]

[Name of country] (see Attachment 1, for description of know-your customer rules).

[Name of country] (see Attachment 2, for description of know-your customer rules).

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[Name of entity affiliated with QI]

[Name of country] (see Attachment ____, for description of know-your customer rules).

[Name of country] (see Attachment ____, for description of know-your customer rules).

Appendix B

QI and the IRS agree that any of the following auditors may be used by QI, or any PAI with which QI has an agreement, to perform the external audits required by section 10 of this Agreement.

[Names, addresses, telephone, and fax numbers of external auditors]

ATTACHMENT

1. QI is subject to the following laws and regulations of [name of country] governing the requirements of QI to obtain documentation confirming the identity of QI's account holders.
2. QI represents that [name and citations to laws and regulations identified in item 1, above] are enforced by [name of enforcement body] and QI shall provide the IRS with an English translation of any reports or other documentation issued by [name of enforcement body] that relates to QI's failure to comply with [laws and regulations identified in 1, above].
3. QI represents that the following penalties apply for failure to obtain, maintain, and evaluate documentation obtained under [name and citations to laws and regulations identified in item 1].
4. QI shall use the following specific documentary evidence to comply with section 5 of this Agreement:
   a. For natural persons:
   b. For legal persons:
5. QI shall follow the procedures set forth below to confirm the identity of account holders that do not open accounts in person.

SECTION 5. EFFECTIVE DATE

This revenue procedure is effective on January 24, 2000. The IRS may conclude agreements under this revenue procedure at any time after that date, but such agreements will not have effect before the date specified in the agreement.

SECTION 6. EFFECT ON OTHER REVENUE PROCEDURES

This revenue procedure supersedes Rev. Proc. 98–27, 1998–15 I.R.B. 30. In addition, Notice 99–8, 1999–5 I.R.B. 26 is obsoleted.

SECTION 7. FURTHER INFORMATION

For further information regarding this revenue procedure, telephone the Office of Assistant Commissioner (International) at (202) 874-1800 (not a toll-free number).

Cash or Deferred Arrangements; Nondiscrimination

Notice 2000–3

I. PURPOSE

This notice provides additional guidance regarding 401(k) plans that are intended to satisfy the 401(k) safe harbors. This guidance responds to comments and suggestions regarding ways to make it easier for employers both to adopt and to administer 401(k) safe harbor plans. The notice:

- Encourages adoption of 401(k) safe harbor plans by giving sponsors of existing 401(k) plans the flexibility to wait as late as December 1 of a calendar year to decide to adopt the 401(k) safe harbor 3-percent employer nonelective contribution method for that calendar year;
- Permits 401(k) safe harbor plans to match elective or employee contributions on the basis of compensation for a payroll period, month, or quarter;
- Provides an extended period of time — until May 1, 2000 — for 401(k) plan sponsors adopting the 401(k) safe harbor methods for the first time in 2000 to provide the required safe harbor notice to employees;
- Provides explicitly that 401(k) safe harbor plans are permitted to require salary reduction elections to be made using whole percentages of pay or whole dollar amounts;
- Permits plan sponsors to provide the 401(k) safe harbor notice electronically and otherwise simplifies the notice requirement;
- Permits 401(k) safe harbor plans to provide matching contributions on an employee's aggregate employee and elective contributions;
- Makes clear that 401(k) safe harbor plans are permitted to apply to employee after-tax contributions a suspension similar to the 12-month suspension that may be applied to employee elective contributions after an in-service withdrawal of those contributions;
- Permits plan sponsors using the 401(k) safe harbor matching contribution method to exit the safe harbor prospectively during a plan year (and switch to ADP and ACP nondiscrimination testing) if employees are notified beforehand;
- Clarifies the interaction between the 401(k) safe harbors and the election to separately test otherwise excludable employees for purposes of the § 410(b) minimum coverage requirements; and
- Makes clear how the 401(k) safe harbor rules apply in the case of a profit sharing plan to which a 401(k) feature is added for the first time during a plan year.

In addition to modifying the guidance provided in Notice 98–52, 1998–46 I.R.B. 16, relating to 401(k) safe harbor plans, this notice requests comments regarding two significant areas that relate to 401(k) plans in general. The two areas are (1) potential approaches for simplifying the multiple use test applicable to § 401(k) plans, and (2) potential approaches for applying the highly compensated employee definition under § 414(q), the nondiscrimination requirements under § 401(k) and 401(m), and possibly other applicable qualification requirements, when a plan sponsor is involved in a merger, acquisition, disposition, or similar transaction.

II. BACKGROUND

A. SBJPA Amendments to §§ 401(k), 401(m), and 414(q)

Under § 401(k)(3) and § 401(m)(2) of the Code, the actual deferral percentage ("ADP") and the actual contribution percentage ("ACP") of highly compensated employees ("HCEs") are compared with those of nonhighly compensated employees ("NHCEs"). Section 414(q) defines a highly compensated employee for purposes of §§ 401(k) and 401(m), and for other purposes under the Code.

Section 1433(a) and (b) of the Small Business Job Protection Act of 1996 ("SBJPA") added new §§ 401(k)(12) and 401(m)(11) to the Code, effective for plan years beginning after December 31, 1998, to provide design-based safe harbor methods for satisfying the ADP test contained in § 401(k)(3)(A)(ii) and the ACP test contained in § 401(m)(2). Section 401(k)(12) provides that a cash or deferred arrangement ("CODA") is treated as satisfying the ADP test if the CODA meets certain contribution and notice requirements. Section 401(m)(11) provides that a defined contribution plan is treated as satisfying the ACP test with respect to matching contributions if the plan meets the contribution and notice requirements contained in § 401(k)(12) and in addition meets certain limitations on the amount and rate of matching contributions available under the plan.

Section 1433(c) of SBJPA amended § 401(k)(3)(A) and § 401(m)(2)(A), effective for plan years beginning after December 31, 1996, to provide for the use of prior year data in determining the ADP and ACP of NHCEs, while current year data is used for HCEs. Alternatively, an employer may elect to use current year data for determining the ADP and ACP for both HCEs and NHCEs, but this election may be changed only as provided by the Secretary. Prior to the effective date of these amendments, plans were required to use current year data in determining the ADP and ACP for both HCEs and NHCEs. Section 1433(d) of SBJPA amended § 401(k)(3) and § 401(m)(3) to provide a special rule for determining the ADP and ACP for NHCEs for the first plan year of a plan (other than a successor plan) where the prior year testing method is used.

Section 1433(e) of SBJPA amended § 401(k)(8)(C) and § 401(m)(6)(C), effective for plan years beginning after December 31, 1996, to provide that the distribution of excess contributions and excess aggregate contributions will be made on the basis of the amount of contributions by, or on behalf of, each HCE. Prior to the effective date of these amendments, plans were required to distribute excess contributions and excess aggregate contributions using a method based on the actual deferral ratio or actual contribution ratio of each HCE.

Section 1431 of SBJPA amended § 414(q)(1) to provide that the term "highly compensated employee" means any employee who (1) was a 5-percent owner at any time during the year or the preceding year, or (2) for the preceding year had compensation from the employer in excess of $80,000 (as adjusted) and, if the employer so elects, was in the top-paid group for the preceding year. The amendments made by § 1431 generally apply to years beginning after December 31, 1996.

B.Previous Guidance on the SBJPA Amendments to §§ 401(k), 401(m), and 414(q)

Notice 972, 1997–1 C.B. 348, provides guidance on determining the individuals who are taken into account in computing the ADP or ACP for NHCEs for the prior year under the prior year testing method. The notice also prescribes rules for distributions of excess contributions and excess aggregate contributions.

Notice 97–45, 1997–2 C.B. 296, provides guidance relating to the definition of highly compensated employee under § 414(q), as amended by § 1431 of SBJPA.

Notice 98–1, 1998–3 I.R.B. 42, provides guidance relating to the current and prior year ADP and ACP testing methods.

Notice 98–52 provides guidance on the safe harbor methods under § 401(k)(12) for satisfying the ADP test contained in § 401(k)(3)(A)(ii) and safe harbor methods under § 401(m)(11) for satisfying the ACP test contained in § 401(m)(2).

C. Definitions

Any term used in this notice that is defined in Notice 97–45, 98–1, or 98–52, or in the regulations under § 401(k), 401(m), or 414(q) has the same meaning as in those notices and regulations. For example, the term "employee contribution" means any mandatory or voluntary contribution to the plan that is treated at the time of contribution as an after-tax employee contribution (e.g., by reporting the contribution as taxable income subject to applicable withholding requirements) and is allocated to a separate account to which the attributable earnings and losses are allocated.

In addition, for purposes of this notice, (1) a "401(k) safe harbor plan" means a CODA that is intended to satisfy the ADP test safe harbor under section V of Notice 98–52, and, if applicable, a defined contribution plan (including a § 403(b) plan) that is intended to satisfy the ACP test safe harbor under section VI of Notice 98–52, (2) the "401(k) safe harbor nonelective contribution method" means the alternative for satisfying the safe harbor contribution requirement of the ADP test safe harbor under section V.B. of Notice 98–52 that includes satisfying the nonelective contribution requirement under section V.B.2. of Notice 98–52, (3) the "401(k) safe harbor matching contribution method" means the alternative for satisfying the safe harbor contribution requirement of the ADP test safe harbor under section V.B. of Notice 98–52 that includes satisfying the matching contribution requirement under section V.B.1. of Notice 98–52, and (4) a "401(k) safe harbor method" means the 401(k) safe harbor nonelective contribution method or the 401(k) safe harbor matching contribution method.

D. Effect on Regulations

Because of the amendments made to §§ 401(k), 401(m), and 414(q) by SBJPA, as well as by other recent legislation, certain portions of §§ 1.401(k)–1, 1.401(m)–1, 1.401(m)–2, and 1.414(q)–1T of the Income Tax Regulations no longer reflect current law. However, these regulations continue to apply to the extent they are not inconsistent with the Code, Notices 97–2, 97–45, 98–1, and 98–52, this notice, and any subsequent guidance.

III. Questions and Answers Relating to the 401(k) and (m) Safe Harbor Methods

Flexibility in Adoption of 401(k) Safe Harbor Nonelective Contribution Method

Q-1. By what date must the sponsor of a 401(k) plan adopt the 401(k) safe harbor nonelective contribution method for a plan year?

A-1. Generally, a plan that is intended to satisfy the 401(k) safe harbor requirements for a plan year must, prior to the beginning of the plan year, contain language to that effect and must specify the 401(k) safe harbor method that will be used. (However, see section XI.B. of Notice 98–52 and Rev. Proc. 99–23, 1999–16 I.R.B. 5, for the remedial amendment period applicable to plan changes incorporating the 401(k) safe harbor provisions.)

Notwithstanding section XI.A. of Notice 98–52, a plan that provides that it will satisfy the current year ADP (and, if applicable, ACP) testing method for a plan year may be amended not later than 30 days before the last day of the plan year to specify that the 401(k) safe harbor nonelective contribution method will be used for the plan year (including that the safe harbor nonelective contribution will be made), provided that the plan otherwise satisfies the ADP (and, if applicable, ACP) test safe harbor for the plan year (including the notice requirement under section V.C. of Notice 98–52, as modified by this notice). For purposes of the preceding sentence, in applying the content requirement of section V.C.1 of Notice 98–52:

(1) Instead of stating the amount of the safe harbor nonelective contribution to be made under the plan, the notice

given to eligible employees before the beginning of the plan year must provide that (a) the plan may be amended during the plan year to provide that the employer will make a safe harbor nonelective contribution of at least 3 percent to the plan for the plan year, and (b) if the plan is so amended, a supplemental notice will be given to eligible employees 30 days prior to the last day of the plan year informing them of such an amendment, and

(2) A supplemental notice must be provided to all eligible employees no later than 30 days prior to the last day of the plan year stating that a 3 percent safe harbor nonelective contribution will be made for the plan year. For administrative convenience, the supplemental notice may be provided separately or as part of the safe harbor notice for the following plan year.

Similar rules apply if, pursuant to section IX.A.1. of Notice 98–52, the safe harbor nonelective contribution is made to another plan of the employer.

Thus, for example, a plan sponsor that maintains a calendar-year 401(k) plan using the current year ADP testing method and that wishes to have the flexibility to decide toward the end of a plan year whether or not to adopt the 401(k) safe harbor nonelective contribution method with respect to its 401(k) plan could achieve that flexibility by providing the initial notice described in section V.C. of Notice 98–52 (as modified by this Q&A-1, and Q&A-7 and Q&A-8 of this notice) before the beginning of the plan year, as provided under section V.C.2. of Notice 98–52 (as modified by Q&A-9 of this notice). If the plan sponsor then decides to adopt the 401(k) safe harbor nonelective contribution method for the plan year, the plan sponsor must, by December 1 of the plan year, (1) amend the 401(k) plan accordingly and (2) provide a supplemental notice to all eligible employees stating that a 3-percent safe harbor nonelective contribution will be made for the plan year.

A plan sponsor that takes advantage of the flexibility provided under this Q&A-1 is not required to continue using the 401(k) safe harbor nonelective contribution method for the following plan year and is not limited in the number of years that it takes advantage of this flexibility. In order to further facilitate the adoption of the 401(k) safe harbor nonelective contribution method under this Q&A-1, the Service intends to provide a simplified, pre-approved means of adopting the 401(k) safe harbor nonelective contribution method under the Service's master and prototype plan program.

Safe Harbor Matching Contribution Requirements

Q-2. Can a 401(k) safe harbor plan match elective and employee contributions on a payroll-by-payroll basis (instead of on an annual basis) without making additional contributions at the end of the year to take into account the total amount of an employee's compensation for the plan year?

A-2. Notwithstanding section VII.A. (or any other provision) of Notice 98–52, the requirements of sections V.B.1. and VI.B. of Notice 98–52 that relate to matching contributions may be met for a plan year by meeting such requirements either (1) with respect to the plan year as a whole, or (2) if the plan so provides, separately with respect to each payroll period (or with respect to all payroll periods ending with or within each month or plan-year quarter) taken into account under the arrangement for the plan year (the "payroll period method"). If the payroll period method is used, however, matching contributions with respect to elective or employee contributions made during a plan year quarter beginning after May 1, 2000 must be contributed to the plan by the last day of the following plan year quarter. Accordingly, in the case of a calendar year plan that uses the payroll period method, matching contributions with respect to elective or employee contributions made during the calendar quarter beginning July 1, 2000, must be contributed to the plan by December 31, 2000. The payroll period method applies only for purposes of satisfying the ADP safe harbor matching contribution requirements of § 401(k)(12) (section V.B.1. of Notice 98–52) and the ACP safe harbor matching contribution requirements of § 401(m)(11) (section VI.B. of Notice 98–52).

Q-3. Can a 401(k) safe harbor plan require that employees make elective contributions in whole percentages of pay or whole dollar amounts?

A-3. Notwithstanding section V.B.1.c.ii. of Notice 98–52, a plan will not fail to satisfy the requirements of sections V.B.1. and VI.B. of Notice 98–52 that relate to matching contributions merely because the plan requires employees to make cash or deferred or employee contribution elections in whole percentages of compensation or whole dollar amounts.

Q-4. Can a 401(k) safe harbor plan suspend additional employee contributions for up to 12 months after the in-service withdrawal of employee contributions?

A-4. Notwithstanding section V.B.1.c. and section VI.B.3. of Notice 98–52, a plan will not fail to satisfy the ACP test safe harbor of section VI of Notice 98–52 merely because, after a withdrawal of employee contributions from the plan, the plan suspends additional employee contributions for a period that does not exceed 12 months. See section V.B.1.c.iv. of Notice 98–52 for a similar exception that applies for purposes of hardship distributions of elective contributions.

Q-5. How do the rules of sections V.B.1. and VI.B.3. of Notice 98–52 apply to a plan that provides matching contributions on both elective contributions and employee contributions?

A-5. A plan will not fail to satisfy the requirements of section V.B.1.a., V.B.1.b., or VI.B.3.(iii) of Notice 98–52 merely because the plan provides matching contributions on both elective contributions and employee contributions if, under the terms of the plan, either (1) the matching contributions provided on an employee's elective contributions are not affected by the amount of the employee's employee contributions or (2) matching contributions are made with respect to the sum of an employee's elective and employee contributions under the same terms as matching contributions are made with respect to elective contributions.

For example, a plan will not fail to satisfy the matching contribution requirement of section V.B.1. or the ACP test safe harbor of section VI of Notice 98–52 merely because the plan provides a required matching contribution equal to 100 percent of the sum of each eligible employee's elective and employee contributions up to 4 percent of compensation. This is the case even if, during a plan year, an eligible employee first makes employee contributions of 4 percent of compensation that are matched by the employer and subsequently makes elective contributions that go unmatched, provided that the same match would have been available if the employee had instead made only elective contributions.

Q-6. May a plan that uses the 401(k) safe harbor matching contribution method suspend matching contributions on future elective and employee contributions during a plan year and instead use the current year ADP (and, if applicable, ACP) testing method for the plan year?

A-6. A plan that uses the 401(k) safe harbor matching contribution method will not fail to satisfy § 401(k) (or § 401(m)) for a plan year merely because the plan is amended during the plan year to reduce or eliminate matching contributions, provided:

(1) A supplemental notice is given to all eligible employees explaining the consequences of the amendment and informing them of the effective date of the reduction or elimination of matching contributions and that they have a reasonable opportunity (including a reasonable period) to change their cash or deferred elections and, if applicable, their employee contribution elections;

(2) The reduction or elimination of matching contributions is effective no earlier than the later of (i) 30 days after eligible employees are given the supplemental notice and (ii) the date the amendment is adopted;

(3) Eligible employees are given a reasonable opportunity (including a reasonable period) prior to the reduction or elimination of matching contributions to change their cash or deferred elections and, if applicable, their employee contribution elections;

(4) The plan is amended to provide that the ADP test and, if applicable, the ACP test will be performed and satisfied for the entire plan year using the current year testing method; and

(5) All other safe harbor requirements are satisfied through the effective date of the amendment.

Notice Requirement

Q-7. Can a plan use electronic media to satisfy the 401(k) safe harbor notice requirement?

A-7. The Service and Treasury are currently reviewing the legal and policy issues relating to the satisfaction of the safe harbor notice requirement through the use of electronic media. Prior to the issuance of additional guidance on this matter, however, a plan will not fail to satisfy the notice requirement of section V.C. of Notice 98–52 (as modified by this notice) with respect to an employee merely because, instead of receiving the notice on a written paper document, the employee receives the notice through an electronic medium reasonably accessible to the employee, provided that (1) the system under which the electronic notice is provided is reasonably designed to provide the notice in a manner no less understandable to the employee than a written paper document and (2) under such system, at the time the notice is provided, the employee is advised that the employee may request and receive the notice on a written paper document at no charge, and, upon request, that document is provided to the employee at no charge. This Q&A-7 also applies for purposes of providing the supplemental notices under Q&A-1 and Q&A-6 of this notice.

Q-8. Can a safe harbor notice cross-reference the plan's summary plan description for a portion of the information required in the notice?

A-8. Section V.C. of Notice 98–52 provides that the notice requirement of that section is satisfied if each eligible employee for the plan year is given written notice of the employee's rights and obligations under the plan and the notice satisfies the content requirement of paragraph 1 of that section and the timing requirement of paragraph 2 of that section.

Notwithstanding paragraph 1.a. of section V.C. of Notice 98–52, a plan will not fail to satisfy the content requirement merely because, in the case of the information described in items (ii) (relating to any other contributions under the plan), (iii) (relating to the plan to which safe harbor contributions will be made), (iv) (relating to the type and amount of compensation that may be deferred), and (vii) (relating to withdrawal and vesting provisions) of paragraph 1.a., the notice instead cross-references the relevant portions of an up-to-date summary plan description that has been provided (or concurrently is provided) to the employee. However, the notice must still accurately describe (1) the safe harbor matching or nonelective contribution formula used under the plan (including a description of the levels of matching contributions, if any, available under the plan) and state that these contributions (as well as elective contributions) are fully vested when made and (2) how to make cash or deferred elections (including any administrative requirements that apply to such elections) and the periods available under the plan for making such elections. In addition, the notice must also provide information that makes it easy for eligible employees to obtain additional information about the plan (including an additional copy of the summary plan description) such as telephone numbers, addresses and, if applicable, electronic addresses, of the individuals or offices from whom employees can obtain such plan information.

Q-9. By what date must the safe harbor notice be provided to employees in the case of a plan that adopts a 401(k) safe harbor method for the first time in the year 2000?

A-9. Generally, the notice required under section V.C. of Notice 98–52 must be provided in accordance with the timing requirements of section V.C.2. (i.e., the notice must be provided within a reasonable period before the beginning of the plan year (or, in the year an employee becomes eligible, within a reasonable period before the employee becomes eligible)). However, in an effort to allow plan sponsors that are considering the adoption of a 401(k) safe harbor method to fully utilize the guidance provided in this notice for plan years beginning in the year 2000, the Service and Treasury have determined that transition relief is appropriate. Accordingly, in the case of a plan sponsor that adopts a 401(k) safe harbor method for the first time with respect to a plan for a plan year that begins on or after January 1, 2000 and on or before June 1, 2000, the notice described in section V.C. of Notice 98–52 satisfies the timing requirement for that plan year if the notice is given on or before May 1, 2000. This transition relief applies whether the 401(k) safe harbor method is adopted under a newly established 401(k) plan or under a preexisting 401(k) plan.

In order to satisfy the 401(k) safe harbor requirements for the plan year, however, a plan that uses the transition relief provided under this Q&A-9 still must satisfy the otherwise applicable requirements of Notice 98–52 (as modified by this notice) with respect to the entire plan year. Thus, for example, in the case of a 401(k) plan that uses the 401(k) safe harbor matching contribution method, matching contributions still must be made with respect to elective contributions made prior to the date the safe harbor notice is provided to employees in the same amount as if the 401(k) safe harbor matching contribution method had been in place since the beginning of the plan year.

Interaction Between Safe Harbor Methods and § 410(b)(4) Election

Q-10. Is a plan required to provide safe harbor matching or nonelective contributions to participants who have not yet attained age 21 and completed a year of service if the plan uses one of the 401(k) safe harbor methods?

A-10. As provided in section IX.B.1. of Notice 98–52, if, pursuant to § 410(b)(4)(B), an employer applies § 410(b) separately to the portion of a plan (within the meaning of § 414(l)) that benefits only employees who satisfy age and service conditions under the plan that are lower than the greatest minimum age and service conditions permitted under § 410(a), the plan is treated as two separate plans for purposes of § 401(k), and the ADP test safe harbor need not be satisfied with respect to both plans in order for one of the plans to take advantage of the ADP test safe harbor. Accordingly, a plan that uses one of the 401(k) safe harbor methods is not required to provide safe harbor matching or nonelective contributions to participants who have not yet attained age 21 and completed a year of service. Those employees do not have to be treated as eligible employees for purposes of the 401(k) safe harbors, so long as the employer has elected to treat them separately for coverage purposes pursuant to § 410(b)(4). However, in such a case, the plan must specifically provide that elective contributions (and, if applicable, matching contributions) on behalf of those employees will satisfy the ADP test (and, if applicable, the ACP test).

Addition of 401(k) Safe Harbor Provisions to Existing Profit-Sharing Plans

Q-11. Can a CODA that is added to an existing profit-sharing plan for the first time during a plan year use a 401(k) safe harbor method for that plan year?

A-11. Generally, the safe harbor requirements must be satisfied for the entire plan year (see sections V.A. and VI.A. of Notice 98–52). In addition, except in the case of a newly established plan, the plan year must be 12 months long (see section X of Notice 98–52). Notwithstanding these requirements, however, in the case of a CODA that is added to an existing profit-sharing, stock bonus, or pre-ERISA money purchase pension plan for the first time during a plan year, the requirements of section V of Notice 98–52 will be treated as being satisfied for the entire plan year and the CODA will not be treated as failing to satisfy the requirements of section X of Notice 98–52, provided (1) the plan is not a successor plan (within the meaning of Notice 98–1), (2) the CODA is made effective no later than 3 months prior to the end of the plan year, and (3) the requirements of Notice 98–52 are otherwise satisfied for the entire period from the effective date of the CODA to the end of the plan year. Thus, an existing calendar-year profit-sharing plan that does not contain a CODA may be amended as late as October 1 to add a CODA that uses a 401(k) safe harbor method for that plan year.

A similar rule applies for purposes of section VI of Notice 98–52 in the case of the addition of matching contributions for the first time to an existing defined contribution plan at the same time as the adoption of the CODA.

IV SIMPLIFYING THE LIMITATION ON MULTIPLE USE

The limitation on multiple use applies to the current and prior year ADP and ACP testing methods (i.e., the nondiscrimination testing methods that § 401(k) plans must satisfy if they do not satisfy the 401(k) safe harbors or the SIMPLE 401(k) requirements). The limitation on multiple use is a nondiscrimination provision intended to limit the extent to which highly compensated employees receive greater benefits (as a percentage of pay) than nonhighly compensated employees, primarily under § 401(k) plans that provide for matching contributions. The Service and Treasury are considering approaches that would substantially simplify the limitation on multiple use administratively, while retaining most of the value of this limitation in ensuring a fairer distribution of benefits under § 401(k) plans and, in many cases, encouraging employers to make fully-vested nonelective contributions on behalf of nonhighly compensated employees.

Generally, the average rate of elective contributions under a § 401(k) plan on behalf of highly compensated employees may not exceed 125 percent of the average rate of elective contributions on behalf of nonhighly compensated employees. However, the Code provides an "alternative limitation" that permits the average rate of elective contributions under a § 401(k) plan on behalf of highly compensated employees to exceed 125 percent of the average rate on behalf of nonhighly compensated employees, provided that average rate for highly compensated employees is not greater than 2 percentage points more than the average rate for nonhighly compensated employees and is not greater than 200 percent of that of nonhighly compensated employees. The alternative limitation is particularly relevant where the average rate of elective contributions on behalf of nonhighly compensated employees is relatively low. For example, if the average rate of elective contributions on behalf of nonhighly compensated employees is 4 percent of pay, then the average rate of elective contributions on behalf of highly compensated employees may not exceed 6 percent of pay. Absent the alternative limitation, the average rate of elective contributions on behalf of highly compensated employees could not exceed 5 percent in such a case. Similar rules apply separately to the average rate of matching and employee after-tax contributions of highly compensated employees under a § 401(m) plan.

Section 401(m)(9) requires the Secretary of the Treasury to "prescribe such regulations as may be necessary to carry out the purposes of this subsection and subsection (k) including . . . such regulations as may be necessary to prevent the multiple use of the alternative limitation with respect to any highly compensated employee." Accordingly, while the alternative limitation may be used to satisfy either the nondiscrimination test for elective contributions or the nondiscrimination test for matching and employee after-tax contributions, the alternative limitation is not available to satisfy both tests. Absent the statutorily contemplated limitation on multiple use, the combined rates of elective and matching contributions on behalf of highly compensated employees under a § 401(k) plan that provides for matching contributions could, for example, be as much as 8 percent (i.e., an ADP of 4 percent and an ACP of 4 percent) while the combined rates for nonhighly compensated employees could be as little as 4 percent (i.e., an ADP of 2 percent and an ACP of 2 percent). In this case, the limitation on multiple use would reduce this 4-percentage-point disparity to 2_ percentage points.

While many employers choose to comply with the limitation on multiple use by reducing or limiting the elective and/or matching contributions on behalf of highly compensated employees, other employers instead increase the employer contributions made on behalf of nonhighly compensated employees. Accordingly, because of the limitation on multiple use, some moderate-income employees covered under 401(k) plans that provide matching contributions receive employer-provided benefits that amount to hundreds of dollars a year.

However, the approach taken under existing regulations in implementing the limitation on multiple use may be unnecessarily complicated. As a result, the Service and Treasury are reviewing potential changes to these regulations that would substantially simplify the application of the limitation on multiple use.

Under one possible approach, the multi-step mathematical test used in determining the aggregate limit on the rates of contributions for highly compensated employees would be replaced by a simple "look-up" table that is based on ranges of aggregate contribution rates for nonhighly compensated employees. For example, such a table could provide that if the combined ADP and ACP on behalf of nonhighly compensated employees is between 5 percent and 6 percent, then the combined ADP and ACP on behalf of highly compensated employees could be as much as 3 percentage points higher.

Alternatively, or in addition, the scope of the limitation's application might be narrowed slightly in order to give relief in cases where the value of the limitation would be inconsequential in comparison to the administrative expense of compliance. For example, where the combined ADP and ACP on behalf of nonhighly compensated employees exceeds a certain level (e.g., 9 percent or 10 percent), the limitation on multiple use might be deemed satisfied.

The Service and Treasury welcome comments on these and other potential approaches for simplifying the limitation on multiple use. Comments on the effect of the SBJPA changes to the methods for correcting excess contributions and excess aggregate contributions and the relation of those changes to corrections of multiple use limitation failures are also welcome. In addition, comments are welcome regarding whether it is more appropriate (as a matter of authority or otherwise) for simplification of the limitation on multiple use to be effected administratively or legislatively.

V POTENTIAL APPROACHES FOR APPLYING VARIOUS QUALIFICATION REQUIREMENTS IN MERGERS, ACQUISITIONS, DISPOSITIONS, AND SIMILAR TRANSACTIONS

The Service and Treasury are in the process of developing guidance regarding the application of the nondiscrimination requirements under § 401(k) and § 401(m), and the highly compensated employee definition under § 414(q), in situations where the entities sponsoring the plans are involved in mergers, acquisitions, dispositions, or similar transactions. Uncertainty among plan sponsors regarding the appropriate application of various qualification requirements in the context of business transactions and reorganizations may be leading to reduced employee protections, increased transaction costs for employers, and the inconsistent application of these requirements among different employers.

The guidance developed by the Service and Treasury will be designed to balance the need to protect employees' pension rights and benefits and provide for the fair distribution of tax-favored pension benefits with the potential burdens on employers of data collection and compliance in the context of business transactions and reorganizations. Simplified alternatives may be provided to address those types of transactions in which the information flow between the selling and purchasing entities or other entities involved in the transactions traditionally has been minimal.

As part of this process, the Service and Treasury are seeking comments from plan participants, plan sponsors, and other interested parties regarding the following:

(1) The types of business transactions and reorganizations (e.g., stock acquisitions, acquisitions of substantially all the assets of a trade or business, or other economically similar transactions) that reasonably would warrant continuity of treatment for purposes of the nondiscrimination requirements under § 401(k) and § 401(m) and the highly compensated employee definition under § 414(q), as well as the degree of specificity that is desirable or appropriate in describing these transactions.

(2) The application of the nondiscrimination requirements under § 401(k) and § 401(m) and the highly compensated employee definition under § 414(q) in cases where plans are combined or divided during (instead of at the beginning of) a plan year as a result of a business transaction or reorganization that occurs during a plan year.

(3) Whether more than one testing alternative may be appropriate when applying the nondiscrimination requirements under § 401(k) and § 401(m) in the case of mid-year transactions. For example, under certain circumstances, one approach to mid-year business transactions that also involve combining plans might be to give plan sponsors the option of applying the § 401(k) and § 401(m) nondiscrimination requirements on a pre-transaction and post-transaction basis as if there were separate short plan years for the uncombined and combined plans, or applying these requirements once on the basis of the entire plan year for the combined plan. A similar approach might apply in cases where plans are divided as a result of mid-year business transactions.

(4) The application of other plan qualification provisions (in addition to the

nondiscrimination requirements for § 401(k) and § 401(m) plans and the highly compensated employee definition under § 414(q)) in the context of business transactions and reorganizations, whether or not such transactions occur in the middle of a plan year. For example, § 414(a)(2) grants the Secretary of the Treasury the authority to prescribe regulations regarding the treatment of service with a predecessor employer as service with a successor employer. Comments are invited on whether regulations should be proposed to address situations in which participants experience an interruption of their vesting service under § 411(a) and eligibility service under § 410(a) by reason of certain business transactions or reorganizations.

VI REQUEST FOR COMMENTS

In addition to inviting comments on the potential approaches for simplifying the limitation on multiple use and for applying various qualification requirements in cases where plan sponsors are involved in mergers, acquisitions, and similar transactions, the Service and Treasury invite comments on the 401(k) safe harbor guidance provided in this notice. It is anticipated that further guidance in these areas would take the form of proposed regulations.

Comments should be submitted by March 24, 2000, in writing, and should reference Notice 2000–3. Comments can be addressed to CC:DOM:CORP:R (Notice 2000–3), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, comments may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (Notice 2000–3), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. Alternatively, taxpayers may transmit comments electronically via the following Internet site: Cynthia.Grigsby@m1.irscounsel.treas.gov.

VII. EFFECT ON OTHER DOCUMENTS

Notice 98–52 is modified.

PAPERWORK REDUCTION ACT

The collection of information contained in this notice has been reviewed and approved by the Office of Management and Budget (OMB) in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1669.

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

The collections of information in this notice are in section III, Q&As 1 and 2. The collections of information are required to enable personnel in the Tax Exempt and Government Entities Division of the Internal Revenue Service to determine if an employer's retirement plan satisfies the requirements to obtain favorable tax treatment and to inform plan participants of their rights and obligations under the plan. The likely respondents are businesses or other for-profit institutions, and not-for-profit institutions.

The estimated total annual reporting burden is 8,000 hours.

The estimated annual burden per respondent is 1 hour and 20 minutes. The estimated number of respondents is 6,000. The estimated annual frequency of responses is on occasion.

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

DRAFTING INFORMATION

The principal author of this notice is Roger Kuehnle of the Tax Exempt and Government Entities Division. For further information regarding this notice, please contact the Employee Plans' taxpayer assistance telephone service at (202) 622-6074/6075 (not toll-free numbers) between the hours of 1:30 and 3:30 p.m. Eastern Time, Monday through Thursday.

Section 1504(d) Elections — Deferral of Termination

Notice 2000–7

PURPOSE

The purpose of this Notice is to provide guidance regarding the effect of the repeal of certain Canadian banking legislation on elections under section 1504(d) of the Internal Revenue Code.

BACKGROUND

Section 1504(d) of the Code allows, in certain circumstances, a domestic corporation owning or controlling, directly or indirectly, 100 percent of the capital stock of a Mexican or Canadian corporation, to elect to treat such corporation as a domestic corporation for all purposes of subtitle A of the Code. Among other requirements, such an election may be made only if the sole purpose for maintaining such corporation is to comply with Canadian or Mexican law regulating the title and operation of property.

If an election under section 1504(d) is in effect with respect to a Canadian or Mexican corporation, and the relevant provision in Canadian or Mexican law regulating the title and operation of property is repealed, it is the view of Treasury and the IRS that the election under section 1504(d) generally is terminated as of the effective date of the repeal. However, a foreign corporation may continue to be viewed as maintained solely for the purpose of complying with Canadian or Mexican law for a short period of time following the repeal of that foreign law if the taxpayer takes reasonable and expeditious measures to respond to the change in foreign law and for good reason is unable to complete such measures by the effective date of the repeal, as would be the case if the taxpayer is required to obtain regulatory approval in order to convert the foreign corporation to a branch of the U.S. parent and cannot obtain such approval by the effective date of the repeal. In such a case, the foreign corporation will continue to be viewed as maintained solely for the purpose of complying with Canadian or Mexican law only for so long as is reasonably necessary to convert to branch form and only for so long as the taxpayer persists in its efforts to convert to branch form during that period. The IRS may issue guidance identifying whether and the extent to which this short period of time exists in appropriate circumstances not specifically addressed by this Notice. Following the end of any such period (or immediately upon the effective date of the repeal of the foreign law if there is no such period), if the foreign corporation remains in existence, it is no longer maintained solely for the purpose of complying with the repealed foreign law.

Repeal of Canadian Banking Legislation

Until recently, Canada prohibited foreign banks from operating in branch form within Canada, under the Bank Act (Canada), S.C. 1991, c. 46 ("Original Act"). Canadian banking operations of a foreign bank were required to be conducted within a Canadian corporation. Thus, Canadian banking subsidiaries of U.S. banks may have qualified for the election under section 1504(d).

Effective June 28, 1999, the Original Act was amended to permit foreign banks to perform certain specified banking functions in Canada directly through foreign branches rather than through Canadian subsidiaries ("Amended Act"). Under the Amended Act, all Canadian subsidiaries of foreign banks seeking to convert to a branch operation must obtain the approval of the Minister of Finance and the Office of the Superintendent of Financial Institutions.

In addition, on May 11, 1999, the Canadian government announced its intention to enact legislation that would allow an indefinite deferral of the Canadian tax imposed upon the liquidation of a Canadian banking subsidiary as part of its conversion to branch form ("Relief Legislation"). Department of Finance Release 99–044 (May 11, 1999). Under the Relief Legislation, relief will be available only if the bank complies, on or before December 31, 2000, with paragraphs 1.0(1.1)(b) and (c) of the draft "Guide to Foreign Bank Branching" issued by the Office of the Superintendent of Financial Institutions ("Foreign Branch Guide"). In addition, the Canadian banking subsidiary must complete its conversion to branch form on or before the earlier of (i) the day that is six months after the day that the Superintendent of Financial Institutions makes an order in respect of the foreign bank under subsection 534(1) of the Amended Act, or (ii) December 31, 2002. The terms of the proposed Relief Legislation indicate that Canada has determined that the period described above is a reasonable period for taxpayers to take the steps necessary to convert to branch form.

Effect of Repeal of Canadian Banking Legislation

Except as provided in the following sentence, a Canadian banking subsidiary that was, immediately prior to June 28, 1999, maintained solely for the purpose of complying with the Original Act shall be considered to be maintained solely for the purpose of complying with the Original Act until the earlier of the date that is six months after the day that the Superintendent of Financial Institutions makes an order in respect of the foreign bank under subsection 534(1) of the Amended Act, or December 31, 2002. If, however, the bank does not comply with paragraphs 1.0(1.1)(b) and (c) of the Foreign Branch Guide on or before December 31, 2000, the Canadian banking subsidiary shall be considered to be maintained solely for the purpose of complying with the Original Act only until December 31, 2000.

After the applicable period described in the preceding paragraph, any Canadian banking subsidiary remaining in existence shall be maintained solely for the purpose of complying with foreign law as to title and operation of property only if it is maintained solely for the purpose of complying with the Amended Act or any other applicable Canadian law regulating the title and operation of property.

The principal author of this notice is Kenneth D. Allison of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in its development. For further information regarding this notice contact Mr. Allison at 202-622-3860 (not a toll-free call).

Weighted Average Interest Rate Update

Notice 2000–8

Notice 88–73 provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 and as further amended by the Uruguay Round Agreements Act, Pub. L. 103-465 (GATT).

The average yield on the 30-year Treasury Constant Maturities for December 1999 is 6.35 percent.

The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	90% to 105% Permissible Range	90% to 110% Permissible Range
January	2000	6.01	5.41 to 6.31	5.41 to 6.61

Drafting Information

The principal author of this notice is Todd Newman of Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this notice, call the Employee Plans Actuarial hotline, (202) 622-6076 between 2:30 and 3:30 p.m. Eastern time (not a toll-free number). Mr. Newman's number is (202) 622-8458 (also not a toll-free number).

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Credit for Increasing Research Activities

REG–105606–99

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 computation of the credit for increasing research activities (the research credit) for members of a controlled group and the allocation of the credit under section 41(f) of the Internal Revenue Code. These proposed regulations are intended to provide guidance on the proper method for computing the research credit for members of a controlled group and the proper method for allocating the group credit to members of the group. These proposed regulations reflect changes to section 41 made by the Revenue Reconciliation Act of 1989 (the 1989 Act). This document also provides notice of a public hearing on these regulations.

DATES: Written or electronic comments must be received no later than April 5, 2000. Outlines of topics to be discussed at the public hearing scheduled for April 26, 2000 at 10 a.m. must be received by April 5, 2000.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–105606–99), 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:DOM:CORP:R (REG–105606–99), Courier's Desk, Internal RevenueService, 1111 Constitution Avenue NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option of the IRS Home Page, or by submitting comments directly to the IRS Internet site at:
http://www.irs.gov/prod/taxregs/regslist.html. The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Lisa J. Shuman at (202)622-3120 (not a toll-free number); concerning submission of comments, the hearing, and/or to be placed on the building access list to attend the hearing, La Nita Van Dyke at (202)622-7190 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224. Comments on the collection of information should be received by March 6, 2000.
Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information in this proposed regulation is contained in the preamble under the heading "**Proposed Effective Date**." The information is required by the IRS to ensure that members of a controlled group filing claims for refund based on a change in method of allocating the research credit to members of the group do not together claim in excess of 100% of the credit with respect to prior taxable years.

Estimated total annual reporting burden: 200 hours.

Estimated average annual burden hours per respondent: 20 hours.

Estimated number of respondents: 10.

Estimated frequency of responses: On occasion.

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

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

Background

The research credit provisions originally appeared in section 44F of the Internal Revenue Code of 1954 (the 1954 Code), as added to the 1954 Code by section 221 of the Economic Recovery Tax Act of 1981. Section 471(c) of the Tax Reform Act of 1984 redesignated section 44F as section 30. Section 231 of the Tax Reform Act of 1986 (the 1986 Act) redesignated section 30 as section 41 and substantially modified the research credit provisions. The 1989 Act substantially revised the computation of the research credit.

On May 17, 1989, the IRS published in the **Federal Register** (54 FR 21203) final regulations under section 41. The 1989 final regulations generally do not reflect the amendments to section 41 made by the 1986 Act, the 1989 Act, and other subsequent legislative revisions to the research credit.

The amendments proposed by this document contain proposed rules relating to the computation of the research credit for members of a controlled group and the allocation of the credit under section 41(f). These proposed regulations reflect changes to the research credit rules made by the 1989 Act and Small Business Job Protection Act of 1996, which introduced the alternative incremental research credit.

Pre-1990 Rules for Computing the Research Credit for Members of a Controlled Group and Allocating the Credit among Members of the Group

Prior to the enactment of the 1989 Act, the research credit was computed by multiplying the credit rate by the excess of the taxpayer's current year qualified research expenses over the average of the taxpayer's qualified research expenses for the preceding three years.

Before amendment by the 1989 Act, section 41(f)(1) provided rules for computing the research credit for members of a controlled group (generally a group of corporations or unincorporated businesses linked by common ownership of more than 50 percent). Section 41(f)(1) treated all members of a controlled group as a single taxpayer for purposes of computing the credit and allocated the credit to the members of the group based on the member's proportionate share of the increase in qualified research expenses giving rise to the credit.

The legislative history to the 1981 Act indicates that the research credit aggregation rules were enacted to ensure that the research credit would be allowed only for actual increases in research expenditures. The aggregation rules were intended to prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related persons. H. Rep. No. 97–201, 1981–3 C.B. (Vol. 2) 364 and Sen. Rep. 97–144, 1981–3 C.B. (Vol. 2) 442.

An example that appears in both §1.41–8(a)(4) of the 1989 regulations and the legislative history to the 1981 Act illustrates the computation and allocation of the research credit under section 41(f)(1) before the 1989 Act amendments to the research credit computation. In the example, the allowable group research credit is allocated among the members experiencing an increase in qualified research expenses over their base period research expenses. The member allocation is based on the ratio that each member's increase in its qualified research expenses over its base period research expenses bears to the sum of the group's increases in qualified research expenses.

Post-1989 Rules for Computing the Research Credit for Members of a Controlled Group and Allocating the Regular Research Credit among Members of the Group

In the 1989 Act, Congress revised the computation of the research credit. Congress retained the incremental structure of the credit but altered the computation to focus on whether and the extent to which a taxpayer increases the proportion of its qualified research expenses relative to its gross receipts.

Under section 41, as amended in 1989, the research credit is computed by multiplying the credit rate by the excess of the taxpayer's current year qualified research expenses over a "base amount." The base amount is defined in section 41(c) as the greater of: (1) fifty percent of the taxpayer's credit year qualified research expenses (the minimum base amount); or, (2) the taxpayer's "fixed-base percentage" times the taxpayer's average annual gross receipts for the four taxable years preceding the taxable year for which the credit is being determined.

In general, a taxpayer's fixed-base percentage is defined in section 41(c)(3)(A) as the ratio that the taxpayer's aggregate qualified research expenses for its taxable years beginning after December 31, 1983, and before January 1, 1989 bear to its aggregate gross receipts for the same period. Section 41(c)(3)(B) provides rules for computing the fixed-base percentage for start-up companies. Section 41(c)(3)(C) provides that the maximum fixed-base percentage is 16%.

Section 41(f)(1), as amended by the 1989 Act, continues to provide rules for computing the research credit for members of a controlled group. As under prior law, all members of a controlled group are treated as a single taxpayer for purposes of computing the credit. However, the allocation rule was amended to eliminate any reference to an "increase" in qualified research expenses. Under the amended allocation rule, the group credit is allocated among the members of the group based on each member's "proportionate share of the qualified research expenses and basic research payments giving rise to the credit."

In explaining the 1989 Act revisions to the research credit, the House Report simply states that the rules relating to the aggregation of related persons and changes in ownership are the same as under present law with the modification that when a business changes hands, qualified research expenses and gross receipts for periods prior to the change of ownership are treated as transferred with the trade or business which gave rise to those expenditures and receipts for purposes of recomputing a taxpayer's fixed-base percentage. H. Rep. No. 101-247 at 1202. The legislative history to the 1989 Act does not refer to the elimination of the word "increase" from the allocation rule.

In the light of the statutory changes enacted in 1989, taxpayers have questioned the proper method for computing the research credit for members of a controlled group and the proper method for allocating the group credit to members of the group under the new rules.

The proposed regulations provide that, for purposes of computing the group credit, all of the computational rules of section 41 are applied on an aggregate basis. This is consistent with the statutory prescription that the controlled group be treated as a single taxpayer and is necessary to preclude taxpayers from creating artificial increases in the credit by shifting qualified research expenses and gross receipts among commonly controlled or otherwise related persons.

In proposing rules for the allocation of the credit, Treasury and the IRS considered, but were not persuaded by, certain taxpayers' argument that the elimination of the word "increase" from the allocation rule in the statute requires that the credit be allocated on the basis of the gross amount of qualified research expenses incurred by the various members of the controlled group. Treasury and the IRS believe that elimination of the word "increase" was necessitated by the 1989 statutory amendments to the computation of the research credit, which afford a credit in certain circumstances even where the taxpayer (or each member of a controlled group) is decreasing its gross amount of qualified research expenses (e.g., because the taxpayer's gross receipts also are decreasing). However, there is no indication that the elimination of the word "increase" was intended to suggest that the credit be allocated without regard to its incremental nature. To the contrary, the statutory prescription that the credit be allocated according to each member's proportionate share of the qualified research expenses "giving rise to" the credit supports a rule that allocates the credit to those members whose share of current year qualified research expenses exceeds their share of the base amount. Thus, the proposed regulation provides that the group research credit is allocated to each member based on the ratio that the member's increase in its qualified research expenses over its base amount bears to the sum of each member's increase in qualified research expenses over its base amount. The member's base amount is computed by multiplying the group fixed-base percentage by the member's average annual gross receipts for the four preceding tax years.

In order to prevent manipulation of the amount of credit allocated to a consolidated group of corporations that is a member of a controlled group with other taxpayers, Treasury and the IRS considered a special rule for allocating the research credit that would treat all members of a consolidated group as a single taxpayer for purposes of allocating the research credit among members of the controlled group. Treasury and the IRS request comments on special rules for allocating the research credit among members of a controlled group that contains a consolidated group of corporations.

Allocation of the Credit for Basic Research Payments and the Alternative Incremental Research Credit

The proposed regulations also address the computation and allocation of the group credit for basic research payments (certain amounts paid to qualified organizations for basic research) and for the alternative incremental research credit (an elective alternative method of computing the research credit, under which taxpayers are assigned a lower three-tiered fixed base percentage, and the credit rate is reduced).

As in the case of the regular credit for qualified research expenses, the proposed regulations provide that all computations with respect to the group credit for basic research payments and the alternative incremental research group credit are undertaken on an aggregate basis. Similarly, these group credits are allocated to the various group members on an incremental basis.

Proposed Effective Date

The regulations generally are proposed to be applicable for taxable years ending on or after the date proposed regulations are filed with the Federal Register, but are also proposed to be retroactive in certain limited circumstances to prevent abuse. To prevent taxpayers that are members of a controlled group from together claiming in excess of 100% of the credit with respect to prior taxable years, the rules for allocating the group credit would apply to any taxable year beginning after December 31, 1989, in which, as a result of inconsistent methods of allocation, the members of a controlled group as a whole claimed more than 100% of the allowable group credit. In the case of a group whose members have different taxable years and whose members used inconsistent methods of allocation, the members of the group as a whole shall be deemed to have claimed more than 100% of the allowable group credit.

No claim for refund (1) attributable to a change in method of allocation; (2) pertaining to a taxable year ending before December 30, 1999; and (3) filed after December 30, 1999, will be allowed unless the taxpayer submits a statement identifying all members of the controlled group for the taxable year at issue. The statement must contain a declaration signed by the taxpayer under penalties of perjury that states: "To the best of my knowledge and belief, taking into account prior claims, this amended claim and any related adjustments, no more than the total amount of the group credit will be allocated to the members of the controlled group."

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 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 contained in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the expectation that few, if any, small entities will file claims for refund attributable to a change in method of allocating the research credit among members of its controlled group. Accordingly, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

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

A public hearing has been scheduled for April 26, 2000 at 10 a.m. in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, 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 15 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" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic (preferably a signed original and eight (8) copies by April 5, 2000). A period of 10 minutes will be allotted to each person 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 Lisa J. Shuman of the Office of the Assistant Chief Counsel (Passthroughs and Special Industries). However, personnel from other offices of the IRS and the Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. In §1.41-0, the table of contents is amended by revising the entries for §1.41–8(a), (a)(1), (a)(4), and (b) and adding entries for §1.41–8(a)(5) and (a)(6) to read as follows:

§1.41–0 Table of contents.

* * * * *

§1.41–8 Aggregation of expenditures.

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

(1) In general.

* * * * *

(4) Allocation of credit for basic research payments.

(5) Allocation of alternative incremental research credit.

(6) Examples.

(b) For taxable years beginning before January 1, 1990.

* * * * *

Par. 3. In §1.41–8, paragraphs (a)(1), (a)(4), (b), and (c)(1) are revised and paragraphs (a)(5) and (a)(6) are added to read as follows:

§1.41–8 Aggregation of expenditures.

(a) *Controlled group of corporations; trades or businesses under common control*—(1) *In general*. In determining the amount of the credit for increasing research activities allowed with respect to a trade or business that at the end of its taxable year is a member of a controlled group of corporations or a member of a group of trades or businesses under common control, all members of the group are treated as a single taxpayer. Thus, for purposes of determining the amount of the credit, all of the rules in section 41, including, for example, the rules in section 41(c)(2) (pertaining to the minimum base amount), section 41(c)(3)(B) (pertaining to the fixed-base percentage for start-up companies), and section 41(c)(3)(C) (pertaining to maximum base amount) are applied only to the aggregate computation of the base amount. The credit (if any) allowed to any member is determined on the basis of the ratio that its increase (if any) in its qualified research expenses over its base amount bears to the aggregate increases in qualified research expenses over the base amount of all members of the group. For purposes of the preceding sentence, a member computes its base amount by multiplying the group fixed-base percentage by the member's average annual gross receipts for the four preceding tax years.

* * * * *

(4) *Allocation of credit for basic research payments*. The credit (if any) attributable to basic research payments allowed to a member is determined on the basis of the ratio that its excess (if any) of basic research payments over its qualified organization base period amount bears to the aggregate excess of basic research payments over the qualified organization base period amount of all members in the group. For purposes of the preceding sentence, a member computes its qualified organization base period amount using similar principles to those used in paragraph (a)(1) to determine the member's base amount.

(5) *Allocation of alternative incremental research credit*. If the credit is computed under the alternative incremental research credit rules, the credit (if any) allowed to the member is determined on the basis of the ratio that its excess (if any) of qualified research expenses over 1% of its average annual gross receipts for the four taxable years preceding the taxable year for which the credit is being determined bears to the aggregate excess of qualified research expenses over 1% of the average annual gross receipts of all members of the group for the four taxable years preceding the taxable year for which the credit is being determined.

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

Example 1. (i) *Facts*. A controlled group of three corporations (all of which are calendar-year taxpayers) had qualified research expenses for the credit year 1999, qualified research expenses for the period 1984 through 1988, gross receipts for the period 1984 through 1988, and average annual gross receipts for the four years preceding the credit year as follows:

	A	B	C	Total
Credit Year Qualified Research Expenses	$200x	$20x	$110x	$330x
1984-1988 Qualified Research Expenses	$40x	$10x	$100x	$150x
1984-1988 Gross Receipts	$1,000x	$350x	$150x	$1500x
Average Annual Gross Receipts for 4 years preceding Credit Year	$1,200x	$200x	$300x	$1700x

(ii) *Computation of the group credit*. (A) The group research credit is computed as if the three corporations are one taxpayer. The research credit is equal to 20 percent of the excess of the group's aggregate credit year qualified research expenses over the group's base amount.

(B) The group's base amount equals the greater of fifty percent of the group's credit year qualified research expenses (the minimum base amount); or, the group's fixed-base percentage times the group's average annual gross receipts for the four taxable years preceding the credit year. The group's fixed-base percentage is the ratio that the group's aggregate qualified research expenses for the taxable years beginning after December 31, 1983, and before January 1, 1989 bear to its aggregate gross receipts for the same period. Therefore, the group's fixed-base percentage is 150x/1500x or 10% and the group's base amount is $170x, the greater of 50% of $330 or 10% of $1,700x.

(C) The group's research credit is equal to 20 percent of the excess of the group's aggregate credit year qualified research expenses over the group's base amount. That is 20% of ($330x - $170x) or $32x.

(iii) *Allocation of the group credit*. The group research credit of $32x is allocated to the members of the group based on the ratio that the member's increase in its qualified research expenses over the member's base amount bears to the sum of the member increases in qualified research expenses over their base amounts. The member's base amount is computed by multiplying the group fixed-base percentage of 10% by the member's average annual gross receipts for the four preceding tax years. The $32x credit is allocated as follows:

Member	Credit Year Qualified Research Expenses	Member Base Amount	Increase	Ratio	Credit
A	$200x	$120x	$80x	80/160	$16x
B	$20x	$20x		0	
C	$110x	$30x	$80x	80/160	$16x

Example 2. (i) *Facts*. The facts are the same as in *Example 1* except that A had no qualified research expenses during the credit year. The following table shows the group's qualified research expenses for the credit year, qualified research expenses for the period 1984 through 1988, gross receipts for the period 1984 through 1988, and average annual gross receipts for the four years preceding the credit year:

	A	B	C	Total
Credit Year Qualified Research Expenses	0	$20x	$110x	$130x
1984-1988 Qualified Research Expenses	$40x	$10x	$100x	$150x
1984-1988 Gross Receipts	$1,000x	$350x	$150x	$1500x
Average Annual Gross Receipts for 4 years preceding Credit Year	$1,200x	$200x	$300x	$1700x

(ii) *Computation of the group credit*. Under these facts, the controlled group's credit year qualified research expenses are less than the group's base amount of $170x, and no credit is allowed to the group unless the group elects to use the alternative incremental research credit under section 41(c)(4).

If the group elects to use the alternative incremental credit under section 41(c)(4), the group is allowed a credit equal to .0165($25.5x - $17x) + .022($34x - $25.5x) + .0275($130x - $34x) or $2.96725x.

(iii) *Allocation of the group credit*. Assuming that the group elects to use the alternative incremental research credit under section 41(c)(4), the group research credit of $2.96725x is allocated to the members of the group based on the ratio that the member's qualified research expenses over one percent of the member's average annual gross receipts for the four preceding years bears to the sum of the member increases in qualified research expenses over one percent of their average annual gross receipts for the four preceding years. The $2.96725x credit is allocated as follows:

Member	Credit Year Qualified Research Expenses	1 % of Member Average Annual Gross Receipts for 4 Preceding Tax Years	Increase	Ratio	Credit
A	$0	$12x	0	0	
B	$20x	$2x	$18x	18/125	$.427284x
C	$110x	$3x	$107x	107/125	$2.539966x

Example 3. (i) *Facts*. A controlled group of three corporations (all of which are calendar-year taxpayers) had qualified research expenses for the credit year 1999, qualified research expenses for the period 1984 through 1988, gross receipts for the period 1984 through 1988, and average annual gross receipts for the four years preceding the credit year as follows:

	A	B	C[1]	Total
Credit Year Qualified Research Expenses	$200x	$20x	$50x	$270x
1984-1988 Qualified Research Expenses	$55x	$15x	0	$70x
1984-1988 Gross Receipts	$1000x	$400x	0	$1400x
Average Annual Gross Receipts for 4 years preceding Credit Year	$1200x	$200x	0	$1400x

[1]C began business in 1999.

(ii) *Computation of the group credit*. (A) The group research credit is computed as if the three corporations are one taxpayer. The research credit is equal to 20 percent of the excess of the group's aggregate credit year qualified research expenses over the group's base amount.

(B) The group's base amount equals the greater of: fifty percent of the group's credit year qualified research expenses (the minimum base amount), or, the group's fixed-base percentage times the group's average annual gross receipts for the four taxable years preceding the credit year. The group's fixed-base percentage is the ratio that the group's aggregate qualified research expenses for the taxable years beginning after December 31, 1983, and before January 1, 1989 bear to its aggregate gross receipts for the same period. Therefore, the group's fixed-base percentage is 70x/1400x or 5% and the group's base amount is $135x, the greater of 50% of $270x or 5% of $1,400x.

(C) The group's research credit is equal to 20 percent of the excess of the group's aggregate credit year qualified research expenses over the group's base amount. That is 20% of ($270x - $135x) or $27x.

(iii) *Allocation of the group credit*. The group research credit of $27x is allocated to the members of the group based on the ratio that the member's increase in its qualified research expenses over the member's base amount bears to the sum of the member increases in qualified research expenses over their base amounts. The member's base amount is computed by multiplying the group fixed-base percentage of 5% by the member's average annual gross receipts for the four preceding tax years. The $27x credit is allocated as follows:

Member	CreditYear Qualified Research Expenses	Member Base Amount	Increase	Ratio	Credit
A	$200x	$60x	$140x	14/20	$18.9x
B	$20x	$10x	$10x	1/20	$1.35x
C	$50x	0	$50x	5/20	$6.75x

Example 4. (i) *Facts*. The facts are the same as in *Example 3* except that C began business in 1989. A, B, and C had qualified research expenses for the credit year 1999, qualified research expenses for the period 1984 through 1988, gross receipts for the period 1984 through 1988, and average annual gross receipts for the four years preceding the credit year as follows:

	A	B	C	Total
Credit Year Qualified Research Expenses	$200x	$20x	$50x	$270x
1984-1988 Qualified Research Expenses	$55x	$15x	0	$70x
1984-1988 Gross Receipts	$1,000x	$400x	0	$1,400x
Average Annual Gross Receipts for 4 years preceding Credit Year	$1,200x	$200x	$1,000x	$2,400x

(ii) *Computation of the group credit.* (A) The group research credit is computed as if the three corporations are one taxpayer. The research credit is equal to 20 percent of the excess of the group's aggregate credit year qualified research expenses over the group's base amount.

(B) The group's base amount equals the greater of: fifty percent of the group's credit year qualified research expenses (the minimum base amount), or, the group's fixed-base percentage times the group's average annual gross receipts for the four taxable years preceding the credit year. The group's fixed-base percentage is the ratio that the group's aggregate qualified research expenses for the taxable years beginning after December 31, 1983, and before January 1, 1989 bear to its aggregate gross receipts for the same period. Therefore, the group's fixed-base percentage is 70x/1400x or 5% and the group's base amount is $135x, the greater of 50% of $270x or 5% of $2,400x.

(C) The group's research credit is equal to 20 percent of the excess of the group's aggregate credit year qualified research expenses over the group's base amount. That is 20% of ($270x- $135x) or $27x.

(iii) *Allocation of the group credit.* The group research credit of $27x is allocated to the members of the group based on the ratio that the member's increase in its qualified research expenses over the member's base amount bears to the sum of the member increases in qualified research expenses over their base amounts. The member's base amount is computed by multiplying the group fixed-base percentage of 5% by the member's average annual gross receipts for the four preceding tax years. The $27x credit is allocated as follows:

Member	CreditYear Qualified Research Expenses	Member Base Amount	Change	Ratio	Credit
A	$200x	$60x	$140x	14/15	$25.2x
B	$20x	$10x	$10x	1/15	$1.8x
C	$50x	50x	0	0	0

(b) *For taxable years beginning before January 1, 1990.* For taxable years beginning before January 1, 1990, see § 1.41-8 in effect prior to December 30, 1999 as contained in 26 CFR part 1 revised April 1, 1999.

(c) *Tax accounting periods used*—(1) *In general*. The credit allowable to a member of a controlled group of corporations or of a group of trades or businesses under common control is that member's share of the aggregate credit computed as of the end of such member's taxable year. In computing the aggregate credit in the case of a group whose members have different taxable years, a member shall generally treat the taxable year of another member that ends with or within the credit year of the computing member as the credit year of that other member. In computing the aggregate base amount, the gross receipts taken into account with respect to another member shall include that other member's gross receipts for the four taxable years of that other member preceding the credit year of that other member.

* * * * *

John M. Dalrymple,
Acting Deputy Commissioner
of Internal Revenue.

(Filed by the Office of the Federal Register on December 30, 1999, 2:06 p.m., and published in the issue of the Federal Register for January 4, 2000, 65 F.R. 258)

Deposits of Excise Tax

Announcement 2000–5

AGENCY: Internal Revenue Service (IRS), Treasury

ACTION: Advance notice of proposed rulemaking.

SUMMARY: This document invites comments from the public on issues that the IRS may address in proposed regulations relating to the requirements for excise tax returns and deposits. All materials submitted will be available for public inspection and copying.

DATES: Written and electronic comments must be submitted by April 6, 2000.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–103827–99), 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:DOM:CORP:R (REG–103827–99), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. Alternatively, taxpayers may send submissions electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or directly to the IRS Internet site at http://www.irs.ustreas.gov/tax_regs/regslist.html.

FOR FURTHER INFORMATION CONTACT: Concerning submissions, the Regulations Unit, (202) 622-7180; concerning the proposals, Susan Athy, (202) 622-3130 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

The Excise Tax Procedural Regulations (26 CFR part 40) set forth the requirements related to filing the Quarterly Federal Excise Tax Return, Form 720, and making deposits of excise taxes. Certain provisions of the current regulations are complicated. The IRS is interested in simplifying the filing and deposit rules both as to the timing and the calculation of the correct amount to deposit. Simplification would reduce recordkeeping burdens and costs for taxpayers, improve compliance, and facilitate proper administration of the excise taxes and trust funds. The IRS requests comments on how the regulations can be simplified; comments are requested in particular on the following issues.

Time for Filing Returns

The regulations currently provide that the Form 720 generally must be filed by the last day of the first calendar month following the quarter for which it is made. However, in the case of returns related to taxes imposed by chapter 33 (communications and air transportation) and section 4681 (ozone-depleting chemicals), the due date is the last day of the second calendar month following the quarter for which it is made.

The IRS requests comments on whether there should be one filing date for all Form 720 filers, such as 30 days after the end of the quarter. This would be a simple rule that would apply equally to all taxpayers.

Use of Government Depositaries

Background. The regulations currently provide that excise taxes must be deposited on a semimonthly basis. Generally, taxes must be deposited by the 9th day of the semimonthly period following the semimonthly period for which the deposit is made (the 9-day rule). There are, however, exceptions to this rule. Taxes on ozone-depleting chemicals must be deposited by the end of the second semimonthly period following the semimonthly period for which the deposit is made (the 30-day rule). In addition, for taxes imposed by section 4081 (gasoline, diesel fuel, and kerosene), communications taxes, and air transportation taxes, taxpayers may choose a deposit rule other than the 9-day rule. For section 4081 taxes, section 518 of the Highway Revenue Act of 1982 provides that a qualified person may deposit by the 14th day of the semimonthly period following the semimonthly period for which it is made if the deposit is made by electronic funds transfer (the 14-day rule). For communications and air transportation taxes, if a person computes the amount of tax to be reported and deposited on the basis of amounts considered as collected, the person may deposit the taxes considered as collected during a semimonthly period by the third banking day after the seventh day of the semimonthly period (the alternative method).

The regulations also provide that the amount of the deposit for a semimonthly period must equal the amount of net tax liability incurred during that period unless either the look-back quarter safe harbor rule or the current liability safe harbor rule applies. In general, the look-back quarter safe harbor rule is met if the deposits for each semimonthly period in the quarter are at least 1/6 of the net liability reported for that tax in the second calendar quarter preceding the current quarter, and the current liability safe harbor rule is met if the deposit for each semimonthly period is at least 95 percent of the net tax liability for the semimonthly period. Safe harbor rules apply separately to each class of tax. Each semimonthly deposit must be timely made at an authorized Government depository. Also, the amount of any underpayment must be paid by the due date of the return, without extension. A failure to meet all the deposit requirements of a safe harbor rule for any semimonthly period eliminates the availability of that safe harbor for the entire quarter.

As the above description of current regulations illustrates, the deposit rules are quite complicated, and taxpayers have experienced difficulty in complying with them. In addition, under existing safe harbor rules, penalties for failure to deposit may be imposed for all semimonthly periods in a quarter if a taxpayer fails to deposit timely and in the correct amount during any semimonthly period in that quarter.

Request for Comments. With respect to the deposit rules, the IRS specifically requests comments on the following issues:

1. Whether there should be a single deposit date for all excise taxes, such as 14 days after the end of the semimonthly period. (The IRS believes it would be appropriate to retain the alternative method allowing communications and air transportation tax collectors to file returns and make deposits based on amounts billed or tickets sold.)
2. Whether a taxpayer should have to deposit at least 95 percent of tax liability incurred for the corresponding semimonthly period (in lieu of the current requirement of 100 percent with safe harbor rules).
3. Whether the amount required to be deposited for a quarter should be computed without reduction for the amounts of any claims made on Schedule C of Form 720 for that quarter.

Judith C. Dunn,
Associate Chief
Counsel (Domestic).

(Filed by the Office of the Federal Register on January 6, 2000, 8:45 a.m. , and published in the issue of the Federal Register for January 7, 2000, 65 F.R. 1076)

Adequate Disclosure of Gifts; Correction

Announcement 2000–6

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correction to final regulations.

SUMMARY: This document contains corrections to final regulations (T.D. 8845, 1999–51 I.R.B. 684) which were published in the **Federal Register** on Friday, December 3, 1999, 64 FR 67767, relating to the valuation of priorgifts in determining estate and gift tax liability, and the period of limitations for assessing andcollecting gift tax.

DATES: This correction is effective December 3, 1999.

FOR FURTHER INFORMATION CONTACT: William L. Blodgett, (202) 622-3090, (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The final regulations that are subject to these corrections are under section 6501 of the Internal Revenue Code.

Need for Correction

As published, final regulations (TD 8845) contain errors that may prove to be misleadingand are in need of clarification.

Correction of Publication

Accordingly, the publication of the final regulations (TD 8845), which were the subject of FR Doc. 99–30944, is corrected as follows:

§301.6501(c)–1 [Corrected]

1. On page 67772, column 3, §301.6501(c)–1(f)(5), line 9 from the top of the column, thelanguage “transfer will not be subject to inclusion” is corrected to read “transfer will be subject to inclusion”.
2. On page 67772, column 3, §301.6501(c)–1(f)(5), line 11 from the top of the column, the language “purposes. On the other hand, if the” is corrected to read “purposes only to the extent that a completed gift would be so included. On the other hand, if the”.

Cynthia E. Grigsby,
Chief, Regulations Unit
Assistant Chief Counsel (Corporate).

(Filed by the Office of the Federal Register on January 6, 2000, 8:45 a.m., and published in the issue of the Federal Register for January 7, 2000, 65 F.R. 1059)

Definition of Terms

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

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

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

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

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

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

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

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

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

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

Abbreviations

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

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

Numerical Finding List[1]

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[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 1999–27 through 1999–52 is in Internal Revenue Bulletin 2000–1, dated January 3, 2000.

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[1] A cumulative list of previously published items in Internal Revenue Bulletins 1999–27 through 1999–52 is in Internal Revenue Bulletin 2000–1, dated January 3, 2000.

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